



HKE_x
香港交易所

RECEIVED
11 NOV 2011

BY: K

The Stock Exchange of Hong Kong Ltd.

(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

9 November 2011

BY FAX (2865 6776)
AND BY POST

Our Ref: LD/CC/098-11

Mr. Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37/F., Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

Dear Steve,

IASB Request for Views on Agenda Consultation 2011 (the "Agenda Consultation")

I refer to your letter dated 28 July 2011 on the above to our Mr. Mark Dickens which has been passed to me for my attention.

We are pleased to be given the opportunity to comment on the Agenda Consultation which seeks views on the strategic direction and overall balance of the IASB's work plan, and the priority of the projects in the next three years. However, without detailed information on the time needed by the Board members and its staff to complete the various projects we are not in a position to comment on what would be achievable within the time-frame of three years. Accordingly, our comments are primarily on which projects we believe the IASB should undertake and their order of priority. Moreover, our comments below are based on the information provided in the Agenda Consultation.

The IASB's proposed priorities and agenda

As set out on page 13 of the Agenda Consultation the major projects that the IASB intends to give the highest priority are:-

1. Revenue from contracts with customers;
2. Leases;
3. Insurance contracts; and
4. Financial instruments, including
 - (a) hedge accounting
 - (b) impairment of financial assets measured at amortised cost
 - (c) offsetting of financial assets and financial liabilities.

206 451

The Stock Exchange of Hong Kong Ltd.

(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

In addition, the IASB plans to undertake the following work because it has already committed to do so:-

1. Complete the project on the Conceptual Framework;
2. Perform post-implementation reviews;
3. Undertake a three-yearly review of the IFRS for SMEs; and
4. Continue with its minor amendments to IFRSs through its Annual Improvements programme.

Appendix C on page 20 of the Agenda Consultation provides a list of projects previously added to the agenda but deferred and new project suggestions.

Our views

If not already in place, we believe that to assist the IASB in making informed decisions on its priorities and on what should and can be achieved, it should have in place a process or mechanism that provides it with an estimate of the total number of man-days required by both the Board members and its staff to complete the planned projects. For the estimates to be useful, the information of man-days required should be determined for each major step of the process leading to the completion of the project so that the Board can assess the reasonableness of the estimates including the specific resources required and their timing.

In our view, the IASB should focus on the following five core projects in the coming three years and these are set out below in what we believe should be their order of priority:-

1. Completion of the Conceptual Framework
2. Review of the purpose and use of the “Statement of other Comprehensive Income” (“OCI”)
3. Revenue from contracts with customers
4. Financial instruments
5. Insurance contracts

We believe that the first priority of the IASB should be to complete its Conceptual Framework project and to address in particular the fundamental question of the conceptual reasons for the current requirement for re-measuring certain assets and liabilities to their fair value after their initial recognition and for the changes to be recognised in profit or loss or OCI. Currently, some assets and liabilities are required to be regularly re-measured at their fair value whereas other assets and liabilities of a similar nature are not.

We believe that fair value information is useful to readers of financial statements, but fair value changes should not be recognised in the income statement, which is required under the current standards. We believe fair value re-measurements distort reported

The Stock Exchange of Hong Kong Ltd.

(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

earnings or “financial performance” disclosed in the income statement (or “profit or loss”) and as a consequence they also distort “earnings per share” figures.

We believe that fair value re-measurements, with the changes being recognised in the income statement, is not generally appropriate as they represent recognising “hypothetical transactions” with “hypothetical parties” at “hypothetical exit prices”. That is, they are not “actual” or real transactions but are “as if” transactions. In substance, fair value re-measurements represent a sale and buy-back of the same asset which is normally not permitted under revenue recognition rules. Fair value re-measurement “assumes” that a transaction has happened but it has not. Moreover, in most cases we believe that an entity does not have the intention nor is able to undertake the hypothetical transaction at the reporting date. We believe that the IASB should complete the Conceptual Framework project first and proceed with caution in its reform of accounting for financial instruments.

The Conceptual Framework, being the key benchmark containing the underlying basic principles and core concepts, should address the above and other fundamental issues. Once the Conceptual Framework is in place, individual accounting standards, where needed, may be developed to provide more detailed guidance.

We believe that the IASB should continue with its major four identified priority projects with the exception of the “lease” project. As expressed in our letters to the Institute dated 3 July 2009 and 30 November 2010 we have significant concerns on the proposed standard on leases as it is inconsistent with the current Conceptual Framework and will in effect result in a re-definition of the fundamental conceptual terms of what is an asset and what is a liability. The proposals on leases also raise fundamental conceptual questions on how future obligations and commitments such as employment contracts and bank overdraft facilities, which are also “rights to use”, should be accounted for.

In our view, a lease contract is an executory contract and the obligation of the lessee is to make a series of future transactions or rental payments. These “future transactions” are not liabilities or “present obligations” but future obligations. When entering into a lease contract, the lessor has unperformed service obligations which have to be performed in the future. These include making the asset continuously available for use and also, in the case of a property, rectification of any structural and other defects that may arise in the future. Similarly, the lessee has an obligation to pay rentals but these obligations will arise only if the asset is continuously made available to him in the appropriate condition throughout the lease term. To illustrate, we would ask the question of whether a lessee of a property that was destroyed in the Fukushima disaster in Japan would be obliged to pay rentals to the lessor. We believe that the answer must be a no.

We therefore would suggest that the IASB should shelve the proposed leasing standard until after completion of the Conceptual Framework project.

The Stock Exchange of Hong Kong Ltd.

(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

Moreover, we believe that the Conceptual Framework as well as other detailed standards should be written in clear simple language and should be self-explanatory on how they are expected to be applied in practice. To ensure consistency in the meaning of terms, the Conceptual Framework should include as an appendix a glossary of core terms and definitions used. The same terms and meanings should be used across all standards. We nevertheless accept that new terms may develop over time and these can be added in the future. Incorporating key definitions as part of the Conceptual Framework should ensure that they are used consistently across all standards issued by the IASB.

In the Appendix attached to this letter we comment and include our suggestions and recommendations on the individual projects mentioned in Appendix C to the Agenda Consultation. You will note from our comments that many of the issues raised in the proposed projects could be resolved through core principles developed in the Conceptual Framework project.

In closing, we would like to emphasize that accounting standards do influence human behavior and getting it right is extremely important as accounting standards have an impact on the working of financial markets and therefore global financial stability. We would also like to take the opportunity to repeat the message made by Hans Hoogervorst to the European Parliament ECON Committee on 3 October 2011 at which he said:

“Asking accountants to describe economic volatility is one thing, but we should be careful that in doing so financial information does not become the source of economic volatility Accounting should not mask volatility, but neither should it be the source of it.”

We hope that the above comments are useful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited



Colin Chau
Senior Vice President
Listing Division

Encl.
CC/KYS/el

c.c. Mr. Mark Dickens JP – Head of Listing

Appendix

In relation to the projects set out on pages 20 to 25 of the Agenda Consultation, we have the following comments and recommendations.

| Project | Comments and recommendations |
|---|---|
| <p>Agriculture, particularly “bearer” biological assets</p> | <p>This project raises the more fundamental conceptual issue of whether assets and liabilities should be stated at fair value and if so, which ones and why. Currently some assets and liabilities are carried at fair value while others are not.</p> <p>The project raises the issue of differentiating the accounting treatment for “bearer” or “producing” assets (such as grape vines and orange trees) that are seen to be equivalent to plant and machinery from other assets such as “consumable” assets (for example, the “grapes” and “oranges”) which are equivalent to inventories.</p> <p>In substance, we believe fair value re-measurements represent a sale and buy-back of the same asset which is normally not permitted in the recognition of revenue.</p> <p>Therefore, we recommend that priority should be placed in re-visiting the fundamental issue of fair value re-measurements and how assets and liabilities should be accounted for in the Conceptual Framework project. Once the conceptual issue is resolved the appropriate response can be made to relevant individual standards.</p> |
| <p>Business combinations under common control</p> | <p>IFRS 3 “Business Combinations” does not currently cover business combinations under common control.</p> <p>We believe that it is important that accounting for business combinations under common control should be addressed in order to avoid diversity in practice. However, we believe that the guidance should stipulate that it can only be used in limited circumstances, such as in a group restructuring in preparation for an initial public offering.</p> <p>The Hong Kong Institute of Certified Public Accountants (“HKICPA”) has issued its Accounting Guideline 5 – “Merger Accounting for Common Control Combinations” (“AG 5”) which provides some guidance. However, we believe that AG 5 should not normally be allowed post listing as its adoption results in the re-statement of prior year financial statements and raises the issue of why the business combination was not made at the time of listing.</p> <p>We believe that as business combinations under common control alter the risks and obligations of both the acquirer and acquiree as well as their own underlying debtors and creditors, we take the view that the ability to look upward beyond the acquirer itself to the ultimate acquirer, which is permitted under AG 5, should be restricted to specific unique once-off circumstances.</p> <p>We also believe that IFRS 3 should be revisited from a conceptual perspective as it does not primarily deal with “business combinations” as seen from a layman’s point of view. Rather, we believe IFRS 3’s principal objective relates to the need for the preparation of “group” or “consolidated” financial statements, which acts as a replacement to presenting the separate financial statements of the reporting entity itself in circumstances where the reporting entity has controlling interests in other entities, that is, subsidiaries. Its purpose is to provide detailed financial information of all the <u>underlying</u> assets and liabilities of the reporting entity rather than merely just disclosure of the equity interest in its subsidiaries.</p> |

| Project | Comments and recommendations |
|--|--|
| | <p>Because of the above, we believe that the project on business combinations under common control is special purpose accounting and should be clearly separated from the development of general purpose accounting standards which is the main focus of the IASB.</p> |
| <p>Country-by-country and project-by-project disclosures</p> | <p>We believe that disclosures of payments by governments to entities involved in extractive activities, on a country-by-country basis, is actually a sub-set and an issue that may be addressed in IFRS 8 "Operating Segments". IFRS 8 requires segmental information to be disclosed in the financial statements only if such information is provided to the chief operating decision maker ("CODM"). Thus, we believe that the key question is whether the disclosure of country-by-country and project-by-project reporting information is essential and material for investment decision making even though it may not be used by the CODM.</p> <p>We believe that "materiality" of the information should be the key criteria and principle. For this reason we believe that a specific major project on this issue is not warranted.</p> |
| <p>Discount rate</p> | <p>Discount rates used in estimating discounted cash flows is inherently subjective and case specific but do have a significant impact on the resulting measurement of the carrying value of assets and liabilities.</p> <p>This raises the fundamental Conceptual Framework issue of what should be accounted for, what should be the basis of measurement and whether changes in fair values should be recognised in profit and loss which is the present requirement. We believe this conceptual issue should be addressed in the Conceptual Framework project.</p> |
| <p>Diluted earnings per share</p> | <p>Diluted earnings per share disclosure is in substance disclosure of pro forma "as if" information. The fundamental conceptual issue is how "as if" information should be recognised or presented in financial statements. We would also point out that "fair value" re-measurement information is also "as if" pro forma information and the IASB should seriously consider this in its Conceptual Framework project, namely, how such information should be treated, and in particular whether changes in fair values should be only disclosed rather than be recognised in the income statement or profit and loss.</p> <p>We would suggest that the best and simplest solution to deal with the diluted earnings per share pro forma information issue is to disclose the formula and detailed calculation so that investors can make their own decisions on the weight they wish to place on the information.</p> |
| <p>Emissions trading schemes</p> | <p>The Agenda Consultation noted that many jurisdictions are implementing different emission trading schemes and this has led to financial reporting issues.</p> <p>We believe that if the Conceptual Framework project is completed, this should resolve the conceptual issues of whether and what assets and liabilities arise from participating in the emission trading schemes and how they should be reflected in financial statements.</p> |
| <p>Equity method of accounting</p> | <p>We believe that the key issue to address is the question of what the "equity method of accounting" is attempting to achieve or portray. That is, is it intended to implement one-line consolidation or does it represent or intended to reflect a re-measurement or revaluation of the investment? We believe that the issue should be clarified in the Conceptual Framework project as there is a need to determine its purpose – the presentation of some form of consolidated financial statements vis-à-vis – a re-measurement of an investor's interest in an acquiree.</p> |

| Project | Comments and recommendations |
|--|---|
| Extractive activities | <p>As stated in the Agenda Consultation, the diversity in accounting practice has arisen because extractive activities are excluded from the scope of otherwise relevant standards. The fundamental issue therefore is why they are excluded and if so should they not be required to comply with the Conceptual Framework given the absence of a specific standard.</p> <p>We believe that key principles that would be applicable for accounting for extractive activities would be covered by the Conceptual Framework project as it should address the key issue of “what and how things should be recognised or presented and how they should be measured”.</p> <p>We understand that the project team of national accounting standard setters from Australia, Canada, Norway and South Africa tentatively concluded that cost accounting should be used to account for exploration and mining rights. We concur with this view and believe that if fair value information is deemed useful, fair value information could be included as supplementary information to the financial statements.</p> <p>If the IASB intends to issue a specific and more detailed standard on extractive activities, we would recommend the separate disclosure of exploration rights from mining rights as they have different characteristics. Exploration rights only provide the right to explore whereas mining rights provide the ability to recover the carrying value of the rights through extraction of mineral reserves.</p> |
| Financial instruments with characteristics of equity | <p>We believe this project raises the fundamental conceptual issue of what is the “unit of account” for the transaction. We believe it is not appropriate to bifurcate a transaction, such as a financial instrument into equity and liability elements <u>upon initial recognition</u> as the counter-party to the transaction has treated the transaction as a single whole. The two elements are inseparable yet the current requirements is for the separate accounting for the liability and equity elements. For example, we believe convertible bonds are primarily loans that involve actual cash flows that have attached a right to convert to equity. However, the option to convert the loan into equity is just right to convert but no equity arises until the right is exercised.</p> <p>We recommend that the IASB should deal with the matter in the Conceptual Framework project in its consideration of “unit of account”. We believe the considerations will have significant implications on IASB’s Financial Instruments project.</p> |
| Financial statement presentation – including consideration of the “other comprehensive income” (OCI) | <p>We believe the key area to be addressed is the purpose of OCI which leads to the Conceptual Framework issue of what is the meaning of the “performance” or “operating results” of a reporting entity which financial statements are intended to present, and the related question of what should be included in the measurement of “performance”. Currently the use of OCI with specific rules on if and when recycling to profit and loss is permitted has confused the meaning of “performance” and what is “realised profits”. Moreover, the treatment has implications on the computation of earnings per share.</p> <p>We recommend that the IASB should re-consider the conceptual reasons for recognising fair value re-measurement changes in profit and loss or OCI since fair value changes merely represent opportunity cost and are not supported by actual transactions but represent the recognition of “hypothetical transactions” with “hypothetical parties” at “hypothetical exit prices”. We believe that the IASB should re-consider the conceptual reasons why some items in OCI currently have to be recycled to the profit and loss while others do not.</p> <p>We therefore believe that the purpose and use of OCI should be re-examined as a priority project.</p> |

| Project | Comments and recommendations |
|--|---|
| | <p>On the presentation of information in the statement of financial position, we believe that the appropriate level of disaggregation is a materiality issue and the basic principle should be that significant balances should be presented separately where it is necessary to achieve the principal objective of financial statements, that is, to be useful to readers in making investment decisions.</p> |
| Foreign currency translation | <p>We believe that foreign currency issues arise from the choice of what should be the reporting currency of the reporting entity. For example, a multi-national company with operations in different countries may choose US\$ as its reporting currency.</p> <p>Although identification and choice of the functional currency and the reporting currency will impact on reported results, we believe that foreign currency issues are essentially disclosure issues and the reasons for change in currencies used should be disclosed under the "materiality" principle.</p> |
| Government grants | <p>The issue of government grants raises the fundamental conceptual issue regarding how they should be treated and we believe the principle should be that the treatment should mirror the purpose of the grant; whether its purpose is to reduce the cost of acquiring an asset or to provide an entity with compensating income.</p> |
| Income taxes | <p>We believe that the IASB should consider undertaking a fundamental review of accounting for income taxes but this should be a future project rather than a priority project for the next three years. We would suggest that the IASB should in its Conceptual Framework project clarify and clearly distinguish "liabilities", (which are "<u>present</u> obligations"), from "provisions", which represent an unilateral decision made by the reporting entity to reduce the carrying value of its assets or the making of allowances for expected future liabilities. We believe this analysis may assist the IASB in its considerations to revise IAS 12.</p> |
| Inflation accounting (revisions to IAS 29) | <p>We believe that the issue raises the fundamental conceptual question of how changes in value, which we would stress should include fair value re-measurement changes, should be reflected in financial statements.</p> <p>We believe that key concepts and principles should be developed under the Conceptual Framework project.</p> |
| Intangible assets | <p>The issues concerning intangible assets relate to whether an entity should be allowed to recognise an asset in the absence of an actual transaction with another counter-party.</p> <p>This again is a Conceptual Framework project issue, namely, the issue of the purpose of accounting and whether it should be confined to the recognition of actual real transactions with other parties and making allowance for subsequent events that impact on the recovery of receivables arising from those <u>past</u> transactions, or whether hypothetical "as if" transactions or future transactions should also be recognised.</p> |
| Interim reporting | <p>We believe that the frequency of reporting should not affect the measurement of assets and liabilities. The accounting policies applied in interim reporting should be the same as those adopted in annual financial reporting.</p> <p>The issue appears to arise because of the current need to re-measure assets and liabilities and as mentioned above this is a core principle question that should be addressed in the Conceptual Framework project.</p> |

| Project | Comments and recommendations |
|--|---|
| Islamic (Shariah-compliant) transactions and instruments | We suggest that the IASB should give a low priority to this project since we believe it is currently not an urgent or widespread issue. |
| Liabilities - amendments to IAS 37 - Cost of restructuring activities | <p>The key questions concerning IAS 37 are conceptual and relate to what is a "liability" and when is a liability created? We believe there needs to be clarity on the difference between a "liability" and mere "obligations" or commitments. "Obligations" are currently defined as "responsibilities to act or perform in a certain way" namely commitments to act in the future. In contrast, a "liability" is currently defined as a "<u>present</u> obligation".</p> <p>The Conceptual Framework project should clarify the difference between a "liability" and a "provision" and when making "provisions" is permitted.</p> |
| Other comprehensive income | <p>We suggest that the IASB should place priority on this project. There is an urgent need to clarify the fundamental conceptual basis and purpose of OCI and inclusion of items in "other comprehensive income" vis-à-vis "profit or loss".</p> <p>The fundamental conceptual issues that arise include the following:-</p> <ul style="list-style-type: none"> (a) What is financial performance and how should financial performance be measured, and should all gains/losses that relate to financial performance be recognised in "profit or loss"? (b) why and what type of gains/losses should be included in "profit or loss" vis-a-vis "other comprehensive income"? (c) what is the basic principle that supports "recycling" from "other comprehensive income" to "profit or loss"? <p>We believe that the above need to be addressed urgently and a review of OCI should be a priority project, preferably as an element of the Conceptual Framework project, but if not as a separate project.</p> |
| Post-employment benefits (including pensions) | We believe that the post-employment benefits issue is linked to the issue of what is a "liability" and when "provisions" for future losses or claims should be recognised. This is a core principle that should be addressed in the Conceptual Framework project. |
| Presentation and disclosure standard | As set out in our letter to the Institute dated 30 September 2011 on the IASB's discussion paper on "IASB Exposure Draft ED/2011/2 Improvements to IFRSs", we believe that the principle of " <u>materiality</u> " of the disclosure, which is the recommendation resulting from the research undertaken for IASB by the New Zealand and Scottish Chartered Institutes and published in July 2011, would be an appropriate criteria and we would suggest that the IASB consider the recommendation. The amendments to the individual accounting standards based on this principle should be reasonably easily to implement. |
| Rate-regulated activities - effect of rate regulation in setting prices | We believe the issue is principally a disclosure issue which could be dealt with by revisiting the disclosure requirements in IAS 18 "Revenue". |
| Share-based payment | Share-based payment is in substance a "non-monetary" transaction issue. It is also linked into the issue of whether they represent "liabilities" or should be regarded as "provisions" and when they should be recognised. As mentioned above, the core principle should be addressed in the Conceptual Framework project. |