



cutting through complexity

TRANSPORT

# Shipping Insights

Issue 5

Turning risk  
into advantage

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# Introduction



**Risk and operational excellence are two topics at the top of the Boardroom agenda. Both are covered in this, our fifth edition of Shipping Insights, KPMG's regular publication which seeks to shine a light on the emerging trends and issues most relevant to the Boards of shipping groups across the world.**

The general consensus is that the global economy is on the mend, and accordingly the shipping sector is forecast to follow. However, whilst certain subsets of the shipping sector are looking a little more buoyant, the structural issues in other subsectors – over capacity, non-performing loans – remain.

Many shipping companies that have been gripping their businesses, shoring up balance sheets and cash flow problems are now looking at ways to unlock business potential. But before longer term growth arrives, operating more efficiently and effectively whilst managing and mitigating risk are the order of the day.

In this publication we cover the following five areas:

## **Who's looking at risk?**

In this article we consider the types of risks organisations are grappling with, and how companies are investing more significantly in governance, risk and compliance functions to monitor and help mitigate risks.

## **Every drop matters**

We shine a light on new and potentially market-shifting analysis that considers operational effectiveness of the global shipping fleet. The data collected by University College London highlights that ship fuel efficiency is currently well below theoretical consumption. With bunker costs rising, understanding and interpreting this new intelligence may alter the way in which shipping companies operate in the future.

## **Managing third party risk**

Knowing who you do business with matters. In this article we assess how companies can more robustly verify their supply chains and, following a recent

KPMG survey, we highlight just how risky doing business can be.

## **A view of the future: 2017 – bigger balance sheets**

In June 2013 we issued a Shipping Insights Briefing alerting the Finance Community within the Shipping sector to significant forthcoming changes to the way in which leases are accounted for. In this article we highlight the key points arising from the briefing, showing why the consequences of the accounting proposals could cut across all aspects of future business.

## **Reforming Brazil's ports**

In May 2013 the Brazilian Government announced major changes to the way in which it will support Brazil's port infrastructure. With a population of over 200 million and a country rich in natural resources unlocking some of the logistics chain bottlenecks could have a significant impact on the prosperity of the country and increase its attractiveness for inbound investment.

KPMG's global transport network comprises over 3000 professionals in 156 countries dedicated to helping companies within this critical sector and its supply chain. If any of these topics raise concerns or questions within your organisations then I would encourage you to get in touch with your usual KPMG contact, or link up with our network.

## **John Luke**

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# Who's looking **at risk**?



In mid super cycle there are no bad decisions? Or at least, there are few catastrophically bad decisions. However, the shipping market has turned and may never quite reach the same peak again. Against this backdrop risk assessment, management and mitigation are critical if companies are to survive and thrive in the challenging new world.

Complexity and risk have been standard fare for many Boards and Audit Committees, yet a changing business and complex risk environment – rapidly being reshaped by technology, globalisation, increased government regulation and expectations for greater transparency – mean that the understanding of risk and how risk is being managed and monitored should now be centre stage for every CEO.

## What is risk?

So what are KPMG member firms saying about risk?



In a recent Economist Intelligence Unit (EIU) survey<sup>1</sup>, nearly half of respondents said that it was the executive management team which is the stakeholder group exerting greatest pressure on organisations to improve governance, risk and compliance functions ("GRC"). Regulators, auditors and investors were only second, third and fourth respectively.

Internal Audit, Compliance or Operational Audit (together referred to as "Internal Audit" for the remainder of this report) is now arguably more important than it has ever been. Companies that have failed to invest in GRC and Internal Audit are focussing on how to catch up.

Shipping is like no other industry, yet it is not alone in grappling with how best to manage risk internally. In a recent KPMG survey<sup>2</sup> of over 1,800 worldwide Audit

Committee members, the summary findings were quite stark:

- Only 37 percent said their company's risk management programme was "robust and mature", with 45 percent saying that the programme required "substantial work";
- Only one in four said that the company's risk management process "extends far enough into the horizon"; and
- The quality of risk related information within organisations continues to be an area of concern.

## What risks need to be considered?

KPMG's Audit Committee survey identified five risk-types (excluding those relating to financial reporting risk) which respondents considered pose the greatest challenges for companies. In order of importance:

1. Uncertainty and volatility (economic, political, social);
2. Government regulation and impact of public policy initiatives;
3. Operational risk/control environment;
4. Legal and regulatory compliance; and
5. Technology (including data privacy, protection of intellectual property and pace of technology change).

<sup>1</sup> Economic Intelligence Unit Survey, Expectations of Risk Management Outpacing Capabilities – Its time for action, KPMG International

<sup>2</sup> KPMG Audit Committee Institute, Global Audit Committee Survey, January 2013

How much assurance do you need?

Absent specific regulatory pressures (perhaps the requirements of local stock exchanges), companies needn't have Internal Audit functions. However, all companies should be assessing risk appetite and thereafter the extent of control and assurance needed.

What is clear from the breadth of risks identified to the right is that they cross all aspects of running a business; are unlikely to be areas where you have all the in-house skills at your disposal to effectively manage and monitor them; and are not areas which external auditors typically spend any meaningful amount of time assessing.

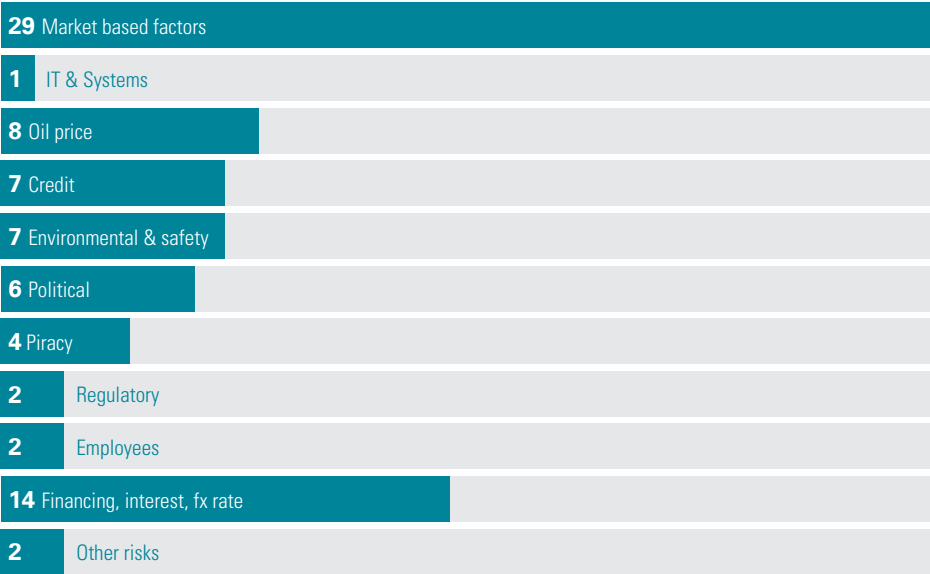
Only when you have an holistic view of risk appetite, financial and non financial controls and processes, business controls and existing assurance work flows can you truly consider the positioning, people and processes required of an in-house or in-sourced Internal Audit function.

What's the assurance landscape in shipping?

Assessing the level and remit of Internal Audit within shipping companies is almost impossible from publically available information. We have reviewed the Annual Reports and Corporate websites of some of the larger global shipping companies to obtain a picture of the assurance landscape.

It is not possible to assess the size of in-house Internal Audit departments or their budgets. Fifty five percent of

Common risks for shipping companies



Source: Annual Reports of 20 large shipping companies for 2012 (of the sample, 70% were listed on a regulated stock exchange).

companies we reviewed publically state that they have Internal Audit functions (or similar). This statistic is likely to be far higher than if you looked at the sector as a whole. In KPMG member firms' experience, outside the listed company environment and with smaller companies the extent of Internal Audit activity tails off considerably. So a key question is "who is monitoring risk"?

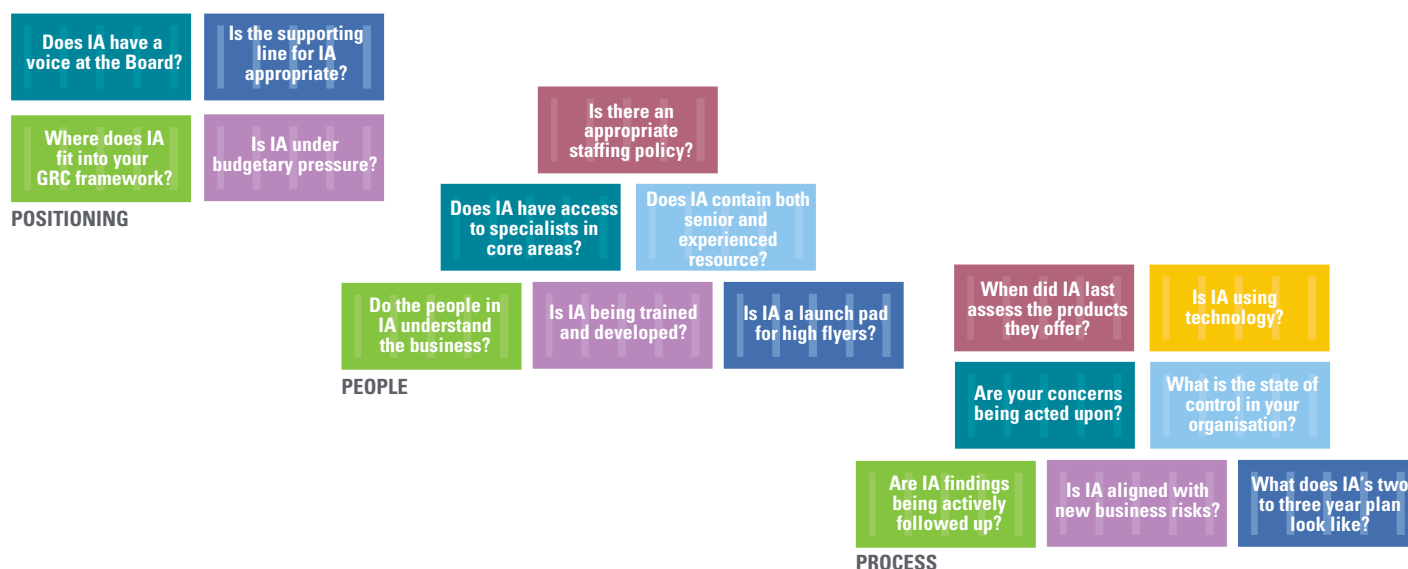
Almost all the companies we looked at identified key risks in their most recent Annual Reports. With some common themes and many aside from financial reporting risk, Internal Audit departments and assurance providers have a big challenge.

When comparing these results to the KPMG survey, the key risk not being so frequently identified is that relating to IT and data security. This is perhaps somewhat surprising when you consider the complexity of IT systems operated by shipping companies and the extent of potentially sensitive data being stored.

Given the current downturn in the shipping market, it is to be expected that companies are focused on market based risk. Managing these risks will be critical to prosperity.



## Does the opinion of Internal Audit count in your organisation?



## How effective is your Internal Audit function?

The structure and remit of Internal Audit functions varies significantly across businesses, and few businesses regularly challenge whether efforts are being targeted in the right areas. Some businesses have a very narrow view of the role of Internal Audit – traditionally focusing on financial controls that support the financial statements. In today's environment, where the spot rate for a Capesize is perhaps a tenth of where it was at the top of the cycle, companies need to re-define Internal Audit's role. Internal Audit is often most effective when it is focused on the critical risks to the business, including key operational risks and related controls. Internal Audit can use the rigour of its traditional strong financial control environment to bring advantages to the front line of businesses. Internal Audit needs to be talking to other functions within the organisation and ensure that control gaps are plugged. Tomorrow's Internal Auditor will become an increasingly valuable resource.

As shipping companies pursue new strategies, seek operational excellence and exploit tomorrow's opportunities, an excelling Internal Audit (or broader assurance) function will be a valued advisor to the Board. Leading Internal audit teams will be expanding their focus, truly integrated with the risk agenda and become a proactive, strategic partners.

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# Every drop **matters**







Picture the scenario. You pick up a new car from the local dealer. Whilst it looks great, one of the key reasons you bought it was down to the fuel efficiency – the manufacturer's claim over the model's miles per gallon (mpg). Driving along, you flick on the car's computer system and can't help noticing that the mpg you are achieving is some way off where you believe it should be!

With the advent of the Energy Efficiency Design Index ("EEDI") and the ever-expanding claims of the new breed of 'eco ships', there has been a clear focus on the technical energy efficiency of the world fleet – or rather the energy efficiency of a ship when operated in its as-designed condition.

However, as car owners, we know there can be a world of difference between the 'as designed' efficiency and the efficiency and fuel consumption of a vehicle in practice.

Fuel efficiency of ships is a complicated matter, influenced not only by a vessel's design characteristics, but also by size and the speed they travel. And when it comes to a shipping company's bottom line and profitability, it is not the hypothetical technical efficiency that a ship can achieve, but the actual fuel consumption, per unit of revenue, that matters.

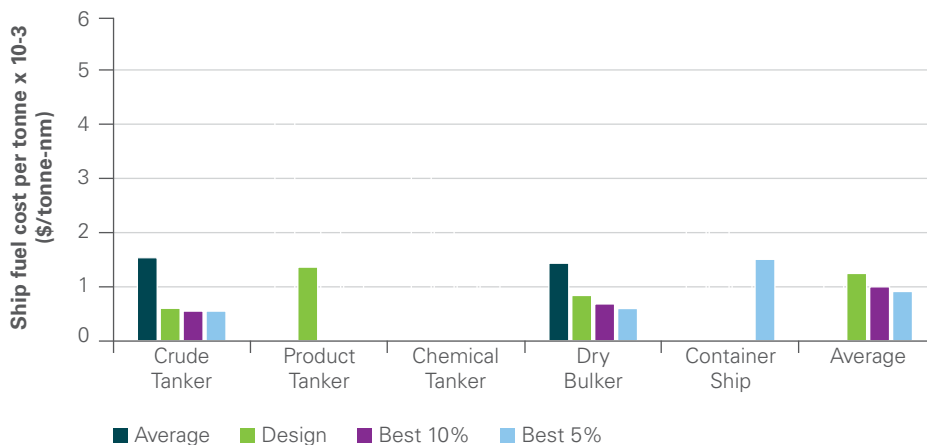
Collecting data on their own fleet's fuel consumption has been at the core of shipping companies' activities for decades. However access to data and analysis that enables a company to benchmark its measured performance against their competitors estimated performance, with a metric such as operational efficiency 'fuel consumed per unit of transport supply or revenue', has until recently been somewhat more difficult.

Two key steps have enabled a new data source to progress insights into this for the first time:

- access to new satellite gathered data describing deep sea movements of about 36,000 ships within the global fleet; and
- the development of models to estimate an individual ship's performance and fuel consumption while at sea.

With this in mind KPMG in the UK and University College London's ("UCL") Energy Institute recently teamed up with the International Council for Clean Transportation ("ICCT") to produce the first ever analysis of the global shipping fleet using Satellite AIS to assess ships' activities and derive estimates of fuel consumption and operational efficiency.

The method, developed by UCL Energy Institute uses two data sources, Satellite Automatic Identification System ("AIS") data describing shipping activity (position, speed, heading) and Clarksons World Fleet Register data (hull and machinery technical specifications). The satellite data requires careful processing to remove spurious observations and prepare a robust and reliable dataset for assessment of shipping activity (time spent in port, at sea, in loaded and ballast, and at different speeds). These outputs, calculated for every individual observed ship are then used as inputs to models of the naval architecture and marine engineering fundamentals to represent the behaviour of the ship in real conditions (fouling and weather) and the variation of fuel consumption as a function of ship speed. The processed



Source: UCL Energy Institute analysis

activity data is then used to estimate fuel consumption and efficiency statistics for a range of aggregations (ship type, size etc) of the global fleet.

The chart above illustrates just how much value leakage some ships are experiencing, operating well below design capability. Worryingly for the owners and/or operators of these ships, is the 'best in class' ships are costing half as much to run.

The results also provide justification for not just a two-tiered, but a multi-tiered market.

From a commercial perspective, the analysis has revealed several further insights:

- New ships with high technical efficiency – as promoted by the EEDI standards – are translating to more efficient vessels in real-world operating conditions;
- Much of the difference in operational efficiency between different ship types can be attributed to the difference in average ship capacity, since ship size is such a significant driver of energy efficiency. However, the data reveals just how broadly a ship's operational energy efficiencies can vary within a ship type (i.e.,

tankers). One of the core underlying reasons for this variation is the average speed at which ships are operating;

- For crude tankers, for example, differences in operational efficiency can be attributed predominantly to the fleet's heterogeneity in speed (a range of 9 to 16 knots), rather than capacity utilization;
- The results indicate that ships tend to be operated, in 2011, at an average of 15% below their design speed. Some ship types are found to operate at lower relative speeds (e.g. container ships at 23% below design speed), whereas others are at higher relative speeds (e.g. chemical tankers, dry bulkers, and LPG tankers at about 10% below design speed); and
- The results suggest that the differences between best and average in class are consistently significant across all sub-sets. Some of the best are managing to 'beat the design', which warrants further analysis.

These results are particularly interesting considering speed is a function of the market, where ship owners face the trade-off between costs and revenue that pull speed in opposite directions. A slower speed means the duration of

the voyage is longer which affects a shipper's inventory costs and reduces potential future employment, while a faster speed increases voyage costs. These important considerations are driven by current freight rates, expectations about future earnings and fuel costs.

Capturing this information has moved the dial in terms of business intelligence and strategic planning and cuts across the whole procurement and supply chain. Imagine a world where you could understand how better or worse your fleet was performing against the competition. Armed with this knowledge you would likely:

- Make more informed and perhaps different decisions about when and what ships to order;
- Alter the way you operate your fleet, and potentially the way you incentivize your work force; and
- Potentially change the way you transact with your customers.

In a world where operating margins are far tighter, gripping and altering the business model may make all the difference.

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The UCL Energy Institute delivers world-leading learning, research and policy support on the challenges of climate change and energy security. KPMG and the UCL have collaborated on a number of projects related to Low Carbon Shipping.





“ Some of the best are managing to ‘beat the design’, which warrants further analysis, whilst in Product Tankers no operator is getting close. ”

# Managing third party risk: smarter solutions to protect your business



Knowing who you do business with matters. The consequences of not knowing your business partners could be severe. Whether as a result of commercial imperatives to avoid vulnerabilities in your supply chain or regulatory pressures driving you to improve governance standards, third party due diligence is an increasingly critical aspect of your company's risk management. Yet supply chains have been stretched and complicated to such an extent that it is increasingly difficult to understand who you are really doing business with.

Managing third party integrity risk is one of the priority risks facing shipping companies as the regulators get tougher and the impacts of the global financial crisis spread financial vulnerabilities deeper across the supply chain, making companies more likely to cut corners and increasing integrity risks. This is causing many companies to re-examine their approach to third party risk and due diligence.



**“ The Islamic Republic of Iran Shipping Lines...uses an array of deceptive practices to conceal its identity and skirt sanctions – including falsifying shipping documents, changing names and nominal ownership of vessels, and even repainting ships. It has also sought to assign vessel ownership to front companies outside Iran. ”**

Stuart Levey, the US Treasury Department's undersecretary for terrorism and financial intelligence, *Financial Times*, August 2010

### The issues

There are three key areas where regulatory pressures require companies to conduct third party due diligence:

- i) Anti-bribery and corruption;
- ii) Anti-money laundering; and
- iii) Trade sanctions and export controls.

Any third party relationship not scrutinised for regulatory breaches or reputational and integrity risks could cause your company significant losses not only in terms of potential criminal or financial penalties – fines, debarments, director jail time – but also lost management time, legal fees, extra supply chain delivery costs, loss of market share and, not least, reputational damage.

The last few years have seen a growing emphasis by the US and European governments on enforcement of anti-bribery and corruption, anti-money laundering and sanctions regulations. Trade sanctions (dominated by Iranian and Syrian sanctions) pose an obvious risk to the shipping industry and the requirements of the law are clear: you must not do business with an entity on a sanctions list. Anti-money laundering and anti-bribery and corruption laws

generally follow a risk-based approach, which can make it more challenging to determine how to mitigate the risk of a regulatory breach.

However, these regulations all place emphasis on the requirement to understand who your third parties are and ensuring that they are not acting in an illegal or unethical way on your behalf without your knowledge.

The US Department of Justice, for example, has issued more than US\$2 billion in criminal penalties to firms in relation to bribery and corruption since 2009 and the Securities and Exchange Commission (“SEC”) has brought more than 40 civil enforcement actions. Many of the enforcement actions have affected companies who have indirectly and sometimes unwittingly paid bribes through intermediaries and business partners. One of the most high profile Foreign Corrupt Practices Act (“FCPA”) cases in 2010 involved a freight forwarder; the case not only affected the company directly, but many of those firms who used its services.

The shipping sector is widely regarded as high risk for bribery and corruption for a number of reasons. Shipping companies operate in many jurisdictions with high levels of corruption; and they

must regularly deal with foreign agents and government officials, increasing their exposure to corruption and demands for facilitation payments. Shipping companies often provide services to clients in the natural resources sector, which is an industry also susceptible to corruption risk.

Another area where shipping companies face considerable risks is in transacting with entities or ships which are the subject of US sanctions against Iran. The Specially Designated National (“SDN”) sanctions lists, as designated by the Office of Foreign Assets Control (“OFAC”) of the US department of Treasury, make specific references to ships, as well as companies, organisations and individuals.

It is not always easy for private companies to identify when a company or a ship is sanctioned. Iran's national maritime carrier, Islamic Republic of Iran Shipping Lines (“IRISL”), which has been designated by the US and EU as supporting Iranian “nuclear proliferation activities”, is known to use front companies incorporated in a range of different jurisdictions. Sanctioned tanker companies may also reflag their ships, often without the knowledge of the country to which the flag belongs.

Although the penalties for sanctions breaches are serious, they are avoidable. The risks of transacting with a sanctioned entity can be mitigated by asking some standard due diligence questions: Who are the beneficial owners of the purchasing company? Is there any link between the beneficial owners or directors of the purchaser and the Islamic Republic of Iran? These questions are not always easily to answer, of course, but understanding beneficial ownership of third parties is a core part of any integrity due diligence exercise.

### Reputational risk

Reputational risk is as important a driver for conducting thorough due diligence on third parties as regulatory risk. It could be argued that reputation damage lasts far longer than regulatory sanctions.

The increasingly tough stance taken by the US and other European regulators on bribery and corruption, sanctions and money-laundering is mirrored by the growing scrutiny of the general public on companies and their third party relationships. For example, the horsemeat scandal in the European retail industry that emerged in 2013 focused the public's attention on how large retail firms were managing their supply chain and understanding their third parties. Consumers lost trust in those at the heart of the scandal: for one UK supermarket chain, sales fell by over 5 percent in the quarter after the scandal hit the headlines.

### The challenge of managing third party risk

Companies in the shipping sector typically have complex supply chains that involve multiple providers spanning multiple countries.

Companies in the sector reasonably ask whether they can effectively conduct due diligence and monitor every third party relationship. Regardless of the number of a company's business partners and the complexity of the supply chain, the key to successful management is proactive due diligence on third parties using a risk-based approach. This means having a clear methodology for assessing and ranking third parties and focusing the most resources on the highest risk relationships.

### Leading practice approaches

KPMG member firms work with companies in the shipping industry suggests that whilst many have clear policies and procedures in place to support their staff in detecting or preventing internal breaches of bribery and corruption, money laundering or sanctions risks, few have a globally consistent strategy for managing their exposure to these risks through third parties.

One of the ways to improve the robustness and efficiency of third party risk management and due diligence is to develop consistent policies and procedures around the determination, review and analysis of third parties and the risks they represent.

## SANCTIONS AND REPUTATIONAL RISK:

A leading commodities trader admitted it had traded at least one large cargo of Iranian fuel oil in 2012, a move which, while legal because of the Swiss status of the firm, damaged the company's reputation in Washington, London and Brussels. The revelation of the Iranian fuel oil deal forced the company to confirm it was ending all sales of oil to and from Iran and had not broken trading sanctions.

To establish a clear third party risk assessment and due diligence framework, companies need to understand their existing third party risk management procedures and know where information on third parties is kept. Is third party data stored on one universal system, and does this system capture the right kind of information to determine integrity and commercial risks? Who within the organisation has responsibility for managing third party risk?



### What does leading practice look like?

In developing an approach to third party risk management, useful steps and questions to consider include:

- **Defining the third party population:** Does the company capture information on all third parties, including agents, lobbyists, consultants, freight forwarders and joint venture partners? Laws such as the FCPA and the UK Bribery Act define 'third party' in very broad terms. Often the biggest integrity risks are faced from third parties who do not necessarily expose a company to significant financial risks and may fall under the radar of conventional counterparty monitoring.
- **Gathering information:** Are third party on-boarding questionnaires conducted, and does this information factor into the risk assessment and ranking of the third party? Is third party information managed by a central team? Who has visibility of the data and how it is used?
- **Educating third parties:** Does the company share policies and procedures on integrity risk with third parties? Are third parties provided with a clear understanding of the company's values and ethics and the objectives of third party due diligence? What kind of training do third parties receive on bribery and corruption, money-laundering or sanctions risks?
- **Risk assessment and ranking:** Is there a clear process which risk ranks the third party population according to a variety of factors? Does the risk assessment process look beyond financial risk to cover additional risk factors, such as country of operation(s) of the third party, country of payment to the third party, length of relationship, annual turnover, business activity type, nature of relationship, level of government involvement or exposure to government officials, level of oversight etc? Is there a technology-enabled risk assessment process that links directly to due diligence requirements?
- **Defining due diligence levels:** Risk rankings should define protocol for due diligence levels. Is there a scalable approach to due diligence that can provide proportionate solutions, from straightforward screening to more in-depth and independent research and investigation? Are some due diligence processes automated or using research technology for efficiency?
- **Determining protocol for escalation:** Does the output of third party due diligence provide a clear and consistent measurement of risk (e.g. red, amber, green)? Is there a clearly defined protocol for escalation where due diligence results on third parties require action?
- **Monitoring:** Reputational and commercial risks can change over time: is there a policy and procedures for the ongoing monitoring of third party risks and refreshing due diligence of third parties? Is monitoring of third parties linked to the review and revision of risk assessment and rankings of third parties?

“ Third party due diligence must be robust, thorough, impeccably documented and preserved ”

The former DOJ Fraud Section Deputy Chief Mark Mendelsohn, November 2009



Having answers to these questions will take companies a long way in defining a robust approach to third party risk management and due diligence. But overlaying all of these questions is the need to review how third party risk management is structured: who takes ownership of the process to ensure it is integrated through the entire third party sourcing and procurement lifecycle, and to what extent shared service solutions, existing technology platforms, or existing procedures can be employed to manage the process.

#### Technology enabled approaches to due diligence

A critical aspect of leading practice approaches to third party due diligence is the requirement for a technology-enabled solution, using an online platform to bring together the risk assessment of third parties,

outcome of third party questionnaires, determination of the proportionate level of due diligence, and the results of that due diligence and subsequent actions and monitoring of the third party.

A technology-enabled approach to due diligence should support a risk-based approach, which provides the following:

- A centralised, transparent workflow that tracks end-to-end due diligence requests in real-time and tracks the handover of responsibilities across various roles (for example, the business sponsor for the third party, the third party representative, procurement, compliance, legal and risk teams);
- Automation and storing of third party information through an online portal, available to internal personnel and appropriate external users;
- End-to-end visibility through real-time reporting of due diligence results and configurable dashboards;
- A globally consistent approach to third party due diligence (covering research in all relevant languages);
- The capability to conduct risk analysis based on an established risk model and assigned scores;
- A full featured mobile capability for all users of due diligence.

“ Recognising the increasing challenges of maintaining a robust diligence process, KPMG has developed Astrus, a due diligence service for risk-based third party risk assessment. ”





### KPMG's technology based solution - Astrus

Recognising the increasing challenges of maintaining a robust diligence process, KPMG has developed Astrus, a due diligence service for risk-based third party risk assessment. Astrus due diligence reports are designed to provide an objective assessment of the commercial and reputational risks associated with a third party. The reports draw on an extensive range of public information sources across the world and include analysis by KPMG firms experienced corporate intelligence specialists. Integrity risk factors are categorized according to: the company

or individual's background details; shareholders; directors; adverse press and media comment; litigation; exposure to sanctions, Politically Exposed Persons ("PEPs") and published lists of high risk entities. Each risk factor is weighted as green, amber or red according to the significance of integrity risks identified.

### Astrus Insights on third party risk

KPMG member firms recently completed an analysis<sup>3</sup> of around 8,000 Astrus integrity due diligence reports on third-parties across the globe to understand what lessons could be learnt about the nature of risks organisations

are exposed to through their third party business associations.

The headline message from this analysis indicated that over 20 percent of third party subjects were given an overall risk rating of red, meaning they were associated with significant risks (such as allegations or incidences of corruption, fraud, money-laundering or other unethical or illegal practices). 66 percent of reports were rated amber overall, meaning risk issues were identified, but these were not necessarily serious (such as opaque ownership structures; association of the subjects with politically exposed persons; significant involvement of the subject in civil litigation). Only 12 percent of reports received a green rating and the 'all-clear' from an integrity risk perspective.

Our analysis showed that the most prevalent risk uncovered by our due diligence is fraud associated with the third party. More than any other type of risk, fraud-related findings drive most red-rated reports. Fraud risk is followed by bribery and corruption, money laundering, regulatory violations, business disputes and sanctions.

Restricting screening (typically against sanctions and PEP lists, and negative media searches) just to the name of the organisation will miss the majority of potential risk flags. Our analysis showed that individuals, and not organisations, present the highest level of risk. Where the subject of a report was an organisation, in 84 percent of cases an elevated risk was caused by negative information on the directors or shareholders of the business.

Filtering the results of the analysis by subjects in the shipping and logistics industry showed us that the sector was broadly in line with the overall trends identified with 12 percent of reports rated red risk overall and 64 percent rated amber.

<sup>3</sup> Astrus Insights, published by KPMG International in September 2013 available at <http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/astrus-insights.aspx>



## CASE STUDY

A UK-headquartered firm in the transport industry was dealing with a UK-based manufacturer of logistics and lifting equipment. Research of the shareholder structure of the business, regional and national press, and litigation records revealed that the shareholders of the business had been accused of serious fraud and of orchestrating a £4 million shortfall in their former business by falsifying invoices for stock that was never delivered. Former business partners were now pursuing a claim for damages against the shareholders of the firm's supplier and the shareholders were involved in a variety of lawsuits that the firm was not aware of.

The case illustrates that firms can be exposed to fraud risks through third party relationships in any situation. Timely identification of these risks through effective due diligence can avoid getting caught up in a relationship that could pose serious commercial and financial risk.

The findings clearly demonstrate that third party due diligence focused solely on the subject organisation, and not its principals and shareholders, misses the majority of risks.

The Astrus Insights analysis provides a clear indication that companies need to better manage the risks associated with their third parties. In order to begin to apply a leading practice approach to third party risk and due diligence, companies need to:

- Understand the universe of their third party relationships;
- Execute a risk assessment to determine and focus on those relationships where further information is required;
- Create a risk ranking of their third party relationships and perform appropriate and risk-based due diligence to obtain the critical information that can help in managing business risk.

Leading practice approaches aim to provide a globally consistent and robust approach to conducting due diligence and understanding where third party risks lie. By applying a clear framework for third party due diligence, shipping companies can go a long way to protecting themselves against the growing commercial, regulatory and reputational risks that they are exposed to through their third party network.

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“ Leading practice approaches aim to provide a globally consistent and robust approach to conducting due diligence and understanding where third party risks lie ”



# A view of the future: 2017 – **bigger balance sheets**



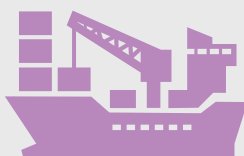


It may feel like Groundhog Day! In this, our fifth edition of Shipping Insights, it is the fourth time we have written about proposed changes to lease accounting. In May 2013 long awaited, revised proposals were released by the accounting standard setters<sup>4</sup> which would have huge ramifications to the shipping sector. Get ready for bigger balance sheets.

## KEY FACTS:



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



Proposals affect 'big-ticket' ship 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

<sup>4</sup> Joint proposals of the International Accounting Standards Board (for IFRS's) and Financial Accounting Standards Board (for US GAAP).

## So what would be the impact?

Key aspect	Impact to Shipping companies
<b>Identifying a lease</b>  A lease would exist when both of the following conditions are met: <ul style="list-style-type: none"> <li>- Fulfilment of a contract depends on the use of an identifiable asset; and</li> <li>- The contract conveys the right to control the use of the identifiable asset for a period of time in exchange for consideration</li> </ul>	<p>Under this definition, contracts of affreightment are unlikely to be considered leases because the underlying asset is not identifiable</p> <p>Equally a charter whereby the underlying vessel is not identified (and/or can be substituted for a similar type of vessel) could remain outside the scope of the proposals</p>
<b>Multiple component arrangements</b>  A single contract may contain several lease components and may also contain non-lease components  When the purchase price or selling price of each components is an observable standalone price then they should be separated and accounted for on this standalone price basis  When the purchase or selling price of one or more, but not all of the components are observable they elements should be separated and allocated using the residual method  When no observable standalone prices are available for any of the components, then the arrangement is accounted for as one lease	<p>Shipping companies will need to consider whether the separate elements of a time charter contract (such as crewing, provisions, maintenance etc.) should be accounted for as individual components</p> <p>Given that bareboat and time charters are standard contracts in the sector, it should be possible to derive standalone prices</p> <p>However, with such a volatile market, and certainly in a depressed market where the charterer is principally concerned with utilisation, accounting for arrangements in this way will be complex</p>
<b>Determining the lease term</b>  A company would determine the lease term as the non-cancellable period of the lease, together with periods covered by: <ul style="list-style-type: none"> <li>- Renewal options, if the lessee has a significant economic incentive to renew; and</li> <li>- Termination options, if the lessee has a significant economic incentive not to terminate</li> </ul>	<p>Introduction of this new threshold – ‘significant economic incentive’ – will require close inspection of the option price. Given the volatility of the shipping market, determining whether an option creates a significant economic incentive will be complex</p>

Key aspect	Impact to Shipping companies
<p><b>Classifying the lease</b></p> <p>The introduction of dual lease accounting models – and a new lease classification test will require companies to assess whether a lease is Type A (non-property) or Type B (property).</p> <p>A non-property lease is Type A, unless:</p> <ul style="list-style-type: none"> <li>- The lease term is for an insignificant part of the total economic life of the underlying asset; and</li> <li>- The present value of the lease payments is insignificant relative to the fair value of the underlying asset</li> </ul>	<p>Some in the shipping industry may question the distinction the new lease classification test makes between ships and buildings. Suppose a company leases a brand new asset for 10 years. The asset has a useful economic life of 30 years. The lease is at a market rate and does not contain a purchase option. In this case:</p> <ul style="list-style-type: none"> <li>- If the asset is a ship, the lease will be a Type A lease; but</li> <li>- If the asset is a building, the lease will be a Type B lease</li> </ul> <p>Economically, these seem like similar transactions. But the lease classification will be different – and so the lease accounting will be different</p> <p>The Proposals do not define what is mean by ‘significant’ or ‘insignificant’ and for a US\$150 million ship expected to operate for 25 years, judging what is insignificant will clearly be a matter of interpretation</p>
<p><b>Recognition and initial measurement for lessees</b></p> <p>A lessee would recognise a lease liability representing its obligation to make lease payments.</p> <p>Future lease payments include:</p> <ul style="list-style-type: none"> <li>- Fixed payments, less any incentives;</li> <li>- Variable payments that depend upon an index, or are in-substance fixed payments;</li> <li>- Amounts expected to be payable under residual value guarantees; and</li> <li>- The exercise price of a purchase option is the lessee has a significant economic incentive to exercise that option</li> </ul> <p>A lessee would recognise a right-of-use (“ROU”) asset, measured initially at cost, comprising:</p> <ul style="list-style-type: none"> <li>- The amount of the initial measurement of the lease liability;</li> <li>- Any lease payments made to the lessor at or before the commencement date, less any incentives; and</li> <li>- Any initial direct costs incurred by the lessee</li> </ul>	<p>At the inception of a lease, shipping companies will need to consider whether to include purchase options. ‘Significant economic incentive’ is a new, currently undefined accounting term, and therefore may be open to interpretation</p> <p>Certain bunker escalators would be accounted for as incurred</p>
<p><b>Impact on the lessee income statement</b></p> <p>A lessee in a Type A lease would present amortisation of the ROU asset and interest on the lease liability as separate expenses. The profile of total lease costs (amortisation plus interest) would generally be front-loaded</p>	<p>This will result in earlier expense recognition than for current operating leases. However it may result in a higher EBITDA<sup>5</sup> as lease expense would now be presented as amortisation and interest</p>

<sup>5</sup> Earnings before interest, tax, depreciation and amortisation



Key aspect	Impact to Shipping companies
<p><b>Lessor accounting for Type A leases</b></p> <p>On lease commencement, a lessor would derecognise the underlying asset and recognise:</p> <ul style="list-style-type: none"> <li>- A lease receivable, representing its right to receive lease payments; and</li> <li>- A residual asset, representing its interest in the underlying asset at the end of the lease term</li> </ul>	<p>Ship owners may be surprised to see that they would be required to remove their ships from their balance sheets when the ships are put on lease – even for lease terms of only a couple of years</p>
<p><b>Impact on the lessor income statement</b></p> <p>A Type A lessor would present the profit or loss arising on the lease commencement as revenue and costs (if the lessor enters into leases to realise value from goods that it would otherwise sell); or as a single line item, if the lessor uses leases to provide finance</p>	<p>Ship owners will also need to become used to potentially recognising a profit on entering into a lease</p>
<p><b>Foreign currency revaluation</b></p> <p>The lessee's lease liability and lessor's lease receivable would be recognised on the respective balance sheets as monetary items and therefore within the scope of IAS 21 for foreign currency translation</p>	<p>This could create income statement volatility if the company's functional currency is different from the currency of the lease</p>
<p><b>Re-measurement of the lease following reassessment</b></p> <p>A company would be required to reassess the lease for changes in certain circumstances including whether there is a change in an incentive to exercise a renewal option</p>	<p>In shipping, where charter rates are volatile, this requirement could be particularly onerous to apply</p>
<p><b>Short-term leases</b></p> <p>A company can elect not to apply the proposed lease models to short-term leases. Short-term means less than 12 months, including any extension options, and a lease is not short-term if it includes a purchase option</p>	<p>Short-term spot deals and voyage charters are likely to fall outside the scope of the proposals – instead entities may apply a version of the current operating lease accounting to such contracts</p>

### What are the wider implications of these proposals?

Key financial metrics would be affected by the recognition of new assets and liabilities, and by changes in the profile and presentation of lease income and expense. Increased volatility can be expected on the balance sheet as arrangements are continually reassessed. All of this will need careful communication with providers of finance and wider stakeholders. There could also be impacts on:

- compliance with debt covenants;
- employee compensation arrangements;
- tax balances (if the company is outside a tonnage tax regime); and
- the company's ability to pay dividends.

Additionally these proposals could influence sale and leaseback arrangements. A traditional, economical and popular financing option will no longer deliver the benefits. This could add further pain to the shipping industry where sources of finance remain tight.

### Not quite on the last lap

The comment period on this latest Exposure Draft closed in September, with over 600 parties issuing responses – many of them shipping companies or bodies. It's fair to say that the industry is less than convinced by the leasing proposals, with some arguing that voyage charters and charters up to two years in length should be exempted. Almost all are concerned about the wider implications on balance sheets and funding.

In KPMG's response<sup>4</sup>, we were unconvinced that the proposals would achieve the aim of increasing the relevance of financial statements. We also recognised the complexity (and therefore cost of implementation) associated with the proposals.

What the standard setters do next is anyone's guess. But it seems likely that they will be undeterred from pushing this controversial project forward.

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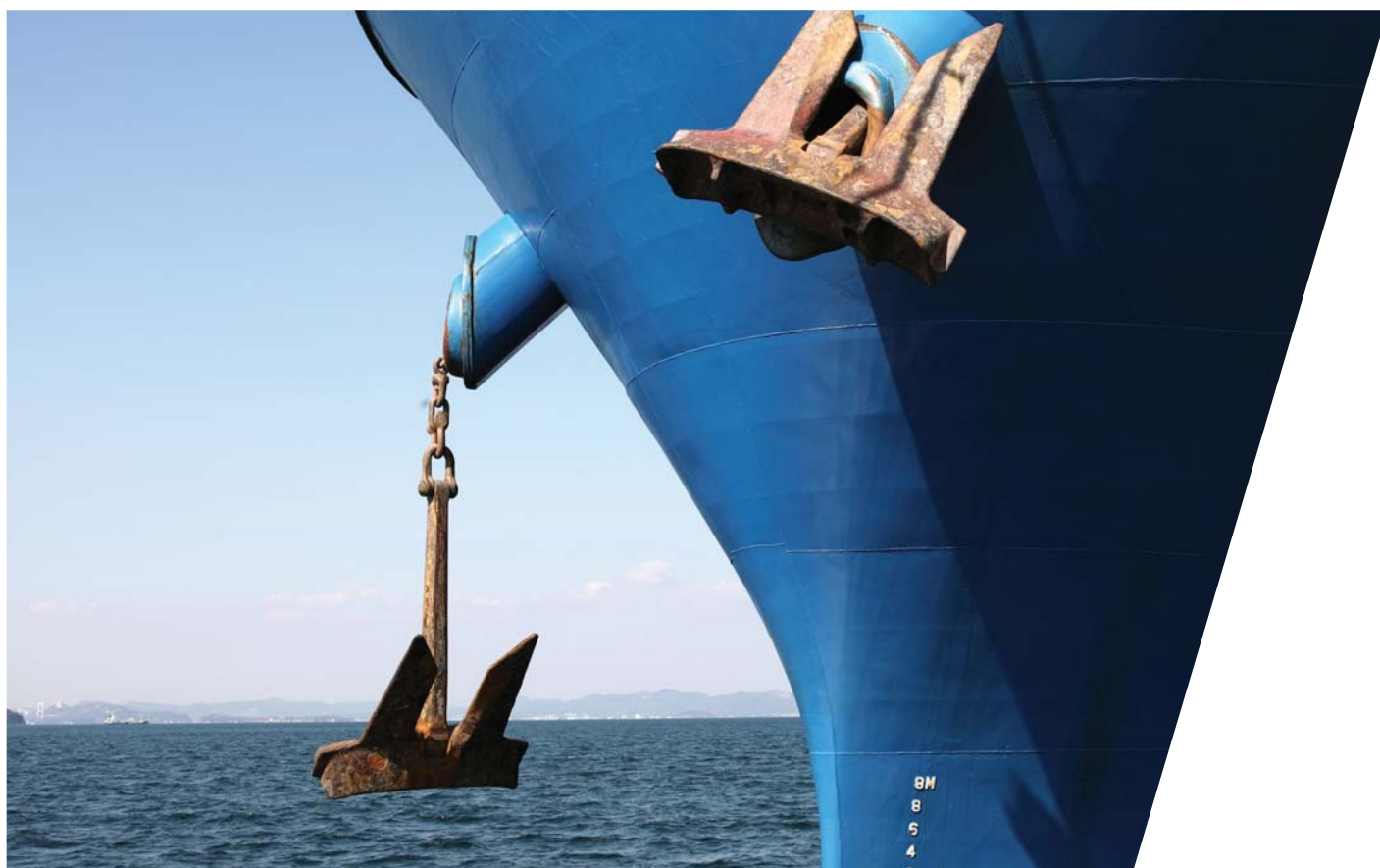
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<sup>4</sup> Issued by KPMG IFRG Limited in September 2013.





# Reforming Brazil's **ports**







After years of deliberation, the Brazilian Government has recently approved new laws which could have a transformational impact on the efficiency and operational effectiveness of Brazil's ports. But, as KPMG in Brazil caution, much more infrastructure investment is required, if Brazil is to realise its full potential.

#### **Need of implementing structural changes**

Following the implementation of the Real Economic Plan in 1994, Brazil has challenged several barriers that historically restricted its consistent economic development. Starting with the control of hyper-inflation (which was the core of Real Economic Plan), the country has encountered privatisations, reforms in government spending (law on fiscal responsibility), social assistance programs, and selected tax incentives that enabled the recovery of the purchase power of the so called medium-class and attracted an influx of foreign investment. As a consequence, over the last ten years, its economic growth has propelled the country, not only within the BRIC nations (Brazil, Russia, India and China), but to a major global economy. One that has remained relatively stable despite global crises that affected other nations more acutely (mainly the Eurozone and the USA) during the last five years. However, it seems that the internal consumption driven cycle is showing signs of exhaustion and new challenges will need to be addressed to allow a second wave of economic development. This means that political, foreign trade, tax and infrastructure reforms cannot be postponed anymore (recent street protests across Brazil have more than emphasised this).

#### **Infrastructure: one of the major challenges**

Statistics highlight the potential and power that Brazil has to become a major economic power, driven mainly by its agribusiness and plentiful supply of natural resources. However, the growth in recent years has showed that the existing infrastructure is insufficient to enable further development. Significant investments in education, energy sources, telecommunications, roads, railroads, ports and healthcare, are vital, otherwise the economy is in danger of looking and feeling like a motorcar driven with its hand brake is on.

#### **Starting from the ports**

Approximately 95 percent of the Brazilian foreign trade is made through ports. The country's 34 public and 129 private ports handle hundreds of millions of tonnes of cargo each year. Volumes passing through Brazil's terminals are rising at a rate of 7 percent a year. Consequently, the Government elected this sector as one of the starting points of implementing structural reforms. The Brazilian Government approved the new port law (Nr. 12,815) in May 2013, after years of discussions with Congress, the public, and other key stakeholders. The main purpose is to incentivise private investments, and to improve the overall productivity of the Brazilian ports.



“ Volumes passing through Brazil’s terminals are rising at a rate of 7 percent a year ”

Among others, major changes include:

- **New concessions**

The Brazilian Government expects that more than 150 terminals will be subject to new concessions. Approximately 40 terminals are planned in unexplored areas, a further 50 terminals operated via expired authorisations, and the balance relating to terminals in which the operational authorisation expires between now and 2017. New concessions, estimated to last at least 25 years, will pass through public bidding processes, with the winners being those who offer the lowest fare per good transported (in principle, no concession liability will be assumed).

- **No distinction between private and public use terminals**

Previous law established a distinction between terminals of public and private use. Public-use terminals are those that move third-party goods, providing services to ship owners, exporters and importers, whilst the private-use terminals are those that transport own goods. Removing this distinction is expected to promote port flexibility and ultimately lead to reductions in overall port costs.

- **Distinction between “organised” and “non-organised” areas**

Terminals will now be segregated by geography that is, as based on “organised” and “non-organised” areas. Organised areas are those that are established by the Government (through its regulatory agency) and are subject to concession bidding process. The new law enables port operations to be established in non-organised areas, subject to Government authorisation (or concession bidding process if more than one potential operator is interested in the area).

- **Hiring labour force**

Under the previous law the labour force could only be hired through an independent specific agency (the

so-called “OGMO”), which was responsible for managing the work force in accordance with the type of service to be provided, with the aim of ensuring a fair relationship between the workers and terminal operators. With the new law, this requirement will not exist anymore and terminals will be able to opt for hiring labour force under the standard labour laws currently applicable to the rest of the country’s labour force (the “CLT” law).

### High expectations

The Brazilian Government is optimistic about the expected benefits that should be generated by implementing these legal changes. The Government expects to attract more than R\$50 billion (around US\$23 billion) in new private investment. However, the major belief is that competition will significantly increase in the sector, resulting in higher productivity and overall reduction in port costs. Anyone who has shipped goods through a Brazilian port will acknowledge the current challenges. With goods frequently taking up to five days to clear, its not surprising that local port costs can be anywhere between 100 and 300 percent higher than the best performing European ports.

This situation highlights the tremendous opportunity for the Government to enhance Brazilian productivity as a whole (motivating related sectors), and the new port law represents a great opportunity to private operators to benefit from the growth of the Brazilian economy (aligned with global economic recovery of course). Unless something fundamentally changes with the world economic order, it is likely that in the medium/long term Brazil will continue to be one of the lead exporters in agribusiness, and importers to supply its current internal market of 200 million people. In addition, expectations regarding pre-salt oil exploration, which indicate that Brazil will jump from 14th to 8th position in relation to worldwide oil production, contribute to reinforce this positive outlook for Brazilian ports.

### Does this mean that everything is solved and ready?

No.

Despite the long process to enable the approval of the new port law, consensus among existing operators has not been reached yet. The law that came from the Congress has been approved by the President with several vetoes, which is a legal recourse established by the Brazilian constitution. This means that the law is valid, but may be subject to Congress analysis (for which no specific timing is defined). There is also a risk of legal claims from the current operators (who allege infringement of acquired rights in relation to the previous authorisations and unfair competition with the new operators) and unions against the new labour hiring process. However, the Government has publicly announced that it is confident that these will not change the law and it expects to start concession bidding processes as early as autumn 2013.

Infrastructure entrepreneurs in general recognise that the new port law is not only positive, but essential for the country’s economic agenda. However, there is a consensus that this is only a first (but significant step) to enhance Brazilian infrastructure and reduce costs, but several other Government measures are necessary to implement a full logistic infrastructure (i.e. roads and railroads) in a country the size of a continent. As the saying goes *“a drain is essential, but it only works if there are pipes linked to it”*.

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# KPMG's Shipping Insights series

To find out what KPMG member firms are saying, visit [www.kpmg.com](http://www.kpmg.com).



An IFRS accounting guide addressing all the key sector specific accounting issues. This publication considers not only the technical accounting requirements, but also analyses the practical application issues.



Issued in response to proposed changes to accounting for leases, this guide highlights the proposals and considers the most significant issues likely to impact the Shipping sector



## Shipping Insights 1

### Accounting and financial reporting in the shipping industry

In this publication we surveyed the publicly available financial information of the largest shipping companies to assess the usefulness and comparability of reported results. We looked at critical accounting policies relevant to the sector, including revenue recognition, pool arrangements and fixed asset accounting. The survey concluded that financial reporting in the sector was lagging best practice and that financial information was difficult to obtain, assess and compare.



## Shipping Insights 2

### Insights arising from the economic downturn

Issued at the height of the 2009 economic crisis, this publication looked at the measures being taken by shipping companies to survive the downturn and the cash flow and profit impact of such decisions. We also reflected on the challenges of assessing impairment of vessels when reliable cash flow forecasting was difficult. The publication also looked at more complex accounting issues such as cost capitalisation policies and borrowing costs, together with a first view on emerging accounting issues such as lease accounting and revenue recognition where changes to accounting standards were expected.



## Shipping Insights 3

### Thriving in a changing world

Recognising that the range of topics being covered in the Boardrooms of shipping companies was ever expanding, this publication considered anti-bribery and corruption laws, sustainability and raising new finance. We also looked at the pace of recovery in the Far East and provided a more in depth assessment of the proposals around changes to the accounting for operating and finance leases.



## Shipping Insights 4

### Keeping ahead

In this issue, we surveyed the annual financial reports of the biggest shipping companies in the world and asked whether they were fit for purpose. We also contrasted the tonnage tax regimes across the major shipping centres, highlighted the emerging threat from cyber crime and analysed the M&A activity since the onset of the 2008 economic crisis.

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Oliver Marketing for KPMG | OM 006028A | November 2013