

Application of FRS 110 Consolidated Financial Statements

Consolidation of Real Estate Investment Trusts (REITs)
Managers by Sponsors



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ISCA is the Administrator of the Singapore Qualification Programme (Singapore QP) and the Designated Entity to confer the Chartered Accountant of Singapore - CA (Singapore) - designation.

It aims to raise the international profile of the Singapore QP, a post-university professional accountancy qualification programme and promote it as the educational pathway of choice for professional accountants seeking to achieve the CA (Singapore) designation, a prestigious title that is expected attain global recognition and portability.

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Preface

Following the issuance of FRS 110 “Consolidated Financial Statements” (“FRS 110”), investments in Real Estate Investment Trusts (“REITs”) was identified by the Working Group¹ as an industry that was significantly impacted on adoption of the standard. In response to this, in December 2013, the Institute of Singapore Chartered Accountants (“ISCA”) issued a practical guide titled “Application of FRS 110 Consolidated Financial Statements: Investments in Real Estate Investment Trusts (REITs)”. Whilst the guide outlined some key considerations on whether the Sponsors of REITs have control over the REITs of two different governance structures, it did not address specifically whether the Sponsors would control the REIT Manager.

In cases where the REIT Sponsor is the sole shareholder of the REIT Manager and can unilaterally appoint and remove the board of the REIT Manager, it may be clear that the REIT Manager is controlled by the REIT Sponsor. However, under the alternative structure (the “Alternative Structure”) as set out in Appendix 3 to the practical guide on “Application of FRS 110 Consolidated Financial Statements: Investments in Real Estate Investment Trusts (REITs)”, questions arise as to whether a REIT Sponsor still has control over its wholly-owned REIT Manager after relinquishing its right as the sole shareholder of the REIT Manager to appoint and remove the board of the REIT Manager.

The purpose of this guidance is to set out the specific facts and circumstances to consider when assessing whether or not consolidation of the REIT Manager by a REIT Sponsor is required if the REIT Sponsor puts in place the alternative structure.

¹ IFRS 10 Working Group was set up by ISCA’s Financial Reporting Committee in 2011. Members of the Working Group include Mr. Reinhard Klemmer (Chairman), Ms. Kok Moi Lre, Mr. Shariq Barmaky, Mr. Tan Seng Choon, Ms. Chan Yen San, Ms. Ong Suat Ling and Ms. Soh Lin Leng.

We would like to acknowledge and thank these individuals for their contributions towards the development of this guidance.

General principles in FRS 110 *Consolidated Financial Statements*

To determine control, an investor needs to demonstrate the following:

- a) Power over the investee;
- b) Exposure, or rights, to variable returns from its involvement with the investee; and
- c) Ability to use its power over the investee to affect the amount of investor's returns.

As the sole shareholder of the REIT Manager (RM), it is clear that the REIT Sponsor has exposure and rights to variable returns from its involvement with the RM via the right to receive dividends from the RM.

This guidance therefore focuses on the consideration of whether the REIT Sponsor have the power (i.e. the current ability) to direct the relevant activities of the RM and the ability to use that power to affect the REIT Sponsor's returns.

Application to the Alternative Structure

As mentioned in the preceding paragraph, a Sponsor that owns 100% equity interest in a RM would control the RM if it has the power to direct the relevant activities of the RM and the ability to use the power to affect its returns from the RM. This will require an understanding of the relevant activities of the RM based on its purpose and design under the Alternative Structure, and an assessment of the extent of substantive rights held by the Sponsor over those relevant activities set out in the contractual arrangements between the Sponsor and the RM. This is especially important as under the Alternative Structure, the Board of the RM is appointed by the unit holders of the REIT.

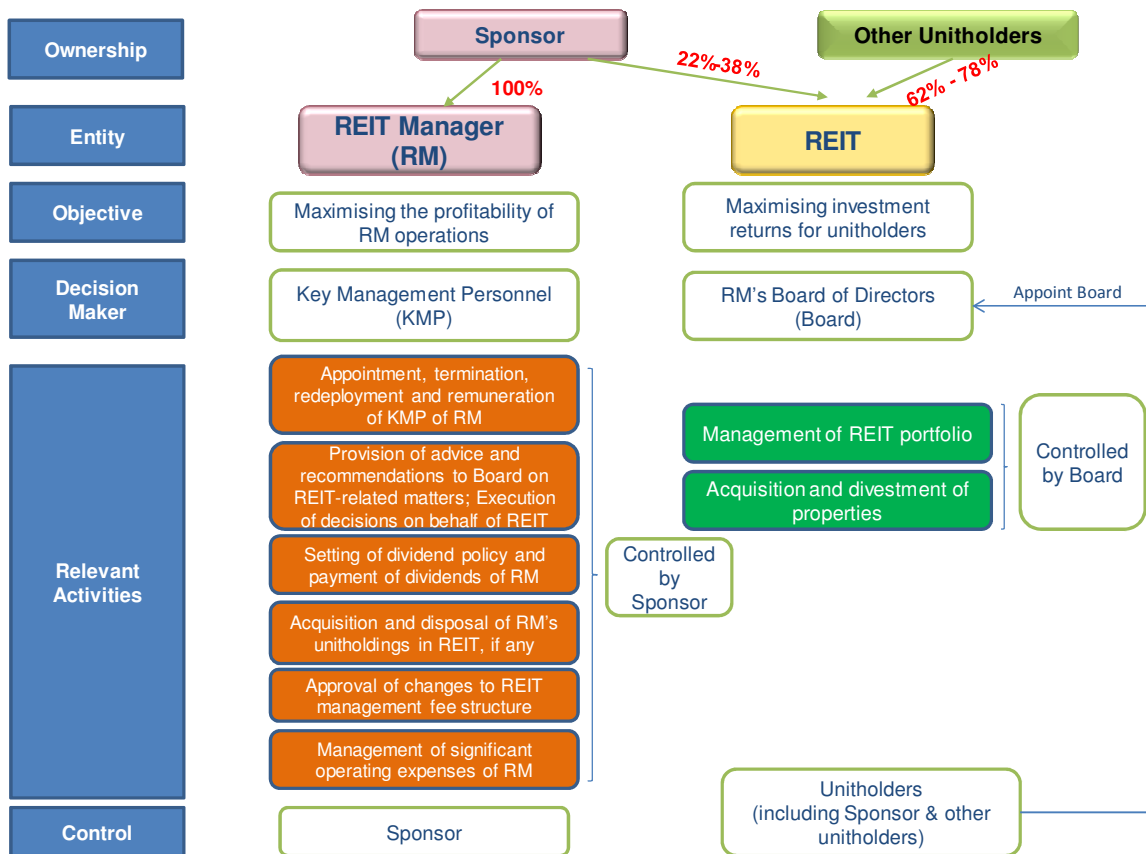
An example where the REIT Sponsor controls the RM but not the REIT after it relinquishes its right to appoint and remove the Board of the RM

Set out below are the specific facts and circumstances where the REIT Sponsor may still have control over the relevant activities relating to the asset management business residing in the RM.

The purpose and design of the RM is to earn returns for the Sponsor as an external asset management service provider to the REIT (i.e., it is an extension of the Sponsor's asset management business in a separate legal entity). Its services to the REIT involve providing professional advice and recommendations on the relevant activities of the REIT i.e., management of the REIT portfolio, and the acquisition and divestment of properties.

The relevant activities of the RM, in contrast to the relevant activities of the REIT, are as follows:

- 1) Appointment, termination, re-deployment and remuneration of the KMP of the RM to provide professional asset management services to the REIT
- 2) Providing advice and recommendations to the Board over the portfolio of the REIT, acquisitions and divestitures and any other related matters to managing the REIT (the revenue generating decisions for the REIT), and carrying out the decisions made by the Board for the unitholders
- 3) Set dividend policy and payment of dividends of the RM
- 4) Approve changes to REIT management fee structure with the REIT
- 5) Acquisition (other than management fees received in units) and disposal of the RM's unitholdings in the REIT if any
- 6) Managing the significant operating expenses of RM



The Sponsor has the power (separately from the Board of Directors) to direct the above relevant activities to affect the significant returns it is entitled from the RM as the Sponsor has unilateral decision-making rights set out in contractual arrangements with the RM. The decision-making rights held by the Sponsor would include:

- 1) The ability to appoint and terminate the employment of the KMP of the RM (who is a party related to the Sponsor), subject to the Board's concurrence, which should not be unreasonably withheld without cause.
- 2) The ability to re-deploy the personnel to manage other REITs or perform other revenue generating activities of the REIT Sponsor.
- 3) The ability to decide on the performance and remuneration package of the KMP of the RM subject to the Board's concurrence, which should not be unreasonably withheld without cause.
- 4) The ability to approve changes to the REIT management fee structure, decide on acquisition/disposal of units held in REIT if any, management of the operating expenses, and dividend policies and mechanisms.
- 5) Set dividend policy and payment of dividends of the RM

Under the structure and facts illustrated above, it may be appropriately concluded that the decisions over the portfolio of the REIT, acquisitions and divestitures and any other decisions related to managing the REIT are the decisions of the REIT and not the relevant activities of the asset management business of the Sponsor residing in the RM. The relevant activities of the asset management business residing in the RM are different from those of the REIT and are controlled by the REIT Sponsor through separate contractual arrangements between the REIT sponsor and the RM. The Board makes decisions over these relevant activities of the REIT in the interest of the unitholders. On the other hand, the Sponsor makes decisions over the relevant activities of the RM to maximize the returns of RM as an asset management service provider to the REIT (RM's primary purpose) in the interest of the Sponsor. Consequently, the REIT Sponsor has control over the asset management business residing in the RM. By consolidating the RM, the REIT Sponsor reports the service fee income earned by the RM, which reflects the substance of its involvement in the REIT as an external asset management service provider.

About ISCA Technical Standards Development and Advisory

The Technical Standards Development and Advisory (TSDA) team is part of the Technical Knowledge Centre and Quality Assurance division of the Institute of Singapore Chartered Accountants (ISCA). It is committed to supporting the Institute in advancing and promoting technical developments within the profession as part of the effort to transform Singapore into a leading global accountancy hub by 2020.

ISCA TSDA engages external stakeholders in soliciting meaningful feedback on accounting and auditing related issues to develop a consistent approach to addressing industry issues identified. It also prescribes auditing and assurance standards that are closely aligned to international best practices, champions thought leadership initiatives with key stakeholders and drives projects in collaboration with various ISCA technical committees.

It actively engages international standard setters and strives to be an advocate of matters pertinent to the development of Singapore's accountancy profession. Furthermore, it aims to cultivate a mindset change and raises awareness of new and revised standards through the publication of articles authored by the team.

Additionally, ISCA TSDA seeks to empower members and the profession at large to achieve their aspirations by equipping them with relevant technical expertise and this is achieved through the development of a range of resources that they can tap on.

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