PricewaterhouseCoopers

Corporate Watch

Volume 2 2005

*connectedthinking

Contents

Acronyms

AGM	Annual General Meeting
CCDG	Council on Corporate Disclosure and Governance
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CLRFC	Company Legislation and Regulatory Framework Committee
COSO	Committee of Sonpsoring Organisations of the Treadway Commission
CPF	Central Provident Fund
EPS	Earnings Per Share
ED	Exposure Draft
FRS	Financial Reporting Standards
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICPAS	Institute of Certified Public Accountants of Singapore
IFRS	International Financial Reporting Standards
MAS	Monetary Authority of Singapore
MOF	Ministry of Finance
NC	Nominating Committee
OFR	Operating and Financial Review
RAP	Recommended Accounting Practices
Sarbox	Sarbanes-Oxley Act
SGX	Singapore Exchange

Significant Changes Arising from Business Combination Project – Phase 2

Following the issuance of IFRS 3 *Business Combinations* in March 2004, the IASB issued the ED *Proposed Amendments to IFRS 3 Business Combinations* for public comment by 28 October 2005, on 12 July 2005. This is known as Phase 2 of the Business Combination Project. On 5 August 2005, the CCDG issued the same ED *Proposed Amendments to FRS 103 Business Combinations*, for local comment by 28 September 2005. The ED retains the fundamental requirements in FRS 103 *Business Combinations* for acquisition method of accounting to be used for all business combinations and for an acquirer to be identified for every business combination. However, the ED proposes significant amendments to the existing accounting framework for business combinations. The significant changes and implications are discussed in the following paragraphs.

Scope and Definition

The ED proposes to include business combinations involving only mutual entities; and business combinations achieved by contract alone. Both types of business combinations were previously excluded from the scope of FRS 103. Consequently, the acquisition method (purchase method in FRS 103) should be applied to the accounting for such business combinations.

The definition of 'business combination' has been amended to incorporate the concept of control. 'Business combination' is currently defined as the bringing together of separate entities or businesses into one reporting entity. The amended definition, which has been narrowed, views that virtually all business combinations result in one entity obtaining control of another entity or business.

The definition of 'business' has been relaxed. Previously, a business is generally defined as comprising inputs, processes and outputs. In the ED, a business need not have outputs, nor is it necessary to include all the inputs and processes used by the seller if the business can be integrated within the buyer's own inputs or processes. For example, an integrated set of activities and assets in the development stage may not have outputs. Furthermore, a buyer may have a more advanced plant and thus, does not intend to include the seller's plant within the business combination. Also, the strategic management, operational and/or resource management processes of the seller need not be transferred wholesale to the buyer.

Implication:

Although the definition of 'business combination' has been narrowed, the relaxation of the definition of 'business' could result in more incidents of transactions qualifying as a business and thus accounted for as a business combination rather than asset acquisition.

Acquisition Method – Measuring Fair Value of Acquiree

Fair Value of Acquiree

The ED requires business combinations to be recognised and measured as of the acquisition date at the fair value of the acquiree, even if the business combination is achieved in stages or if less than 100% of the equity interest in the acquiree is owned at acquisition date.

Under the ED, the transaction price is presumed to be the best indication of the acquisition-date fair value, in the absence of evidence to the contrary. If there is contrary evidence, the ED provides additional guidance on valuation techniques in a separate appendix to assist users in determining fair value measures. The guidance emphasises consistency in valuation methodology, the assumption of an absence of duress, and the use of market inputs.

Valuation techniques may need to be applied in determining the fair value of the acquiree as a whole, such as when less than 100% of equity interest is acquired. Take for example, an acquisition of 80% of equity interest at $160m may not necessarily result in the fair value of 100% of the equity interest at $200m by simply regrossing the price paid to 100% ($160m/80 x 100 = $200m). The market approach and the income approach are discussed in the ED. FRS 103 recognises and measures business combinations on the basis of accumulated cost of the combination.

Implications:

With the fair value requirement of the acquiree as a whole, there may be a requirement for higher levels of involvement of the valuation specialist. The recognition of full goodwill including the non-controlling interest's portion would result in a higher goodwill balance subject to annual impairment test. Furthermore, the additional amount paid for obtaining control of the business may become more transparent.

Acquisition-related Costs

The ED requires the costs which the acquirer incurs in connection with the business combinations, to be accounted for separately from the business combination accounting, as they do not represent assets and liabilities acquired. Such costs include finder's fees, advisory, legal, accounting, valuation, other professional or consulting fees, general administrative costs, including the costs of maintaining an interest acquisitions department, and costs of registering and issuing debt and equity securities. Although the ED does not specify how they should be separately accounted for, it is likely that they will be charged to the income statement. Such costs are included in the cost of the acquiree in FRS 103.

Implication:

Separate accounting of acquisition-related costs will be more transparent and may result in lower earnings in the year of acquisition as these costs are charged to the income statement in the year of acquisition. Consequently, the Earning Per Share would be lower.

Contingent Consideration

The ED requires the acquirer to recognise contracts for contingent consideration in a business combination at fair value as of the acquisition date. Subsequent changes in the fair value of such consideration will be recognised in accordance with FRS 37, FRS 39 or other appropriate FRS. The ED also requires such contracts to be accounted for in accordance with the requirements of FRS 32 and FRS 39 (currently these contracts are excluded from the scope of these standards). While it is acknowledged that the fair value of such contracts might be difficult to measure, the possibility of the delayed recognition of such contracts which would cause financial reporting to be incomplete, has to be considered as well. In FRS 103, such contracts are included in the business combination accounting only if the resulting adjustment to the cost of the business combination is probable and can be reliably measured.

Implications:

The requirement to recognise contingent considerations at fair value may involve valuation specialists. There will be no adjustment to the cost of the business combination as a result of additional consideration. Currently, under FRS 103, any remeasurement of the contingent consideration results in an adjustment to the business combination accounting. The ED treats such remeasurement as post-combination adjustments to the income statement, thus affecting the post-combination earnings and EPS.

Acquisition Method – Measuring and Recognising Assets Acquired and Liabilities Assumed

Measurement of assets and liabilities

The ED proposes that all assets and liabilities acquired, including all identifiable contingent assets and liabilities, are to be recognised at fair value as at the acquisition date with the following exceptions:

1. Assets held for sale;
2. Deferred taxes;
3. Operating leases;
4. Employee benefit plans; and
5. Goodwill.

FRS 103 requires the cost of acquisition be allocated to the assets acquired and liabilities assumed based on their estimated fair values. However, as explained in FRS 103.BC153, identifiable net assets may be acquired at amounts that are not fair values but are treated as though they are fair values for the purpose of allocating the cost of combination. As such, FRS 103 requirement for allocating the cost of the business combination conflicted with the general principle of recognising the net assets at fair value.

Implication:

Fair valuation would involve valuation specialists.

Contingencies

Contingencies are identifiable assets acquired or liability assumed whereby future economic benefits embodied in the asset or liabilities are contingent or conditional. Such contingencies are recognised, separately from goodwill, at the acquisition-date fair value. After initial recognition, the assets and liabilities shall be accounted for in accordance with FRS 38 or FRS 39 and FRS 37 respectively. FRS 103 requires the recognition of contingent liabilities at fair value only if their fair value can be measured reliably. Subsequent measurement is in accordance with FRS 18 and FRS 37.

Implications:

Contingent assets are now required to be recognised with subsequent adjustments made to the income statement.

Intangible Assets

The acquirer is required in the ED to recognize separately from goodwill an acquiree's intangible assets if they meet the definition of an intangible asset in FRS 38 *Intangible Assets*, with the exception of an assembled workforce acquired from the business acquisition. FRS 103 requires both the definition and reliable measurement conditions in FRS 38 be met before the intangible asset can be separately recognised from goodwill.

Implications:

Generally, there are only limited circumstances in which the fair value of the asset cannot be reliably measured and that uncertainty enters into the measurement of the asset's fair value rather than demonstrating an inability to measure fair value reliably. The less restrictive recognition requirement of intangible assets would result in a re-allocation from goodwill to intangible assets and consequently, lower earnings in the year of acquisition due to the amortisation charges. Intangible assets are also subject to indicator rather than annual impairment testing. The movements in the earnings and financial position would impact the borrowing covenants which may need to be renegotiated.

Acquisition Method – Other Guidance

Goodwill

Under the business combination accounting method proposed in the ED, goodwill is computed as the difference between the fair value of the acquiree as a whole and the fair value of the net assets and liabilities acquired.

This differs from the existing treatment in FRS 103, which computes goodwill as the difference between the cost of the acquisition and the acquirer's share of the net fair values of the assets and liabilities acquired, as follows:

1. Goodwill computed according to the ED includes the share attributable to non-controlling interests (minority interests in FRS 103). In FRS 103, goodwill includes only the acquirer's share.
2. Goodwill computed according to the ED focuses on the fair value of the acquiree, while goodwill in FRS 103 focuses on the cost of acquisition.

Implications:

Please refer to discussion in 'Fair Value of Acquiree'.

Adjustments to provisional values used in a business combination

As is the case under the existing guidance, where certain measurements can only be made provisionally at the end of the reporting period in which the business acquisition occurs, the ED allows the provisional values to be reported. In such cases, however, the ED also specifies considerations to determine whether a subsequent change in fair values should be treated as an adjustment to the provisional values through an offsetting adjustment to goodwill, or as a post-combination adjustment recognised in the income statement. The ED looks at the timing of the subsequent information, the type of subsequent information, the size of the adjustment and the ability to identify the reason for the adjustment. Information that is more likely to result in an adjustment to the provisional values is obtained close to the acquisition date; it reflects upon an actual exchange with a third party, and represents significant gains and losses that do not have other identifiable causes.

Implications:

With the constraints placed on the time period for such adjustments, adjustment previously qualifying as an adjustment to the provisional value may now be required to be treated as a post-combination adjustment. Such post combination adjustments will impact the earnings and EPS.

Business Combinations Achieved in Stages

In a step acquisition, the ED requires the acquirer to re-measure its non-controlling equity investment in the acquiree to fair value as at the acquisition date and recognise any gain or loss in the income statement. Goodwill is then computed using only the fair value of the acquiree at the date of acquisition. This is in contrast to FRS 103 which compares the cost at each step with the acquirer's interest in the fair values of the identifiable assets and liabilities assumed at the time of each step to determine goodwill.

Implications:

The re-measurement requirement of the non-controlling equity investment in the acquirer to fair value when business combinations are achieved in stages injects volatility to the earnings and EPS. There maybe gain or loss recognised when acquiring the incremental stake although there is no actual disposal.

Changes in Ownership Interest After Control is Obtained

The ED prohibits post-combination acquisitions of additional non-controlling equity interests from being accounted using the acquisition method, with gains and losses recognised in the income statement. Such post-combination transactions (both acquisitions and disposal) are to be accounted for as equity transactions. This is not discussed in FRS 103.

Implication:

This is an alignment with FRS 1 *Presentation of Financial Statements* which views non-controlling interest as part of equity rather than liability.

Going Forward

The effective date of the ED is 1 January 2007 and prospective application is required. In achieving the objective of providing users of financial statements with reliable and relevant information that are useful, preparers of financial statements should focus on these developments. One should be aware of the financial effects of the proposals and be ready for communication with the investing community given that the financial statements would be significantly altered. In view of the impending effective date in 2007, companies exploring any major acquisition should also take into consideration the ED requirements when negotiating a deal.

Companies (Amendment) Act 2005 – Impact on Directors and Companies

The Companies (Amendment) Act 2005 ('CA 2005') was passed by the Parliament on 16 May 2005. The date of commencement of CA 2005 ('appointed date') is not published in the Gazette yet and hence, the Amendment Act is not in effect. The expected implementation date is 30 January 2006.

The majority of the changes stem from the recommendations relating to capital maintenance addressed in the Company Legislation and Regulatory Framework Committee Final Report (October 2002). It should be noted that the Companies Act has been amended from 2002 to 2004 to implement the other recommendations of the CLRFC. The key changes introduced by the CA 2005 and the associated implications are discussed below.

Solvency statement

CA 2005 introduced the requirement of a solvency statement. In the new section 7A(1), a solvency statement is required for:

- a proposed redemption of preference shares by a company out of its capital under section 70;
- a proposed giving of financial assistance by a company under section 76(9A) or (9B); or
- a proposed reduction, by a company, of its share capital under section 78B or 78C.

These are discussed in greater detail in later sections.

Under the new section 7A, the solvency statement will include the directors' opinion that:

1. with regard to the company's situation at the date of the statement, there is no ground on which the company could then be found to be unable to pay its debts;
2. the company is able to pay its debt at the end of 12 months from the date of the solvency statement. If the company intends to commence liquidation within 12 months from the date of the solvency statement, this period extends to the end of 12 months from the date of commencement of liquidation; and
3. the value of the company's assets is greater than its liabilities (including contingent liabilities) at the date of the statement and immediately after the transaction.

The solvency statement must either be in the form of a statutory declaration by directors, or accompanied by a report from the auditors of the company that the statement is not unreasonable given all the circumstances [new section 7A(2)].

Key implications:

1. In determining that a company is solvent, the valuation of assets, liabilities and contingent liabilities may prove challenging and require significant judgment by management and directors.
2. This achieves the objective of the CLRFC to simplify the rules while safeguarding the interests of shareholders and creditors.
3. It is still unclear at the moment as to the exact form of the auditors' report required for the solvency statement.

Redemption of redeemable preference shares

The existing Companies Act provides that any redemption of redeemable preference shares must be made out of distributable profits. Under CA 2005, redemption of such shares can be funded out of capital if the directors sign a solvency statement [revised section 70(4)].

Key implications:

1. If the redemption is made out of both capital and profits, allocation to the respective capital and revenue reserve accounts will be required. Any redemption made out of distributable profits will reduce the amount available for distribution to shareholders.

Authorised share capital

Currently, all companies are required to state their authorised share capital in the memorandum and articles of association. The concept of authorised share capital and the associated legislative requirements will be removed when CA 2005 comes into effect.

Key implications:

1. The memorandum and articles will no longer be required to state the authorised share capital. Existing legislative requirements associated with changes in authorised share capital will cease to be applicable (e.g. existing section 71(1)(a), which requires an increase in authorised share capital in the memorandum to be approved at a general meeting).
2. Disclosure of authorised share capital in the financial statements will no longer be applicable and should be removed when CA 2005 takes effect.

Share premium and capital redemption accounts

When CA 2005 takes effect, all shares will cease to have par values (new section 62A). As a result, there will no longer be a share premium account.

As a transitional measure, a new section 62B(3) permits the amounts standing to the credit of the share premium account immediately before the appointed date to be utilised for the following purposes:

- provide for premium payable on redemption of debentures or redeemable preference shares issued before the appointed date;
- write off:
    i. preliminary expenses of the company incurred before the appointed date;
    ii. expenses incurred; or commissions or brokerages paid or discounts allowed, on or before the appointed date, for or on any duty, fee or tax payable on; or in connection with any issue of shares of the company;
- pay up fully-paid bonus shares which are to be issued on or after the appointed date pursuant to an agreement made before the appointed date;
- pay up to members of the company the balance unpaid on shares issued before the appointed date;
- pay dividends declared before the appointed date, if such dividends are satisfied by the issue of shares to members of the company;
- for a company that carries on insurance business in Singapore, transfer to any fund established and maintained pursuant to the Insurance Act.

The liability of a shareholder for calls in respect of money unpaid on shares issued before the appointed date will not be affected by the shares ceasing to have a par value [section 62B(5)].

CA 2005 will remove the requirement under the existing section 76G to create a capital redemption account upon share buy-backs and also upon the redemption of redeemable preference shares.

Key implications:

1. The share premium and capital redemption reserves will be combined with share capital on the appointed date in accordance with the new section 62B(2). These accounts will be presented jointly as share capital in the financial statements.

2. Companies should notionally track the amount standing to the credit of the share premium account carried forward from the appointed date, in order to utilise these amounts for the various purposes spelt out in the transitional measures (see above).

3. The existing section 69 permits a company to write off share issue expenses against the share premium account. With the revocation of section 69, the Companies Act no longer deals with share issue expense and reference should be made to the FRS.

   Under FRS 32, the cost of equity transactions should be deducted against shareholder equity. However, FRS 32 does not specify if such costs should be charged against share capital, retained earnings or other reserves.

Share-buybacks

At present, share-buybacks must be made out of a company's distributable profits. CA 2005 introduces provisions that allow share-buybacks to be funded out of distributable profits as well as capital as long as the company is solvent [revised section 76F(1)].

Under the revised section 76F(4), a company is solvent if:

i. it is able to pay its debt in full during the 12 months immediately following the date of payment; and

ii. the value of the company's assets is greater than its liabilities (including contingent liabilities) immediately after the transaction.

In determining that the company is solvent, directors must have regard to the most recently audited financial statements, other relevant circumstances, and may rely on valuations or estimates of assets or liabilities [revised section 76F(5)]. In determining the value of contingent liabilities, directors may take into account the likelihood of the contingency occurring, as well as any counter-claims by the company [revised section 76F(6)].

Key implications:

1. The implications of the changes in redemption of redeemable preference shares (see above) are also applicable to share-buybacks.

Treasury shares

At present, repurchased shares must be cancelled and the amount by which the company's issued share capital is diminished on cancellation of the shares repurchased must be transferred to a capital redemption reserve.

A new section 76H in CA 2005 provides that repurchased shares may be cancelled or otherwise held by the company in treasury (as 'treasury shares'). While held in treasury, their voting and other rights, including dividend rights, are suspended (new section 76J).

The number of shares that can be held as treasury shares is limited to 10% of the total number of shares of the company (new section 76I).

Any gains derived from the disposal of treasury shares will not be distributable to shareholders [new section 403(1C)].

Key implications:

1. Under FRS 32, treasury shares purchased should not be presented as assets of the company. Instead, they are presented as a deduction from shareholders' equity at the amount paid, including directly attributable transaction costs. Treasury shares are commonly presented as a separate item in equity unless they have been cancelled. On cancellation, the company should reduce the revenue and capital reserves in the proportion in which these reserves were used to fund the share acquisition (revised section 76G).

2. FRS 32 requires the gain/loss on purchase and sale of treasury shares to be included directly in equity, rather than through the profit and loss account. Such gains/losses may be included in revenue or capital reserves.

3. Treasury share transactions conducted by subsidiaries and associates may cause the percentage ownership of the parent company to rise above, or fall below the threshold that results in control or significant influence. This may result in a deemed acquisition/disposal of the subsidiary/associated companies, which will in turn affect the consolidated financial statements of the parent company.

4. Earnings per share computation should exclude treasury shares. However, diluted earnings per share should include treasury shares held for the purposes of employee share options.

Other procedural changes not affecting the financial statements

1. Capital reduction process that does not require court sanction

   At present, a company may only reduce its share capital according to the procedures set out in the existing section 73, which involves the passing of a special resolution and confirmation by the court. The existing section 73 will be repealed by CA 2005. It will be replaced by new sections 78A to 78K which introduce an alternative capital reduction process that requires shareholders' approval by special resolution as well as a solvency statement by all directors of the company. No court sanction is required. However, the company must meet publicity requirements as prescribed by the Minister. The capital reduction process is also susceptible to creditor challenge in court.

No solvency statement is required if the reduction of share capital is solely by way of cancellation of any paid-up share capital which is lost or unrepresented by available assets [new section 78C(2)]. (Refer to the previous discussion on 'Solvency statement')

2. Situations where a company may provide financial assistance for the acquisition of its shares

Companies are prohibited from providing financial assistance in connection with acquisitions of its shares or shares of its holding company. Before CA 2005, the only exceptions to the prohibition were set out in section 76(8) and 76(9).

New sections 76(9A) and 76(9B) in CA 2005 introduce new exceptions to the prohibition. Companies are allowed to provide financial assistance to third parties in connection with acquisitions of the company's shares or shares of its holding company if the amount of financial assistance does not exceed 10% of the aggregate of the total paid-up capital and reserves of the company. Before financial assistance is granted, a solvency statement by all directors of the company must be made and other conditions prescribed in the new sections 76(9A) and 76(9B) must also be complied with. (Refer to the previous discussion on 'Solvency statement')

3. Simplified merger and amalgation process that does not require court sanction

At present, companies may only be amalgamated following court approval of the amalgamation.

New sections 215A to 215J in CA 2005 provide for a voluntary amalgamation process without the need for a court order. Two or more companies may amalgamate and continue as one company, which may be one of the amalgamating companies or a new company, in accordance with the procedures set out in sections 215B and 215G. As part of these procedures, the board of directors of each amalgating company must make a solvency statement in relation to both the amalgating company and the amalgated company. (Refer to the previous discussion on 'Solvency statement')

Key implications:

1. These amendments simplify corporate processes and remove certain restrictions on companies, however, they generally require the directors to issue solvency statements. The implications associated with solvency statements discussed above will be applicable.

2. The merger and amalgamation process may be the result of business combinations involving entities under common control and/or reverse acquisitions. These circumstances will require the consideration of the business combinations guidance in FRS 103 *Business Combinations* and the consolidation requirement in FRS 27 *Consolidated and Separate Financial Statements.* For example, the accounting treatment of reverse acquisition in FRS 103 requires the deemed acquirer (legal subsidiary rather than the parent) to apply the purchase method to the assets and liabilities of the entity issuing the shares.

ICPAS approves revised RAP 7 *Reporting Framework for Unit Trusts* and issues Exposure Draft of Revised RAP 6 *Accounting and Reporting by Charities*

In May 2005, the Council of the ICPAS approved the revised RAP 7 *Reporting Framework for Unit Trusts* and issued the ED of Revised RAP 6 *Accounting and Reporting by Charities.*

RAP 7 *Reporting Framework of Unit Trusts* sets out recommendations on how the managers of a unit trust authorised by the Monetary Authority of Singapore, including unit trusts registered with the Central Provident Fund Board, should prepare the unit trust's financial statements for unit holders. RAP 7 was first approved in 2002 and subsequently revised in 2004 based on the Statement of Recommended Practice on Financial Statements of Authorised Funds issued by the Investment Management Association in the United Kingdom. The revised RAP 7 was updated in 2005, primarily to take into consideration the changes in accounting standards applicable to unit trust.

The proposed ED of Revised RAP 6 *Accounting and Reporting by Charities* sets out recommendations on the way in which a charity should account for and report on the resources entrusted to it and the activities which it undertakes. These are based on the Statement of Recommended Practice issued by the Charity Commission for England and Wales. The ED RAP 6 is intended to supersede the current RAP 6 which was issued in 1986 and to incorporate accounting standards that are in force.

The purpose of preparing a charity's Annual Report and Accounts is to discharge the charity trustees'/office bearers' duty of public accountability and stewardship. This RAP sets out the recommended practice for this purpose; however charity trustees/office bearers should consider providing such additional information when necessary, in order for donors, beneficiaries and the general public to get a greater insight into the charity's activities and achievements. Accounts prepared on the basis of this ED RAP 6 are not a substitute for management accounts required to run the charity on a daily basis

Among other recommendations, the ED requires charities with gross annual income or expenditure of $1,000,000 or less to comply with the ED; while those with gross annual income or expenditure of more than $1,000,000 should refer to the additional detailed guidance contained in ED. The ED provides guidance and requirements in relation to recognition, measurement and disclosure that may be applicable to bigger charities. Charitable entities, projects, activities or events with a gross income or expenditure of $250,000 or less should, as a minimum, prepare a statement of income and expenditure, as illustrated in the ED.

Code of Corporate Governance – What is new for the Board of Directors

On 14 July 2005, the Ministry of Finance released the Code of Corporate Governance 2005 ('2005 Code') that supersedes the existing Code of Corporate Governance issued in 2001 ('2001 Code'). The 2005 Code incorporates most of the recommendations submitted by the CCDG in its Consultation Paper issued in December 2004 ('Consultation Paper'). As proposed in the Consultation Paper, the 2005 Code is structured in the form of 'Principles', 'Guidance Notes' and 'Commentaries'. Listed companies will not be required to disclose and explain any deviation from the commentaries.

This article highlights the changes affecting directors and also outlines the differences between the 2005 Code and the proposed code espoused in the Consultation Paper. Details of the Consultation Paper have been set out in the last issue of Corporate Watch (Volume 1, 2005).

Role of the Board

Principle 1 of the 2001 Code has been amended to clearly outline the role of the Board to:

(a) provide entrepreneurial leadership, set strategic aims and ensure that the necessary financial and human resources are in place for the company to meet its objectives;

(b) establish a framework of prudent and effective controls which enables risk to be assessed and managed;

(c) review management performance; and

(d) set the company's values and standards and ensure that obligations to shareholders and others are understood and met.

Directors are also required to make decisions objectively in the interest of the Company and first-time directors should be provided training in areas such as accounting, legal and industry-specific knowledge. The above were previously not addressed in the 2001 Code.

Definition of independent director

Guideline 2.1 of the 2005 Code extends the circumstances whereby a director will be deemed non-independent to capture business relationships with close family members of the director. [See (c) and (d) below]

Examples of the relationships which would deem a director not to be independent, include:

(a) a director being employed by the company or any of its related companies for the current or any of the past three financial years;

(b) a director who has an immediate family member who is, or has been in any of the past three financial years, employed by the company or any of its related companies as a senior executive officer whose remuneration is determined by the remuneration committee;

(c) a director, or an immediate family member, accepting any compensation from the company or any of its subsidiaries other than compensation for board service for the current or immediate past financial year; or

(d) a director, or an immediate family member, being a substantial shareholder of or a partner in (with 5% or more stake), or an executive officer of, or a director of any for-profit business organisation to which the company or any of its subsidiaries made, or from which the company or any of its subsidiaries received, significant payments in the current or immediate past financial year.

The Consultation Paper proposed that directors who are directly associated with, or who are substantial shareholders (with interest of 5% or more in the voting shares) of the company should be considered non-independent. This proposal has been excluded from the 2005 Code. The Ministry of Finance, in its response to CCDG, cited the following four reasons for this exclusion. First, directors who are substantial shareholders do not pose the kind of principal-agent problems that executive directors can potentially pose. Second, the interests of substantial shareholders are often more aligned with those of all shareholders of the company. Third, tightening the definition will deprive companies, especially those with substantial shareholders which are large establishments, the pool of talent from the shareholder companies which can enhance the quality of the directors on the board and the various board committees of the companies. Fourth, the tightening of definition could cause large companies and conglomerates to list their subsidiaries in alternative jurisdiction. The MOF feels that independence issues should be dealt with by strengthening the Nominating Committee (see discussion below).

Role of non-executive directors

The role of the non-executive directors is now outlined in the 2005 Code as to constructively challenge and help develop proposals on strategy, review the performance of management in meeting agreed goals and objectives, and monitor the reporting of performance. The 2005 Code did not adopt the proposal in the Consultation Paper for non-executive directors to meet without the Chairman present at least annually to appraise the Chairman's performance. However, in its commentary, the 2005 Code encourages non-executive directors to meet regularly without the presence of management.

Role of Chairman

The 2005 Code has adopted practically all the amendments proposed by the Consultation Paper in this area. The 2001 Code focused on the responsibilities of the Chairman to schedule meetings, prepare agenda, exercise control over information between Management and the Board, and assist in ensuring compliance with guidelines on corporate governance. The 2005 Code expands the Chairman's role to specifically require the Chairman to lead the Board to ensure its effectiveness, ensure effective communication with the shareholders, facilitate relations between the Board and Management as well as between executive directors and non-executive directors. The Chairman should also facilitate effective contribution of non-executive directors and promote high standards of corporate governance. In its commentary, the 2005 Code also encourages a lead independent director to be appointed where the Chairman and the CEO are both part of the executive management team.

Composition and role of Nominating Committee

In addition to the proposals in the Consultation Paper, the 2005 Code requires the NC chairman to be a director who is neither a substantial shareholder (with interest of 5% or more in the voting shares of the company) nor directly associated with one. The 2005 Code also specifically gives the NC the discretion to determine whether a director is non-independent, even if he does not fall under the circumstances set forth in Guideline 2.1 (see section 'Definition of independent director' above). Further, the 2005 Code, in its commentary, encourages companies to set notice periods of six months or less in service contracts. If it is necessary to offer longer notice periods to new directors recruited from outside, such periods should be reduced to six months or less after the initial notice period.

The Consultation Paper proposed that companies should disclose whether a company has conducted an independent search for directors. The 2005 Code has replaced this specific requirement with a general requirement for disclosure on the search and nomination process. (See 'Disclosures' section)

The 2005 Code did not adopt the proposals in the Consultation Paper for:

- non-executive directors to be responsible for the performance evaluation of the Chairman; and
- the lead independent director (if appointed) or the chairman of the NC to lead the non-executive directors in the performance evaluation of the Chairman.

Removal of limit on the number of proxies for nominee companies

The 2005 Code encourages companies to amend their Articles of Association to avoid imposing a limit on the number of proxies for nominee companies, so as to enable shareholders who hold shares through nominees to attend AGMs as proxies.

Minutes of general meetings

Despite a proposal to the contrary in the Consultation Paper, the 2005 Code, in its commentary, encourages companies to prepare minutes or notes of general meetings and to make these minutes or notes available to shareholders upon their requests.

Communication with shareholders

The 2005 Code specifies that the external auditors should be present to address shareholders' queries about the audit and the preparation and content of the auditors' report. This revision addresses the relevant queries referred to in the 2001 Code.

Disclosures

As proposed in the Consultation Paper, the 2005 Code requires companies to provide shareholders with a description of the process for the selection and appointment of new directors. This should also include disclosure on the search and nomination process, rather than disclosure on whether the company conducted an independent search for directors as proposed in the Consultation Paper.

The 2005 Code has not adopted the proposal in the Consultation Paper to disclose the exact remuneration of each director on the basis that this may result in poaching of directors among companies and upward ratcheting of fees. However, this is recommended as a best practice in the commentary section.

The Missing Link – How to sharpen up your corporate reporting

Over the last two years, the Singapore stock market has been rocked by news of unexpected corporate losses. To make matters worse, such corporate news and scandals do not seem to be losing their momentum. The questions are: Who's next? Can you tell the 'good guys' from the 'bad guys'? Are there any tell-tale signs of impending corporate failure? Is currently reported financial information adequate and indicative of potential trouble areas?

What is missing in current financial reports?

The business environment of today is much more complex than in yesteryears. A profitable company today may not always be as profitable in the future, and could even be loss-making tomorrow. In a bid to maintain or improve profitability, companies are required to be highly innovative in their business strategies, and develop new business models, products, markets and processes. They are required to look at business costs critically, and get the best value for money spent. They often have to operate across borders. Intermediaries in the financial markets are actively marketing complex structured products that promise to 'enhance' corporate results.

All these, in a nut shell, expose companies to new or higher risks that need to be carefully understood and managed. Investors and stakeholders need to assess the quality and sustainability of the company's future profit streams. The dismal fact is that currently, information required that enables such assessments does not need to be reported, and is simply not provided by many listed companies.

A recent high-profile case of unexpected corporate losses is a clear example of inadequate disclosure of the extent of a company's activities, which limited the investor's ability to appreciate fully the risks which the company's performance, and the sustainability of that performance, were subject to. Take as a further example, a typical software company. Its key value drivers are brand, software under development, and human capital. How can it be possible to evaluate the sustainability of the company's performance if such information is not disclosed? When a company reports exceptional profits arising from its business model which are incongruous with the market or industry, investors should be alerted to a sustainability issue and should even question the reliability of the information they are being fed.

So, what should companies report?

The CCDG issued a guide on Operating and Financial Review in January 2004, which set out the principles that should govern the preparation and presentation of an OFR. Amongst other things, the OFR recommends that companies should provide investors with contextual information that would enable readers to develop an in-depth understanding of the company's performance, including the risk factors and measures taken to maintain/ enhance the current and future profitability of the company, ie. the value drivers which sustain and enhance its corporate performance.

Are listed companies preparing their OFR in accordance with the Guide? Possibly not, for compliance with the OFR is currently optional. Whilst some reputable companies do comply with the principles in the Guide, many listed companies do not. Something short of rocket science will tell you that companies which lack proper strategies and risk management procedures will have little reason to volunteer information about their inadequacies. However, it is these very companies that should sound alarm bells for their investors. It is interesting to note that in the UK, Reporting Standard, RS 1 *Operating and Financial Review*, which was issued in May 2005, is now mandatory for all quoted companies in the UK.

How reliable is the information reported?

Even when relevant information is reported, one needs to consider whether the information – which is compiled by the company itself - is reliable. Companies with a strong corporate governance structure and a sound system of internal controls would be better placed to report reliable information. Furthermore, strong internal controls would also make it more likely that the company will be able to deter and detect fraud or other irregularities, should they occur.

The Code

The Code of Corporate Governance ('Code') sets out principles relating to board matters, remuneration, accountability and audit, as well as shareholder communication. Compliance with the Code is not mandatory but deviations would need to be explained. Do companies that report compliance with the Code produce more reliable information for stakeholders? It is interesting to note that those companies which failed recently did not highlight any significant deficiencies in their compliance with the Code. Therefore, by inference, these companies had the necessary internal controls and relevant infrastructures in place. So, what went wrong? Perhaps the problem lies in the implementation and execution of the principles in the Code. Codes and principles are meaningless in the face of high level management collusion and fraud, or the overriding of control procedures by senior key management personnel (sometimes allegedly by the CEO and/or CFO), or unclear reporting lines, or ineffective audit committees and/or independent directors.

Sarbox gets into the act

The reliability of financial reports depends on the company's internal controls over financial reporting. Hence, for readers to derive some comfort over the reliability of the financial reports, it is important that an evaluation of the effectiveness of the company's internal controls be made and the results reported. In the US, the Sarbanes-Oxley Act requires management and directors to make an assessment of the effectiveness of internal controls and report on any deficiencies. Auditors are required to make an independent attestation of the assertions made by the company. The SGX has recently proposed that directors provide a negative assurance on internal control matters in the listed companies' annual reports. We believe that this is a step in the right direction. However, one could question the reliability of the directors' negative assurance, as there is at present no common framework for the directors to refer to, when they make such assessments. Different boards may use different yardsticks as their basis for evaluation. Comparability and reliability are impaired. To address this issue, the requirement to assess the effectiveness of the internal controls should be benchmarked against an established internal control framework, such as the COSO framework. Obviously, the reliability of the attestation in the directors' statement would be further enhanced if independent reviews of these evaluations were made by external auditors. There is at present a reluctance to introduce this requirement, as it is expected to increase corporate compliance costs.

What next?

Compliance with the OFR Guide, and full disclosure of corporate governance practices and internal control matters should indicate or highlight symptoms of corporate problems, thus alerting stakeholders to any impending issues at an early stage. Should such compliance be left to market forces, or should the regulators take an active step and mandate compliance? Our regulators have an interest in upholding the integrity of the Singapore capital markets and our reputation of having the most robust corporate governance structure and the highest standard of corporate reporting in the region. Investors would welcome any move by regulators in this direction, as it should provide higher investor protection. Listed companies should similarly welcome this, for such compliance would translate into higher shareholder value, which would offset any increased compliance costs.

At some point, the link between internal controls and external reporting needs to be made. Otherwise your company's disappearance may become another in a line of historical mysteries.

To achieve best practices in corporate reporting, companies should:

- have a strong corporate governance structure and sound internal controls system to report reliable information
- benchmark the effectiveness of its internal controls against an established internal control framework such as the COSO framework
- comply with the Code of Corporate Governance and implement and execute the principles in the Code
- provide investors with information which will help them develop an in-depth understanding of the company's performance such as risk factors and value drivers, in accordance with the Guide on OFR by CCDG

This article was first published in Business Times on 14 July 2005.

Latest development:

- CCDG issues FRS 106 *Exploration for and Evaluation of Mineral Resources* on 18 August 2005
- CCDG issues amendments to FRS 39 relating to cash flow hedge accounting of forecast intra-group transactions on 18 August 2005
- CCDG publishes Draft Technical Correction 1 Proposed Amendments to FRS 21 on 5 October 2005 for comments by 19 October 2005

Contact Us:

For any comments or further information, please contact our team in corporate reporting:

Yeoh Oon Jin
Leader, Corporate Reporting
oon.jin.yeoh@sg.pwc.com
Tel: (65) 6236 3108

Peter Low
Partner, Corporate Reporting
peter.low@sg.pwc.com
Tel: (65) 6236 3348

Choo Eng Beng
Partner, Corporate Reporting
eng.beng.choo@sg.pwc.com
Tel: (65) 6236 7003

Kok Moi Lre
Associate Director, Corporate Reporting
moi.lre.kok@sg.pwc.com
Tel: (65) 6236 3049

Chew Tong Gunn
Senior Manager, Corporate Reporting
tong.gunn.chew@sg.pwc.com
Tel: (65) 6236 4360

Corporate Watch is a periodic newsletter produced by the Professional Standards Group of Assurance/ Business Advisory Department of PwC Singapore, with the objective to apprise corporates of emerging corporate reporting issues.