

Across the board

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Michael Andrew
National Chairman

Introduction

While we are seeing some promising signs that the worst of the worldwide economic downturn, triggered by the global financial crisis (GFC), could be behind us there are still plenty of challenges facing the Australian business community.

In the coming months as boards reflect on their key priorities, taking into account the 'hang-over' from the GFC and the economic downturn, there is likely to be a shift in the strategic agenda towards positioning for the future and establishing strong foundations for growth.

Also, as Andries Terblanche writes in this issue of *Across the Board*, it is vital we understand how the crisis came about if we are to reduce the risk of a reoccurrence and improve our risk management practices more generally. His article outlines some of the key underlying factors contributing to the GFC, as well as lessons to be learnt and applied going forward in relation to risk management.

Executive remuneration practices have also been highlighted as a result of the GFC. To keep us up to date on this issue, Martin Morrow and Andy Hutt examine the current state of play with respect to the regulatory reforms being proposed in Australia, as well as some key considerations for boards in relation to executive remuneration.

Another consequence of the market environment we find ourselves in is the number of public companies that have engaged in so-called 'rapid fire' equity raisings as they have sought to strengthen their balance sheets in the wake of the GFC. James Seabrook, reminds us that these transactions are not without their risks. Indeed, as James explains, the risks for boards can be greater than for a more conventional rights issue.

Finally, Kris Peach updates us on the latest changes to accounting standards being proposed by the International Accounting Standards Board. The proposals are, in part, a response to the GFC. Boards will do well to familiarise themselves with how these changes may affect the balance sheet if they are adopted.

A new era of risk management: learning the lessons of the global financial crisis

The severity of the GFC has taken the world by surprise. Understanding the key underlying factors that contributed to this crisis is essential if we are to improve our understanding and ability to reduce future systemic failures as well as improve risk management practices generally.



Andries Terblanche
Partner
Financial Services

The GFC is a result of a number of contributing factors but, in my view, there are four key ones, namely:

- connectivity
- economic and financial theory
- policy and regulation
- private sector behaviour.

Connectivity

The global economy has become increasingly interconnected. The drivers of this connectivity include the growth in world trade, advances in logistics management and communications technology, and the increased mobility of both people and capital.

Increased connectivity has greatly increased the complexity of the financial and economic relationships among nations and between commercial enterprises, including financial institutions. Wider participation in free trade has exponentially increased the level of complexity and opportunities for a country or a business and, as a consequence, exposure to upside and downside risk.

Another (unintended) consequence of the current level of connectivity is the near universal adoption of modern economic theory – particularly as it relates to risk quantification and management. As more entities in more countries applied similar risk quantification and mitigation strategies, we constructed – at a consolidated, global level – a highly concentrated risk profile. As chairman of the US Federal Reserve Board, Ben Bernanke, explained¹, “a single firm may have an

acceptable exposure to a particular type of risk that would be unacceptable if replicated across many firms.”

Whilst the global risk profile being constructed became increasingly unbalanced, it did so in an environment of growing confidence in the mechanisms to quantify and manage risk exposures at an individual entity level. This confidence, however, was seriously misplaced as an examination of the next contributing factor to the GFC highlights.

Economic and financial theory

The efficient market hypothesis has gained widespread acceptance over the past third of a century, influencing the development of impressive risk management theories and models. The work of Markowitz on modelling risk, Sharp on quantifying the worth of assets and Merton, Black and Scholes on the value of risk, changed investment management practices around the world.

These theories were widely adopted by academics and practitioners. They were used to calibrate the price of risk to hitherto unobserved levels of precision. Such levels of accuracy, in turn, facilitated unprecedented ‘certainty’ about risk measurement and downside risk exposures – to the point where capital requirements were refined to unusually low levels, in order to optimise capital efficiency and returns.

What received comparatively less attention, were the principles on which these theories were based. The latter drew from fields such as the laws of physics, and applied these to

¹ *The Economist*, 25 April 2009 p.67, c. 1.



...the theories treated humans (investors) broadly similar to molecules in physics: neutral, statistically independent, and rational.

the field of economics. In doing so it applied observations from a controlled, statistically 'independent' environment to a rapidly evolving, exponentially expanding human interventionist and mathematically 'chaotic' environment. This is a critical distinction: the efficient market theory assumes that:

- people (investors) are alike, and rational
- investment decisions are made with no price memory
- investment decisions are made with no sense of anticipation.

In short, the theories treated humans (investors) broadly similar to molecules in physics: neutral, statistically independent, and rational.

Economic theories and risk management models built on this work were applied without contextualisation of their limitations and without consideration of their original design and objectives. Used in this way, they seriously overstated the levels of risk management accuracy and precision. For broadly similar reasons, they understated downside, catastrophic risks.

As a result there has been a resurgence in the use of scenario planning and analyses, as well as stress testing. Indeed, these analyses constitute some of the few risk management tools currently available to complement the mathematical theories and models (including applications such as *inter alia* Value at Risk or VaR).

The broad application of the efficient market theory and related models that under-quantified risk, contributed to the chronic underpricing of risk that, in turn, fuelled an increasingly global interconnected appetite for risk.

Policy and regulation

Following the dot com crash and the events of September 11, the US Federal Reserve moved to lower the federal funds rate in response to the perceived risk of deflation. Subsequent decisions continued to lower the federal funds rate – decisions that (inadvertently) fuelled two unintended consequences.

First, the decision appeared to support the notion that global systemic risk was in decline, lulling more businesses in more parts of the world into a false sense of security about the robustness of their risk quantification and measurement.

Second, it *lowered* the cost of debt at a time when more countries and commercial entities were able and willing to participate in international capital markets. One consequence was to drive US house prices ever higher as investors around the world bought US mortgage-backed securities, fuelling the now notorious sub-prime crisis.

The historic 'dampening mechanism' – regulation – was also being impacted by emerging thinking. In the US, the *Glass-Steagall Act* was partly repealed allowing retail banks access to sophisticated transactions and balance sheet leverage previously reserved for investment banks. Regulation in the US allowed conglomerates to elect which parts of their business should be regulated by different regulators. Furthermore, arbitrage opportunities opened up on the global stage as different countries adopted different regulatory responses to similar economic and accounting issues.

Private sector behaviour

In a world in which risk appeared to have been conquered, participants in the private sector came to believe that high returns could be generated without risk and human greed asserted itself. Returns that by past standards would have been regarded as good were often greeted with disappointment by investors, prompting many boards and executives to eschew past caution in the quest for ever-better returns.

The increased use of leverage and various forms of 'financial engineering' were deployed in an effort to multiply rates of return.

Conclusion

The extent and depth of the GFC were magnified by the degree of global involvement, increased risk appetite at global levels in the lead up, the cycle being deepened through relatively inexpensive debt, and being exacerbated by regulatory arbitrage opportunities and the increased expectation of ever-greater returns.

In combination, these developments synchronised into an unmatched, explosive combination which was allowed to negate historic, hard-learned values and principles.



Practical questions for boards and executives

As the lessons of the GFC begin to emerge, they raise some useful questions that boards should be asking of their executive teams, their corporate advisers and their auditors.

- Under what conditions will our existing risk strategy/risk appetite become inappropriate?
- Is risk in all its manifestations regarded as an add-on function, or is it truly embedded in everything we do throughout the organisation?
- Are we preserving a 'corporate memory' about past setbacks and failures in the business, to avoid the same issues in the future? If so, where does it reside?
- How 'elastic' is our capital? What contingency plans are in place to deal with capital constraints? Are they realistic?
- Are we using scenario planning and stress testing as part of our risk management processes? Do they take account of relevant global and systemic risks? How are the results of this work fed back into our risk policies and processes? How are the results communicated to the board?
- Are statistical risk management tools such as Value at Risk being applied across the full economic cycle?
- Who in the organisation can commit to significant new balance sheet risks? How and by whom are these decisions monitored and reviewed? Do decision-makers share in the potential downside of their decisions?
- Are returns on capital 'too good'? To what extent do these returns reflect the inadequate quantification of risk, or its under reporting?
- Which managers have an end-to-end detailed understanding of product offerings, their associated risks and resultant capital requirements and the maximum potential downsides? Who at the oversight level has similar detailed knowledge?
- Is executive remuneration linked to risk-adjusted performance?



Country	Currency	BUY	SELL
United States	USD	1.1865	1.1865
Euro	EUR	1.4315	1.4315
England	GBP	2.1140	2.1140
Australia	AUD	0.8300	0.8300
Denmark	DKK	0.1580	0.1580
Hongkong	HKD	0.1480	0.1480
Japan	JPY	1065	1131
Norway	NOK	0.1735	0.1735
Sweden	SEK	0.1480	0.1480
Switzerland	CHF	0.1480	0.1480

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Understanding the risks of rapid fire equity raisings

Despite their popularity among listed entities, rapid fire equity raisings can create risk issues for directors.



James Seabrook
Partner
Transaction Services

Secondary equity raisings of various kinds have figured prominently in the strategies adopted by many listed companies to maintain the health of their balance sheets, reduce refinancing risk and manage their debt covenants.

So called 'rapid fire' equity raisings, including institutional placements and accelerated rights issues, offer speed and convenience of execution. They allow companies to quickly take advantage of favourable market conditions that may be relatively transitory, and have become increasingly popular over the past 18 months. In the 2008-09 financial year the total value of equity raised on the ASX was over \$60 billion¹. Recent major rapid fire issues have included:

- Asciano – \$2.35 billion
- OneSteel – \$789 million
- Qantas – \$500 million
- Santos – \$3 billion
- Stockland – \$2 billion
- Wesfarmers – \$4.6 billion.

The main feature of rapid fire equity raisings is the ability to raise equity without having to issue a formal prospectus or product disclosure statement. The Australian Securities and Investments Commission (ASIC) recently issued further guidance on the topic and extended its disclosure exemptions to certain non-traditional rights issues. ASIC appears to be keen to encourage rights issues as they enfranchise small, retail shareholders who are often locked out of institutional placements.

Instead of preparing a prospectus or product disclosure statement, rapid-fire equity issuers release a 'cleansing

notice' under section 708AA of the *Corporations Act 2001*. Such a notice must make certain specified disclosures, including confirmation of compliance with continuous disclosure obligations. Often additional disclosures under the cover of an "investor presentation" are made to the market in conjunction with the announcement to raise new equity. Such disclosures typically include reasons for the equity raising, a pro forma balance sheet, revised profit guidance and debt covenant compliance statements.

Boards should be cognisant of the fact that, in relation to incorrect or misleading statements included in these investor presentations, a legal due diligence defence is not available to directors as it is for a prospectus or product disclosure statement.

The 'due diligence defence' absolves directors of liability for misleading statements in a prospectus or product disclosure statement provided they have exercised appropriate diligence in their oversight of the preparation of the prospectus. Such oversight includes making adequate inquiries, taking appropriate precautions and ensuring there are no material omissions in the information provided.

Given the speed with which a rapid fire equity raising is conducted, the information supporting the investor presentation disclosures is often prepared quickly in a highly pressurised environment. In these circumstances its accuracy can be problematic, raising the inherent liability risks for directors.

¹ Source: Thompson SDC published in *Australian Financial Markets Snapshot 2008-09*, KPMG



Given these implications, how should directors protect themselves in the context of rapid fire equity raisings? It is useful to consider the following questions.

- Have we satisfied our continuous disclosure obligations and thereby confirm our compliance in a cleansing notice? Are there any other disclosures that should be made in conjunction with the equity raising to satisfy these obligations?
- Is there a reasonable basis for the assumptions underlying any profit guidance we are releasing to the market? Have they been subject to sufficiently robust due diligence? Are key risks associated with the profit guidance being adequately explained in our presentations, including consideration of key sensitivities?
- If the equity raising is taking place close to the company's financial year-end, what are the risks that our audited financial statements may differ materially from our current profit guidance? Have year-end accounting matters such as impairments and provisions been adequately considered?
- What checking and verification has been undertaken to support any statements or calculations regarding debt covenant compliance based on a post equity raising balance sheet?
- What external, independent advice and comfort can we obtain in the time available?

Given the increasingly litigious environment in which we all inhabit, answering these questions would be a prudent approach for boards.



Reform 'storm' for executive remuneration

In response to the GFC and general public outcry, the Australian Government has initiated a 'torrent' of changes affecting executive remuneration.



Martin Morrow
Partner
Tax

Changes include reform of the taxation of employee share schemes, new rules for executive termination benefits, the Australian Prudential Regulation Authority's (APRA) proposed standard on the governance of executive remuneration and the Productivity Commissions review of executive and director remuneration.

If financial results and public sentiment weren't enough, the reform 'storm' will keep executive remuneration firmly at the top of the board agenda over the next 6 months.

Why should directors be concerned now?

The annual general meeting (AGM) season has intensified the scrutiny on executive remuneration and while many boards will be defending decisions about executive remuneration policies that were formulated in better times,

the greater concern now is the way forward.

The current focus is on how to best align shareholder and executive interests going forward, without the certainty of final legislation and detailed policies from the many remuneration reform programs currently underway, complicated by continuing uncertain market conditions.

What reforms will impact decisions on executive remuneration?

The 14 August 2009 release of the draft legislation for the reform of the taxation of employee share schemes – which introduced new conditions for tax deferral, removed the choice of the timing of taxation, changed the treatment of foreign source employees' share scheme income and introduced new reporting requirements – was



Andy Hutt
Partner
Tax

All this activity poses a significant challenge for boards that need to make decisions now on what they believe to be the most appropriate remuneration structures for their organisation.

the most recent 'squall' in the reform program.

A number of aspects of the tax framework interact with other reforms and will need to be addressed as part of any executive remuneration program. The related reforms include:

- The proposed limitations on termination benefits for executives, which are being made by amendments to the *Corporations Act 2001*. (The government has introduced the *Corporations Amendment (Improving Accountability on Termination Payments Bill 2009)* to strengthen the framework relating to termination benefits, including requiring that termination benefits for company directors and executives exceeding 1 year's average base salary are subject to shareholder approval). These amendments are expected to be passed in the Autumn sittings of parliament.
- APRA's updated proposed governance requirements on remuneration for financial institutions, which are intended to be effective from April 2010 and can be expected to strongly influence the requirements for all listed entities.
- The Productivity Commission's Inquiry into executive remuneration. The Commission is scheduled to release its first report in late September and its final findings are due to be tabled in December 2009.

All this activity poses a significant challenge for boards that need to make decisions now on what they believe to be the most appropriate remuneration structures for their organisation.

What are the key issues and challenges for directors to address?

Many of the submissions to the Productivity Commission called for it to find that executive remuneration should not be further regulated but, rather, should be left to the determination of the board. These recommendations were made on the basis that it is board directors who are best placed to understand the nature of the business, the vagaries of the particular industry and markets in which the company competes.

Similarly, APRA has recommended boards establish a remuneration committee consisting entirely of non-executive directors (with a majority independent, and an independent chair) with the requisite skills and knowledge to perform its functions and have in place a remuneration policy. The policy will need to address the alignment of employee remuneration with the long-term financial stability of the organisation, its risk management framework, and who is covered by the remuneration policy and why.

APRA's proposals make it clear that boards should be held accountable for the effectiveness of the remuneration structure. All directors should be aware of these requirements, not just directors of financial institutions, as we expect the Productivity Commission will support APRA's approach. A broad adoption of the APRA proposals would require boards to ensure:

- performance hurdles for executives reflect the risks in their particular business activities, rather than the company as a whole
- there are controls reflected in the performance hurdles to mitigate the risks, so that the variable reward component of remuneration is only paid once the performance can be reliably measured
- the board is able to adjust an executive's variable reward where the performance – on which the reward is based – is subsequently found to be inadequate
- they understand how the remuneration for all employees who are, or should be, on performance based arrangements has been structured
- they understand why a particular remuneration design has been used and how its intended effect will impact the business
- they select an external remuneration consultant if they need assistance, and they determine the appropriate contractual arrangements without relying on executives of the organisation.

Whatever the final details of the APRA proposals and Productivity Commission Inquiry, it is safe to say that directors now need to have a far deeper knowledge of their company's remuneration structure and understand

Many of the submissions to the Productivity Commission called for it to find that executive remuneration should not be further regulated...

the reasons behind its design, the expected impact on executive behaviours and the implications for the company of the outcomes of the remuneration program.

The other significant challenge for boards will be to maintain the level of executive remuneration in light of these reforms. There is little question executives are currently 'feeling the pain' as many long-term incentives are 'out of the money'.

Executives' concern for their future remuneration will be compounded by the legislation on termination benefits. The effect of this will, of course, be some executives seeking higher base pay at a time when any increase will be particularly unpalatable to the majority of shareholders and the broader market.

The phrase "It never rains, but it pours" seems an apt summary of the current situation in the executive remuneration space, but boards that take ownership of the remuneration agenda and ensure clear communications with stakeholders will be best placed to weather this reform storm.

What should directors do now?

- If your company is yet to hold its AGM, consider how the reforms may impact your messaging or responses on executive remuneration.
- If your company has held its AGM, reflect on the questions raised, the answers given and the remuneration report itself. What communication improvements can be made for next year. Are they likely to be impacted by the reforms?
- Ensure the reform agenda progress is being closely monitored and identify all of the potential implications for the company and the board. Determine an action plan to address them.
- Understand the current remuneration structure and why it has been designed the way it is.
- Determine the extent to which the remuneration structure is aligned with your organisation's 1 year and 3 year objectives.
- Take the lead on executive remuneration and set the program for the coming year, and the

longer-term, by first setting the terms of reference within which management should operate.

- Determine whether the remuneration committee has the skills and knowledge to perform its functions and, if not, whether it should be engaging external assistance from a specialist adviser if changes are needed to the committee composition. Take ownership of that engagement.

More detailed analysis of the impacts of the government's various executive remuneration reforms is contained in KPMG's Reform in Focus brief. Please contact your KPMG adviser, Martin Morrow on mmorrow@kpmg.com.au or Andy Hutt on ahutt@kpmg.com.au to obtain a copy or further information.

The other significant challenge for boards will be to maintain the level of executive remuneration in light of these reforms.



The changing face of the balance sheet

Proposed changes in accounting standards will affect the treatment of important balance sheet items. Boards need to understand the consequences of these changes now so they can assess the commercial implications on key decisions.



Kris Peach
Partner
Audit

Recent proposals by the International Accounting Standards Board (IASB) cover consolidation, financial instruments, leases, revenue and tax and respond, in part, to issues experienced during the global financial crisis. Although none of the mooted changes will apply in respect of FY2010 reporting, the IASB proposals could significantly change the future accounting treatment of certain financial transactions and arrangements being entered into now, potentially affecting key balance sheet ratios and reported profits in the future.

In addition, the IASB proposals are inconsistent, in several important respects, with changes being considered currently by the Financial Accounting Standards Board in the US – significantly threatening the goal of having one global set of standards, endorsed at the Group of Twenty (G20)¹ financial crisis summit.

What are the proposals affecting the balance sheet?

There are several IASB papers containing proposals that could significantly affect the look of your company's balance sheet. They include:

- exposure drafts on consolidation, tax, de-recognition of financial instruments and financial instruments' classification and measurement (including impairment) and hedge accounting
- discussion papers on revenues and leases.

KPMG's overall impression of these proposals is that the quantum and value of assets and liabilities recognised on the balance sheet is going to increase. It represents a clear push to get as much as possible

onto the balance sheet, rather than treating them as so-called off-balance sheet items. So for organisations renegotiating borrowings and credit lines, loan covenants which are comfortable now could become too restrictive within a few years and lease financing may lose its appeal.

Consolidation

More entities are likely to be consolidated. The following situations will probably require consolidation.

- Where 'de facto' control is deemed to exist, even though the relevant shareholding in the entity is less than 50 percent. A typical example could involve a major shareholding of 45 percent with no other shareholding greater than 5 percent.
- Managers and responsible entities of managed investment funds (and property trusts) are likely to consolidate these vehicles if their direct interests in the funds concerned are more than 'insignificant'. (Currently consolidation is generally only required where an interest exceeds 50 percent.)

Tax

We expect an increase in deferred tax assets and liabilities for several reasons.

- Reducing the recognition threshold for deferred tax assets to being 'more likely than not' (a probability of around 50 percent) from the current 'probable' (considered by some to represent a 75 percent chance of being utilised).
- Removing the exemption for the tax consequences of investing in domestic subsidiaries and joint ventures.

¹ The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialised and developing economies to discuss key issues in the global economy. It is an informal forum.



- Recognising tax uncertainties relating to disputes with the tax office using a probability weighted estimate rather than the most likely outcome. This will likely result in there always being an exposure to recognise and related disclosures to make.
- Superannuation funds undertaking securities lending transactions will de-recognise the asset 'lent' and recognise a gain on sale if the asset is listed. They will be required to recognise stock received as collateral for the loan as an asset if they have a right to sell the collateral.

De-recognition of financial instruments

We have identified several likely consequences of de-recognition.

- Financial institutions that regularly sell assets with a forward contract to repurchase them (i.e. 'repos') will be able to de-recognise the asset and recognise the gain on the sale if the asset is readily available (e.g. a listed security). Currently these assets cannot be de-recognised.
- Non-banking institutions that securitise their trade receivables (e.g. transfer a portfolio to a bank or special-purpose entity) are unlikely to be able to de-recognise such assets and will need to recognise a liability for the cash received if they provide any form of ongoing guarantee.
- If additional liabilities are recognised there will be consequential interest expense increases in profit and loss while assets will continue to accrue interest income.

Financial instruments

The IASB proposes to revamp its existing IAS 39 (*Financial Instruments: Recognition and Measurement*) in a number of stages. The three main phases of the project cover classification and measurement, impairment methodology and hedge accounting. Although the aim of the exercise is to make the present requirements simpler, we suspect the proposals will concern many preparers and users of financial statements. In connection with the first phase of the proposals (classification and measurement), there are several points to note.

- Broadly, simple debt instruments that are managed on a contractual yield (interest rate) basis would be accounted for on an amortised cost basis.
- All other instruments would be measured at fair value and generally accounted for through net profit.



- Only some equity investments (e.g. listed shares) may still be fair valued through equity (not through profit and loss). However, gains or losses on disposal and dividend income on these instruments will be recognised directly in equity and not in net profit. Impairment testing will no longer be required for these assets.

The IASB expects to release an exposure draft on the other phases of this project in the second half of 2009.

Revenue

The revenue proposals are most likely to affect entities undertaking the following type of transactions.

- **Warranties.** Revenue will now be deferred rather than recognised immediately, with an associated provision.
- **Long-term service or construction contracts.** Revenue can only be recognised if the customer has 'control' of the asset or service. This change may result in more revenue being deferred until the asset under construction is completed or the service fully provided.
- **Contract acquisition costs.** Such costs will only rarely be permitted to be capitalised.

Leases


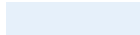

The proposed leasing changes will mean that all leases will be recognised on the balance sheet. Effectively, current operating leases will be recognised on a similar basis to finance leases. Net profit will no longer recognise current operating lease rentals on a straight line basis. Rather, it will recognise interest expense and amortisation of the lease asset, which generally results in greater front ending of the costs of the lease.

What directors should do

Directors need to be alert to the possible consequences of accounting changes for their organisations' balance sheets and profit and loss statements. Without necessarily getting into the fine details of the proposals, directors should satisfy themselves that their finance teams are across the complexities and their commercial implications. Also, if your organisation opposes any of the proposed changes then ensure submissions are made to the IASB within the relevant timeframes.

Summary of proposed changes in accounting standards

Joint ventures							
Financial statement presentation	Liabilities						
Revenue	Consolidation	Consolidation					Financial statement presentation
Earnings per share	Financial instruments	Liabilities	Annual improvements II	De-recognition			Revenue
Leases	Rate regulated activities	Discontinued operations	Post employment benefits	Financial instruments	Earnings per share		Post employment benefits
Fair value measurement guidance	Management commentary	Extractive activities	Insurance	Income tax	Financial statement presentation		Leases
Derecognition	Share based payments: group transactions	Joint ventures	Financial instruments with equity	Fair value measurement guidance	Revenue		Insurance
Income tax	SMEs	First time adoption	Emission trading	Emission trading	Leases		Financial instruments with equity
Already issued		To be issued in 2009		2010		2011	

Discussion Paper	
Exposure Draft	
Final Standard	

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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