GLOBAL TRANSPORT

Leases: Final Stop or Will the Discussion Continue?

Another US$30 billion of debt for the top rail and bus companies?

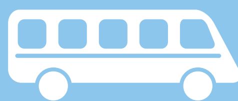
In this Rail and Bus briefing, KPMG reflects on what the proposed changes to lease accounting will mean for the Transport sector – a sector undergoing significant expansion as different countries seek to invest in their infrastructure to support economic development.

Proposal headlines

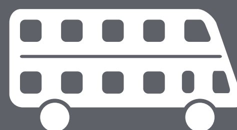
- A new dual model for lease accounting along with different classification tests for property and non-property leases
- A front loaded profile of total lease expense on most non-property leases
- Lease definition based on the use of an identified asset when the contract conveys a right to control the use of the asset
- A new requirement to monitor leases throughout the lease term and re measure assets and liabilities even if there is no change to the agreement
- Transition will require all existing and potential lease contracts to be reanalyzed

Key facts

Many lessee companies would see an **increase** in reported **assets and liabilities**



Proposals affect **'big-ticket'** vehicle leases and smaller items such as company cars and office space



New **'dual models'** for both lessees and lessors, with property leases retaining the straight-line expense method

Remaining leases will result **in amortization and interest expense** (similar to today's finance leases), which could adversely affect net profit

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What has happened?

- The IASB and FASB propose a major shake-up of lease accounting in revised proposals published in May 2013. If implemented these proposals are likely to have a significant effect throughout the industry, affecting both transport operators and asset suppliers/funders.
- At the moment, a significant number of companies pay for assets under so-called operating leases where neither the asset nor the value of their future lease payments is recognised on their balance sheet. These companies are known as lessees; including many bus and train operating companies.
- The new proposals would bring most lease liabilities and a related asset onto the balance sheets of lessees. KPMG International estimates that this could add over US$30 billion of debt to the balance sheets of the top rail and bus companies.
- The proposals would accelerate recognition of a lease expense for most leases of vehicles and rolling stock currently classified as operating leases, although EBITDA is likely to improve as lease rentals will now be presented as amortisation and interest.
- A complex new accounting model would apply to lessors who currently lend rolling stock and vehicles (i.e the companies such as suppliers and financiers which currently record the assets on their balance sheets), including ROSCOs and manufacturers.
- We encourage all interested parties to send their comments on the proposals to the IASB and FASB by the deadline of 13 September 2013.

Introduction

The International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) released a joint revised exposure draft on lease accounting on 16 May 2013 (the ED). There is a 120-day comment period. Both the IASB and the FASB have indicated that they will perform extensive outreach during the comment period.

Under the ED, operating lease agreements would be brought onto the balance sheets of lessees. A lessee would recognise a new lease liability and a corresponding 'right-of-use' asset that would be depreciated over the term of the lease.

Operating leases of vehicles in the bus industry and rolling stock in the rail industry are used extensively throughout the world. Capitalising these leases would significantly change the balance sheets of many transport operators. The proposed guidance would also significantly change the income statement profile for many leases, accelerating expense recognition compared to current operating lease treatment. Organisations who are about to enter into new lease arrangements should consider the impact of the new rules before making any financial commitments.

The ED aims to respond to long standing criticism that lease accounting has been too permissive of off-balance sheet treatment by lessees. However many may feel that the ED is overly complex and dominated by arbitrary rules.

KPMG has identified a number of issues with a likely significant impact on operators (lessees) and financiers (lessors), which are described below.

We encourage transport operators and financiers who wish to see these issues resolved prior to the issuance of a final standard to submit comment letters to the IASB and FASB before the comment deadline of 13 September 2013.

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Issues for rail and bus companies

1. Introduction of a new lease classification test

Proposal

IAS 17 *Leases* distinguishes between operating and finance leases. Leases under which 'significantly all' the risks and rewards of ownership of an asset are transferred to the lessee are defined as finance leases and are capitalised by lessees on the balance sheet. Leases other than finance leases are defined as operating leases. They are not capitalised by lessees and the related expense is generally recognised on a straight-line basis over the term of the lease.

FASB ASC Topic 840 *Leases* also distinguishes between an operating and a capital lease based on similar guidance; however, it also contains 'bright line' quantitative tests based on the present value of the future minimum lease payments and the economic life of the underlying asset.

The ED proposals introduces new dual lease accounting models – and a new lease classification test to assess whether a lease is Type A lease or Type B lease.

Underlying asset*	Lease classification
Non-property	Type A, unless: • the lease term is for an insignificant part of the total economic life of the underlying asset; or • the present value of the lease payments is insignificant relative to the fair value of the underlying asset.
Property	Type B, unless: • the lease term is for the major part of the remaining economic life of the underlying asset; or • the present value of the lease payments accounts for substantially all of the fair value of the underlying asset.

* defined as either (i) land and/or a building (classification property) or (ii) everything else.

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Type A and Type B leases would both be on balance sheet for the lessee – but with a different profile of lease expense. A lessor would apply a complex new accounting model to Type A leases but would continue to apply a version of current operating lease accounting to Type B leases.

The new threshold of 'insignificant' is critical in determining the classification and hence the accounting model to be applied to a lease arrangement could be an area of significant judgement in accounting for leases. This is particularly so in the case of 'big ticket' assets, such as rolling stock in the rail industry that cost a substantial amount and have long useful economic lives. For example, judgement would be required to determine what is insignificant in the context of the leasing of a train that costs US$15m and is expected to operate for 25 years or more.

The ED does not provide bright-line quantitative thresholds on what constitutes an 'insignificant part' of the total economic life of the underlying asset or 'insignificant amount' of the fair value of the underlying asset when performing the classification test for leases other than property. Some of the examples in the ED suggest that 16.6% of the economic life and 27.8% of the fair value would not meet the thresholds set above. It is not clear how much lower these percentages would need to be before an equipment lease is classified as a Type B lease.

Rail and bus industry implications

Lessee (transport operator) implications		Lessor (financier) implications	
The ED does not define what is significant or insignificant and, therefore, will require the application of judgement. Most existing operating leases will likely be for more than an insignificant part of the economic life of the vehicles or the rolling stock and similarly the lease rental payments will be more than insignificant, relative to the fair value of the underlying assets – except for the very shortest vehicle and rolling stock leases.			
Almost all existing rail and bus operating leases are expected to be classified as Type A under the proposals. Therefore, they would be recognised on the balance sheet and the lease expense in the income statement would be front loaded. This will lead to a greater income statement charge for interest in the first half of the lease when compared to the second half. The financial impact will be different depending on the current portfolio of operating leased vehicles and the strategy for managing lease renewals. For example, it is likely to accelerate recognition of total lease expense for a company that is expanding and entering into many new leases.		Most existing operating leases are expected to be classified as Type A under the proposals. Therefore, the lessor would derecognise the underlying leased asset and recognise a lease receivable for the right to receive payments and a residual asset. This will often result in day one profit on lease commencement and in the frontloading of lease income over the term of the lease. This may have implications for lessors seeking to raise funds in the capital markets. Without regular renewal or growth in a fleet, the income profile will always be declining, notwithstanding that the cash flows may be constant.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High

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2. Component accounting for the right-of-use asset

(This is a specific requirement under IFRS and not a requirement of US GAAP, therefore this is not relevant for companies that report their financial statements in accordance with US GAAP)

Proposal

The right-of-use asset that the operators would recognise in the underlying asset would be an intangible asset, though it would be presented as part of property, plant and equipment. It is unclear how the proposals interact with the requirements of IAS 16 *Property, Plant and Equipment* for component accounting and whether significant components of the right-of-use asset would have to be accounted for separately.

Rail and bus industry implications

Lessee (transport operator) implications	Lessor (financier) implications
Under IAS 16, operators and owners of assets are required to identify significant components of vehicles and rolling stock and separately assess the useful economic life and residual value. This ensures that the charge to the income statement is consistent with the use of the asset. Operators should generally welcome the ability to account for the right-of-use asset in the same way.	
Likelihood of Impact	**Potential Impact**
Moderate	Moderate

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3. Accounting for maintenance rentals/supplemental rents ("maintenance payments")

Proposal

In many transport related operating lease arrangements the transport operator (lessee) is obliged to maintain the vehicles and rolling stock at its own cost and to make payments to the lessor based on usage. The usage-based payments may or may not be related specifically to maintenance services provided by the lessor. If the lessor does not provide the maintenance service itself, then the lessor usually agrees to make a contribution to the cost of maintenance undertaken by the lessee. The detailed terms and conditions vary between agreements.

The ED does not include specific guidance on this complex topic. Lessees and lessors of rolling stock and vehicles will be concerned as to whether the application of the general principles of the ED is sufficiently clear to these arrangements and how the resulting accounting compares to the current, sometimes diverse, accounting approaches seen in practice.

A key step in the analysis would be to assess the nature of the maintenance payments – whether they are a separate non-lease component of the arrangement, or part of the lease.

If the maintenance payments are a separate non-lease component, then they would be accounted under the general requirements for revenue and maintenance costs.

If the maintenance payments are part of the lease, then they would often be accounted for under the ED's guidance on variable lease payments. This means they would not be included in the initial measurement of the lessee's lease liability or the lessor's lease receivable. Instead, the lessee would account for them as incurred. The lessor would include estimated maintenance payments in the residual asset on lease commencement; over the term of the lease, the lessor would recognise the actual maintenance payments as earned and write-off to profit or loss a portion of the expected payments included in the residual asset.

A further complication will be the treatment of payments by the lessor, including whether these should be seen as a reduction in the lessee payments, a lease incentive or a separate cash flow.

As a result of these issues there could be a significant difference in the profile of income and expense recognition. Also, lessors could face asymmetry regarding accounting for changes in expected return condition: if the asset is returned below its scheduled condition the lessor could face an impairment – but there is no mechanism to increase the carrying amount of the residual asset if the asset is returned in better than scheduled condition.

Rail and bus industry implications

Lessee (transport operator) implications		Lessor (financier) implications	
The maintenance accounting for rolling stocks and vehicles is complex. The interplay of existing maintenance accounting requirements under US GAAP and the multiple models under IFRS will require detailed review. Ultimately, the profile of maintenance expense over the term of the lease could be significantly different in some cases.		If maintenance charges are considered part of the lease, the lessor is likely to recognise variable lease payments relating to maintenance as income as earned, together with a corresponding expense reflecting the write-off of expected maintenance payments included in the carrying amount of the residual asset component. This treatment could give rise to significantly different reported results than those under current standards – potentially significantly changing both the timing and amount of maintenance income recorded over the term of a lease. Application of the proposals is likely to require development of additional models and systems to account for the residual asset and appropriately test the residual asset for impairment.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High

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4. Sale and leaseback transactions

Proposal

Some rolling stock and vehicle purchases by operators are immediately followed by a sale and leaseback transaction with a leasing company. These transactions result in a gain or loss, in either in the profit or loss or deferred on the balance sheet, being recognised by the operator and result in either an operating or finance lease of the underlying asset.

Under the ED, a sale and leaseback of the rolling stock or a vehicle would be recognised if the requirements for sale recognition in the forthcoming revenue recognition standard are met; otherwise, the transaction would be accounted for as a financing. The existence of the leaseback would not, on its own, result in a conclusion that the buyer-lessor did not obtain control of the underlying asset under the forthcoming revenue recognition standard's provisions. In all cases, a sale-leaseback transaction would be accounted for as a financing rather than a separate sale and leaseback if:

- the lease term is for a major part of the remaining economic life of the underlying asset; or
- the present value of the lease payments amounts to substantially all of the fair value of underlying asset.

Rail and bus industry implications

<table>
<tr><th colspan="2">Lessee (transport operator) implications</th><th colspan="2">Lessor (financier) implications</th></tr>
<tr><td colspan="4">The ED does not define how to determine a 'major part' or 'substantially all' and therefore each contemplated sale and leaseback transaction will require careful consideration and judgement as to whether it qualifies as such or is to be treated as a financing.</td></tr>
<tr><td colspan="2">Operators that engage in sale and leaseback transactions for commercial, financing or other financial reasons will need to reconsider their accounting due to the change in treatment under proposed guidance.

Under the proposals, there would be a reduced accounting incentive to conduct sale and leaseback transactions, because the transaction would always be on-balance sheet for the lessee. The only question would be the quantum of measurement of the asset and liability.</td><td colspan="2">If a current lease arrangement is assessed as a sale and finance leaseback under current IAS 17 and ASC 840, it is likely to be treated as not a sale but a financing arrangement. The exclusion of the transaction from the Leases standard will mean that receivables arising would not be lease receivables but would be within the measurement scope of IAS 39 Financial Instruments: Recognition and Measurement and, when effective, IFRS 9 Financial Instruments.

If this occurs, then arrangements that are assessed to be financings and not sale and leasebacks and contain options and interest or tax variations may fail the solely for payment of principal and interest ("SPPI") test under IFRS 9 and would consequently be accounted for at fair value through profit or loss. This treatment would differ from the current sale and leaseback accounting treatment under IAS 17.</td></tr>
<tr><th>Likelihood of Impact</th><th>Potential Impact</th><th>Likelihood of Impact</th><th>Potential Impact</th></tr>
<tr><td>High</td><td>High</td><td>High</td><td>High</td></tr>
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5. Other variable or contingent rentals

Proposal

Variable payments that depend on an index or a rate would initially be measured using the index or rate at the lease commencement date. The lease payments would then be recomputed at each reporting date if there is a significant change in the index or rate. Other contingent rentals would be recognised in the period to which they relate. For the transport industry, interest and tax variation clauses are common terms found in a lease arrangement and changes to interest and tax rates subsequent to the commencement dates are likely to be assessed as significant.

Rail and bus industry implications

Lessee (transport operator) implications		Lessor (financier) implications	
Lessees would be required to reassess the future cash flows and to adjust the right-of-use asset. This will introduce balance sheet volatility and make it difficult for lessees to forecast future covenant compliance etc. In some cases the lessee may not have all the necessary information to allocate the change between future and past periods particularly if the lease is a complex tax-based lease and/or if the lessee does not know the lessor's assumed residual value.		The lessor would have sufficient information and may not find it difficult to perform the reassessment and adjustments, when required. The lessor however, may face an operational challenge as it may be inundated with requests for information from lessees with such variable rental arrangements.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High

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6. Identification and separate treatment of service component

Proposal

If a contract includes a service component, then the lessee would account separately for the components unless there are no observable prices that can be used to allocate the payments between service and lease components. Lessors would always account for the components separately, using the revenue guidance to allocate payments.

Rail and bus industry implications

Lessee (transport operator) implications	Lessor (financier) implications
Some rolling stock and vehicle leasing contracts involve items such as complicated maintenance / supplemental rent arrangements (where the basis of the calculation is not clearly set out based on observable market prices) or the provision of operating crew that are likely to require significant judgment in distinguishing between service and lease components and allocating payments. Whilst this requirement is not new the accounting implications of identifying service contracts versus leases are likely to be greater. Lessors may also see increased requests from lessees to restructure their existing leases or to structure new arrangements so as to include more service components than lease elements, thereby reducing the grossing up of their balance sheets and leverage. The proposals could give rise to more fundamental changes to the leasing sector, whereby lessees request provision or access to an asset (say, a vehicle) with particular specifications or characteristics, which may be sourced from a common pool of such assets, thereby changing the arrangement to being more of a service to that of a lease – such arrangements would likely favour larger lessors who might be able to facilitate such arrangements, and transport operators or alliances who share similar types of assets and could benefit from such arrangements.	

Likelihood of Impact	Potential Impact
Moderate	High

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7. Requirement for additional disclosures

Proposal

The lessee would be required to present or disclose its lease liabilities separately from other financial liabilities. The right-of-use assets would be presented or disclosed separately from property, plant and equipment that the entity does not lease. The amortisation of the right-of-use asset and the interest expense on the lease liability would be required to be presented separately from other amortisation and interest expense. Similarly, lessors would be required to present lease receivables separately from other financial assets and the residual assets separately within property, plant and equipment.

For leases featuring accelerated expense recognition, payments of principal would be presented as financing activities, payments of interest would be presented as either operating or financing activities, and payment of variable amounts would generally be presented as operating. Lessors would be required to show all cash payments under leases as operating cash flows.

Rail and bus industry implications

Lessee (transport operator) implications		Lessor (financier) implications	
The requirements are more detailed and may be more onerous to apply than the current requirements in relation to finance leases that are recognised on the balance sheet or indeed current off-balance sheet operating leases.			
The separate recognition of the right-of-use asset for the rolling stock and vehicles in particular may be confusing to users of the financial statements.		Lessors may expect that the quantum of the lease receivable balance may increase focus of users more towards credit risk associated with lessees rather than asset risk associated with assets. Lessors may be required to provide, and users may seek information about concentration risk, geographical dispersion and expected periods of recovery of lease receivable balances.	
Likelihood of Impact	**Potential Impact**	**Likelihood of Impact**	**Potential Impact**
High	High	High	High

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8. Introduction of new terminology and thresholds specific to leases

Proposal

The ED includes a number of terms that have not previously been used under IFRS or US GAAP. These include:

- significant economic incentive;
- threshold tests; and
- right-of-use asset.

Rail and bus industry implications

Lessee (transport operator) implications	Lessor (financier) implications
The current IAS 17 and ASC 840 terminology and classification criteria relating to finance/capital leases and operating leases are well understood by preparers and users of financial statements. There is a risk that introducing new, additional terms may create unnecessary complexity.	
Likelihood of Impact	**Potential Impact**
Low	Low

9. Overview and effective date

The ED does not provide an effective date for the new standard and does not specify whether early adoption will be permitted. However, it seems unlikely that entities would be required to adopt the new lease requirements before the effective date of the Boards' new standard on revenue recognition. The Boards have decided tentatively that the new revenue standard would be effective for annual periods beginning on or after 1 January 2017. Early adoption of the revenue standard would be permitted under IFRS but not US GAAP.

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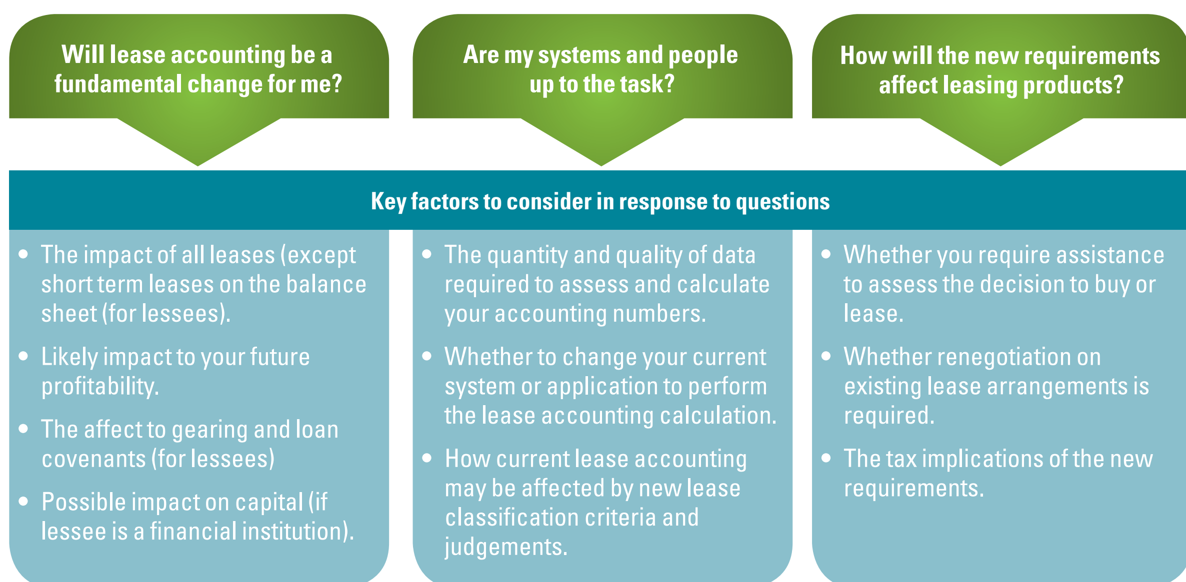
Do you require further assistance in dealing with the Leases ED?

KPMG firms are some of the leading advisors to the rail and bus industries. We are well positioned to help you understand the potential impacts of the Lease ED on your business.



KPMG provides a framework for dealing with this accounting change. In addition, KPMG has developed a Web-based tool to assist organisations with their preparedness activities and eventual adoption of the new leasing standard. The tool can help companies make the conversion to the new lease accounting standard more efficient. The Web-based tool is hosted in our private cloud allowing for easy maintenance and future upgrades. In addition, by allowing KPMG to host the tool, companies can benefit from improved efficiency and flexibility in terms of data storage, processing, and security. KPMG can also offer companies the option to install the tool within their IT environment through a licensing agreement.

Tax Considerations

The proposals may have significant impacts on the tax treatment of leasing transactions in many jurisdictions, in particular in those where the treatment for tax purposes is often based on or follows the accounting principles. As there is no consistent leasing concept for tax purposes globally, the effect of these proposals will vary from jurisdiction to jurisdiction, and the likely impact that the proposals may have will similarly vary from jurisdiction to jurisdiction.

KPMG contacts

To discuss this further, contact your local member firm, or the contacts listed in the brochure in your region.

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KPMG Contacts

For more information, please contact a professional from the following KPMG member firms.

Global Leadership

Dr Ashley Steel
Global Chair – Transport
15 Canada Square
London, E14 5GL
U.K.

T: +44 20 7311 6633
E: ashley.steel@kpmg.co.uk

Dr Steffen Wagner
Global Head of Rail and Bus
The SQUAIRE
Frankfurt, 60549
Germany

T: +49 69 95871507
E: steffenwagner@kpmg.com

John Luke
Partner - Transport
15 Canada Square
London, E14 5GL
U.K.

T: +44 20 73116461
E: john.luke@kpmg.co.uk

Contact us

Argentina
Eduardo H Crespo
+54 11 4316 5894
ecrespo@kpmg.com.ar

Australia
Malcolm Ramsay
+ 61 2 9335 8228
malramsay@kpmg.com.au

Belgium
Serge Cosijns
+32 3 821 18 07
scosijns@kpmg.com

Brazil
Mauricio Endo
+55 11 3245 8322
mendo@kpmg.com.br

Canada
Laurent Giguère
+1 514 840 2393
lgiguere@kpmg.ca

Chile
Alejandro Cerda
+56 2 798 1201
acerda@kpmg.com

China
Jeffrey Wong
+86 21 2212 2721
jeffrey.wong@kpmg.com

Costa Rica
Erick Brenes
+50622014100
erickbrenes@kpmg.com

Cyprus
Sylvia Loizides
+357 25869104
sylvia.loizides@kpmg.com.cy

Czech Republic
Eva Rackova
+420 222 123 121
evarackova@kpmg.cz

Denmark
Jesper Ridder Olsen
+45 7323 3593
jesperolsen@kpmg.dk

East Africa
Mahesh Punia
+254 20 2806126
mpunia@kpmg.co.ke

Finland
Pauli Salminen
+358 20 760 3683
pauli.salminen@kpmg.fi

France
Philippe Arnaud
+33 1 5568 6477
parnaud@kpmg.fr

Germany
Steffen Wagner
+49 69 9587 1507
steffenwagner@kpmg.com

Greece
Dimitra Caravelis
+30 2106062188
dcaravelis@kpmg.gr

Hong Kong
Shirley Wong
+852 2826 7258
shirley.wong@kpmg.com

Hungary
Zoltan Szekely
+36 1 887 7394
zoltan.szekely@kpmg.hu

India
Manish Saigal
+912230902410
msaigal@kpmg.com

Indonesia
David East
+62 215740877
david.east@kpmg.co.id

Ireland
Michele Connolly
+353 1 410 1546
michele.connolly@kpmg.ie

Israel
Guy Aharoni
+972 4 861 4801
gaharoni@kpmg.com

Italy
Alessandro Guiducci
+39 010 553 1913
aguiducci@kpmg.it

Japan
Atsuki Kanezuka
+81 3 3266 7002
atsuki.kanezuka@jp.kpmg.com

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Korea
Ha Kyoon Kim
+82 2 2112 0271
hakyoonkim@kr.kpmg.com

Luxembourg
Philippe Neefs
+35222 5151 5531
philippe.neefs@kpmg.lu

Malta
Pierre Portelli
+356 2563 1132
pierreportelli@kpmg.com.mt

Malaysia
Hasmanyusri Yusoff
+60377213388
hyusoff@kpmg.com.my

Mexico
Alejandro Bravo
+525552468360
labravo@kpmg.com.mx

Mozambique
Reny Varkey
+25821355200
rvarkey@kpmg.com

Netherlands
Herman van Meel
+31 20 656 7222
vanmeel.herman@kpmg.nl

New Zealand
Paul Herrod
+64 9 367 5323
pherrod@kpmg.co.nz

Norway
John Thomas Sørhaug
+47 4063 9293
john.thomas.sorhaug@kpmg.no

Panama
Glenn Tjon
+5072080700
gtjon@kpmg.com

Peru
Victor Ovalle
+5116113000
vovalle@kpmg.com

Poland
Andrzej Bernatek
+48225281196
abernatek@kpmg.pl

Portugal
João Augusto
+351 210 110 000
jaugusto@kpmg.com

Qatar
Gopal Balasubramaniam
+97444576444
gopalbala@kpmg.com

Russia
Alexei Romanenko
+7 495 663 8490 ext.12694
aromanenko@kpmg.ru

Saudi Arabia
Ebrahim Baeshen
+96626581616
ebaeshen@kpmg.com

Singapore
Wah Yeow Tan
+65 6411 8338
wahyeowtan@kpmg.com.sg

South Africa
Dean Wallace
+27 83 251 9585
dean.wallace@kpmg.co.za

Spain
David Hohn
+34 91 456 3886
dhohn@kpmg.es

Sweden
Anders Rostin
+46 8 723 9223
ander.rostin@kpmg.se

Switzerland
Marc Ziegler
+41 44 249 20 77
mziegler@kpmg.com

Taiwan
Fion Chen
+886 2 8101 6666
fionchen@kpmg.com.tw

Turkey
Yavuz Oner
+90 216 681 90 00
yoner@kpmg.com

U.A.E.
Andrew Robinson
+9 71 4356 9500
arobinson1@kpmg.com

U.K.
Ashley Steel
+44 20 7311 6633
ashley.steel@kpmg.co.uk

U.S.A.
Chris Xystros
+1 757 616 7009
cmxystros@kpmg.com

Uruguay
Rodrigo Ribeiro
+59829024546
rribeiro@kpmg.com

Vietnam
John Ditty
+84 8 3821 9266
jditty@kpmg.com.vn

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