

Application of FRS 110 Consolidated Financial Statements

Investments in Real Estate
Investment Trusts (REITs)



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Preface

Following the issuance of the suite of consolidation standards, namely International Financial Reporting Standard (IFRS) 10, 11 and 12, the Financial Reporting Committee of the Institute of Singapore Chartered Accountants set up an IFRS 10 Working Group¹ (the Working Group) in 2011, comprising experienced technical accounting professionals from the large public accounting firms. The Working Group was tasked to look into potential application issues of the consolidation standards (FRS 110, 111 & 112) and also to engage in outreach efforts for the accounting profession in Singapore. In March 2013, two seminars were organised for the general public and for companies with investments in unit trusts and funds, with the support of the Working Group members.

The Working Group had identified investments in Real Estate Investment Trusts (REITs) as one industry that would likely be significantly impacted upon adoption of the consolidation standards, largely due to its unique structure in Singapore as compared to that of other jurisdictions. Currently, most, if not all of the investments in REITs are not consolidated by their sponsors in Singapore under the requirements in FRS 27 (2009) Consolidated and Separate Financial Statements. However, this may not be the case under FRS 110 Consolidated Financial Statements which comes into effect for financial periods beginning on or after 1 January 2014.

In addressing this matter, the Working Group held several consultative dialogues with regulators and stakeholders from the REITs industry to better understand the challenges faced in the application of FRS 110. Robust discussions were carried out within the Working Group. After due deliberations and considerations, the Working Group developed this guidance to assist the REIT sponsors in assessing whether the sponsors have control over a REIT.

This guidance consists of the following:

- Frequently asked questions on rights held by parties other than the sponsor and other considerations in the assessment of control, based on a typical Singapore REIT structure
- Illustration of aggregate economic interest using examples in FRS 110 and the Effect Analysis
- Consideration of an alternative REIT structure whereby the REIT would not be consolidated on the premise that the sponsor would not have power to direct the relevant activities of the REIT via the REIT manager.

Whilst this guidance is prepared with the accounting profession and the business community in mind, it serves only as guidance for the user and should be used in conjunction with the relevant standards.

¹ Members of the Working Group include Mr. Reinhard Klemmer (Chairman), Ms. Chan Yen San, Ms. Lim Sio Hoon, Mr. Frederick Baudin, Mr. Wong Koon Min, Ms. Kok Moi Lre, Ms. Ong Suat Ling, Mr Mohd Ghamazy, Ms Poh Poh Lin and Mr. Jeremy Toh.

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

Introduction

Currently, all listed REITs in Singapore are structured as externally-managed trusts. What this means is that on creation of the REIT, decision-making authorities are delegated to professional managers.

The professional managers (REIT Manager² and Property Manager) are usually wholly-owned subsidiaries of the REIT sponsor. As the relevant decisions of a REIT in Singapore are made by its REIT Manager in most cases, in this analysis, alternative arrangements such as those where the Property Manager or its equivalent is one of the key decision makers, are not considered. The REIT sponsor, typically the entity that injects the initial investment portfolio into the REIT, frequently retains a significant but less than the majority interest in the REIT.

As the REIT Manager (a subsidiary of the sponsor) is typically the key decision maker of the relevant activities of the REIT, and the sponsor is exposed to variability of returns both from the managers' remuneration and its unitholding in the REIT, all REIT sponsors would need to consider whether the application of FRS 110 *Consolidated Financial Statements* would result in the consolidation of the REIT in its consolidated financial statements.

This list of frequently asked questions serves to provide guidance on how to assess control under FRS 110 on a typical Singapore REIT (as set out in Appendix 1), including assessment of the aggregate economic interest held by the sponsor.

In addition, certain specific changes to the existing REIT structure contemplated by sponsors (alternative structure) have been considered.

Under the alternative structure, the sponsor relinquishes its right as the shareholder of the REIT Manager to appoint and remove the board of the REIT Manager. Appendix 3 sets out the specific facts and circumstances to consider when assessing whether or not consolidation of the REIT is required if the alternative structure is put in place before the date of initial application of FRS 110.

² A REIT Manager is a capital market licensee for REIT management and is subject to corporate governance requirements imposed by license conditions.

Frequently Asked Questions

Q1 – Do the Trustee’s rights prevent the REIT Manager from having power over the relevant activities of a REIT?

No.

In accordance with the Securities and Futures Act (Cap. 289), its subsidiary legislation and the Code on Collective Investment Schemes, the Trustee is responsible for monitoring the activities of the REIT Manager for compliance with the limitations imposed on the investment and borrowing powers as set out in the Trust Deed in each annual accounting period. The Trustee is also under a duty to take into custody and hold the assets of the REIT in trust for the unitholders.

The right of the Trustee is considered to be *protective* in nature and not intended to prevent the REIT Manager from using the delegated decision making authority to manage the relevant activities of the REIT [FRS 110.B26].

Q2 –Is the kick-out right that is held by the Monetary Authority of Singapore (MAS) in its capacity as the Regulator, by itself, affirmed that the REIT Manager is using its decision making rights in the capacity of an agent for all unitholders?

No.

In accordance with section 286(14) of the Securities and Futures Act (Cap. 289), MAS may direct the trustee of a REIT to remove the REIT Manager and appoint a new REIT Manager only if the REIT Manager fails to comply with the Securities and Futures Act (Cap. 289) or the Code on Collective Investment Schemes.

Therefore, the kick-out right held by MAS is considered *protective* in nature and not intended to prevent the REIT Manager from using the delegated decision making authority to manage the relevant activities of the REIT [FRS 110.B26].

Q3 – Do the independent directors’ rights at the REIT Manager level prevent the Sponsor from having power over the relevant activities of a REIT?

No.

The independent directors are nominated, appointed by and can be removed without cause by the sponsor as the sponsor is the sole shareholder of the REIT Manager.

Whilst we understand the sponsors and independent directors are mindful of reputational risks, and will take into consideration the unitholders interests, this does not diminish the fact that the sponsor has the current ability to appoint and remove the independent directors at its sole discretion without involvement of the unitholders.

Q4 – At what level of unitholding would a sponsor consolidate a REIT?

The standard does not provide a threshold below which consolidation is not required.

Instead, the standard suggests that the stronger the rights held by other investors to remove the REIT Manager (kick-out rights), the more aggregate economic interest can be accepted. Conversely, the

weaker the kick-out rights, the less aggregate economic interest can be accepted while still being considered an agent.

Aggregate economic interest in FRS 110 refers to remuneration and other interests in the REIT attributable to the sponsor group (e.g. investments in units and guarantees) in aggregate.

Based on a typical REIT as illustrated in Appendix 1, the remaining unitholders are widely dispersed and the sponsor wholly owns the REIT Manager and the Property Manager which direct the relevant activities of the REIT, the following factors are relevant:

- kick-out rights held by the remaining unitholders are less likely to be exercised as the remaining unitholders are widely dispersed; and
- FRS 110 Example 14B suggests that based on the computation in Appendix 2, with weak kick-out rights, aggregate economic interest of 37% could lead to the conclusion that the fund manager is a principal.

FRS 110 requires an evaluation of the exposure to variability of returns from interests in the REIT, taking into account the *magnitude of and variability associated with* the aggregate economic interest in the REIT relative to the total variability of returns of the REIT. This evaluation is made primarily on the basis of returns expected from the activities of the REIT, but in marginal cases, consideration should also be given to the maximum exposure to variability of returns. The maximum exposure should reflect the maximum economic return a sponsor group could earn from its involvement with the REIT. The rationale for calculating the maximum exposure is to reflect some extreme scenarios so as to determine if at that extreme, it would change the conclusion.

The standard, however, does not include a mathematical formula that could be used to calculate variability of returns. Sponsors would have to develop a model with reasonable assumptions to determine both the expected level of return and the extent of exposure to variability of returns from the REIT.

In the specific fact pattern in Appendix 1, the sponsor has two interests for which the maximum effect should be factored into the calculation.

- (a) Fees are based on gross benchmarks (before effect of gearing) and the REIT Manager has the decision making authority to increase the REIT's gearing to 60%. This limit is imposed on the REIT in the Property Funds Guidelines.
- (b) Acquisition fee, divestment fee and asset management fee are earned if properties are purchased or sold (churned).

In addition, the calculation of maximum exposure should address the misalignment of interests between the sponsor and the unitholders as the sponsor, through the ownership of the Managers, participates at different levels of the revenue "waterfall" compared to the unitholders of the REIT. One way of accounting for the misalignment in computing aggregate economic interest is to assume the widest misalignment that is legally and economically possible.

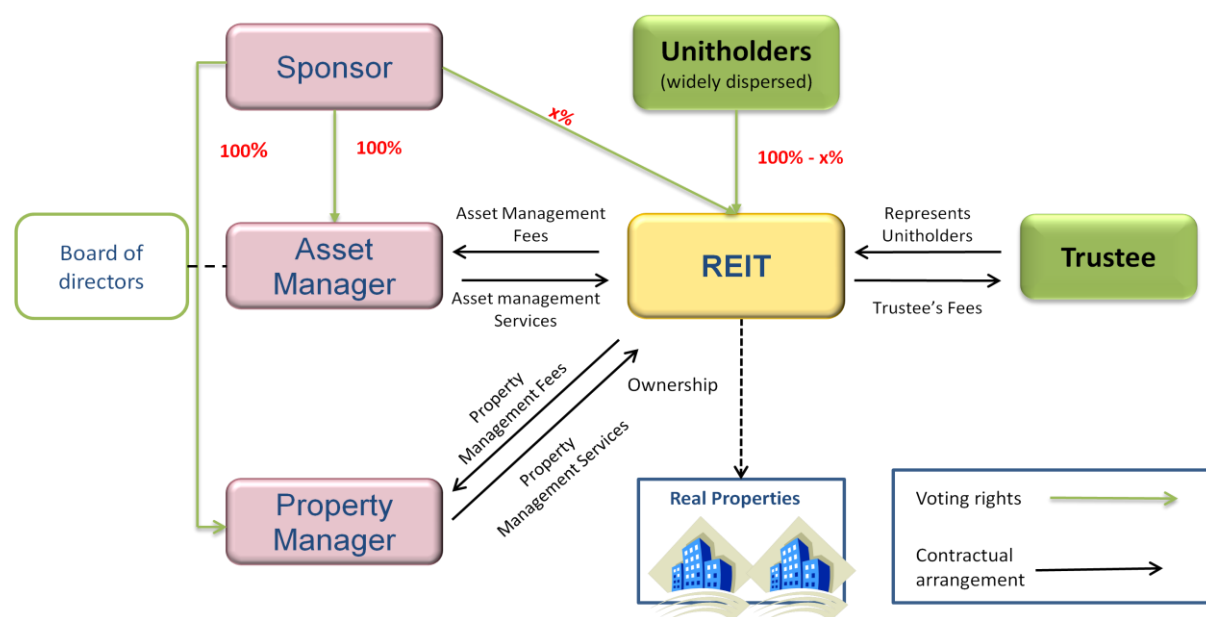
Some REITs may pay additional fees such as leasing commission, marketing service fee, project management fee, asset redevelopment fee etc. to the Property Manager. These additional fees also represent additional variable returns that should be included in the computation of aggregate economic interest.

Some REIT sponsors may have other forms of involvement with the REIT such as long-term master leasing arrangements, provision of income support and provision of use of trademarks and tradenames. Such involvement may represent additional variable returns from the REIT that are not available to other unitholders as the sponsor group may benefit or suffer additionally from the involvement. If the involvement is significant or results in the REIT being economically dependent on the REIT sponsor, these factors need to be considered.

Appendix 1: A Typical Singapore REIT

The REIT is set up as a collective investment scheme constituted by a Trust Deed³ and is listed on the Singapore Exchange (SGX) in the form of a unit trust after formation. The Monetary Authority of Singapore (MAS) regulates the offers of collective investment schemes (including REITs) in Singapore. Because the REIT is listed, it is supervised by SGX, the listing authority, and must also comply with the Singapore Listing Rules.

The following diagram illustrates the relationship between a typical REIT, the Sponsor, the REIT's service providers (the REIT Manager, the Property Manager and the Trustee) and the external investors (3rd party unitholders).



The Sponsor holds X% of the voting rights of the REIT and its wholly-owned subsidiaries are the REIT Manager and the Property Manager of the REIT. The REIT is funded partly by borrowings (35% gearing) and the remaining equity instruments are held by a large number of external investors (unitholders).

Purpose and design

The REIT is designed for the following purposes:

- 1) To be an investor of real estate assets that provide a steady rental stream to its unitholders;
- 2) To expose the unitholders to real estate price risk at a smaller capital outlay as compared to a direct investment in the real estate assets; and
- 3) To provide the Sponsor with an alternative way to divest the real estate assets and to redeploy the capital locked in these assets into higher yielding activities.

3rd party unitholders do not participate in the design of the REIT. As the typical features of a REIT structure are specified in the Code of Collective Investment Schemes and the guidelines which a REIT Manager has to adhere to are specified in the Guidelines on Criteria for the Grant of a Capital Markets Services Licence, although the Sponsor is involved in the establishment of the REIT, the Sponsor cannot unilaterally change the typical features of a REIT structure as all REITs must be authorised by MAS and all REIT Managers must be licensed by MAS.

³ The Trust Deed is the agreement between the REIT Manager and the Trustee that governs the way the REIT is legally organised and managed. It describes the duties and responsibilities of the REIT Manager and the Trustee, as well as the rights and interests of unitholders.

REIT Manager⁴

The REIT Manager is an entity wholly owned by the Sponsor, whose relevant activities are directed by voting rights. The REIT Manager makes decisions about the acquisition and divestment of properties within the investment guidelines, sets the annual operating budget for the management of the properties, makes decisions about tenant mix, enhancement and redevelopment of existing properties and decides the debt-equity financing mix and the hedging strategies of the REIT to optimise yield. These are the relevant activities of the REIT.

In return, the REIT Manager is compensated with a market-based fee using the following fee structure:

1. Base fee: 0.5% of gross property value under management
2. Performance fee: 4.5% of net income before gains on disposal or revaluation of properties
3. Acquisition fee: 1.0% of price of property acquired
4. Divestment fee: 0.5% of sale price of property sold

The REIT Manager can be removed by a resolution passed by a majority (50%) of unitholders present and voting at a meeting of unitholders duly convened and held. A general meeting may be convened at the request in writing of not less than 50 participants or participants representing not less than 10% of the issued units in the REIT. At such a meeting, if voting is taken on a poll, each unitholder is entitled to one vote based on the unitholdings of each attendee. If voting is by show of hands, each attendee will have one vote. The Sponsor is permitted to vote on a resolution to remove the REIT Manager.

The Trust Deed includes a provision that would allow MAS the right to remove the REIT Manager.

Board of directors (BOD)

The BOD is the BOD of the REIT Manager and the members are appointed by the Sponsor as the sole shareholder. In the REIT's annual report, the REIT states that the BOD is responsible for the overall management and corporate governance of the REIT Manager and the REIT. The REIT does not have a BOD.

Independent directors should make up at least one-third of the Board of the REIT Manager. An independent director is defined as one who has no relationship with the company, its related corporations⁵, its 10% shareholders⁶ or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement with a view to the best interests of the company.

The constitution of the REIT Manager requires all board resolutions concerning the REIT to be approved by the majority of the directors, including at least one independent director. This requirement, to have at least one independent director approves the matters in relation to the REIT, is imposed by the capital market license condition.

Property Manager

⁴ A REIT Manager is a capital market licensee for REIT management and is subject to corporate governance requirements imposed by license conditions.

⁵ The term "related corporation", in relation to the company, shall have the same meaning as currently defined in the Companies Act, i.e. a corporation that is the company's holding company, subsidiary or fellow subsidiary.

⁶ The term "10% shareholder" shall refer to a person who has an interest or interests in one or more voting shares in the company and the total votes attached to that share, or those shares, is not less than 10% of the total votes attached to all the voting shares in the company. "Voting shares" exclude treasury shares.

The Property Manager is an entity wholly owned by the Sponsor. The Property Manager manages the properties based on the parameters set in the annual operating budget and the strategic direction provided by the REIT Manager.

In return, the Property Manager is compensated with a market-based fee using the following fee structure:

1. Base fee: 3% of gross revenue of the properties
2. Performance fee: 2% of net property income of the properties

Trustee

The Trustee of the REIT is a financial institution and must be independent from the Sponsor group. At initial set up of the REIT, the Trustee is sourced by the Sponsor and is deemed approved by the unitholders when they subscribe for the units. The Trustee has a fiduciary duty to safeguard the rights and interests of all unitholders. It is the legal owner of the assets of the REIT and hence, controls the disbursement of funds and signs all legal documents involving the REIT. It also has the legal ability to veto the REIT Manager's decisions.

In return, the Trustee is compensated with a market-based fee based on 0.03% of gross property value under management subject to a floor of \$10,000.

The Trustee can be removed by a resolution passed by a super majority (75%) of unitholders present and voting at a meeting of unitholders duly convened and held. The Trust Deed includes a provision that would allow MAS the right to remove the Trustee.

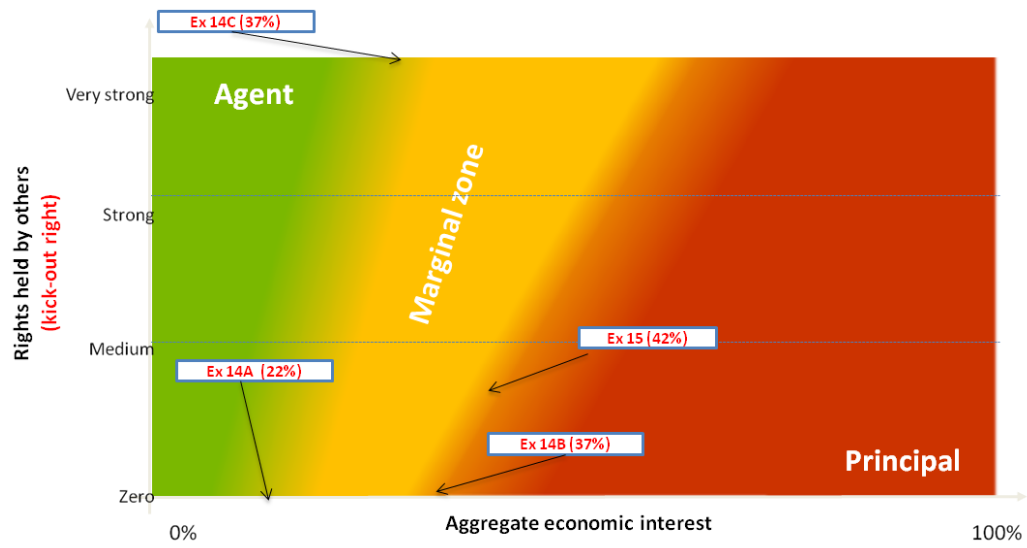
Appendix 2: Aggregate Economic Interest

The standard (as well as the *Effect Analysis* published by the IASB in September 2011 and republished in January 2012) provides examples of combinations of solely kick-out rights and aggregate economic interest, as shown below. From these examples (see table below), some fixed points about certain combinations can be derived.

In FRS 110 (and the *Effect Analysis*), the examples do not quote figures for aggregate economic interests. The variability is calculated based on the marginal return approach.

FRS Application Example	110 Fee	Performance fee	Interest held	Kick-out rights	Variability of aggregate economic interest	Agent/Principal?
13	1%	-	10%	None	$1\% + 10\% \times 99\% = 11\%$	Agent
14A	1%	20% over unspecified hurdle	2%	With cause only – zero weight	$1\% + 20\% \times 99\% + 2\% \times (80\% \times 99\%) = 22\%$	Agent
14B	1%	20% over unspecified hurdle	20%	With cause only – zero weight	$1\% + 20\% \times 99\% + 20\% \times (80\% \times 99\%) = 37\%$	Principal
14C	1%	20% over unspecified hurdle	20%	Without cause and held by a Board – very strong	$1\% + 20\% \times 99\% + 20\% \times (80\% \times 99\%) = 37\%$	Agent
15	1%	10% over unspecified hurdle	35%	Largely dispersed –weak	$1\% + 10\% \times 99\% + 35\% \times (90\% \times 99\%) = 42\%$	Principal
Effect analysis p.27	Immaterial (inferred)	Immaterial (inferred)	45%	None (inferred)	45%	Principal

Although these examples do not provide bright lines, they do narrow down the areas in which significant judgement is required to operationalise the model. By presenting them in the format below, the concept of a marginal zone between agent and principal becomes clearer. However, we do not suggest that such a chart can be used as a quantitative tool, it merely illustrates the basic idea.

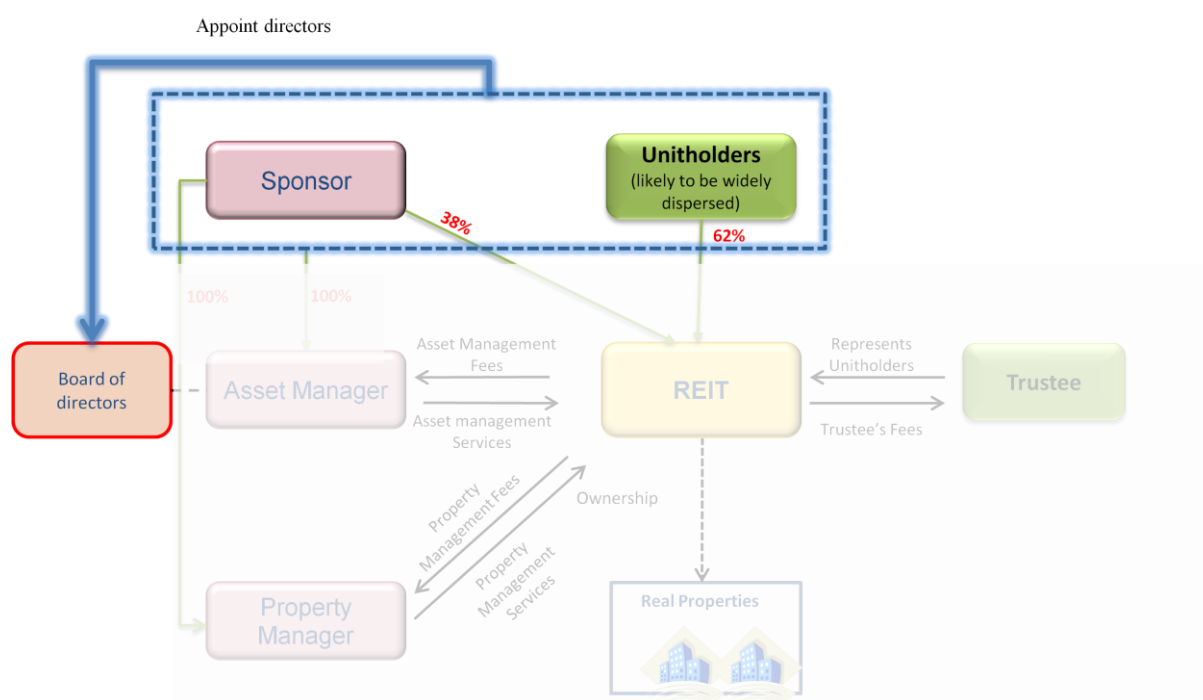


Appendix 3: An example of an alternative REIT Structure

Same fact pattern as Appendix 1 except that:

The sponsor relinquishes its right as the sole shareholder of the REIT Manager to appoint and remove the board of the REIT Manager. Instead, the right to appoint and remove the directors vests in the unitholders collectively through a separate arrangement.

The sponsor undertakes to the unitholders to appoint the directors who are approved by the REIT unitholders.



Analysis:

As set out in Appendix 1, the board is the governing body of the REIT Manager and makes the relevant decisions over the REIT's activities. Relevant decisions refer to decisions about the direction of REIT's activities that significantly affects the REIT's total return.

The underlying premise that the board is controlled by the unitholders is effected by the sponsor relinquishing its power to appoint and remove the board of the REIT Manager to the unitholders of the REIT.

Given that the board is effectively controlled by the unitholders of the REIT and the sponsor does not have majority of the units of the REIT and does not have *de facto* control over the REIT, it does not have power to direct the relevant activities of the REIT.

However, the sponsor should assess whether, as a unitholder, it has *de facto* control over the appointment of directors of the REIT Manager under FRS 110. Consolidation of the REIT is required if the sponsor has *de facto* control over the appointment of directors of the REIT Manager. The sponsor does not consolidate the REIT if it does not have *de facto* control over the REIT.

For this example, we would expect the sponsor **not** to have *de facto* control over the REIT if the rights given to the unitholders of the REIT are substantive. The presence of the following elements may suggest that rights are substantive and could effectively detach the sponsor from the decision making over the REIT:

1. Majority of the board members are independent of the sponsor.

2. The independent directors are actively involved in making the relevant decisions over the REIT's activities;
3. The sponsor does not dominate the process of nominating directors;
4. The board is required to and in practice does act in the best interests of all unitholders of the REIT;
5. The board makes decisions independently and does not take instructions from the sponsor; and

The sponsor's voting rights at previous unitholders' meetings (past voting patterns) do not provide conclusive evidence that it has the continuing ability to secure the majority of votes at future meetings in respect of election of directors. The above elements should be considered in aggregate, together with any other facts and circumstances, which may be relevant. No single element on its own would provide conclusive evidence about whether *de facto* control exists.

The sponsor should consider all facts and circumstances including past voting patterns on an ongoing basis as FRS 110 requires continuous assessment. If the facts and circumstances including past voting patterns provide persuasive evidence that the sponsor has *de facto* control over the appointment of directors, the sponsor should consolidate the REIT.

The sponsor should disclose the judgements made in the determination of *de facto* control in the consolidated financial statements.

Consolidation of REIT Manager by sponsor

The sponsor should separately assess whether it has control over the REIT Manager with its 100% equity interest in the REIT Manager.

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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.

Knowledge sharing with the accounting community is facilitated through a variety of print and online channels including the sharing of regular updates and thought leadership articles via in-house publications like the journal, "IS Chartered Accountant", the E-newsletter, "ISCA Weekly", and various online knowledge centres and a technical forum. Seminars and workshops are regularly organised and ISCA TSDA also provides value added technical clarification services to assist the profession in resolving accounting, auditing and ethics related issues.

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