

Corporate Watch

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Acronyms

CCDG	Council on Corporate Disclosure and Governance	IP	Investment Property
CEO	Chief Executive Officer	IPO	Initial Public Offering
EPS	Earnings Per Share	IVSC	International Valuation Standards Committee
ED	Exposure Draft	NPAE	Non-Publicly Accountable Entities
FRS	Financial Reporting Standards	PPE	Property, Plant and Equipment
IAS	International Accounting Standards	RAP	Recommended Accounting Practices
IASB	International Accounting Standards Board	RC	Remuneration Committee
ICPAS	Institute of Certified Public Accountants of Singapore	SAR	Share Appreciation Rights
IFRS	International Financial Reporting Standards	SAS	Statements of Accounting Standards
FRS	Interpretations of Financial Reporting Standards	SME	Small and Medium-sized Entities

FRS 40 *Investment Property* – Implications for the Investment Property sector

The current FRS applicable to Investment Properties is FRS 25 *Accounting for Investments*. IAS 25, the international equivalent of FRS 25, was withdrawn when the IASB issued IAS 39 (2000) and IAS 40 (2000) in 2001. In 2000, ICPAS issued ED/SAS 40, the equivalent of IAS 40 (2000), for public comment. However, this Exposure Draft was not adopted as a FRS until 2005. IAS 40 was revised in 2003 as a result of the IASB's Improvements Project.

On 4 February 2005, the CCDG adopted IAS 40 (2003) as FRS 40 *Investment Property* for annual periods beginning on or after 1 January 2007. Companies can choose to apply FRS 40 before this effective date.

The article first highlights the key requirements of FRS 40 and then compares them to those of FRS 25. The article also discusses the implications of applying FRS 40.

Key features of FRS 40

Definition -

What is an Investment Property?

The Standard defines Investment Property as property (land or a building; or part of a building; or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- a) use in the production or supply of goods and services or for administrative purposes; or
- b) sale in the ordinary course of business.

A property interest held by a lessee under an operating lease may be classified and accounted for as Investment Property if and only if, the property would otherwise meet the definition of an Investment Property and uses fair value model for the asset recognised.

Measurement rules

Initial measurement

Investment Property is initially measured at cost plus transaction costs. However, the initial cost of a property interest held under a lease and classified as an Investment Property has to be accounted for as if it is a finance lease and recognised at the lower of the fair value of the property and the present value of the minimum lease payments.

Some properties comprise of a portion used to earn rentals or for capital appreciation; while another portion is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold or leased out under finance lease separately, such portions should be split and accounted for separately as Investment Property and Property, Plant and Equipment respectively.

Investment Properties may be acquired in exchange for non-monetary assets or a combination of both monetary and non-monetary assets. The costs of such Investment Properties are measured at fair value unless:

- a) the exchange transaction lacks commercial substance; or
- b) the fair value of either the assets received or the assets given up is not reliably measurable.

If the acquired assets are not measured at fair value, the costs are measured at the carrying amount of the assets given up.

Subsequent Measurement

Subsequent to initial measurement, an entity has the option to apply the fair value model or the cost model, but it must apply the chosen policy consistently to all its Investment Properties. When a property interest held by a lessee under an operating lease is classified as an Investment Property, the entity has no option but to apply the fair value model.

Fair value model

The fair value of an Investment Property is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. The fair value should reflect the market conditions at that given date. Any gain or loss arising from a change in the fair value is recognised in the income statement for the period it arises.

The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts.

There is a rebuttable presumption that one can reliably determine the fair value of an investment on a continuing basis. The presumption can be rebutted when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value are not available. In such cases, one should measure the Investment Property using the cost model under FRS 16 until its disposal and the residual value shall be assumed to be zero.

Despite the presumption discussed above, fair value model should continue to be applied consistently even if comparable market transactions are less frequent or market prices become less readily available.

Cost model

When the cost model is chosen, the entity measures all its Investment Properties using the requirements of FRS 16, i.e. at cost less

accumulated depreciation and accumulated impairment losses. Notwithstanding the adoption of the cost model, the fair value of all Investment Properties has to be obtained and disclosed.

Transfers

FRS 40 has explicit provisions which deal with change in use of a property that results in transfers to or from Investment Property. This is outlined in Table 1.



Table 1 Transfers to or from investment property

Changes in use	Transfer from	Transfer to	Treatment of fair value gains/losses
End of construction	PPE	IP	Income statement
Start of owner occupation	IP	PPE	No fair value gain/loss as transfer at fair value
End of owner occupation	PPE	IP	Any fair value gain/loss is treated as a revaluation under FRS 16
Start of development to sell	IP	Inventories	No fair value gain/loss as transfer at fair value
Start of operating lease to third party	Inventories	IP	Income statement

Disposals

An Investment Property should be derecognised (eliminated from the balance sheet) on disposal or when the property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Gains or losses arising from the retirement or disposal of Investment Property, i.e. the difference between the net disposal proceeds and the carrying amount of the asset, are recognised in the income statement in the period of the retirement or disposal.

Transitional Provisions

Fair value model

When an entity elects, for the first time, to classify and account its eligible property interests

held under operating leases as Investment Property, the entity should recognise the effect of that election, as an adjustment to the opening balance of retained earnings, for the period in which the election was first made.

In addition, if the entity has previously publicly disclosed the fair value of those property interests in earlier periods, the entity is encouraged to:

1. adjust the opening balance of retained earnings for the earliest period presented for which fair value was publicly disclosed; and
2. restate comparative information for those periods.

If the entity has not previously publicly disclosed the information described above, it shall not restate comparative information and should disclose this fact.

When the Standard is first applied, the adjustment to the opening balance of retained earnings includes the reclassification of any amount held in revaluation surplus for Investment Property.

Cost model

FRS 8 applies to the change in accounting policies which includes the reclassification of any amount held in revaluation surplus for Investment Property.

The requirements regarding the initial measurement of an Investment Property acquired in an exchange of asset transaction shall be applied prospectively only to future transactions.

Significant differences between FRS 25 and FRS 40

Significant differences between the current FRS 25 and the new FRS 40.

Table 2 Comparison between FRS 25 and FRS 40

	FRS 40	FRS 25	Implications
Definition	Property (land or building) - or part of building held to earn rentals or for capital appreciation	Investment in land or buildings that are not occupied substantially for use by, or in the operations of, the investing enterprise or another enterprise in the same group as the investing enterprise	Multipurpose buildings, which some parts are owner-occupied and some parts are held to earn rentals, are recognised in parts, PPE and IP respectively
	Property leased to and occupied by another enterprise in the same group does not qualify as Investment Property in the consolidation financial statements but is classified as Investment Property in the standalone financial statements	Property leased to and occupied by another enterprise in the same group does not qualify as Investment Property in both standalone and consolidated financial statements	Different classifications in standalone financial statements
Subsequent Measurement	Can choose either a) fair value model; or b) cost model (according to FRS 16); and apply that policy to all Investment Property	Can choose either a) revalued amount; or b) cost less impairment; or c) according to FRS 16; and apply to same class of investment	See below
Fair value model	IASB's concept of fair value is similar to IVSC's concept of market value. IVSC defines market value as the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion	Market value is defined at the amount obtainable from the sale of an investment in an active market	Highest and best-use market value, is the preferred market value determined from market evidence, by considering any use that is financially feasible, justifiable and reasonably probable. Using this approach, the existing use of the property is not the only basis considered
	Fair value assessment is performed on an individual basis	Fair value assessment is performed on an individual or portfolio basis	Fair value assessment based on portfolio basis is prohibited in FRS 40
	Gain or loss arising from a change in the fair value is recognised in income statement for the period in which it arises	An increase in carrying amount arising from the revaluation is credited to equity as a revaluation surplus. To the extent that a decrease in carrying amount offsets a previous increase, for the same investment, that has been credited to revaluation surplus and not	Reported earnings will become more volatile as change in fair value is recognised in income statement for the period in which it arises

FRS 40	FRS 25	Implications
	<p>subsequently reversed or utilised, it should be charged against that revaluation surplus. In all other cases, a decrease in carrying amount should be recognised as an expense. An increase on revaluation directly related to previous decrease in carrying amount for the same investment that was recognised as an expense, should be credited to income to the extent that it offsets the previously recorded decrease.</p>	
Cost model	<p>Impairment assessment is performed on individual basis</p>	<p>Impairment assessment is performed on individual or portfolio basis</p>
Transfers to and from investment property	<p>When there is a change in use, evidenced by:</p> <ul style="list-style-type: none"> a) commencement of owner-occupation; b) commencement of development with a view to sell; c) end of owner-occupation; d) commencement of an operating lease to another party; or e) end of construction or development. 	<p>Not discussed</p> <p>Implication is dependent on the classification. Please refer to Table 1</p>
Disposals	<p>Gain or loss on disposal is recognised in income statement for the period in which it arises</p>	<p>Gains and losses on disposal are recognised in income statement in the period it arises; and if the investment was previously revalued, or was carried at market value and an increase in carrying amount transferred to revaluation surplus, the enterprise should adopt a policy either of crediting the amount of any remaining related revaluation surplus to income or of transferring it to retained earnings.</p> <p>Reported earnings will be more volatile as the gain or loss on disposal is recognised in income statement for the period in which it arises, without the option of transferring the revaluation surplus to retained earnings</p>

Implications of applying FRS 40

Accounting impact

Valuations

FRS 40 allows Investment Property to be held at fair value or at cost, with the fair value approach being encouraged. The generally accepted interpretation is that a highest and best use valuation should be adopted. The Standard encourages but does not require an independent valuation.

Earnings volatility

The unrealised valuation gains and losses resulting from the valuation will impact the income statement. This means that reported earnings become more volatile and will lead to

a mix of what are traditionally considered capital and income items.

Earnings Per Share

The volatility of the earnings will in turn cause uncertain fluctuations in the entity's EPS. This might result in the investors having a lack of confidence in the entity's performance, if not managed appropriately.

Business impact

Performance fees

Asset management fees, performance hurdles, management incentive and bonus schemes may be dependent on earnings. There may be a disparity in the actual and target performance, due to these fair value

adjustments. The schemes may need to be re-based and possibly redesigned.

Borrowing covenants

Borrowing covenants, which are pegged against earnings, may need to be renegotiated because of the volatility in the earnings as a result of the changes in fair value.

Moving forward

FRS 40 is a whole new Standard - the changes will need to be explained clearly, and in advance, to better manage the expectations of the stakeholders of the company.



Different compensation plans - How do they affect your financial results?

With the introduction of FRS 102 *Share-based Payment*, companies are required to recognise the expenses of employee equity compensation schemes with effect from 1 January 2005. This article highlights the major implications to the financial results of the three most common equity compensation schemes, namely share option scheme, performance shares scheme, and Share Appreciation Rights (SAR, also known as phantom share scheme).

Key Characteristics

The key characteristics of each scheme are as follows:

Share option scheme

- The company grants employees the right to subscribe for new shares in the company at a fixed price.
- Employees are required to pay the company the exercise price in consideration for the shares.
- Employees can generally only exercise the right after remaining in service with the company for a period of time and/or after meeting certain performance targets.
- The right would generally expire after a period of 5 to 10 years from the date of the grant.

Performance share scheme

- The company grants employees shares in the company.
- Employees will generally receive the shares, at no cost, after remaining in service with the company for a period of time and/or after meeting certain performance targets.

Share Appreciation Rights

- Similar to the share option scheme except that:

Upon exercise of the option, the employees do not pay the exercise price to the company nor receive the shares; instead, they are paid the difference between the exercise price and the market price of the shares in cash.

While all three schemes require the use of fair values of the share options or shares for the recognition of the compensation expense over

the vesting period, the impact on the company's financial position and financial results is different.

Impact on net assets

The three schemes have a different effect on the net asset values of companies. Under FRS 102, share option scheme and performance share scheme are considered "equity-settled". This means that in recognising an expense for the compensation costs, a corresponding increase in shareholders' equity is recognised. Hence, the net asset position of the company is unchanged. In contrast, obligations under SAR schemes are considered liabilities of the company as there would be a cash settlement when the right is exercised. The recognition of the compensation cost under SAR results in a decrease in the net asset of the company.

Impact on earnings volatility

1) Revaluation of share options/shares during life of grant

With share option and performance share grants, fluctuations in the values of the share options and shares during the life of the grant do not affect the results of the company. This is because the measurement of the share option or share is determined at the date of the grant and is not subsequently revalued. In contrast, for SAR, the company is required to revalue the SAR at every reporting date until the right is settled or expires. This is because the company has to measure its liability (cash payment to employees) at the expected settlement amount. Hence, SAR schemes create more volatility to the financial results. In addition, more resources are also required to perform the revaluation at every reporting date.

SAR will continue to impact earnings even after the vesting period because the liability is re-measured until the exercise date.

(2) Treatment of unvested rights

The compensation cost is a function of number of options or shares that are expected to vest by the vesting date and the fair value of the option or share. In estimating the number of options or shares expected to vest, only non-market based conditions, which are not based on the market performance of the shares, are considered. These conditions include the continuance of service over a period of time and the meeting of a certain revenue target. If no employees meet the non-market based



vesting condition by the vesting date, the company does not incur any expense. No performance shares would be issued for performance share schemes and no share options or SAR would vest. If share options or SAR are vested by vesting date, the financial impact of the two schemes is different.

For share option schemes, if the share options are not subsequently exercised by the employees (for instance, because the options are out of the money), the company is not allowed to reverse the expenses already charged to the income statement. For SAR schemes, the liabilities are stated at the expected cash settlement. If the SAR are not subsequently exercised, the company is allowed to reverse the expenses previously charged to the income statement.

Impact on Tax

Regardless of the above changes, charges to an entity's income statement relating to share option or performance share schemes, in form of capital or notional cost (such as cost of options granted), are not tax-deductible. Compensation charges that represent actual outgoings (cash outflow or actual liability) to the company may be deductible such as the buying back of its own shares, i.e. treasury shares, to satisfy the obligation to the employees. In addition, such share-based compensation costs must be directly related to the employee's employment compensation benefits in Singapore to be tax-deductible. The compensation costs to the entity should match the services rendered by the employee to the same entity. Certain steps must be taken to support the claim for a deduction.

Impact on Earnings Per Share

Share option and performance share grants have a dilutive effect on EPS as shares will be issued. For SAR schemes, shares are not issued, hence there is no dilutive effect on EPS.

Moving Forward

Prior to the implementation of FRS 102, the design of the share compensation plan is often dependent on non-financial factors as the company is not required to recognise an expense on the equity instrument granted. However, with the implementation of FRS 102, it is critical for companies to consider and analyse the financial impact, arising from the design and structure of the scheme, at an early stage.



Accounting Standards for Small and Medium-sized Entities

In June 2004, the IASB published a discussion paper in relation to the development of a separate set of international accounting standards for SME. The comment period for the discussion paper ended on 24 August 2004. CCDG invited comments from interested parties on the IASB discussion paper in July 2004.

The developments of the IASB project, since the expiry of the comment period, are summarised below.

- 13 preliminary SME versions of the IFRS have been developed but they will not be released until the analysis of the comments is completed.
- SME standards should be followed in its entirety rather than selectively.
- Recognition criteria, measurement rules and presentation/disclosure rules will be simplified for SME standards.
- Plans have been developed to discuss recognition and measurement issues in September 2005.
- Due to the focus on Non-Publicly Accountable Entities that consist of external users, reference to SME has been changed to NPAAE.
- No ED is expected in 2005.

In developing the accounting standards for

NPAAE, the cost/benefit should be evaluated.

Considerations should also be given to:

- the needs of the relevant user;
- whether different models should be developed for different user groups;
- the entities that should be applying the accounting standards for NPAAE;
- the financial reporting transition required when a NPAAE expands its operation and no longer fulfills the NAPE definition.

Prior to IASB's discussion paper, the Hong Kong Institute of Certified Public Accountants issued an Exposure Draft, *Proposed Small and Medium-sized Entities Financial Reporting Framework and Financial Reporting Standards* in March 2005. The comment period expired on 30 April 2005. The ED followed the Consultation Paper, *Proposed Implementation of SME Financial Reporting Framework and Financial Reporting Standards for Hong Kong*, which was issued in May 2004 for consultation by 31 August 2004.

The Exposure Draft outlines:

- the eligibility criteria for differential reporting;
- the exemptions relating to measurement and disclosure requirements such as reporting under historical convention rather than fair value and accounting for deferred tax; and
- the exemptions relating to cash flow statements, interim and segment reporting, disclosure of discontinuing operations and related party transactions.

In December 2004, the New Zealand Institute of Chartered Accountants issued ED 98 *Framework for Differential Reporting for Entities Applying the New Zealand Equivalent to IFRS's Reporting Regime*.

Given that the Singapore accounting standards are harmonised with IFRS, it is likely that the developments on accounting standards for NPAAE will follow through in Singapore.



Latest developments:

- Draft Interpretation *Scope of FRS 102*
- Draft Interpretation *FRS 102 - Group and Treasury Share Transactions*
- Proposed changes to SGX Listing Manual to enhance Standards of Governance and Listings
- Companies (Amendment) Act 2005 issued on 31 May 2005
- CCDG issued Amendments to FRS 19 *Employee Benefits* relating to actuarial gains and losses, group plans and disclosures
- CCDG issued INT FRS 104 *Determining whether an Arrangement contains a Lease* and INT FRS 105 *Right to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* on 1 June 2005

Key Proposed Revisions to the Code of Corporate Governance

In December 2004, the CCDG issued a consultation paper proposing revisions to the Code of Corporate Governance. These revisions address the structure of the Code, board matters, remuneration matters, accountability and audit, as well as communication with shareholders. The proposed changes are intended to align the Singapore Code with the developments of corporate governance in the United Kingdom and Australia.

In the proposed revisions, the Board, Chairman and non-executive directors are tasked with specific responsibilities. Further, it is proposed that companies should issue a formal letter to all directors, upon appointment, which sets out their duties and obligations, as outlined below.

The Board should:

1. provide entrepreneurial leadership within a framework of prudent and effective controls which enable risk to be assessed and managed;
2. set strategic aims and ensure that the necessary financial and human resources are in place for the company to meet its objectives;
3. review management performance;
4. set the company's values and standards and ensure that obligations to shareholders and others are understood and met.

Non-executive directors should:

1. constructively challenge and help develop proposals on strategy;
2. review the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
3. meet, without the Chairman's presence, at least once a year, to appraise the Chairman's performance.

The Chairman's role is to:

1. lead the Board and to ensure its effectiveness on all aspects of its role and setting its agenda;
2. ensure that the directors receive accurate, timely and clear information;

3. ensure effective communication with shareholders;
4. ensure constructive relations between the Board and management;
5. facilitate the effective contribution of non-executive directors;
6. ensure constructive relations between executive directors and non-executive directors; and
7. assist in ensuring compliance with company's guidelines on corporate governance.

Where the Chairman and CEO are the same person or are related by close family ties, the proposed Code recommends (but does not require) that companies appoint an independent non-executive director to be a "lead independent director". This is to provide an avenue for shareholders to voice concerns that cannot be resolved through the normal channels of the Chairman, CEO or Finance Director.

Changes have also been proposed to the structure of the Remuneration Committee. The existing Code requires the Committee to comprise of a majority of independent non-executive directors and be chaired by one such director. An independent director is defined as one who has no relationship with the company, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgment with a view of the best interest of the company. The proposed Code requires all committee members to be non-executive directors. The majority of these directors, including the Chairman of RC, should be independent. For companies with a single controlling shareholder, the proposed Code does not require the Chairman of RC to be independent of the substantial shareholders.

The proposed Code has removed the requirement for at least one committee member to be knowledgeable in the field of executive compensation.

There are also new disclosure requirements. These include:

- description of the process for the selection and appointment of new directors, in particular, whether the company conducted an independent search in this respect;
- disclosure of the exact remuneration of each director. The existing Code only recommends, but does not require such a disclosure.

The requirements of the proposed Code, if implemented, will be more specific and extensive than those of the existing Code. Companies may have to implement new or revised corporate processes to enable directors and senior management to comply with the additional requirements.



ICPAS approves RAP 8, RAP 9 and RAP 10

In the last quarter of 2004, the Council of the ICPAS approved three Recommended Accounting Practices, these being RAP 8 *Foreign Income Not Remitted to Singapore*, RAP 9 *IPO Costs* and RAP 10 *FRS 103 Business Combination - Clarification of Transitional Provisions Singapore*.

RAP 8 *Foreign Income Not Remitted to Singapore* sets out recommendations on how an entity accounts for deferred tax, with respect to foreign income not remitted to Singapore. Under this recommended accounting practice, deferred tax liability, with respect to foreign-sourced income not remitted to Singapore, should be recognised and accounted for in the same way as temporary differences associated with investments in subsidiaries, in accordance with FRS 12 *Income Taxes*.

RAP 9 *IPO Costs* provides guidance on the way in which an entity accounts for the costs of issuing an entity's own equity instruments. Promotional expenses, such as advertising expenses and fees paid to public relations firms to promote the image and branding of the company, need to be assessed as to whether these are general costs and therefore to be charged to the income statement, unlike share registration and other regulatory fees which should be deducted from equity. Other expenses should be deducted from equity to the extent that they are incremental costs directly attributable to the IPO; and costs which would have been otherwise avoided. Costs incurred in selling vendor shares are generally borne by the vendors but should be charged to the income statement if these costs are borne by the company.

RAP 10 *FRS 103 Business Combination - Clarification of Transitional Provisions Singapore* clarifies the transitional provisions in FRS 103 *Business Combinations* (revised in September 2004) in relation to:

- (a) goodwill arising from, and intangible assets acquired in, a business combination for which the agreement date is between 1 July 2004 and the beginning of the first annual period beginning on or after 1 July 2004; and
- (b) equity accounted investments acquired on or after 1 July 2004.

Paragraph 78 of FRS 103 states that FRS 103 shall apply to the accounting for business combinations for annual periods beginning on or after 1 July 2004.

Paragraphs 79, 81 and 82 of FRS 103 deal respectively with previously recognised goodwill, previously recognised negative goodwill and previously recognised intangible assets acquired in a business combination for which the agreement date was before 1 July 2004.

Consequently, the accounting treatment for such items that arise from business combinations where the agreement date is between 1 July 2004 and the start of the first annual period beginning after 1 July 2004 is not clear.

Paragraph 83 of FRS 103 deals with the accounting for goodwill arising from equity accounted investments and states that FRS 103 shall apply in the accounting for any acquired goodwill and the excess included in the carrying amount of the investment of the entity's interest in the net fair value of the investee's identifiable assets, liabilities and contingent liabilities over the cost of the investment for investments acquired on or after 1 July 2004. This may lead to disparate accounting treatment of goodwill and the excess included in the carrying amount of the investment of the entity's interest in the net fair value of the investee's identifiable assets, liabilities and contingent liabilities over the cost of the investment for investments arising from business combinations and that arising from equity accounted investments.

Paragraph 84 of FRS 103 deals with acquired goodwill and negative goodwill arising from equity accounted investments acquired before 1 July 2004 and states that FRS 103 is to be applied prospectively for these items from the beginning of the first annual period beginning on or after 1 July 2004. Consequently, the accounting treatment for such items that arise

from acquisitions between 1 July 2004 and the start of the first annual period beginning after 1 July 2004 is not clear. For example, it is not clear how a company with a calendar year-end should account for acquired goodwill arising from an investment acquired on a date between 1 July 2004 and 31 December 2004.

RAP 10 clarifies the transitional provision for FRS 103, whereby Paragraphs 79, 81, 82, 83 and 84 refer to 1 July 2004 as the relevant date for entities with a 30 June year-end. For other entities, the reference to 1 July 2004 should be taken to mean "the first day of the first annual period beginning on or after 1 July 2004".

The RAPs are available on the ICPAS website, <http://www.icpas.com.sg>



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