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Our ref AKKL/20

3 September 2002

Dear Sir

IASB Exposure Draft "Proposed improvements to International Accounting Standards"

We have reviewed the above exposure draft ("ED") issued by the IASB and our comments are organized into the following sections:

- responses to the FASC's invitation to comment;
- responses to the IASB's invitation to comment; and
- other comments.

1 Responses to the FASC's invitation to comment

	Agree	Disagree	Comment
IAS 1, Presentation of Financial Statements (SSAP 1)			
3. IAS 1 uses the terms "fair presentation" and " to present fairly". The existing SSAP 1 however uses the terms "true and fair" and "to give a true and fair view". Given that "true and fair" is the term used in the Companies Ordinance, the FASC proposes to retain the use of the term "true and fair" in SSAP 1. Do you agree?	X		

	Agree	Disagree	Comment
4. IAS 1 requires "revenue" to be disclosed on the face of the income statement. The existing SSAP 1 however requires "turnover" and "other revenue" to be disclosed on the face of the income statement instead. Given that the Companies Ordinance requires the disclosure of "turnover", do you consider that either: ***a.*** The requirements under SSAP 1 in this regard be retained; or		X	We should aim at achieving convergence with IASs.
b. The requirements under SSAP 1 in this regard be amended so that they become consistent with IAS 1 and that a note be added in SSAP 1 to highlight the relevant disclosure requirement under the Companies Ordinance?	X		
5. IAS 1 states that assets and liabilities shall not be offset except when offsetting is required by another Standard. The existing SSAP 1 however sets out detailed offsetting rules (see paragraph 34). Given that there is currently no SSAP in Hong Kong that deals with the offsetting of financial assets and liabilities, the FASC proposes to retain the offsetting rules in SSAP 1 until the exposure drafts on financial instruments are finalised and become effective. Do you agree?	X		

	Agree	Disagree	Comment
6. IAS 8 requires all items of income and expense (including, for example, share issue expenses) recognised in a period to be included in the determination of profit or loss unless a Standard requires or permits otherwise (proposed to be included in IAS 1). SSAP 2 requires such an inclusion unless a SSAP, or in the absence of a relevant SSAP, the law requires or permits otherwise. The FASC proposes to retain the provision in the existing SSAP 2 (proposed to be included in SSAP 1). Do you agree?		X	We should aim at achieving convergence with the IASs. Generally, we should not allow profit reported under HKGAAP to be different from that under IAS simply because Hong Kong law permits it.
7. The IASB exposure draft proposes to remove the disclosure of an entity's country of incorporation. The FASC proposes to retain this disclosure requirement in SSAP 1 because this is a good source of information to distinguish Hong Kong incorporated companies that are required to comply with the Companies Ordinance from those that are not. In particular, certain SSAPs contain specific provisions for Hong Kong incorporated companies. Do you agree?	X		

	Agree	Disagree	Comment
IAS 8, Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies (SSAP 2) ***10.*** IAS 1 sets out the hierarchy of IASB pronouncements and authoritative non-mandatory guidance (proposed to be included in IAS 8). However, within the standard setting framework, unlike that of the IASB, the HKSA also currently has the ability to issue "Accounting Guidelines" and "Accounting Bulletins". The FASC intends in the near future to review the Foreword and Framework for consistency with the IASB's revised Preface and Framework. Notwithstanding this, the FASC proposes to build the above additional forms of guidance into the relevant provisions in SSAP 2. Do you agree?	X		
IAS 10, Events After the Balance Sheet Date (SSAP 9) ***11.*** IAS 10 requires an entity not to recognise dividends declared after the balance sheet date as a liability at the balance sheet date. SSAP 9 includes a footnote to the corresponding paragraph to cross refer to the notes on the legal requirements in Hong Kong that the Tenth Schedule to the Companies Ordinance requires the disclosure of the aggregate amount which is recommended for distribution by way of dividend in the balance sheet. The FASC proposes to retain the footnote in SSAP 9. Do you agree?	X		
IAS 16, Property, Plant and Equipment (SSAP 17) 13. The existing SSAP 17 includes a section on transfers between different types of assets (see paragraphs 57 to 65) that is based on the relevant section in IAS 40, Investment Property. The FASC proposes to retain this	X		

section in SSAP 17 dealing with transfers until IAS 40 is adopted in Hong Kong. Do you agree?			

	Agree	Disagree	Comment
14. The existing SSAP 17 includes two specific transitional arrangements to deal with property, plant and equipment carried at revalued amounts in financial statements relating to periods ended before 30 September 1995 (see paragraph 80) and the implementation of the components approach to major inspection and overhaul costs (see paragraph 81). The FASC proposes to retain these transitional arrangements. Do you agree?	X (para 80)		Para. 81 does not appear to be necessary. Para. 82 serves the same purpose.
IAS 28, Investments in Associates (SSAP 10) ***21.*** The existing SSAP 10 includes guidance on determining the profit or loss on disposal of an associate (see paragraph 24) but such guidance is not included in IAS 28. This paragraph was added because the practices on determining such profit were inconsistent, especially when dealing with the related unamortised goodwill and the related accumulated foreign currency translation differences. The FASC proposes to retain this guidance in SSAP 10. Do you agree?	X		

	Agree	Disagree	Comment
22. The existing SSAP 10 requires that, in the case of associates which are listed on a recognised stock exchange, only published financial information should be disclosed in the financial statements of the investor when making the disclosures required under SSAP 10. No similar requirement is included in IAS 28. Do you consider that this requirement should be retained in SSAP 10?		X	This requirement originated from an old UK SSAP 1 “Accounting for associated companies” on which SSAP 10 is based. Given such requirement is no longer retained in the current UK accounting standard FRS 9 “Associates and joint ventures”, we do not support retaining this requirement in SSAP 10.

2 Responses to the IASB’s invitation to comment

2.1 IAS 1 “Presentation of financial statements”

<u>Question 1 - Proposed approach regarding departure from a requirement of an International Financial Reporting Standard (“IFRS”) or an Interpretation of an IFRS</u>

We agree that a true and fair override is necessary in a financial reporting framework. However, we believe that the proposed revision to the wording regarding the true and fair override is not helpful in clarifying the extremely rare circumstances when such an override will be required. The proposed revisions appear likely to encourage more frequent overrides based on the Framework. We believe the IASB should retain the current wording of paragraphs 16 to 18 of IAS 1, which requires a conclusion that application of a standard will be misleading and clearly inappropriate. The IASB may wish to strengthen the existing guidance by emphasising, perhaps in the Basis for Conclusion, that disagreement with the IASB's conclusion in a standard, even if supported by an alternative analysis of the Framework, is not a sufficient basis for an override. An override would be expected only if an issue not considered by the IASB arose and the result of applying the Standard to this unanticipated event clearly is misleading.

<u>Question 2 - Prohibition of the presentation of items of income and expense as "extraordinary items"</u>

We agree to the proposed prohibition of presentation of income and expenses as "extraordinary items".

<u>Question 3 - Refinancing after the balance sheet date are not taken into account in classifying liabilities as current/non-current</u>

We agree to the proposed amendment as it is consistent with the principles under IAS 10 "Events after the balance sheet date". Agreement to refinance or reschedule payments completed after the balance sheet date is a non-adjusting event under IAS 10 and therefore the classification of a liability based solely on this event at the balance sheet date is inappropriate.

<u>Question 4(a) - A long-term financial liability that is payable on demand because the entity breached a condition of the loan agreement should be classified as current, even if the lender agreed not to demand payment after the balance sheet date</u>

Same comments as that for refinancing after the balance sheet date.

<u>Question 4(b) - Exemption under paragraph 63 of the ED from classifying a liability that is payable on demand as current at the balance sheet date</u>

We have no strong views on this issue as there are valid arguments for either treatment.

<u>Question 5 - Disclosure of management judgements in applying accounting policies</u>

We consider that paragraph 108 should be a general discussion of the need to provide context to financial statement users so that they can understand better how the measurement decisions have been made. We believe the language in paragraph 80 is a better model for the wording of a requirement – an entity should be required to disclose the nature and amount of items whose measurement is impacted significantly by management judgment, as well as describing how that judgment has been applied.

We also encourage the IASB, when it is drafting standards, to identify what the Board believes are the critical judgments involved in applying the standard and highlighting these items as potential disclosure items. We would expect these to be concentrated in areas where judgment overrides normal expectations – for example, why a conclusion is reached that control exists without majority ownership (or vice versa).

Question 6 - Disclosure of key assumptions about the future and other sources of measurement uncertainty

We do not support the introduction of the requirements in paragraph 110 as drafted. The current wording could be read to require management to develop (and auditors to report on) a forecast of all possible changes in carrying amounts of assets and liabilities in the next twelve months due to actual results differing from assumptions, especially in light of the proposed requirement to disclose key assumptions "that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year". We believe that the IASB's objective can be addressed more appropriately by requiring identification of key assumptions and measurement uncertainties and of the basis for the judgments made. This requirement should be clarified as applying in the absence of specific requirements in an individual standard. We also encourage the IASB to consider this concern as it formulates standards, and seek to identify what disclosures it should require in a specific standard in order to address this general concern.

2.2 IAS 2 "Inventories"

Question 1 - Eliminating the allowed alternative of using the last-in, first-out (LIFO) method

Generally we are supportive of the IASB's efforts to remove options in standards. We support this proposal as it would make IAS 2 consistent with Hong Kong GAAP which does not permit the use of the LIFO method.

Question 2 - Reversal of write-downs of inventories

We believe that the requirements in respect of reversal of write-downs of inventories should be retained. We agree that if the circumstances of the original write-down no longer exist then the write-down should be reversed. This would be consistent with the objective of valuing inventory at the lower of cost and net realisable value.

2.3 IAS 8 "Accounting policies, changes in accounting estimates and errors"

Question 1 - Removal of allowed alternative treatment for changes in accounting policies and corrections of errors

We concur with the proposal to eliminate the allowed alternative treatment of adjusting prior periods via a cumulative effect adjustment in opening retained earnings, generally for the reasons provided in the Basis of Conclusions. IAS emphasises the importance of comparability of financial information, both in its Framework (see, e.g. paragraphs 39-42) and its standards (e.g., the requirement for comparative information). We agree that the current allowed alternative reduces the comparability of financial information.

Question 2 - Eliminating the distinction between fundamental errors and other material errors

We agree with this proposal. However, we suggest that the IASB expand its discussion of the difference between correction of an error and revision of estimates, in part to emphasise that errors should not occur in properly prepared financial statements, and that correction of an error is necessary when and only when previous financial statements have been misstated materially.

2.4 IAS 16 "Property, plant and equipment"

Questions 1 and 2 – Exchanges of items of property, plant and equipment and intangible assets measured at fair value

We are not in favour of the proposed changes. Recording exchanges of property, plant and equipment at fair value also involves recognition of gains (and losses in addition to impairment losses) on these transactions. We believe that the issues surrounding gain recognition for non-monetary transactions would be dealt with more effectively in conjunction with the Board's new project on revenue recognition, which should cover barter transactions. Until such time the current position should be maintained in both IAS 16 and IAS 38 in respect of exchanges of assets to avoid multiple changes to the requirements for a major class of transaction.

Question 3 – Depreciation of an item of property, plant and equipment when it becomes temporarily idle or is retired from active use and held for disposal

We do not agree with the proposal. We believe that assets that have been removed from use should be measured at the lower of depreciated cost and recoverable amount. If an asset has been removed from use, its recoverable amount should be its net selling price (value in use will reflect the same cash flows from disposal). As the asset has been removed from use, we believe that allocation of cost is no longer appropriate and therefore depreciation should cease (impairment tests under IAS 36 would continue).

Our view is conditioned on the assets being removed from service. We believe that if assets continue to be used, even if they are designated as held for sale, they should continue to be depreciated. Depreciation is defined as "the systematic allocation…of an asset over its useful life." In our view, the useful life is the period of use; after an asset is removed from service, the rationale for allocation is removed. Instead, it should be measured at the lower of its carrying amount (either cost or revalued amount under the allowed alternative) and its recoverable amount.

Where the assets are used in a seasonal industry or have scheduled "down" time for repair and maintenance, the estimated useful life selected should reflect the expected pattern of use.

2.5 IAS 17 “Leases”

Question 1 – Classification of a lease of land and buildings

We agree with this proposal as it enables a company to better account for a lease according to its substance, especially in those circumstances where the risks and benefits of ownership are not all passed to the lessee. Please see our comments in 3.5 on leasehold interest in land.

Question 2 – Initial direct costs in negotiating a lease

We agree with this proposal as it requires treatment of transaction costs that is consistent with other IAS (e.g. IAS 39).

2.6 IAS 21 “The effects of changes in foreign exchange rates”

Question 1 - Proposed definition of and guidance on functional currency

We agree with the definition of functional currency, but we are concerned that the guidance in paragraph 9 (foreign operation) has some inconsistencies from the functional currency concept in paragraph 7. The “economic environment” test is, in our view, different to the “independence from parent” test.

For example, a French company with the Euro as its functional currency may have a foreign operation based in the USA. The US subsidiary may be funded by the parent in USD and all its transactions may be in USD, including purchases from the parent company. Its primary economic environment may be the US environment using the guidance in paragraphs 7 and 8. However, it may source all of its product from the parent, remit proceeds to the parent and otherwise operate as a traditional “branch”.

Under paragraph 9 it clearly is an integral part of the parent’s activities, which implies that the Euro is its functional currency. Paragraph 10 deals with circumstances where the indicators are mixed, and seems to revert to the definition of functional currency, suggesting that paragraphs 7 and 8 would override paragraph 9. We do not disagree with this conclusion, but we do believe that further guidance should be provided to explain that the “economic environment” test should override the “independence from parent” test in circumstances where there is conflict.

We believe that the Board’s focus on the primary economic environment in which the entity operates, rather than on the currency in which transactions are denominated, is an improvement that will focus on the substance – the most meaningful currency – rather than currency in which an entity may choose to denominate its transactions.

Question 2 - Choice of presentation currency (or currencies)

We agree that a reporting entity (whether a group or a stand-alone entity) should be permitted to present its financial statements in any currency (or currencies) that it chooses.

As noted in the Basis for Conclusion (paragraphs A8 - A10) an entity can have many different users of its financial statements who, for varying reasons, may want or need to have these financial statements presented in different currencies (e.g. local tax authorities, foreign lenders, local and international investors). The exposure draft's proposal will accommodate these information needs appropriately.

Question 3 - Method of translating financial statements into the presentation currency (or currencies)

We agree that the method of translation should be the same as is required for translating a foreign operation for inclusion in the reporting entity's financial statements.

Question 4 - Capitalisation of exchange differences

We agree with the proposal to remove the allowed alternative to capitalise exchange differences as we believe that the option is no longer necessary.

Question 5 - Translation of goodwill and fair value adjustments to assets and liabilities that arise on the acquisition of a foreign operation

We support the Board's effort to eliminate options and believe that, while valid arguments can be made to support each of the alternatives permitted currently under IAS 21, it is preferable to require one approach. Like the Board we believe the balance of arguments weighs in favour of the approach proposed, but also support reviewing this conclusion as part of the Board's business combinations project, as indicated in paragraph A27.

2.7 IAS 24 "Relater party disclosures"

Question 1 – Disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations

We do not agree with the Board's proposal that disclosure of executive and non-executive management compensation should not be required. While we have sympathy with the privacy rationale for the exemption, as provided in the Basis for Conclusions, we would prefer an approach that would allow aggregation of amounts to the extent necessary to avoid specific breaches of national privacy requirements.

We also are concerned with the view expressed in paragraph A3(a) in the Basis for Conclusions that corporate governance processes may remove the need for related party disclosures. While this may be true in some jurisdictions, we wonder whether it is wise to rely on such processes in the current environment.

We believe that disclosure of compensatory arrangements should be required for those identified as related parties in paragraph 9 of the ED. We do not believe that further definition of management would be necessary.

Issues to consider when adopting the ED in Hong Kong

Even if paragraph 2 of the ED is retained, it would be irrelevant to users in Hong Kong since Hong Kong incorporated or listed companies are required to disclose directors' remuneration in the financial statements in accordance with S161 of the Companies Ordinance and/or Appendix 16 of the Rules Governing the Listing of Securities issued by The Stock Exchange of Hong Kong Limited.

Question 2 – Wholly-owned subsidiary exemption

We do not have any strong views on this issue but we prefer retaining the existing exemption under paragraph 4(c) of SSAP 20.

2.8 IAS 27 "Consolidated and separate financial statements"

Question 1 - Proposed exemption from preparation of consolidated financial statements

We agree to the proposal. Some countries permit or require presentation of unconsolidated financial statements using IAS, and more are expected to do so in the future. We believe the requirements of paragraph 8 will allow entities to prepare IAS-based separate company financial statements in only those circumstances where they will be appropriate.

Question 2 - Presentation of minority interests within equity, separately from parent shareholders' equity

We have no objection to this proposal.

Question 3 - Accounting treatment of investments in subsidiaries, jointly controlled entities and associates in the investor's separate financial statements where these entities are consolidated, proportionally consolidated or equity accounted for in the investor's consolidated financial statements

We believe that investments in these entities should be required to be accounted for at cost in an entity's separate financial statements, rather than permitting or requiring measurement at fair value under IAS 39. Generally, we believe the IASB should strive to eliminate options. If the focus of separate company financial statements is on the legal entity alone, we believe measurement at cost is more consistent with that focus, rather than mixing in valuation adjustments relating to other entities.

Question 3 - Requirement to account for investments in subsidiaries, jointly controlled entities and associates in the investor's separate financial statements in accordance with IAS 39 if the same treatment is being adopted in the consolidated financial statements

We agree with this proposal.

2.9 IAS 28 “Accounting for investments in associates”

Question 1 - Proposed exemption for venture capital organisations, mutual funds, unit trusts and similar entities from complying with IAS 28 and IAS 31

We agree with this proposal.

Question 2 - Equity method – recognition of losses

We support this proposal as we believe that other interests, such as long-term receivables, in substance form part of an entity’s investment in equity of the associate and therefore should be measured in the same way as other elements of an investment.

2.10 IAS 33 “Earnings per share”

Question 1 – Contracts that may be settled either in ordinary shares or in cash at the issuer’s option

We consider that it would in practice be difficult to apply paragraph 51(c), which requires an assessment of whether the presumption may be overcome for each period.

As an alternative to the approach in paragraph 51 of the ED, we propose the IASB to adopt the presumption that the contract will be settled in the most advantageous way from the standpoint of the entity, unless there is evidence to the contrary. Any changes to the numerator follow the requirements in paragraph 28 or 51(c) of the ED, as appropriate. This approach mirrors the presumption adopted in paragraphs 33 and 52 of the ED, which is from the standpoint of the holder of the instrument.

Question 2 – Approach to the year-to-date calculation of diluted earnings per share

We recognise that the approach proposed will achieve convergence with US GAAP. However, one likely result is that the frequency of interim reporting will impact EPS. This is inconsistent with the principle that frequency of reporting should not impact measurement (IAS 34.28). Using the warrant data from example 12 in Appendix B, an entity that reports on a quarterly basis will include 12,500 shares with respect to the first half year. However, an entity reporting on a semi-annual basis would include 0, as the year-to-date average of the quarterly share prices of 49 and 60 is 54.5, which is anti-dilutive.

We recommend that the average (or weighted average) data is the average (or weighted average) for the reporting period without regard for any diluted earnings per share information reported in respect of an earlier sub-period during the period.

3 Other comments

3.1 IAS 1 “Presentation of financial statements”

<u>Compliance statement (paragraph 11)</u>

We believe that there is a need to address an issue of when financial statements can be referred to as in accordance with IFRS. In practice a number of financial statements are prepared “in accordance with IAS except for…”. We think it is important for the IASB to recognise that, in some circumstances where IAS has been used as the reporting framework subject to a non-pervasive, discrete departure, it may be more useful to a financial statement user to describe the basis of preparation in that way rather than, for example, “in accordance with the accounting policies described in note 1”. The current version of IAS 1 describes in paragraph 14 a number of situations where "almost" compliance with IAS might have been claimed in the past, and we agree with paragraph 14 of IAS1 that in these cases claims of compliance with IAS, even if qualified, are not appropriate. We encourage the IASB to work with the International Auditing and Assurance Standards Board (“IAASB”) in order to address this issue in a timely fashion.

<u>Departure from a requirement of an International Financial Reporting Standard (“IFRS”) or an Interpretation of an IFRS (paragraphs 13 to 16)</u>

We believe that a disclosure should be required of situations where, even though there is no current period departure, an opening balance sheet contains amounts derived from a departure from an IFRS, where such a departure will continue to impact the results and net assets of future financial statements of the entity.

<u>Accrual basis of accounting (paragraph 21)</u>

We believe that the reference to the Framework is not sufficient when explaining the recognition criteria for the elements of the financial statements under the accrual basis of accounting, as certain older standards, e.g. IAS 20 and IAS 17, set out definitions that may not be wholly consistent with the Framework. We suggest the following wording to be used:

“… income and expenses in accordance with the requirements of IFRS, or otherwise when they satisfy the definitions and …”.

<u>Information to be presented on the face of the balance sheet</u>

Paragraph 65(o) requires disclosure of issued capital and reserves attributable to owners of the parent on the face of the balance sheet. We think it would be better to refer to “issued capital and reserves attributable to owners of the *reporting entity*” rather than the *parent* as the reporting entity may have a parent.

Other

We believe that paragraph 12 of the existing IAS 1 should be retained. It is desirable to state clearly in a discussion of either "selection of accounting policies" or "true and fair override" that disclosure does not compensate for inappropriate accounting treatment.

3.2 IAS 2 "Inventories"

Scope (paragraph 1(c))

The exposure draft of IAS 2 proposes widening the scope exclusion by deleting the word "producers" in paragraph 1(c). As a result IAS 2 would not apply to inventories of agricultural and forest products and mineral ores to the extent that they are measured at net realisable value ("NRV") in accordance with well established practices in certain industries. This proposed drafting means that commodity broker/dealers whose inventories are measured at fair value rather than NRV still would be required to follow IAS 2.

We would not regard the text of paragraphs 25 to 30 of the ED on IAS 2 as encompassing fair value measurement of the type required by IAS 39. NRV, as discussed in IAS 2, implies "lower of cost and NRV" measures rather than a mark-to-market approach. We believe that established practice for commodity broker/dealers more closely resembles mark-to-market accounting in accordance with IAS 39. Therefore, we recommend:

- not deleting the word "producers", i.e. keep the original paragraph 1(c) of IAS 2;
- adding to the scope exclusion a separate line for "commodity broker/dealers whose inventories are measured at fair value"; and
- adding measurement guidance in IAS 39 for such commodity broker/dealers, which would require a modification to the scope of IAS 39.

3.3 IAS 8 "Accounting policies, changes in accounting estimates and errors"

Selection of accounting policies

We noted that the IASB has introduced "appendices that do not form a part of the standard" and "implementation guidance" to the hierarchy (paragraph 4). We support both clarifications of the status of these documents and the proposed "ranking" in the IASB hierarchy. We suggest that the IASB also state the status of the Basis for Conclusions.

Furthermore, we support the IASB's articulation of a hierarchy and its application to situations where a financial statement item is not addressed specifically by the standards or interpretations. However, we believe the IASB's proposed hierarchy should be changed in respect of situations where an item is specifically excluded from the scope of a relevant standard. If the hierarchy is applied to an item for which there is no relevant standard by virtue of exclusion, then the effect will be to require application of that same standard. Clearly, scope exclusions should continue to be infrequent and be provided in specific and limited circumstances, for example as in IAS 37 where insurance contract liabilities are excluded because of the IASB's insurance project. In these cases, we would support looking first to paragraph 6(c), rephrased as "to the extent that these are not inconsistent with (a) and (b) of this paragraph."

Adoption of a Standard

It is unclear what circumstances paragraph 16 describes, for example, whether it refers to the situation where restatement of the opening balance is not required? We suggest clarifying the wording.

Undue cost and effort

A notion "undue cost and effort" has been used in the standard (paragraphs 23(d), 30, 33 and 35(d)). In the absence of clarification or guidance, entities may interpret this as cost-benefit analysis. However, we understand from discussions at the IASB meetings that "undue cost and effort" implies the instances where even after investing a reasonable amount of cost and effort, the probability of arriving at reliable results would be low. Therefore, we recommend that the IASB discuss its intention in the standard or perhaps in the Basis for Conclusion to avoid misinterpretation.

We also suggest requiring disclosure of the reason why reclassification would cause undue cost and effort. If this change is not made, undue cost and effort might be cited as the reason in many cases, which would not be very helpful.

Classification of the effect of a change in accounting estimates

The IASB has dropped language currently included in paragraph 28 of IAS 8 regarding classification of the effect of a change in accounting estimate. We suggest that this guidance be retained.

Corrections of errors

We agree that comparatives should be restated except in the rare circumstances when it genuinely is too costly or time consuming to achieve. We therefore recommend the wording of paragraph 34 of the ED is strengthened to emphasise that in the vast majority of cases this exemption is not expected to be taken.

3.4 IAS 16 "Property, plant and equipment"

Accounting for property interest held under an operating lease

We believe that the amendments to IAS 40 "Investment property" in respect of property interest held by a lessee under an operating lease to be accounted for as an investment property should also be made in IAS 16, provided that the property meets the definition of "property, plant and equipment" and is accounted for under the allowed alternative method under IAS 16.

Assets under construction

The IASB has proposed a change in paragraph 4 of the ED to repeat the guidance in IAS 40.7(d), that investment property under construction is within the scope of IAS 16. However, the explanation added, "because the property does not yet satisfy the definition of "investment property" in IAS 40" could be made about IAS 16, which lacks explicit guidance for accounting for property, plant and equipment under construction. We suggest that the Board add a discussion to IAS 16 clarifying that:

- it applies to assets under construction and how the recognition guidance in IAS 16.7 should be applied to property, plant and equipment under construction; and
- where the assets under construction are held for sale, IAS 2 should apply.

Meaning of "more clearly evident"

The IASB should provide clarification of the phrase "more clearly evident" used in paragraphs 16A and 21 in IAS 16, paragraphs 26 and 34 in IAS 38 and paragraph 21A in IAS 40. The proposed paragraph 21 states inter alia that when an item of property, plant and equipment is acquired in exchange of another item of property, plant and equipment or other asset "*the cost of such an item is measured at the fair value of the asset given up. The fair value of the asset received is used to measure its cost if it* ***is more clearly evident*** *than the fair value of the asset given up* [emphasis added]." The IASB should, either in guidance material or in its Basis for Conclusions, clarify whether this phrase means "*more easily available*" or "*more accurate valuation*" or "*most reliable method*". The IASB also should clarify if it intends this guidance to be different from that in IAS 22.24, which looks to measure fair value based on assets received only if the fair value of the item surrendered is not measurable reliably.

Example of opening a new facility

In order to clarify paragraph 17(a), "the costs of opening a new facility", we suggest adding examples such as feasibility studies or the cost of selecting, hiring and training employees.

Items of property, plant and equipment used in incidental operations

We suggest linking in paragraph 17B with paragraph 59 to clarify that where assets are used in producing incremental revenue they are depreciated/amortised in that time period.

Review of estimated residual value

We agree with the proposed change in paragraph 46 only in respect of situations where an entity has a policy of revaluation; in these cases the residual values should be based on current prices for those assets. However, if the assets are carried at historic cost then the use of residual values based on current values would seem to be inconsistent. This would lead to a depreciation charge which would be a mixture of both historical and revaluation accounting. Therefore, we believe that if the cost method is being applied then no revaluation of the residual value should be allowed.

Recognition of compensation

The ED proposes in paragraphs 53A and 53B(B) that compensation is included in the period in which it is **received**. This is not in accordance with the accrual concept. We therefore recommend the IASB to follow more closely the original wording in Interpretation SIC-14 “Property, plant and equipment – compensation for the impairment or loss of items”. In paragraph 53A, “when it is received” is to be replaced by “when it is recognised”. In paragraph 53B, the time to recognise the compensation is explained as when the amount of compensation can be measured reliably and it is probable that the economic benefits associated with the compensation will flow to the entity.

Effective interest method

We think that the last sentence of paragraph 58A should be aligned with IAS 18.11 to be consistent with both IAS 18 and IAS 39.

Transitional provisions

As previously contained in Interpretation SIC-23 “Property, plant and equipment – major inspection or overhaul costs”, the implementation of the component approach on major inspection or overhaul cost is treated as a change of accounting estimate. However, this conclusion is not repeated in the ED. It is not clear whether this conclusion still applies under the revised IAS 16.

3.5 IAS 17 “Leases”

Leasehold interest in land

Paragraph 11 of IAS 17 requires a leasehold interest in land to be recognised as an operating lease unless title of the land is expected to pass to the lessee at the end of the lease term. The justification is that land normally has an indefinite life and the lessee does not enjoy substantially all the risks and rewards incident to ownership if title is not transferred. We disagree with the treatment of all leasehold interest in land as operating leases for the following reason.

Interests in long term leasehold land (e.g. 999 year lease term) that are common in places such as Hong Kong and the United Kingdom are in substance very similar to freehold interests. In Hong Kong, the lessor is the Government. Not only are the lessees the registered “owners” in legal documents and the land registry records, their rights are virtually indistinguishable from the rights acquired on buying a piece of land - the lease grants the lessee the right to use the land and to transfer ownership to a third party, and prevents others from using it.

Inception of a lease - paragraph 3

We believe that the current definition of the inception of a lease is incomplete, as it does not take into account situations where the asset subject to the lease agreement does not yet exist, for instance because the asset is under construction. Although a lease agreement may be already entered into, lease payments generally would not begin until the asset is constructed and made available to the lessee to use and the construction contract is settled.

When applying the current definition for classification, in such cases the present value of the minimum lease payments are discounted back to the date of the lease agreement. This can potentially impact the outcome of lease classification, and allow for manipulation of classification as a finance lease versus an operating lease simply by changing the period of time between signing a lease contract and the expected date that construction would be completed. Regardless, the interpretation of "inception of a lease" could lead to a grossing up of the balance sheet prior to the start of the actual lease term.

We suggest that the definition should address this situation by further noting that if the asset subject to the lease has yet to be constructed or acquired by the lessor, the lease inception is considered to be the date that construction is complete or when the asset is acquired by the lessor.

Drafting comment - paragraph 29A

This paragraph as drafted conflicts with paragraph 34 because it specifies the treatment for all initial direct costs, but then paragraph 34 introduces an exception for initial direct costs incurred by manufacturer or dealer lessors. This potential conflict could be avoided by modifying the drafting as follows: "for finance lease other than those involving manufacturer or dealer lessors, these initial costs …".

3.6 IAS 21 "The effects of changes in exchange rates"

Definition of foreign operation

We recommend clarifying whether the definition of a foreign operation in paragraph 6 requires it to be a separate legal entity or a division as long as it has separate operations, books and records. This clarification is important taking into account that some wording, for example, references to inclusion by consolidation in paragraphs 41 - 45, do not cater for branches.

Paragraphs 7 and 9

We believe it is useful to provide an approach to determining the functional currency for a foreign operation when the currency of a majority of its intercompany transactions differs from the functional currency of the parent.

Monetary items

We support the introduction of monetary items and examples provided in paragraph 14. We also encourage the Board to clarify that an equity security investment is non-monetary: while its value can be measured as a determinable amount of money, it is not a right to receive that amount of money. Conversely, if amounts prepaid for goods and services are refundable they do represent the right to receive a fixed amount or determinable amount of money and they are monetary.

Paragraphs 30 and 31

We disagree with the treatment proposed in these paragraphs in respect of the separate financial statements. If a loan is, in substance, part of the parent's net investment in the subsidiary, we believe it should be regarded as such in both the separate and consolidated financial statements in the same manner as goodwill and fair value adjustments to assets and liabilities that arise on the acquisition of a foreign entity.

In the financial statements of the subsidiary, the classification of the intercompany investment should be in accordance with IAS 32. We note that even if such an item is treated as non-monetary in the parent's financial statements, in the subsidiary's books it may be classified as a liability. For example, an investor may conclude that an advance is part of a long term investment in accordance with paragraph 26, however if this instrument is denominated as a loan (e.g. with interest payments and/or a nominal redemption date), the foreign operation would have to classify it as a liability under IAS 32.

Paragraph 46 and 47

We would appreciate some guidance on whether the repayment of a "permanent" loan in a foreign entity (see paragraph 13) constitutes a partial disposal that requires some portion of the cumulative exchange difference to be transferred to the income statement. Although this would appear to be a natural interpretation of the proposals, we note that US GAAP considers only ownership interests in accounting for a partial disposal.

Drafting comment – paragraphs 53 and 55

We agree with the Board's intention to permit use of convenience translations so long as they are labelled clearly as supplementary information not presented in according with IFRS. However, the drafting of paragraph 53 should be deleted. It is not appropriate to single out certain paragraphs as required – somehow it implies that other paragraphs in this or other standards are less required. We suggest deleting paragraph 53 and revising reference in paragraph 55 to be "the requirements of paragraphs 37 and 40 are not met…".

3.7 IAS 24 "Related party disclosures"

Exemption for financial statements of state controlled enterprises from disclosing transactions with other state controlled enterprises

The ED proposes to eliminate the exemption available to state controlled enterprises under paragraph 4(d) of IAS 24. This will have a profound impact on the financial statements of a lot of companies in an economy like China's in which most of the companies are state owned. We disagree with the elimination of this exemption for the following reasons:

- We believe that an accounting standard should only require disclosure of information which a company could reasonably be expected to be able to obtain without an excessive amount of effort.

  China was (and still is) a planned economy and most companies are still state owned, including banks, insurance companies, airlines, supermarkets, trading companies, hotels etc. Any business enterprise would have a significant portion of its business dealings with state owned enterprises. To require all state owned enterprises to capture and correctly identify all transactions with other state owned enterprises would put undue burden on these companies as they need to establish a system to track all transactions with other state owned enterprises. This may not be workable in practice because some state owned enterprises are vast groups with hundreds of subsidiaries and associates, and the reporting entity does not have the rights or the means to obtain information concerning the ownership of all its customers and suppliers.

- We also believe that accounting standards should only require disclosure of information pertinent to the presentation of a true and fair view.

  Most of the state owned enterprises are not related to one another other than the fact that they have a common owner, the state. However, the state does not have a coherent managerial role on all these enterprises which were traditionally under the control of the respective ministries. In recent years, the central government has been pushing hard to separate the regulatory role and the business role of various ministries. Some ministries (e.g. the Ministry of Information Industry) only retain a regulatory role, having ceased its business role over their former "controlled entities". Indeed, these former controlled entities may in fact be competing against one another. Each of these entities has its own independent management and board of directors to make final decisions on its financial and operating policies. The ministry does not take part in any aspect of managing the entity. Where the counter party, even though state owned, is not under common control or common significant influence, we believe the disclosure of transactions with such a party is irrelevant to giving a true and fair view of the financial statements. Removing the paragraph 4(d) exemption could result in transactions with competitors being described as related party transactions, which would be misleading.

> The ED justifies the disclosure of related party transactions by stating that knowledge of related party transactions "may affect assessments of an entity's operations by users of financial statements, including assessments of the risk and opportunities facing the entity". We agree with this statement but do not find it relevant to the circumstances of state owned enterprises described above. There is a big difference between information which some users of the financial statements might find of interest (such as transactions in the normal course of dealings between state owned enterprises) and information which is necessary for the financial statements to give a true and fair view.

While we recognise that the exemption available under the proposed paragraph 11(c) of the ED for transactions with public utilities, government departments and agencies in the course of normal dealings with the state controlled enterprise would eliminate the disclosure of transactions that would not be of interest to a financial statement user, there are still a significant number of state owned enterprises which are neither a public utility nor a government department or agent.

We are not of the view that all transactions with state owned enterprises should be exempted from IAS 24. However, we strongly recommend that the IASB consider clarifying that state owned entities should not be regarded as related parties simply because they are both owned by the state. Rather, a substance over form approach should be adopted and entities should disclose such information where it is necessary for the financial statements to give a true and fair view of the financial position of the reporting entity and its performance and cash flows, from the point of view of the intended users of the financial statements.

<u>Exemption for companies preparing accounts under s.141D of the Companies Ordinance</u>

SSAP 1 "Presentation of Financial Statements" states that those private companies that take advantage of the exemptions granted by section 141D of the Companies Ordinance are considered to be preparing special purpose financing statements that do not necessarily comply with the requirements of Hong Kong SSAPs, and which do not show a true and fair view.

In our opinion, the disclosures required by IAS 24 contribute to the "fairness" of the view given by a set of financial statements rather than the "truth" of those financial statements. It therefore seems appropriate to exempt companies which apply section 141D from the scope when the HKSA adopt the revised IAS 24 as a SSAP. In this respect it might be advisable to require such companies to make a statement in their financial statements that they are relying on this exemptions so as to minimise any uncertainty in the minds of the users of the financial statements as to the extent of related party disclosure.

3.8 IAS 27 "Consolidated and separate financial statements"

<u>Subsidiary operating under severe long-term restrictions</u>

We suggest rephrasing paragraph 12A to explain the reason for this observation.

Presumably the basis for the IASB's view is similar to that in SIC-12: that the concept of control is not just the power to manage but also the power to obtain benefit. Paragraph 12A should be rephrased to emphasise that significant uncertainties over the ability to realise benefits result in the conclusion of lack of control.

Potential voting rights

Withdrawing SIC-33 and including only its conclusion in IAS 27 (paragraphs 12B and 15A) means that the examples included in SIC-33 will no longer be available. We feel that the examples are helpful in understanding the SIC, especially as it is a relatively new interpretation and therefore we suggest that they be included in the amended standard.

Furthermore, we believe disclosure should be made about the specific impact of potential voting rights. Therefore, we suggest paragraph 32 to require disclosure of the following:

- when majority ownership does not provide control because of potential voting rights held by others; or
- when control exists despite a current lack of majority ownership due to potential voting rights; and
- a general description of terms of potential voting rights.

Consolidation for venture capital organizations (paragraph 13A)

We believe that the most meaningful information for a venture capital organisation's managers and investors often are financial statements prepared using a comprehensive fair value accounting model rather than consolidated financial statements based largely on historical costs. We think these different information needs distinguish users of a venture capital organisation's financial statements from those described in paragraph 30A. Therefore, we believe that the scope exclusion should be extended to all venture capitalist investments including subsidiaries. However this view on the venture capitalist's financial statements is only valid so long as the use of fair value is comprehensive and not selective. Therefore, we believe that the exemption from use of IAS 27 should be available only if substantially all of a group's investments are measured at fair value. We would interpret substantially all as 90%. If an entity asserts that lack of reliability in determining fair value requires the use of cost measurement for more than an insignificant portion of its investments, then it should not be able to utilise this option in respect of some or all of its subsidiaries. We would interpret an insignificant portion as 10%.

We also believe that an enterprise should be required to make a consistent policy election in respect of the fair value alternative for measurement of subsidiaries and associates held for investment purposes.

Temporary investments in subsidiaries (paragraph 13)

We consider that the guidance set out in paragraphs 24 and 25 of Hong Kong SSAP 32 "Consolidated financial statements and accounting for investments in subsidiaries" are useful and suggest that they should be proposed for inclusion in the revised IAS 27.

3.9 IAS 28 "Accounting for investments in associates"

Elimination of unrealised profits and losses on transactions with associates (paragraph 16B)

We note that the conclusions in SIC-3 will be incorporated in IAS 28 (paragraph 16B). We believe that the standard should clarify where the elimination is recorded.

Potential voting rights (paragraph 5A)

Comments we have raised in respect of IAS 27 (see 3.8 above) apply equally to IAS 28.

Accounting treatment of investments in associates in the investor's separate financial statements (paragraphs 8A and 24A)

Paragraph 8A of the ED on IAS 28 seems to imply that where an investor has no investment in subsidiaries, the investor should account for an investment in an associate in its separate financial statements by using the equity method. This guidance is inconsistent with paragraph 24A of the same ED which requires that an investment in an associate shall be accounted for in the investor's separate financial statements in accordance with IAS 27. Under the ED on IAS 27, where separate financial statements are prepared, investments in associates shall be accounted for either at cost or in accordance with IAS 39.

We do not agree with the proposed amendment as it creates confusion. We suggest deleting this paragraph.

Disclosures (paragraph 27)

We suggest clarifying whether disclosures under items (a) and (b) of paragraph 27 are to be made in aggregate or on some other basis.

In addition, we suggest that the cost figure is given in addition to the fair values as required under item (a) of paragraph 27.

3.10 IAS 31 "Financial reporting of interest in joint ventures"

Joint venture operating under severe long-term restrictions (paragraph 3A)

Same comments as 3.8 above for "subsidiary operating under severe long-term restrictions".

<u>Accounting treatment of investments in jointly controlled entities in the venturer's separate financial statements (paragraphs 25A and 32A)</u>

We do not agree with the proposed amendments as they create confusion. We suggest deleting paragraphs 25A and 32A for the reasons given in 3.9 above.

3.11 IAS 33 "Earnings per share"

<u>Definition of "contingently issuable ordinary shares"</u>

The definition of contingently issuable ordinary shares limits them to situations where little or no cash is paid for the shares. We are not aware of why this was done and we encourage the Board to revise the definition to be "contingently issuable ordinary shares, warrants and options are shares, warrants and options issuable (or exercisable) upon the satisfaction of certain conditions pursuant to a contingent share, warrant or option agreement." This would then subject warrants and options to (a) the contingency guidance to see if conditions are satisfied; and, if they are, to (b) anti-dilution provisions. This would be helpful in establishing the clarification provided in paragraph 44 regarding employee share options (which may involve payment of more than a small sum of money). Paragraph 45 should then be reworded accordingly for the suggested revised definition.

<u>Definition of "profit or loss from continuing operations</u>

We believe that the term "profit or loss from continuing operations" used in paragraphs 8 and 26 should be defined, as continuing operations could be interpreted in different ways, and although paragraph 38 gives the answer, a definition would be best. At the same time it should be clarified that it is actually the net profit or loss from continuing operations, i.e. after tax and minority interests.

<u>Increasing rate preference shares</u>

The term "increasing rate preference shares" may refer to cases involving original issue discount/premium as illustrated here, or to preference shares with an accelerating dividend as described in the current version of paragraph 22 of IAS 32. The second sentence of paragraph 13 and Example 1 of Appendix B illustrate how an equivalent of a discount/premium is computed and amortised to yield a constant dividend rate if the preference share is classified as equity, rather than as a liability. We suggest modifying the wording of paragraph 13 as follows (with changes highlighted in italics):

"~~*Increasing rate p*~~Preference shares ~~*often*~~ *may* provide…. Any original issue discount or premium *on preference shares classified as equity* is amortised to retained earnings…".

We also suggest to retitle Example 1 as "Preference shares issued at a discount" and modify the fourth paragraph as follows (with changes highlighted in italics):

"Under paragraph 13 the original issue discount is amortised to retained earnings, *as the preference shares are classified as equity*, using the *effective* interest *rate* method ……."

Uniting of interests

The concept of “uniting of interests” appears in paragraphs 20 and 56. This concept is not applicable under HKGAAP. In the Appendix to SSAP 30, the HKSA expresses its view that only in the rarest circumstances that an acquirer is not identifiable in a business combination. Acquisition accounting, therefore, applies in almost all circumstances. Given the HKSA’s position on this issue, modifications to paragraphs 20 and 56 of the ED would be necessary in the revised Hong Kong SSAP should these paragraphs be incorporated in the revised IAS 33.

Restatement of amounts of earnings per share

We believe that, in paragraphs 8, 26 and 56, the Board should clarify that an entity shall restate EPS to present separate EPS from continuing, discontinuing and the entity’s operations by adjusting the numerator when in accordance with IAS 35, it restated comparatives for discontinuing operations.

Conditions for including contingently issuable shares in earnings per share calculation

We believe that the comment in paragraph 45 about when necessary conditions are satisfied for contingently issuable shares (when ‘the events have occurred’) seems inconsistent with the language in paragraph 65 of IAS 22, which requires contingently issuable consideration to be accounted for once the resolution is probable and the amount can be measured reliably. This may be before the event, i.e., final resolution, occurs.

Earnings per share for discontinuing operation

We believe that the reference in paragraph 60 to “for this line item” should be changed to “in respect of discontinuing operations”. Under IAS 35 discontinuing operations are not presented as a single line item.

Potential ordinary shares of subsidiaries, joint ventures or associates

Paragraph A9(a) seems unnecessarily complex, requiring many allocations. EPS for a group is not the sum of the EPS for each of the units, but rather is computed once for the group in total, the same way that EPS for an annual period is not the sum of the EPS for each quarter. If a subsidiary has issued warrants, options or other potentially dilutive instruments, the impact on net income for the group (via minority interest) can be computed. If the subsidiary’s instruments are convertible into shares of the parent, the impact of assumed exercise on the subsidiary’s net income can also be computed and adjusted. While recognising that the approach proposed is consistent with US GAAP (SFAS 128.156) we do not support requiring this complex computation.

We believe that the IASB’s desired approach – to reflect the dilution from potential ordinary shares – can be achieved by adjusting net income for the additional minority interest that would be created by the potential ordinary shares of a subsidiary (if they become interests in the subsidiary, joint venture or associate) or by considering them as potential ordinary shares of the parent, if they become interests in the parent.

Dilutive or anti-dilutive potential ordinary shares

We suggest rewording slightly the note to Example 12 of Appendix B to address the following inaccuracy. The example implies that dilutive/anti-dilutive rests on whether the control number is negative or positive. Instead, if the incremental earnings per share (i.e. the income statement impact/number of incremental shares) on the convertible is less than the EPS then it also may be anti-dilutive.

We trust you find the above comments helpful.

Yours faithfully