

Across the board

A newsletter for Australian directors

AUSTRALIA

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Introduction

The corporate landscape in Australia has changed dramatically over recent years. The increase in private equity is driving immense change, and when it comes to disposals, many boards are failing to realise full value.

A poorly planned and executed disposal can destroy as much value as an ill-conceived acquisition, but how do boards avoid value leakage? Many sellers underestimate the time required to complete a successful disposal and aggressive timetables can curtail proper planning and preparation. Our first article in this issue of *Across the board* examines the challenges and looks at some of the common value-sapping issues that can sour a transaction.

We also look at the governance challenge of private equity offers. Private equity firms raised more than US\$400 billion globally last year and this year we've seen a number of mega take-overs on the table. Establishing discussion protocols upfront is a key early step, and risk needs to be identified and managed on a continuous basis. Right throughout there is a clear need for a strong governance process.

Elsewhere, we profile the role of the chief financial officer and ask whether the relationship with the board and board audit committee is all that it should be.

Finally, we consider the practicalities of establishing a tax governance system and the impact of the Simpler Regulatory System legislation or *Red Tape* reform. Two key aspects are electronic distribution of annual reports and changes to financial threshold tests for small and large proprietary companies.



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A poorly planned and executed disposal can destroy just as much value as an ill-conceived acquisition.

Extracting maximum value from disposals

Although it's a sellers' market, new research suggests many boards are still failing to realise full value from their business disposals.

The review has been completed and the board has decided that a disposal makes business sense. They have determined the minimum sale price required to realise fair value from the transaction. They are ready to go to the market... or are they? Experience has shown that a poorly planned and executed disposal can destroy just as much value as an ill-conceived acquisition.

Right through a divestment the board should satisfy itself that the process is:

- maximising the value of bids
- reducing or eliminating leakage of value, particularly *after* the deal completes
- minimising disruption caused by the sale
- keeping the deal on time and on track
- controlling execution of the divestment
- managing the expectations of stakeholders.

The reality that boards are not always getting these things right has been confirmed in a recent KPMG survey of the divestment experience of 358 corporate entities and 61 private equity (PE) firms in Europe, North America and Asia.¹ This research followed a similar, but smaller, disposals' survey conducted by KPMG two years previously. While many organisations are undoubtedly becoming more sophisticated and professional in their approach to disposals, nearly half the corporates surveyed still believed they hadn't maximised the value extracted from their most recent disposal transactions.

Perhaps even more surprisingly, more than 20 percent of the PE firms surveyed felt the same way.

Failing to maximise disposal values

Maximising transaction values is difficult. Thus it was notable that around 45 percent of corporate respondents to the survey stated that their most recent disposals had been unsuccessful in extracting full value from the transaction. The main reasons given for this value shortfall included purchase price and completion accounts disputes, other post-deal completion issues and loss of control over the disposal timeframe.

Although many value-sapping issues appear to arise at, or subsequent to, the formal settlement of transactions, they often have their genesis much earlier in the process. A majority of respondents reporting less than optimum disposal values believed that value had actually been lost *before* a preferred bidder had been chosen. Their experience reinforces the importance of getting the process right from the start.

Respondents who achieved successful transaction outcomes attributed their success to avoiding purchase price and completion account disputes, protecting purchasers from unpleasant surprises and managing effectively the tax consequences of the transaction.

Preventing value leakage

Over two thirds of the sellers surveyed by KPMG experienced post-completion issues of some kind, including warranty or indemnity claims, completion accounts disputes, other unforeseen accounting issues, tax issues, unexpected price adjustments and separation costs.

Nearly one third of corporates reported warranty or indemnity claims, which was in line with the results of the previous survey. By way of contrast, the proportion of PE firms experiencing these claims fell from 30 to 21 percent over the two surveys.

¹ *Increasing Value from Disposals: Investing in Divesting*. KPMG International 2007. The survey did not include any Australian firms. However, there is no evidence to suggest that Australian companies approach disposals in a substantially different manner to their offshore counterparts.

Many corporates could do more to reduce the risks arising from warranties and indemnities.

Key insights into current business divestment practices.

- Many sellers are failing to maximise value in their disposals.
- Value leakage remains a big issue, particularly after the deal has been completed.
- The market environment for disposals is being influenced by increasing liquidity and the rise of private equity players.
- The importance of planning in achieving financial and strategic advantage.
- Many sellers underestimate the time required to complete a successful disposal.

The ability of PE firms to avoid such disputes probably reflects the fact that they are usually selling relatively 'clean', stand-alone businesses, making it easier for them to provide appropriate information and disclosure to purchasers. They also have probably been more successful in limiting the warranties or indemnities they give, or in avoiding them altogether. Corporates find it more difficult to avoid giving warranties and indemnities, and in minimising the incidence of claims arising from these undertakings, although many could do more to reduce the risks arising from warranties and indemnities.

Similar problems arise with completion accounts. The process needs to be well defined and carefully drafted into the sale and purchase agreement. Some sellers are avoiding the need for completion accounts by adopting an agreed pre-completion 'effective date' balance sheet as a reference point for the transaction. This is sometimes called a 'locked box' mechanism. The success of this approach depends on a robust reference date balance sheet for pricing the deal and the practical ability to ring fence and protect the business assets until completion i.e. 'locking the box'.

Unforeseen separation costs emerged as a problem, highlighting the need for careful separation planning and detailed assessment of a disposal's consequences for the seller's retained business. More work is going into the preparation and pricing of transitional supply and service agreements.

Exploiting market conditions

The rise of private equity has greatly added to the liquidity of markets for business acquisitions. Globally, PE firms raised US\$160 billion in 2004, rising to more than US\$400 billion in 2006. Debt is freely available and relatively cheap.

It all adds up to a sellers' market in which both trade and financial buyers are pushing up values.

Trade (corporate) buyers generally enjoy a greater understanding of the business on offer than their PE counterparts and often exhibit fewer concerns about liabilities, particularly those that are intrinsic to a particular line of business. PE buyers are seen as being quicker in their decision making

and deal execution, reflecting high order financial skills and a very disciplined, focused approach to deal making.

A more recent development is the way in which some PE firms and corporates are teaming up to acquire suitable businesses. The resulting combination of skills and experience can be formidable.

Achieving financial and strategic advantage

Both corporate and PE respondents nominated careful planning and preparation as the key factor in obtaining optimum transaction outcomes. Other relevant influences included the ability to find potential purchasers, negotiating skills, pre-sale due diligence and the provision of information.

Insufficient preparation is seen as leaving sellers on the back foot in negotiations and vulnerable to post-completion complications. It's not unknown for buyers to arrive armed with more knowledge than the vendor about a business and its value drivers. In response, more sellers are undertaking 'vendor due diligence'. Still regarded by some as an unnecessary extravagance, vendor due diligence involves commissioning an independent assessment of the business being sold and the resulting report being made available to potential buyers.

Allowing sufficient time

Disposals take time. More than 80 percent of corporate respondents reported their latest disposals had taken six months or more to complete. Twenty percent had taken over 12 months.

Most sellers want to shorten the disposal timetable, although our survey found no correlation between perceptions of success and the time taken to sell. In fact, aggressive timetables can curtail proper planning and preparation. Nevertheless protracted disposals can distract the business being sold, leading to value leakage. Paradoxically, early planning and preparation can help compress the process. Other ways of shortening the timetable nominated by sellers included learning from experience, earlier and greater use of external advisers and undertaking vendor due diligence.

In general, boards should remember that management can invest considerable psychological capital in both disposals and acquisitions, increasing the pressure to get a deal 'across the line'. Boards can provide a dispassionate reality check, affirming that the deal in its final form makes commercial sense and adds to enterprise value. Of course, boards

can't — and shouldn't try to — supervise every aspect of a divestment. Rather, they should exercise appropriate oversight by demanding answers to the right questions at the right time. The accompanying breakout lists some of the questions a board could usefully ask to maintain proper oversight of the process.

Managing disposals: what questions should the board ask?

What are our options?

- Have all the relevant disposal options — trade sale, joint venture, management buyout, PE deal, initial public offering (IPO) — been properly evaluated?
- What affect will the disposal have on the remaining business, including central overheads and other costs?
- Have we prepared an initial valuation of the business to be sold?
- Have external advisers been selected, briefed and their role clearly defined?

What are we selling?

- Do we have a detailed understanding of the business being sold?
- Should we undertake pre-sale due diligence?
- Have we identified any potential upsides to the business and hidden value?
- Have we extracted performance improvement 'quick wins' from the business to be sold?
- What is the optimal deal structure for this transaction?

Are we properly planning the deal?

- Has responsibility for the disposal been assigned to a senior executive with the appropriate authorities and access to sufficient resources?
- Have potential purchasers been identified and the disposal procedure adapted to their needs?
- Have potential transaction issues been identified?
- Is the project working to a realistic timetable?
- Are both internal and external communications relevant to the transaction being closely planned and controlled?

How do we maximise the sale price?

- Have we organised a truly competitive sales process?
- Have we created a compelling sales proposition?
- Are potential bidders being supplied with sufficient information to understand the business and potential upsides and synergies?

- Have we set up a data room with material focusing on buyer concerns such as commercial and legal issues and individual buyer concerns? Have we instituted a comprehensive Q&A process?
- Have we drafted a sale and purchase agreement?
- Have we prepared a detailed separation plan and isolated specific separation costs?
- Are we encouraging and facilitating pre-emptive offers?

Are we limiting post-completion value leakage?

- Are we limiting the extent of any warranties and indemnities given to the purchaser? Is their wording tightly drafted?
- Has all relevant information been disclosed to the vendor? (What's the point of inflating the sale price if much of the increase is clawed back after completion?)
- Have we designed a robust purchase price adjustment and completion accounts mechanism?
- Are we actually implementing our agreed separation plan?



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Private equity – the governance challenge

If a board is approached regarding a potential private equity offer, what questions should they ask?

- Is the approach serious? Is it a complete proposal, or an exploratory concept?
- Has the market been accurately valuing the target company? Is there more the company could be doing to identify and create value?
- What is the realistic value of the company for the potential bidder and, indeed, for other potential bidders?
- Does the approach need to be disclosed to shareholders and the market generally?
- How should the board justify rejecting an approach or offer?
- Should a potential or actual bidder be given exclusive access to the target's books?
- Should an auction process be encouraged by providing opportunities for other bidders to make a play?

There are clear differences in how boards are managing private equity deals but there are some basic governance steps.

Establish discussion protocols

These include protocols on who from the organisation should be involved in discussions, the terms of engagement, and clarity over access to company data. Equally important is to agree what action is to be taken if protocols are not adhered to.

Manage conflicts of interest

The Takeovers Panel has issued a paper *Insider Participation in Control Transactions* and a Guidance Note. Where management potentially is to retain or acquire an equity stake in the business, a serious conflict of interest could arise. Often overlooked, however, is that existing share option schemes may themselves create incentive issues for management during the deal process – over and above any other incentives which might potentially apply.

Comply with continuous disclosure rules

This is a particularly difficult area which really has to be assessed on a case-by-case basis.

Consider repercussions of change of ownership, including potential industrial relations issues

Major loan agreements, supplier and customer contracts or government infrastructure arrangements may have change of ownership provisions which might be triggered by the transaction. Political intervention and union unrest could also complicate the deal.

Prepare to clear relevant regulatory hurdles

These may be wider impacts than those overseen by the Australian Competition Commission and Foreign Investment Review Board.

Identify and manage execution risk

Often those driving private equity transactions want to close the deal quickly, leading to the possibility that important matters are overlooked or incompletely considered. It can be particularly difficult for boards to develop the relevant financial forecasts if management has been excluded from the day-to-day operations, perhaps for conflict of interest reasons. The change in management and board focus also adds pressure to ensuring the efficient and profitable continuing operations and may highlight succession-planning issues if the deal activity runs for many months.

In the United States, boards have already been sued by disgruntled shareholders for rejecting private equity bids. Of course, they might also be sued for accepting bids that were later considered to be inadequate. All the more need for a strong governance process.

The governance of tax

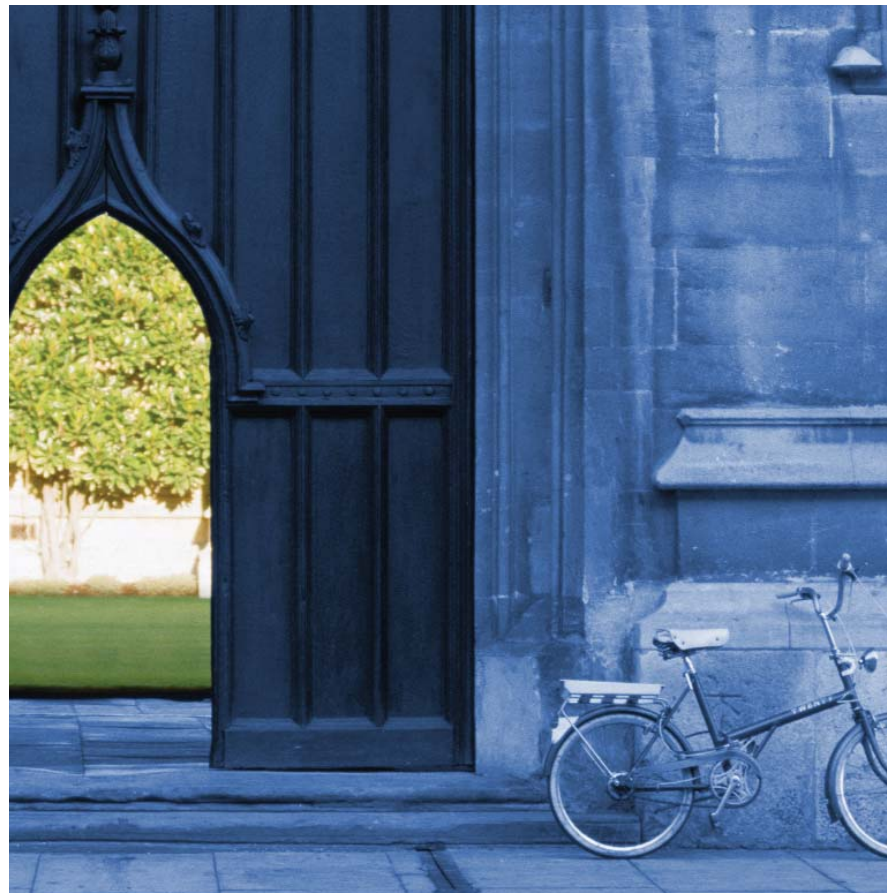
Over the last two years, KPMG has identified a 'creeping conservatism' in tax matters among boards of directors around the world. This has occurred as they balance requests from regulators, investors, the media and pressure groups for more and better information on tax policy, against the need to find ways to generate shareholder value. This conservatism is a concern to KPMG, as we believe boards that adopt an over-cautious policy on tax could lose ground to competitors.

KPMG's discussion paper entitled *The Governance of Tax* explores the developments driving the increased external interest in tax management. It provides practical guidance for organisations seeking to develop a tax governance system for this new world in which companies are scrutinised by their external stakeholders more intently than ever before.

KPMG has published *The Governance of Tax* to encourage debate around

these issues, as well as to offer our clients practical guidance. It follows on from our 2004 discussion paper, *Tax in the Boardroom*, in which we put forward the case for elevating tax issues from their traditional obscurity and onto the boardroom agenda.

The Governance of Tax is available online at kpmg.com.au or printed copies can be obtained by contacting aci@kpmg.com.au.





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The CFO's role – all that it should be?

Boards typically spend more time with their chief financial officers (CFOs) than with any other member of management excluding the CEO. Similarly, board audit committees are likely to have a particularly close relationship with the CFO. Given that the CFO is arguably the second most important appointment many companies will make, is the board making the most of its relationship with the CFO?

A new study into the role of the chief financial officer² found CFOs spend about half their time on 'traditional' tasks such as transaction processing, compliance, risk management, budgeting and forecasting, internal control and reporting and analysing and interpreting business performance.

The study also noted that CFOs are typically spending less than 10 percent of their time working directly with their boards and audit committees. Moreover, they expect to slightly reduce their board/audit committee time commitments over the next three years, as the Australian equivalents of International Financial Reporting Standards (AIFRS) issues are bedded down. Is a reduction in the time the CFO spends with the board appropriate?

Directors interviewed in our study were largely in agreement that a CFO's primary role is to make sure 'the numbers are right' and ensure there are no surprises. However, some directors indicated that they saw a role for the CFO to provide a second opinion to that of the CEO, be objective and 'tell it like it is', act as the business's 'conscience' and maintain good relationships with financial analysts.

This second theme is consistent with CFO's own aspirations. CFOs want a more prominent role in directing their organisations' strategic agendas. This has occurred after a significant period post-Enron and HIH, where they found themselves spending more time re-emphasising regulatory compliance, governance standards, risk management and the reliability of financial statements. The implementation of AIFRS also placed 'compliance' demands on the CFOs.

With a greater opportunity now for CFOs to rebalance their priorities, have boards and audit committees reflected on the role they want their CFO to fulfil? For example, the extent to which CFOs should be active in communicating important financial and business information to key stakeholders. Or with climate change and the environment making its way onto the corporate agenda, what role do boards see for the CFO in terms of identifying and assessing impacts on costs, risk profiles, market sentiment and new product and market development?

As the role of the CFO continues to evolve, it will be interesting to see what influence boards and their audit committees exert in defining the role of the CFO of the future.

Questions for the board

- Is the CFO's job description regularly reviewed and updated, and should this be reviewed by the board?
- Is the CFO being provided with sufficient resources to do his/her job properly?
- Has the organisation developed a strategy, and allocated sufficient resources, to attract and retain professional accounting and finance staff?
- Is there a proper succession plan for the CFO's position?
- Should the appointment of a new CFO be subject to board ratification?
- What role should the CFO play in communicating a balanced and realistic view of the organisation's performance prospects to shareholders, investors, analysts and the business media?
- Are the chairman of the board, the CEO and the CFO always in tune when it comes to communicating the organisation's business strategies, performance and prospects?

² The study, *CFO of the Future: the Evolving Role of the CFO*, was published in 2007. It was jointly sponsored by KPMG and the Institute of Chartered Accountants in Australia. Earlier studies in the series were published in 1998, 2001 and 2004.

Getting over the line on *Red Tape* reform

The Simpler Regulatory Systems legislation or *Red Tape* reform as it has come to be known in the media, aims to reduce the regulatory requirements in certain areas including company reporting obligations, auditor independence, corporate governance, fundraising, takeovers and compliance.

The two key aspects with immediate effect for companies that have 30 June 2007 year-ends, are electronic distribution of annual reports and changes to financial threshold tests for small/large proprietary companies.

Below is a summary of the most salient points.

Area	New requirements												
Electronic distribution of annual reports	<p>Hard copies of annual reports and concise reports need only be sent to members requesting one.</p> <p>In order to take up the electronic option, companies need to follow this criteria:</p> <ul style="list-style-type: none"> • Sending a hard copy of the reports to those members that specifically request it. • Sending a soft copy to members who specifically request it in this format. • Making electronic copies readily accessible on the web site. • Notifying members who did not receive a hard copy that the reports are available on a web site. <p>Any company seeking to take up this distribution method should ensure they have the processes in place to comply with all the requirements.</p>												
Company reporting obligations	<p>Changed thresholds for the small versus large proprietary tests, which provides small propriety companies with the option not to prepare financial or directors' reports.</p> <table border="1"> <thead> <tr> <th>Condition</th> <th>Current threshold</th> <th>Proposed threshold</th> </tr> </thead> <tbody> <tr> <td>Consolidated operating revenue</td> <td>\$10 million</td> <td>\$25 million</td> </tr> <tr> <td>Consolidated gross asset value</td> <td>\$5 million</td> <td>\$12.5 million</td> </tr> <tr> <td>Employees of companies and controlled entities</td> <td>50</td> <td>50</td> </tr> </tbody> </table>	Condition	Current threshold	Proposed threshold	Consolidated operating revenue	\$10 million	\$25 million	Consolidated gross asset value	\$5 million	\$12.5 million	Employees of companies and controlled entities	50	50
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Area	New requirements
Executive remuneration	<p>The new legislation means companies can locate all remuneration disclosures in one place – rather than across both the remuneration report and financial report.</p> <p>To ensure that the remuneration report is properly audited, the legislation requires that the auditor reports to members on whether the auditor is of the opinion that the remuneration report complies with the Corporations Act.</p>
Auditor independence	<p>Audit partners who have left the audit firm five or more years ago are now exempted from limitations relating to being an officer of an audited body.</p>
Corporate governance – related parties	<p>Reduces the need for member approval of transactions with related parties that are below \$5000, instead of the \$2000 they are currently at.</p>
Fundraising and takeovers	<p>The following changes are aimed at reducing cost and time.</p> <ul style="list-style-type: none"> • Easing of prospectus requirements and fundraising provisions for offerings of less than \$10 million. • Easing of disclosure requirements for employee share schemes. • Extending stapled securities over some of the provisions that are currently only available to companies.
Takeovers	<p>Removes telephone monitoring requirements during takeover bids.</p> <p>Removes the obligation on a person who holds 85 percent of the beneficial interest to notify remaining security holders.</p>
Breach reporting	<p>Breach reporting requirements to be aligned to a maximum of 10 business days from the date that a compliance officer becomes aware of a breach that is determined to be significant. Current time frames range from five to 28 days so the introduction of 10 business days will bring those timelines in line with each other. Breaches where immediate reporting is required are not impacted by these changes.</p>
Financial services regulation	<p>Reduces the amount of documentation that is required in relation to the rendering of financial services including giving and documenting financial advice.</p>

Regulatory and accounting watch list

A summary of major regulatory and accounting releases expected during July-September 2007.

General

The ASX has released details of proposed listing rule amendments. Changes include:

- corporate governance reporting obligations for new listings
- oil and gas reserve and resource reporting
- management agreements
- miscellaneous amendments

The amendments are the result of rule reviews the ASX has conducted over the past 18 months. To a large extent, these proposed amendments are of a minor or technical nature, or have been the subject of prior consultation. The submissions on any of the proposed listing rule amendments and draft Guidance Notes closed on Friday 20 July 2007.

Accounting Standards

The following accounting standards are being considered by the International Accounting Standards Board (IASB), Australian Accounting Standards Board (AASB) or as a joint project.

Released by the IASB

Following on from comments received on the discussion paper, the IASB plans to hold roundtable discussions on Fair Value Measurement Guidance.

Discussion paper

- Preliminary Views on Insurance Contracts (comments by 16 November 2007).

Exposure drafts

- Accounting standards for small and medium-sized entities (SMEs) (comments by 1 October 2007).

To be released by the AASB and the IASB

Discussion/consultation papers

- Conceptual Framework for Financial Reporting Project – Reporting Entity (phase D – joint project with FASB).
- Liabilities and Equity (joint project with FASB).

Exposure drafts

- Joint ventures: amendments to IAS 31/AASB 131.
- Conceptual Framework for Financial Reporting Project – Objectives and qualitative characteristics (phase A – joint project with FASB).
- Earnings per share: treasury stock method: amendments to IAS 33/AASB 133 (joint project with FASB).
- Annual Improvements Project.
- Financial instruments: portions: amendments to IAS 39/AASB 139.

Amendments to current standards

- Amendments to IFRS 3/AASB 3 Business Combinations (phase II – joint project with FASB).
- Amendments to IAS 1/AASB 101 Presentation of Financial Statements – Performance Reporting (Phase A – joint project with FASB)



- Amendments to IAS 32/AASB 132 Financial Instruments: Presentation and IAS 1/AASB 101 Presentation of Financial Statements: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation.
- Amendments to IFRS 2/AASB 2 Share-based payments: vesting conditions and cancellations.

To be released by the AASB only

Issues papers

- Superannuation plans.
- Not-for-profit entity definition.

Interpretations to be considered by a Panel

- Service Concessions.

Interpretations of accounting standards

The IASB has approved the following interpretations:

- IFRIC 13 – Customer Loyalty Programmes (effective for annual reporting periods beginning on or after 1 July 2008 with early adoption permitted).
- IFRIC 14 – IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their interaction (effective for annual reporting periods beginning on or after 1 January 2008 with early adoption permitted).

Overseas regulation/guidance

United States

Initial Due Process Document

- Accounting for Insurance Contracts

Exposure Drafts

- Emission allowances.
- Insurance risk transfer.
- Loan loss disclosures.
- Subsequent events.
- Going concern and liquidation basis of accounting.

Draft FASB Staff Positions (FSP) and Other activities

- Useful life and amortisation of renewable intangible assets.
- Valuation of commodity inventory and emission allowances that are acquired for resale
- Impact of a transfer of receivables on profit recognition under Statement 66 (Research).

Final Documents

- Derivatives disclosures.
- Financial guarantee insurance.

Final FASB Staff Positions (FSP) and Other activities.

- Classifying and Accounting for a depreciable asset as held-for-sale when an equity method investment is obtained.
- Determining whether instruments granted in share-based payment transactions are participating securities.
- Statement 133 Implementation Issue – Clarification of the application of the Shortcut Method.
- Statement 133 Implementation Issue No. C21 – Scope exceptions: whether options (including Embedded Conversion Options) are indexed to both an entity's own stock and currency exchange rates.

Contact us

For more information on the topics discussed in this newsletter contact your KPMG partner or local KPMG office.

For tailored corporate governance advice contact KPMG's Board Advisory Services +61 3 9288 5790.

Additional information on emerging issues and developments is also available via KPMG's Audit Committee Institute aci.kpmg.com.au

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