Professional and Technical News at a glance

HKSA TechWatch

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This is the 26th 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 .

TechWatch is available on the HKSA's website .

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Financial Reporting

1. New HKFRS 3 *Business Combinations*, HKAS 36 *Impairment Of Assets* And HKAS 38 *Intangible Assets*

The HKSA has issued **HKFRS 3 *Business Combinations***, **HKAS 36 *Impairment of Assets*** and **HKAS 38 *Intangible Assets*** as part of its business combinations project. These Standards become effective for business combinations for which agreement date is on or after 1 January 2005. The objective of issuing these Standards is to improve the quality of the accounting for business combinations, goodwill and intangible assets.

The main features of the Standards are:

- All business combinations within the scope of HKFRS 3 must be accounted for using the purchase method.
- Costs expected to be incurred to restructure an acquired entity's (or the acquirer's) activities must be treated as post-combination expenses, unless the acquired entity has a pre-existing liability for restructuring its activities.
- Intangible items acquired in a business combination must be recognised as assets separately from goodwill if they meet the definition of an asset, are either separable or arise from contractual or other legal rights, and their fair value can be measured reliably.
- Identifiable assets acquired, and liabilities and contingent liabilities incurred or assumed, must be measured initially at fair value.
- Amortisation of goodwill and intangible assets with indefinite useful lives is prohibited. Instead they must be tested for impairment annually, or more frequently if events or changes in circumstances indicate a possible impairment.

These Standards are currently available on the HKSA's website and will be published in the HKSA Members' Handbook in August.

2. New HKFRS 4 *Insurance Contracts*

The HKSA has issued **HKFRS 4 *Insurance Contracts***. HKFRS 4 becomes effective for accounting periods beginning on or after 1 January 2005. HKFRS 4 is converged with the equivalent IASB Standard, IFRS 4 *Insurance Contracts.*

HKFRS 4 is aimed at introducing improved disclosures for insurance contracts, and modest improvements to recognition and measurement practices.

The FASC is currently considering a proposal to revise the transitional provisions in HKAS 39 to permit retrospective application and early adoption of the Standard. The FASC has also issued an invitation to comment on the IASB proposals to ease the implementation of IAS 39 (see below) and expressed an intention to adopt such proposals once they have been finalised by the IASB. Given that many insurance contracts are financial instruments in nature, the FASC agreed at a previous meeting that the transitional provisions in HKFRS 4 should be aligned with those set out in HKAS 39 so that they would both be applied consistently. Accordingly, the transitional provisions presently included in HKFRS 4 might be changed as a consequence to the changes to the transitional provisions in HKAS 39.

HKFRS 4 is currently available on the HKSA's website and will be published in the HKSA Members' Handbook in August.

3. New HKFRS 5 *Non-Current Assets Held For Sale And Discontinued Operations*

The HKSA has issued **HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations***. HKFRS 5 becomes effective for accounting periods beginning on or after 1 January 2005. HKFRS 5 is converged with the equivalent IASB Standard, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

HKFRS 5 requires assets that are expected to be sold and meet specific criteria to be measured at the lower of carrying amount and fair value less costs to sell. Such assets should not be depreciated and should be presented separately in the balance sheet. It also requires operations that form a major line of business or area of geographical operations to be classified as discontinued when the assets in the operations are classified as held for sale.

HKFRS 5 is currently available on the HKSA's website and will be published in the HKSA Members' Handbook in August.

4. New HKAS 26 *Accounting And Reporting By Retirement Benefit Plans*

The HKSA has issued **HKAS 26 *Accounting and Reporting By Retirement Benefit Plans***. HKAS 26 becomes effective for accounting periods that begin on or after 1 January 2005. HKAS 26 is converged with the equivalent IASB Standard, IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.

HKAS 26 deals with accounting and reporting by retirement benefit plans. It contains an appendix that sets out additional guidance on preparing financial statements of Mandatory Provident Fund Schemes and Occupational Retirement Schemes Ordinance Schemes. This appendix supersedes IAG 2 *Financial Statements of Retirement Schemes.*

HKAS 26 is currently available on the HKSA's website and will be published in the HKSA Members' Handbook in August.

5. New HKFRS-Int 1 *Change In Existing Decommissioning, Restoration And Similar Liabilities*

The HKSA has issued **HKFRS-Int 1 *Change in Existing Decommissioning, Restoration and Similar Liabilities***. This Interpretation becomes effective for annual periods beginning on or after 1 September 2004. HKFRS-Int 1 is converged with IFRIC Interpretation 1 *Change in Existing Decommissioning, Restoration and Similar Liabilities.*

This Interpretation addresses how the effect of a change in cash flows, discount rate or the unwinding of the discount that changes the measurement of an existing decommissioning, restoration or similar liability should be accounted for.

HKFRS-Int 1 is currently available on the HKSA's website and will be published in the HKSA Members' Handbook in August.

6. FASC Invites Comment On IASB Exposure Draft, ED 7, *Financial Instruments: Disclosures*

The IASB has published proposals to improve disclosures about financial instruments in financial statements. The proposals are set out in an Exposure Draft of an IFRS ED 7 *Financial Instruments: Disclosures*.

The proposed IFRS would require entities to provide disclosures in their financial statements that will enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance;

(b) the nature and extent of risks arising from financial instruments to which the entity was exposed during the period and at the reporting date; and

(c) the entity's capital.

The IFRS would replace IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and the disclosure requirements in IAS 32 *Financial Instruments: Disclosure and Presentation*. In doing so, it would remove some disclosure requirements that are regarded as too onerous and would simplify other disclosures. ED 7 also proposes to locate in one place all disclosures relating to financial instruments.

Under the HKSA's due process for setting accounting standards, the FASC has issued an **Invitation to Comment on ED 7** with comments requested by 8 October 2004.

On 16 June 2004 the FASC issued an invitation to comment on the **Exposure Draft – *Proposed Convergence of Hong Kong Accounting Standards with International Accounting Standards*** ("The Convergence ED"). The Convergence ED includes an exposure draft of proposed HKAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* (ED/HKAS 30), which is proposed to converge with IAS 30. ED 7 however proposes to replace IAS 30. The FASC continues to seek comments on ED/HKAS 30 with a proposed effective date for accounting periods beginning on or after 1 January 2005 subject to the IASB's progress on finalising ED 7.

Following from the IASB's final approved Standard, the FASC intends to recommend the adoption of similar changes to HKAS 32 and the withdrawal of ED/HKAS 30 so that the Hong Kong Financial Reporting Standards maintain conformity with the IASB's standards. The FASC does not intend to issue a specific Hong Kong exposure draft on the matters covered in the IASB exposure draft.

7. FASC Invites Comment On Three IASB Exposure Drafts Proposing Limited Amendments To IAS 39 *Financial Instruments: Recognition And Measurement*

The IASB has published the following three Exposure Drafts (EDs) proposing limited amendments to IAS 39 *Financial Instruments: Recognition and Measurement*:

- Exposure Draft *Transition and Initial Recognition of Financial Assets and Financial Liabilities (ED1)*
- Exposure Draft *Cash Flow Hedge Accounting for Forecast Intragroup Transactions (ED2)*
- Exposure Draft *Financial Guarantee Contracts and Credit Insurance (ED3)*

Two of the proposed amendments are aimed at easing the implementation of the Standard by providing additional and immediate guidance on issues identified by the business community; the other is intended to ensure that a guarantor's balance sheet includes all guarantees issued.

Under the HKSA's due process for setting accounting standards, the FASC has issued **an Invitation to Comment on the EDs** with comments requested by 30 September 2004.

On 29 April 2004 the FASC issued an invitation to comment on the IASB's exposure draft of a proposed limited amendment to IAS 39 *Financial Instruments: Recognition and Measurement* on The Fair Value Option. The IASB has not yet finalised the above exposure draft. However, the IASB indicates that the limited amendments proposed in the EDs do not relate to the IASB's ongoing broad examination of the accounting for financial instruments and work on interest margin hedging. The EDs should therefore be read in the context of the latest version of IAS 39.

Unlike IAS 39, HKAS 39 currently requires prospective application of the Standard. However, the FASC is considering a proposal to permit, but not require, retrospective application of HKAS 39. In the light of this, the FASC intends, following from the IASB's final approved change to IAS 39 as a result of ED 1, to allow, but not require, an entity to adopt an approach as proposed under ED 1 if the entity decides to apply HKAS 39 retrospectively. Following from the IASB's final approved changes to IAS 39 as a result of ED 2 and ED 3, the FASC intends to recommend the adoption of similar changes so that the Hong Kong Financial Reporting Standards maintain conformity with the IASB's standards. The FASC does not intend to issue specific Hong Kong exposure drafts on the matters covered in the IASB exposure drafts.

8. FASC Invites Comment On IFRIC Draft Interpretation D9, *Employee Benefit Plans With A Promised Return On Contributions Or Notional Contributions*

The International Financial Reporting Interpretations Committee (IFRIC) has released for public comment a draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* giving guidance on the accounting for cash balance plans. These are employee benefit plans with benefits that depend on future returns on assets.

Such plans are defined benefit plans under IAS 19 *Employee Benefits* but the traditional method of accounting for defined benefit plans that is required by that Standard is difficult to apply. D9 proposes that no estimate should be made of the amount that will ultimately be payable for benefits that depend on future returns on assets, because of the difficulty in estimating what asset returns in the future will be. Instead, the measurement of the liability for such benefits should be based on the value of the assets at the balance sheet date.

Under the HKSA's due process for setting accounting standards, the FASC has issued **an Invitation to Comment on the draft interpretation** with comments requested by 7 September 2004.

Following from the IASB's final approved Interpretation, the FASC intends to recommend the adoption of a new Hong Kong Interpretation so that the HKSA interpretations maintain conformity with the IASB's interpretations. The FASC does not intend to issue a specific Hong Kong draft interpretation on the matters covered in the IFRIC draft interpretation.

9. HKSA Comments On IFRIC Draft Interpretations: D5 *Applying IAS 29 Financial Reporting In Hyperinflationary Economies For The First Time* And D6 *Multi-Employer Plans*

The HKSA comment letters on IFRIC Draft Interpretations: D5 *Applying IAS 29 Financial Reporting in Hyperinflationary Economies for the first time* and D6 *Multi-employer Plans* have been posted on the HKSA's website.

10. FASC Meeting Summary – 12 May 2004

The FASC met on 12 May 2004 and discussed the following items:

- Recently issued IFRS – IFRS 3 *Business Combinations*, IFRS 4 *Insurance Contracts* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- SSAP 27 *Accounting for Group Reconstructions*
- Financial Instruments – Proposed HKAS 39 based on the recently amended IAS 39 (macro hedging)
- Proposed ED/Convergence of HKFRS with IFRS

The **FASC meeting summaries** are available on the HKSA's website.

Audit & Assurance

11. Proposed New Quality Control Standards For Firms And Practitioners

As reported in **TechWatch Issue No. 25** (June/July 2004), the HKSA will issue two new Quality Control Standards:

- the proposed HKSQC 1 "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" (the "Firm" Standard), adopting the **new ISQC 1** of the same title; and

- the proposed HKSA 220 "Quality Control for Audits of Historical Financial Information" (the "Engagement" Standard), adopting the **revised ISA 220** of the same title.

The proposed "Firm" Standard would establish a framework and provide guidance on the quality control policies and procedures (collectively, the system of quality control) that should be established by a firm. Such a system of quality control would provide the firm with reasonable assurance that it and its personnel comply with professional standards and applicable legal and regulatory requirements, and that reports issued by the firm are appropriate in the circumstances.

The proposed "Engagement" Standard would provide guidance concerning the specific quality control procedures to be performed by the practitioner and other members of the assurance team in an assurance engagement.

The following provides a brief overview of the two proposed Standards, which will have the same effective date as their international equivalents, i.e. 15 June 2005:

(a) The "Firm" Standard

Emphasizes the importance of the **"tone at the top"** in a firm in promoting an internal culture that recognizes that **quality is essential** and requires the firm to:

- have quality control policies and procedures to provide it with reasonable assurance that **professional standards and applicable regulatory and legal requirements are being met** in the performance of its engagements;

- have policies and procedures to provide it with reasonable assurance that the firm and its personnel maintain **independence** as required by the HKSA Professional Ethics Statements - to enable it to identify, evaluate and deal with threats to independence;

- establish criteria for considering whether **rotation of the practitioner and other members of the assurance team** is necessary;

- have policies and procedures to identify and **assess the potential risks** associated with a client relationship or a specific engagement, for both continuing and prospective engagements;

- establish policies and procedures to deal with such **human resource matters** as recruitment, appraisal, advancement and professional development;

- appoint a practitioner who has the competence, the resources and the time to assume overall responsibility for an engagement;

- have policies and procedures to require that engagements be **adequately planned, properly supervised and appropriately reviewed**;

- have policies and procedures for **consultation** with others, particularly on difficult or contentious issues;

- make an objective assessment of the work of the assurance team before the issuance of the practitioner's report (described as the **engagement quality control review**) in the following circumstances: for audit engagements to report on the financial statements of listed entities, and **for all** other **assurance engagements that meet criteria to be established by the firm**;

- **monitor** both the appropriateness and application of the firm's quality control policies and procedures on a continuing basis and the quality of completed engagements **through a periodic review programme**;

- establish policies and procedures to deal appropriately with complaints and allegations; and

- establish policies and procedures requiring appropriate documentation to **provide evidence** of the operation of each element of its system of quality control.

(b) <u>The "Engagement" Standard</u>

Requires the practitioner, on each individual engagement, to:

- actively **promote a quality-oriented internal culture** in the context of each engagement;

- **obtain sufficient information** to be able to evaluate **whether there are threats to independence**;

- be satisfied that appropriate procedures have been performed **concerning acceptance and continuance of the client relationship** and the specific engagement;

- be satisfied that the **assurance team** collectively **has** the necessary **competencies** to perform the engagement;

- **consult** on a timely basis on difficult or contentious matters;

- perform an **overall review** of the working papers;

- encourage and facilitate **consultation within the assurance team**; and

- ensure that an **engagement quality control review is completed** before issuance of the practitioner's report for engagements where such a review is to be performed.

12. <u>Proposed Revised Standard Calling On Auditors to Plan Audits More Rigorously</u>

The HKSA will adopt the **revised ISA 300** "Planning an Audit of Financial Statements" issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) in July 2004 requiring auditors to be more rigorous in the planning of their audits.

The revised ISA 300 builds on the new Audit Risk Standards (ISAs 315, 330 and 500) and requires the auditor to plan the audit so that the engagement will be performed in an effective manner. The standard emphasizes that planning is a continual and iterative process throughout the engagement and that unexpected events, changes in conditions or other circumstances may lead the auditor to re-evaluate the planned audit procedures. The standard requires the auditor to establish the overall strategy for the audit that sets the scope, timing and direction of the audit.

13. Auditors Beware: Reported Cases Of Window-dressing Of Capital Deficiencies By Securities Brokers

Two cases of Financial Resources Rules (FRR) breaches were reported in the July 2004 issue of the Securities and Futures Commission's "SFC Enforcement Reporter". It is stated in the SFC Enforcement Reporter that it has been common for some brokers to fake FRR compliance by repeatedly transferring money from related entities to the brokers temporarily and withdrawing the money soon afterwards.

Auditors should therefore pay attention to the possibility of such "window-dressing" activities during the course of their audit.

Section 157(1)(a) of the Securities and Futures Ordinance (SFO) provides that auditors shall lodge a written report with the Securities and Futures Commission, as soon as reasonably practicable after they become aware of any "reportable matter". A reportable matter is defined in section 157(3) of the SFO to include, inter alia, a failure of the licensed corporation to comply with section 146 of the SFO concerning compliance with the FRR or with any of the requirements of the FRR that apply to it. The Securities and Futures (Accounts and Audit) Rules require auditors to report in the annual Compliance Report as to whether there appears to have been any contravention of the FRR by the licensed corporation during the financial year in question.

Guidance on reporting under the SFO and its subsidiary legislation are set out in **Practice Note 820 "The audit of licensed corporations and associated entities of intermediaries"**.

Legislation & Government Initiatives

14. Land Titles Bill Passed By LegCo

The revised Land Titles Bill ("Bill"), which was introduced into the Legislative Council ("LegCo") in December 2002, was passed by the LegCo on 7 July 2004 and gazetted on 23 July 2004 as the Land Titles Ordinance ("LTO"). The LTO may be accessed at the **Government website**.

The enactment of the LTO puts in place the introduction of a title registration system, which will generally dispense with the need to review the historical title deeds to establish title under the existing deeds registration system, and replace this with a title register that will provide conclusive evidence of an owner's title to land. A similar system has been in operation for some years in the United Kingdom and elsewhere.

The HKSA has previously made submissions on the Bill in April 2003 and March 2004, which were reported in **TechWatch Issue Nos. 14 and 22**. The HKSA submissions may be accessed at the **HKSA's website**.

The Bill originally proposed a gradual conversion mechanism, under which existing properties can be brought under the title registration system voluntarily at any time or upon sale. As deliberations progressed in the Bills Committee, a new scheme of "daylight conversion" has since been developed and adopted to replace the gradual conversion mechanism. The daylight conversion mechanism provides that:-

(a) there will be a 12-year interim period after the commencement of the LTO during which all existing land will continue to be governed by the deeds registration system under the Land Registration Ordinance. During this interim period, notice of claims arising from unregisterable matters may be given through registration of instruments called "caveats". Action may also be taken to prevent conversion while a claim is being resolved by registering an instrument called a "caution against conversion". As regards new land granted by the Government on or after the commencement date, it will be brought directly onto the title registration system;

(b) at the end of 12 years from the commencement date, each property under the deeds registration system will be transferred to the title register unless a "caution against conversion" still stands against it or there are other outstanding instruments pending registration under the Land Registration Ordinance. "Caveats" lodged under the Land Registration Ordinance will be carried over as "cautions" under the title register; and

(c) after the 12-year interim period, a bona fide purchaser for value of registered land under the new title registration system will not be affected by any claim arising from unregistered matters unless notice of it has been given by way of a "caution".

The Government has indicated its intention to put in place the relevant regulations governing the implementation of the title registration system, prepare guidance notes for legal practitioners and members of the public, and carry out extensive public education programmes before the LTO is brought into effect, which is likely to take place two years after enactment.

15. Companies (Amendment) Bill 2003 Passed By LegCo

The Companies (Amendment) Bill 2003 was passed by the LegCo on 9 July 2004 and gazetted on 23 July 2004 as the Companies (Amendment) Ordinance 2004. This Amendment Ordinance introduces amendments to the Companies Ordinance (Cap.32) relating to prospectuses, the regulation of oversea companies and shareholder remedies. A copy of the Amendment Ordinance may be accessed at the **Government website**.

The HKSA has previously made four submissions on the Bill, including two submissions on the *Consultation Paper on the Statutory Derivative Action in the Companies (Amendment) Bill 2003*. These submissions, which were reported in **TechWatch Issue Nos. 18, 23 and 24**, may be accessed at the **HKSA's website**. The extent to which the HKSA's concerns have been addressed is highlighted in a **table**.

16. Companies Registry Releases First-Half Yearly Statistics

The Companies Registry has recently released its first-half yearly statistics, which may be accessed at the **Companies Registry's website**.

Banking

17. HKMA Issues Proposals For The Implementation Of The New Basel Capital Adequacy Standards ("Basel II") In Hong Kong

The Basel Committee on Banking Supervision, the international standard-setter in the field of banking supervision, has recently issued "**International Convergence of Capital Measurement and Capital Standards: a Revised Framework**", the new capital adequacy framework commonly known as Basel II. The Hong Kong Monetary Authority (HKMA) issued in August 2004 "**Proposals for the Implementation of the New Basel Capital Adequacy Standards ("Basel II") in Hong Kong**" inviting comments by the end of October 2004.

In line with its policy of adhering closely to international best practices and standards, the HKMA will implement the requirements of Basel II in Hong Kong following the Basel timetable with some adaptations to take account of local circumstances. The HKMA aims to put in place the legal and regulatory framework for implementing Basel II in Hong Kong within 2006.

The overarching goal for the Basel II Framework is to promote the adequate capitalisation of banks and to encourage improvements in risk management, thereby strengthening the stability of the financial system.

The Basel II Framework sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. The new framework reinforces these risk-sensitive requirements by laying out principles for banks to assess the adequacy of their capital and for supervisors to review such assessments to ensure banks have adequate capital to support their risks. It also seeks to strengthen market discipline by enhancing transparency in banks' financial reporting.

Trust Services

18. Practitioner's Guide To "Understanding And Implementing Trust Services"

Authored by the Joint Task Force of the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants, the Practitioner's Guide to "Understanding and Implementing Trust Services" in CD-ROM format is now available for purchase by members who wish to involve in e-commerce related engagements. This is a comprehensive guide containing more than 700 pages of resources which:

- Provides an overview of Trust Services.
- Discusses the Trust Services Principles and Criteria in detail.
- Addresses the important reporting issues.
- Discusses key implementation issues for the related services.
- Discusses implications and reporting requirements when third-party service providers are important to a Trust Services engagement.

Interested members should contact Gary Wong, Project Director (Innovation & Technology) at 2287-7233 or email gary@hksa.org.hk for details.

Comment Key Dates

Date	Subject
30 August 2004	Hong Kong Invitation to Comment on IFRIC Draft Interpretation D7 *Scope of SIC-12 Consolidation—Special Purpose Entities*, and D8 *Members' Shares in Co-operative Entities*, which have been posted on the **IASB's website**. The Hong Kong Invitation to Comment has been posted on the **HKSA's website**. [IASB deadline: 13 September 2004]
31 August 2004	Consultation Paper on a Proposed Introduction of a Financial Reporting Framework and Financial Reporting Standard for Small and Medium-sized Entities in Hong Kong, which has been posted on the **HKSA's website**.
31 August 2004	Hong Kong Invitation to Comment on IASB Discussion Paper, *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*, which has been posted on the **IASB's website**. The Hong Kong Invitation to Comment has been posted on the **HKSA's website**. [IASB deadline: 24 September 2004]
7 September 2004	Hong Kong Invitation to Comment on IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*, which has been posted on the **IASB's website**. The Hong Kong Invitation to Comment has been posted on the **HKSA's website**. [IASB deadline: 21 September 2004]
30 September 2004	Hong Kong Invitation to Comment on three IASB Exposure Drafts proposing limited amendments to IAS 39 *Financial Instruments: Recognition and Measurement*, which has been posted on the **IASB's website**. The Hong Kong Invitation to Comment has been posted on the **HKSA's website**. [IASB deadline: 8 October 2004]
8 October 2004	Hong Kong Invitation to Comment on the IASB exposure draft ED 7 *Financial Instruments: Disclosures*, which has been posted on the **IASB's website**. The Hong Kong Invitation to Comment has been posted on the **HKSA's website**. [IASB deadline: 22 October 2004]
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