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This is the 22nd Issue of TechWatch, a publication designed to alert members to topics and issues that impact on accountants and their working environment. We welcome your comments and feedback. Comments and suggestions on TechWatch should be addressed to Stephen Chan, Technical Director (Ethics & Assurance) & Head of Standards & Technical Department Coordination by email: commentletters@hksa.org.hk .

TechWatch is available at the HKSA's website: http://www.hksa.org.hk/professionaltechnical/techwatch/ .

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New Initiatives of the HKSA

1. Technical Update Evening

Technical Update Evening ("TUE") was launched by the HKSA Standards & Technical Department in March 2004 to provide a further channel of communication between members and the HKSA Technical Directors.

The first four sessions of TUE are:

- TUE 401 "New HKSA Independence Pronouncements" which was successfully held on 13 April 2004 with over 40 members attending.

- TUE 402 "SME Financial Reporting Framework and Standards" scheduled for 18 May 2004 has been over-subscribed, and a re-run session TUE 402A has been scheduled for 25 May 2004.

- TUE 403 "New Audit Risk SASs" scheduled for 1 June 2004 and TUE 404 "Tax Issues Relating to Source of Employment under DIPN10" scheduled for 15 June 2004 have also been over-subscribed, and consideration will be given to hold re-run sessions.

For details of TUE and its programme, go to:
http://www.hksa.org.hk/professionaltechnical/TUE/index.php .

2. HKSA Members' Handbook Re-launch

The HKSA will re-launch its Members' Handbook with effect from 1 June 2004. As at that date the new Handbook will supersede the current A5-sized hard copy publication and the electronic version (e-Handbook) available on the HKSA's website.

Members and other Handbook users will have more options on how to obtain, update and access their copies of the Handbook and a simpler subscription framework will apply.

The salient features of the re-launched Handbook are as follows:

- Published in A4 size;
- Electronic and Paper-based Handbook will now have identical formats;
- Electronic Handbook with full functionality (view, print, search, copy & paste and download access, an annual CD-ROM update for off-line use, access to archived Handbook material, and electronic correspondence advising updates) will be available free for HKSA members and available to others by subscription;
- Free public access to the electronic Handbook available but with limited functionality (view, save and print only); and
- Paper-based Handbook available by subscription.

Details about the re-launched Members' Handbook and the subscription order form are available at the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/handbook/ .

3. HKSA Homepage Revamp – Invites Comments And Suggestions

The HKSA will be revamping its Homepage to enhance communication with members. The new design will take a member-centric approach with a view to deliver high quality information dissemination in an interactive and user-friendly manner.

Members are invited to make suggestions and comments of their expectation about the new Homepage so as to help the HKSA in this revamping exercise. All comments can be addressed via e-mail to: hksa@hksa.org.hk, or by fax to 28656603/28656776, or by post to HKSA, 4/F, Tower Two, Lippo Centre, 89 Queensway, Hong Kong, for the attention of Gary Wong, Project Director (Innovation & Technology).

Financial Reporting

4. HKSA Issues Ten Revised Accounting Standards And One New Interpretation

With effect from 1 January 2005, all the existing Statements of Standard Accounting Practice ("SSAPs") and Interpretations for which there are equivalent International Accounting Standards ("IASs") and SIC Interpretations will be renamed as Hong Kong Accounting Standards ("HKASs") and HKAS Interpretations ("HKAS-Int") with numbers corresponding to the equivalent IASs and SIC Interpretations, respectively.

The HKSA has issued the following HKASs and HKAS Interpretation that are converged with Standards and Interpretations issued by the International Accounting Standards Board ("IASB") most of which were revised recently as a result of the IASB's "Improvements" Project:

- HKAS 1 — *Presentation of Financial Statements*
- HKAS 2 — *Inventories*
- HKAS 8 — *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 10 — *Events after the Balance Sheet Date*
- HKAS 16 — *Property, Plant and Equipment*
- HKAS 21 — *The Effects of Changes in Foreign Exchange Rates*
- HKAS 27 — *Consolidated and Separate Financial Statements*
- HKAS 28 — *Investments in Associates*
- HKAS 29 — *Financial Reporting in Hyperinflationary Economies*
- HKAS 33 — *Earnings Per Share*
- HKAS-Int 12 — *Consolidation – Special Purpose Entities*

The above HKASs and HKAS-Int should be applied for annual periods beginning on or after 1 January 2005 with earlier application encouraged and, as a consequence, the following SSAPs and Interpretations of the HKSA will be superseded at that time:

- SSAP 1 — *Presentation of Financial Statements* (revised 2001)
- SSAP 2 — *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* (revised 2001)
- SSAP 5 — *Earnings Per Share* (revised 1998)
- SSAP 9 — *Events after the Balance Sheet Date* (revised 2001)
- SSAP 10 — *Accounting for Investments in Associates* (revised 2001)
- SSAP 11 — *Foreign Currency Translation* (revised 2001)
- SSAP 17 — *Property, Plant and Equipment* (revised 2001)
- SSAP 22 — *Inventories* (revised 2001)
- SSAP 32 — *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (revised 2001)
- Interpretation 1 — *Costs of Modifying Existing Software*
- Interpretation 5 — *Property, Plant and Equipment – Compensation for the Impairment or Loss of Items*
- Interpretation 8 — *Presentation of Financial Statements – Current Assets: Classification of Restricted and Appropriated Cash Balance*
- Interpretation 10 — *Earnings per Share – Financial Instruments and Other Contracts that may be Settled in Shares*

- Interpretation 18 *Consolidated and Equity Method – Potential Voting Rights and Allocation of Ownership Interests*

Consistent with the policy of converging Hong Kong's financial reporting standards with those Standards set by the IASB, the HKSA's objective in issuing the above new HKASs and HKAS-Int are to adopt the changes made as a result of the IASB Improvements Project and to eliminate, to the greatest extent, all differences that previously existed between Hong Kong accounting standards and the equivalent IASs.

The IASB Improvements Project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Project were to reduce or eliminate alternatives, redundancies and conflicts within the IASs that the IASB inherited from its predecessor body, to deal with some convergence issues and to make other improvements.

When issuing these HKASs and HKAS-Int, the HKSA will also publish an explanatory memorandum identifying the main changes made to the Hong Kong SSAPs as a result of these HKASs and HKAS-Int.

The HKAS have been published on the HKSA's website at : http://www.hksa.org.hk/professionaltechnical/accounting/standards/ and an explanatory memo has also been posted at: http://www.hksa.org.hk/professionaltechnical/accounting/rm/memorandum.pdf. Hard copies of the above will be published concurrently with the new A4 format of the Members' Handbook when it is launched in June 2004. Accordingly, the above will not be published in the current A5 Handbook format, which will be superseded when the A4 Handbook is published.

5. FASC Invitation To Comment On IFRIC Draft Interpretation: D5 *Applying IAS 29 Financial Reporting In Hyperinflationary Economies For The First Time*

The International Financial Reporting Interpretations Committee ("IFRIC") has published for public comment a Draft Interpretation: D5 *Applying IAS 29 Financial Reporting in Hyperinflationary Economies for the First Time.*

The proposed Interpretation D5 contains guidance on how an entity shall restate if financial statements in the first year it identifies the existence of hyperinflation in the economy of its functional currency.

Under the HKSA's due process for setting accounting standards, the HKSA has issued an Invitation to Comment on the draft Interpretation with comments requested by 5 May 2004. The Invitation to Comment has been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/accounting/exposuredraft/ and a copy of the Invitation to Comment has been sent to HKSA members and others who are on the Members' Handbook (paper version) mailing list.

Following from the IASB's final approved Interpretation, the FASC intends to recommend the adoption of a new Hong Kong Financial Reporting Interpretation on *Applying HKAS 29 Financial Reporting in Hyperinflationary Economies for the First Time* so that the HKFRSs and Interpretations maintain conformity with the IASB's Standards and Interpretations. The FASC does not intend to issue a specific Hong Kong exposure draft on the matters covered in the IFRIC exposure draft.

6. HKSA Comments On IFRIC Draft Interpretations: D3 *Determining Whether An Arrangement Contains A Lease* and D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*

The HKSA's comment letters on IFRIC Draft Interpretations: D3 *Determining whether an Arrangement contains a Lease* and D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds* have been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/accounting/submissions .

7. FASC Meeting – 11 February 2004

The FASC met on 11 February 2004 and discussed the adoption of proposed Hong Kong Accounting Standards consequent to the IASB's Improvements Project. A copy of the meeting summary has been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/accounting/fascupdate .

A copy of the Financial Reporting Standard Setting project timetable has been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/accounting/dueprocess/HKFRS-timetable.pdf .

Audit & Assurance

8. HKSA Issues Example Report By Auditors On Form HKL1 "Hong Kong Long Term Insurance Business – Revenue Account"

The HKSA has issued an example report by auditors on Form HKL1 "Hong Kong Long Term Insurance Business – Revenue Account", after consultation with the Insurance Authority (IA). The example report has been posted on the HKSA's website at:
http://www.hksa.org.hk/professionaltechnical/insurance/index.php .

The example report requires auditors to perform a high level assurance engagement in accordance with the HKSA Standards on Assurance Engagements, and to express a conclusion that conveys a high level assurance about the record keeping of the insurer and the preparation of Form HKL1, based on the results of the work performed. The conclusion required to be expressed by the auditors is prescribed in the Insurance Companies Ordinance.

Hong Kong long term business insurers are required for the first time to submit to the IA Form HKL1 in respect of the year ended on or after 31 December 2003 together with the audit report thereon, and the deadline for submission is within 4 months after the close of the financial year.

The IA issued on 26 February 2004 "Guide to Forms HKL1, HKL2 and HKL3 under the Insurance Companies Ordinance (Cap. 41)" to facilitate the compilation of the Forms. The IA issued on 7 April 2004 a Circular to provide further clarifications on the above Guide, after discussing with the HKSA. The Guide and the Circular issued by the IA are available at the IA's website at:
http://www.info.gov.hk/oci/text/corner/index.htm# , under "Returns/Forms".

9. PN 810.1 "Insurance brokers – compliance with the minimum requirements specified by the Insurance Authority under sections 69(2) and 70(2) of the Companies Ordinance" – Communication With Client Of Non-Compliance With The Client Account Notification And Acknowledgement Requirement

The HKSA's attention was drawn by The Hong Kong Confederation of Insurance Brokers ("HKCIB") to a finding of twelve site visits conducted by the HKCIB during the period from November 2003 to February 2004. It was pointed out to the HKSA that during these site visits, members of the HKCIB were not able to provide documentary evidence of their compliance with the "Notification and Acknowledgement Requirement", i.e. the provisions of section 71 of the Insurance Companies Ordinance have been notified to and acknowledged by the bank with which the "client account" is maintained.

It was agreed with the HKCIB that it would benefit all parties concerned where auditors identify a failure by their client broker to comply with the "Notification and Acknowledgement Requirement", they would notify the broker in order that immediate remedial action can be taken by the broker, despite the fact that the broker's failure does not directly affect the auditors' conclusion whether the broker has failed to maintain client accounts in accordance with the minimum requirements specified by the Insurance Authority.

10. Mainland Audit Issues Q&As

The AASC Working Group is tasked to develop Questions and Answers ("Q&As") and/or articles for publication in The Hong Kong Accountant to raise practising members' awareness of the common audit issues that may be encountered by auditors in the audits of Mainland enterprises.

The Working Group issued the second set of Q&As which addresses some of the audit issues relating to the PRC value-added tax ("VAT"), including the background information on VAT, the more common questions that auditors ask in obtaining an understanding of the accounting and internal control systems for VAT administration in audit planning and developing an appropriate audit approach, and the practical procedures that auditors can apply to ascertain the amount of input VAT recoverable, and in particular the authenticity of VAT invoices.

The Q&As are available on the HKSA's website at:
http://www.hksa.org.hk/professionaltechnical/assurance/rm/index.php .

11. AASC Meeting – 24 February 2004

The meeting summary of the AASC meeting held on 24 February 2004 has been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/assurance/aasc/index.php .

Listing

12. Government Announces Measures To Enhance The Regulation Of Listing

The Government released the conclusions of its public consultation on Proposals to Enhance the Regulation of Listing ("Consultation Conclusions") on 26 March 2004. The major issues under consultation were summarised in TechWatch Issue No. 18 (November 2003), and a summary of the salient points of the HKSA's submission was contained in TechWatch Issue No. 20 (January 2004).

The Consultation Conclusions are available on the website of Financial Services and the Treasury Bureau at: http://www.info.gov.hk/fstb/fsb/ppr/consult/doc/erlcon-e.pdf and the corresponding press release can be accessed at: http://www.info.gov.hk/gia/general/200403/26/0326182.htm .

The Consultation Conclusions recommend codifying in the statute the more important listing requirements, as follows:

- financial reporting and other periodic disclosure;
- disclosure of price-sensitive information; and
- shareholders' approval for notifiable transactions.

The above will be effected by means of subsidiary legislation to be made by the Securities and Futures Commission ("SFC") under section 36 of the Securities and Futures Ordinance ("SFO").

In parallel, the Government will introduce a Securities and Futures (Amendment) Bill into the Legislative Council to provide that breaches of statutory listing requirements will become a new type of market misconduct. Any persons who breach the statutory listing requirements may be subject either to civil sanctions imposed by the Market Misconduct Tribunal under Part XIII of the SFO, or, following prosecution, to criminal sanctions under Part XIV of the SFO.

To address market calls for swift action to be taken by the SFC, the Government will also amend the SFO to allow the SFC to impose direct civil sanctions, namely reprimands and disqualification orders, on specific, well-defined "primary targets", for breaches of the statutory listing requirements. The consensus view among the regulators is that these "primary targets" should be the issuers, directors and corporate officers, who are primarily accountable for corporate disclosure and other corporate activities under the listing regime.

As for the regulatory structure governing the performance of listing functions, the Government recommends expanding the dual filing system in the light of general public support. The Stock Exchange of Hong Kong Limited ("SEHK") will continue to receive listing applications at the frontline, and no securities will be listed on the SEHK unless they have been approved by the SEHK's Listing Committee. The SEHK will remain responsible for administering the listing process, and the primary point of contact for listing applicants and their advisers.

As for ongoing compliance of listed companies, the SFC will be responsible for enforcing the statutory listing requirements, while Hong Kong Exchanges and Clearing Limited ("HKEx") will continue to enforce the non-statutory requirements in the Listing Rules.

The Government will continue to rely on the regulatory framework under the SFO, in particular the licensing regime, for the SFC to regulate initial public offering sponsors, noting that efforts are being made by the SFC and HKEx to upgrade the regulation of sponsors.

While views were divided amongst different sectors of the HKSA membership as to the most appropriate regulatory structure for Hong Kong, nevertheless the above conclusions are consistent with the views put forward in the HKSA's submission on the consultation, as reported in TechWatch Issue No. 20 (January 2004), in respect of certain key issues, including giving statutory backing to some of the more important listing requirements.

The Consultation Conclusions also recommend a number of improvement measures to enhance the transparency and accountability of the performance of listing functions by both the SFC and HKEx, as follows:

(a) SFC and HKEx to enhance the transparency of their decisions relating to listing;

(b) SFC and HKEx to articulate in a public statement the division of their responsibilities relating to listing;

(c) SFC to submit its reports on the annual audit of HKEx's performance of listing functions to the Financial Secretary, who will cause the reports to be published;

(d) SFC's regulatory oversight of HKEx's performance of listing functions will be subject to regular review by the Process Review Panel ("PRP");

(e) SFC and HKEx to invite the Independent Commission Against Corruption ("ICAC") to study their respective procedures and practices for the performance of listing functions under the dual filing system; and

(f) monitoring of the implementation of improvement measures identified by ICAC's study through the SFC's annual audits of the HKEx Listing Unit, and the PRP's annual reports on the SFC's due process.

13. HKSA Comments On HKEx Exposure Paper Of Draft Code On Corporate Governance Practices And Corporate Governance Report

As reported in TechWatch Issue No. 21 (February 2004), Hong Kong Exchanges and Clearing Limited (HKEx) issued the above exposure paper ("the Paper") on 30 January 2004. The Paper can be accessed on the HKEx's website at: http://www.hkex.com.hk/consul/paper/edc-e.PDF .

The HKSA has made a submission on the Paper, which may be accessed at the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/corporategov/code_submission.pdf .

The HKSA considers that the proposed implementation timetable is achievable. The Code on Corporate Governance Practices ("the Code") (which will replace the existing Code of Best Practice at Appendix 14 of the Listing Rules), and the associated Corporate Governance Report ("CGR") (the requirements for which are contained in a new Appendix 17 of the Listing Rules), will become effective for accounting periods commencing on or after 1 January 2005, with one exception: the provisions of the Code on "Internal Controls" (section C.2) and the proposed disclosure requirements in Appendix 17 relating to listed issuers' internal controls will be implemented for accounting periods commencing on or after 1 July 2005.

The Paper includes a public invitation from HKEx to the HKSA to issue guidance on internal controls, to be developed from guidelines set out in "Internal Control: Guidance for Directors on the Combined Code" (referred to as "the Turnbull Guidance") published in the UK in September 1999. The HKSA has indicated to HKEx that, in principle, it is prepared to take up the invitation to develop guidance on internal controls, subject to clarification of various issues regarding the scope and nature of the project.

It is proposed that the Code will consist of two tiers of board practices. The first tier will be the Code Provisions, which must be adhered to on a "comply or explain" basis, that is, an issuer must either confirm that it complies with the Provisions or, where it does not, disclose and explain any deviations from them. Failure to comply or to disclose and explain any non-compliance will be regarded as a breach of the Listing Rules.

The second tier will be Recommended Best Practices, which are for guidance. No disclosure will be required and there will be no sanction for non-compliance, although HKEx indicates that it encourages issuers to make disclosure in the same way as for Code Provisions.

The HKSA supports the requirements for listed issuers to include a CGR in their annual reports and summary financial reports (if any). It considers that HKEx should also make it clear that the CGR should:

- be presented separately and prominently in the annual report;
- clearly indicate the party that is responsible for it (i.e. the board of directors as a whole);
- be dated and signed-off by a person who has been formally and properly delegated with an authority to sign on behalf of the board.

These CGR-related points reflect recommendations made previously by the HKSA in the publication entitled "*Corporate Governance in Annual Reports*" published in March 2001, which is available on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/corporategov/index.php .

In order to assist communication with the readers of annual reports, and to help listed issuers to present a clear, overall picture of their corporate governance structure, arrangements, policies and practices to shareholders and investors, the HKSA is of the view that all corporate governance-related disclosures should be included or presented in a single CGR, and that the Listing Rules should explicitly state this.

The HKSA also suggests the Exchange to consider making it a compulsory requirement for issuers to arrange appropriate insurance cover for its directors, or, as a minimum, for this to be incorporated into a Code Provision rather than a Recommended Best Practice, as currently stated. This is of particular importance given that, with effect from 31 March 2004 (with a transitional period of six months), every listed issuer is required to have three independent non-executive directors ("INEDs") on its board. The HKSA believes that the requirement for insurance to be arranged would encourage more high-calibre, professional people to act as INEDs.

The HKSA acknowledges that corporate governance best practice standards are constantly evolving and accordingly, the ongoing relevance and effectiveness of the Code Provisions and reporting requirements will need to be monitored and reviewed. It also shares the HKEx's view that enhancement of corporate governance standards should be a progressive process, and that, in the longer term, Hong Kong's standards should be brought into line with the best market practices and international standards. With this in mind, in its submission, the HKSA expressed the hope that HKEx will conduct periodic reviews of the Code after its implementation in an open and transparent way and that, the objective will be, in the longer-term, to confer on the Recommended Best Practices a status similar to that currently proposed for the Code Provisions.

The HKSA's submission also sets out, in an appendix, a number of detailed comments on the Code and the requirements of the CGR and refers to areas of the drafting where greater clarity would be desirable.

Corporate Restructuring & Insolvency

14. High Court To Issue Procedural Guides For Taxation/Determination Of Liquidators' Bills

As reported in TechWatch Issue No. 16, in June 2003 the HKSA made a submission on two sets of draft procedural guides for taxation of remuneration issued by the High Court, one for liquidators and provisional liquidators, and one for their agents, including solicitors. In January 2004, the Registrar of High Court ("HCR") responded to the submissions from the HKSA and other bodies, including the Law Society of Hong Kong, attaching draft revised procedural guides.

In his response, the HCR has clarified the procedural guides would apply only to cases where the liquidator and Committee of Inspection ("COI") have not agreed on the liquidator's remuneration, or where there is no COI. The HCR has also acknowledged that, apart from asset recovery, the duties of a liquidator include, e.g. investigation into the affairs of the company and the conduct of its directors, conducting meetings, avoiding antecedent dispositions and preferences, adjudicating claims, keeping accounts, reconstructing books and records if those are not available, and preparing reports as well as performing many other statutory duties, all of which are chargeable items.

In a submission dated 18 March 2004, the HKSA's Insolvency Practitioners Committee ("IPC") has expressed the view that, in the long term, a complete review and rationalisation of the process of taxation would be desirable. Further, Hong Kong would benefit from establishing a joint working party along the lines of the "Working Party on the Remuneration of Officeholders and Certain Related Matters", set up in the United Kingdom under the chairmanship of Mr. Justice Ferris. The process of taxation could be one of the issues considered by such a working party, comprising representatives from the Judiciary (Judges and Masters), the Official Receiver's Office and the accounting and legal professions. Whilst recognising that, pending any review, it would be useful to establish some procedural guidance to facilitate and help expedite the process of taxation/determination, the IPC is of the view that such guidance should be regarded only as an interim measure and not as a panacea. The IPC has commented on the revised procedural guides and on the issues covered in the HCR's response to the HKSA's June 2003 submission. The HKSA's latest submission, dated 18 March 2004, may be accessed at the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/whatsnew/docs/taxation_guide.pdf .

The HCR has recently responded to the submission dated 18 March 2004. According to the HCR, the procedural guides, which are very similar in wording to the revised draft considered by the IPC, are intended to be implemented on 3 May 2004. The HCR's response, together with the procedural guides, may be accessed at the HKSA website at :
http://www.hksa.org.hk/professionaltechnical/whatsnew/docs/taxation_bills_010404.pdf .

Legislation & Government Initiatives

15. HKSA Comments On Proposed Changes To Land Titles Bill

In respect of the two major changes proposed by the Government to the Land Titles Bill, as reported in TechWatch Issue No. 21, the HKSA has recently indicated in a submission that, in principle, it has no objection to the proposed changes (a copy of the submission may be accessed at the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/whatsnew/docs/land_titles_bill_160304.pdf). Nevertheless, the HKSA has noted that, while the proposed revisions to clause 81 concerning rectification of the title register would make the situation more certain in relation to any changes to the register procured by forgery, the court would still have a wide discretion to rectify the register against the present registered owner in other cases of fraud (i.e. not involving forgery) where the present owner had no knowledge of the fraud and had not caused it or contributed to it by action, neglect or default. Clarification has been requested as to the circumstances in which this might be necessary.

Where the court does "rectify" register against an innocent registered owner, the registered owner would have to rely on claiming compensation from the fund established under the Bill.

The HKSA will consider the detailed changes to the proposed legislation when they are available in due course.

16. Companies Registry Introduces New Thematic Sections On Its Website

The Companies Registry ("CR") advised the HKSA on 1 April 2004 that it has introduced two new thematic sections, namely, "Customer Satisfaction Survey 客戶滿意程度調查" and "Customer Suggestions 客戶建議", on its website.

The address for Customer Satisfaction Survey is:
http://www.info.gov.hk/cr/survey/index.htm (English) and
http://www.info.gov.hk/cr/chinese/survey/index.htm (Chinese)

The address for Customer Suggestions is:
http://www.info.gov.hk/cr/suggest/index.htm (English) and
http://www.info.gov.hk/cr/chinese/suggest/index.htm (Chinese)

Taxation

17. The Financial Secretary Delivers Budget Speech 2004/05

The Financial Secretary ("FS"), Mr. Henry Tang, delivered his maiden Budget Speech on 10 March 2004, the full text of which can be accessed at: http://www.budget.gov.hk/2004/eng/speech.htm . He has since characterised the three main objectives as (i) revitalising the economy, (ii) improving people's livelihoods; and (iii) giving the community a respite. He also emphasized in the speech that the "guiding principle in fostering economic development should be *market leads and government facilitates*".

A consolidated budget deficit of $49 billion was forecasted for 2003/04, as compared to the original estimate in last year's budget of HK$67.9 billion, and the revised estimate announced in October 2003, reflecting the SARS relief package, of HK$78 billion plus or minus $5 billion. The difference was largely attributed to the higher-than-expected investment income from the fiscal reserves and revenue from profits tax and stamp duty, and departmental cost savings. The FS anticipated that the budget deficit (after bond issuance – see below) for 2004/05 would be HK$42.6 billion, equivalent to 3.4% of the GDP.

The FS reiterated his goals of achieving the following by 2008/09:

- bringing operating and consolidated fiscal accounts into balance;
- reducing operating expenditure from HK$212.2 billion to HK$200 billion; and
- reducing public expenditure to below 20% of the GDP.

As regards measures to cut costs, the Government has already begun streamlining departmental structures. The first phase of the civil service pay cut was implemented in January this year, and the second phase will come into effect 12 months later. The FS also indicated that the Government was looking into various management initiatives which could achieve savings and put public resources to more effective use.

While no further tax increases are to be introduced for 2004/05, the second and final phase of adjustments in salaries tax, property tax, and profits tax for unincorporated businesses will be implemented in 2004/05 with a full year annual impact of nearly HK$13 billion in additional revenue.

Revenue measures and concessions proposed by the FS include:

- extending the salaries tax deduction for home loan interest by two years, from five years to seven years, with the maximum deduction in any year maintained at HK$100,000, to take effect from the 2003/04 year of assessment;

- extending the profits tax deduction for research and development expenses to cover expenses on design-related activities;

- extending the duty concession for ultra low sulphur diesel to the end of the year; and

- introducing a Personalised Vehicle Registration Marks Scheme in addition to the existing arrangements for allocating and auctioning vehicle registration marks.

In line with the "User Pays" principle, the Government will consult Legislative Councillors on the revision of government fees and charges where taxpayers may be subsidising fees for other users, focusing initially on those fees and charges that do not directly affect people's livelihood or general business activities.

The Government is proposing to issue bonds not exceeding HK$20 billion in the coming next few years, to fund infrastructure and other investment projects in Hong Kong. The income from the bond issue has been included in the estimates for 2004/05, for indicative purposes. The issue of government bonds is expected to help promote the development of Hong Kong's bond market and offer retail and institutional investors an alternative investment option.

As regards the overall fiscal position of the Government, the figures contained in the Budget indicate that the consolidated account is projected to show a small overall surplus, of HK6 billion, in 2008/09, while the operating account is still projected to reflect a small deficit of HK$5.2 billion in 2008/09.

The HKSA held a press conference after the Budget, attended by Mr. Paul Chan, HKSA vice president and chairman of the Taxation Committee, and Mr. David Cho, convenor of the HKSA Budget Proposals Task Force. At the press conference, the HKSA urged the Government to remain committed to maintaining strict fiscal discipline and not to e.g., issue bonds for the purpose of meeting operating expenditure, which should be covered by operating revenue.

The Government remains committed to its asset sale and securitisation programme, estimated to realise HK$96 billion over five years from 2004/05 to 2008/09, with HK$17 billion raised in 2004/05 from the securitisation of revenue from Government toll tunnels and bridges (HK$6 billion), repayment of capital from the Airport Authority (HK$6 billion) and securitisation of loans (HK$5 billion). The FS also foreshadowed the potential airport privatisation and rail merger in 2005/06.

Acknowledging that Hong Kong's tax base is too narrow, the FS indicated that an internal Government committee was conducting a comprehensive study on the implementation of a Goods and Services Tax ("GST") in Hong Kong and would report, at the end of 2004, on a proposed GST framework suitable for Hong Kong together with an implementation timetable, for discussion. The FS will then decide on the next steps to be taken. He anticipated that it would take at least three years to implement a GST.

The proposal is in line with the suggestion in the HKSA's Budget submission to specify a timetable for implementing a GST and to conduct a consultation with the public (see TechWatch Issue No. 20). The HKSA believes that the Asian financial crisis and the effect of the subsequent global downturn in the economy pointed to the need to improve the stability of revenues in Hong Kong, and that this cannot be achieved by continuing to rely almost entirely on direct taxes, especially profits and salaries tax, and land related revenues. Most of the world has come to a similar conclusion, which is reflected in the prevalence of GST-type taxes and a lowering of direct taxes.

According to the FS, the Government will study the effects on the economy and on government revenue of adjusting estate duty and how best this should be effected to attract foreign capital, thus developing Hong Kong into the premier asset management centre for Asia. The HKSA has been proposing abolition of estate duty or, at least a revamp of the regime, for some time.

In response to suggestions that a "green" tax be imposed on certain polluting industries or products to promote environment protection and raise revenue, the Government is considering various fiscal measures, including levying a tyre tax to reduce the number of used tyres dumped in landfills and to encourage tyre recycling. The HKSA has previously suggested that there is a case for implementing a more co-ordinated "green tax" policy in Hong Kong.

In order for fiscal balance to be restored, some growth in the economy will also be necessary. The Government is projecting GDP growth of 6% in 2004 and a trend GDP growth rate of 3.8% per annum in real terms in the medium-term (4.5% in nominal terms, after taking into account the forecast GDP deflator of 0.7%). This compares favourably with the estimated overall GDP growth of 3.3% in real terms in 2003, and growth of 2.3% in 2002.

18. <u>HKSA Suggests Amendments To DIPN No. 38 (Employee Share Option Benefits)</u>

At the 2004 annual meeting between the Commissioner of Inland Revenue ("CIR") and the HKSA, the CIR indicated that the Inland Revenue Department ("IRD") was reviewing Departmental Interpretation & Practice Notes No. 38 (Employee share option benefits)("DIPN 38") and that the HKSA was invited to express views as to how it could be improved. The HKSA has responded by making a submission to the IRD on areas that need to be clarified and amended in DIPN 38.

The HKSA's submission covers, inter alia, the following aspects of DIPN 38:

- the date for calculating the gain on the exercise of share option (paragraph 17);

- taking into account restrictions in relation to the disposal of any shares acquired under an option scheme in ascertaining the gain realised (paragraph 21);

- in respect of conditional awards:

    - the situation where the source of income, i.e. the location of employment, changes during the vesting period (paragraph 35(viii));

- the determination of chargeability of gain on exercise by having regard to where the services were rendered during the vesting period (paragraphs 39 and 40); and

➢ cases where taxpayers are departing permanently from Hong Kong (paragraph 51).

The HKSA's submission can be accessed at:
http://www.hksa.org.hk/professionaltechnical/whatsnew/docs/DIPN_38.pdf .

Comment Key Dates

Date	**Subject**
30 April 2004	FASC Exposure Draft (ED) of a Proposed SSAP *Accounting and Reporting by Retirement Benefit Plans*. The Invitation to Comment has been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/accounting/exposuredraft/ .
5 May 2004	Invitation to Comment on IFRIC Draft Interpretation: D5 *Applying IAS 29 Financial Reporting in Hyperinflationary Economies for the First Time*, which has been posted on the IASB's website at: http://www.iasb.org.uk . The Hong Kong Invitation to Comment has been posted on the HKSA's website at: http://www.hksa.org.hk/professionaltechnical/accounting/exposuredraft/ . [IASB deadline: 14 May 2004]
Please send comments to commentletters@hksa.org.hk	

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Stephen Chan, Technical Director (Ethics & Assurance) & Head of Department Coordination
Simon Riley, Technical Director (Financial Reporting)
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