



MEMBERS' HANDBOOK

Update No. 30

(Issued June 2006)

Document Reference and Title

Instructions

Explanations

VOLUME II

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HK Interpretation 1
Revised June 2006

Effective on 1 October 2004

HK Interpretation 1

The Appropriate Accounting Policies for Infrastructure Facilities



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

**HK INTERPRETATION 1
THE APPROPRIATE ACCOUNTING POLICIES
FOR INFRASTRUCTURE FACILITIES**

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HK Interpretation 1 *The Appropriate Accounting Policies for Infrastructure Facilities* (HK-Int 1) is set out in paragraphs 1-12. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

This Interpretation was first issued as SSAP-Int 22 in October 2004 and, reissued as HK-Int 1 in May 2005 and revised in June 2006.

References

- ~~SSAP 14~~HKAS 17 *Leases*
- ~~SSAP 17~~HKAS 16 *Property, Plant and Equipment*
- ~~SSAP 29~~HKAS 38 *Intangible Assets*

Background

1. The Council of the Hong Kong Institute of Certified Public Accountants (“Council”) has become aware of inappropriate accounting treatments being applied in respect of infrastructure facilities, in particular toll roads.
2. An entity may enter into an agreement with a government to construct an infrastructure asset on a “Build, Operate and Transfer” (BOT) franchise basis. Under the BOT scheme, the entity has the right to build and operate the infrastructure asset (for example, a toll road/tunnel) on a commercial basis for a finite period of time (for example, 30 years) prior to handing that asset back to the government at nil or minimal consideration. During the franchise period, the entity is often the owner of the infrastructure asset and is allowed to earn a reasonable return through collection of fees from the users of the infrastructure asset.
3. Under paragraph 96 of ~~the Statement 2.04~~ “*Framework for the Preparation and Presentation of Financial Statements*”, the allocation methods of depreciation or amortisation are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire. As further elaborated in ~~SSAP 17~~HKAS 16 and ~~SSAP 29~~HKAS 38, the selection of a depreciation or amortisation method should reflect the expected pattern of consumption of economic benefits from the assets.
4. Under paragraph ~~4962~~ of ~~SSAP 17~~HKAS 16, the depreciation methods include the straight-line method, the diminishing balance method and the ~~sum-of-the-units~~ units of production method. When accounted for as an intangible asset, ~~SSAP 29~~HKAS 38 paragraph ~~8998~~ states that there is rarely, if ever, any persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method.
5. Council noted the 2 broad schools of thought on the meaning of “consumption of economic benefits” of an infrastructure asset: a time based view and a usage based view. Supporters of the time-based view argue for ~~the component approach and~~ primarily the straight-line depreciation method, as they consider the passage of time determines the consumption of economic benefits for ~~most components of toll roads~~. Supporters of the usage-based view argue for ~~the integral asset approach and~~ the units-of-usage depreciation method, as they consider the usage or traffic flow determines the consumption of economic benefits ~~for entire toll roads~~. As the phrase “consumption of economic benefits” is currently subject to debate, Council does not rule out either of the two views before obtaining clarification from the International Financial Reporting Interpretations Committee.
6. Council noted, and is concerned, that some financial statements purporting to be in compliance with Hong Kong Financial Reporting Standards disclosed an accounting policy that the capital cost of an infrastructure asset was allocated by applying a sinking fund method whereby the aggregate annual depreciation amounts, compounded at certain rates of return, up to the expiry of the infrastructure asset (e.g. toll road) concession periods, will be equal to the total cost of the asset.
7. This Interpretation provides guidance on the appropriate accounting policies for infrastructure facilities.

Scope

8. This Interpretation applies to the allocation of cost of infrastructure facilities regardless of whether the related asset (or component thereof) is classified as a property, plant and equipment under ~~SSAP 17~~ HKAS 16, intangible assets under ~~SSAP 29~~ HKAS 38 or operating lease prepayments under ~~SSAP 14~~ HKAS 17.

Issue

9. This Interpretation addresses the issue of determining whether the sinking fund method is an appropriate method of depreciating or amortising infrastructure assets.

Conclusion

10. The sinking fund method is not an appropriate method of depreciating or amortising infrastructure assets, regardless of whether the asset (or components thereof) is classified as property, plant and equipment, intangible assets or operating lease prepayments. By definition, the sinking fund method neither supports the view that consumption of economic benefits (such as in a BOT franchise) is determined by either the passage of time and/or usage.

Effective date

11. This Interpretation becomes effective on 1 October 2004. The marked-up changes in this Interpretation reflect the changes consequential on the issue of HKAS 16, HKAS 17 and HKAS 38 which replaced SSAP 17, SSAP 14 and SSAP 29, respectively, with effect for accounting periods beginning on or after 1 January 2005 (with early application encouraged). Given that there are no material differences between the above HKASs and SSAPs as far as this Interpretation is concerned, this Interpretation continues to apply after the changes.

Transition

12. Where the application of this Interpretation constitutes a change in accounting policy, it should be accounted for as a change in policy in accordance with ~~SSAP 2 Not Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies~~ or HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as applicable.

HK Interpretation 3
Revised June 2006

Effective for pre-completion contracts
for the sale of development properties
entered into on or after 1 January 2005

HK Interpretation 3

Revenue – Pre-completion Contracts for the Sale of Development Properties



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

**HK INTERPRETATION 3
REVENUE – PRE-COMPLETION CONTRACTS FOR
THE SALE OF DEVELOPMENT PROPERTIES
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HK Interpretation 3 *Revenue – Pre-completion Contracts for the Sale of Development Properties* (HK-Int 3) is set out in paragraphs 1-8. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

This Interpretation was first issued as SSAP-Int 24 in March 2005~~and~~¹ reissued as HK-Int 3 in May 2005 and revised in June 2006.

References

- HKAS 11 (~~SSAP 23~~) *Construction Contracts*
- HKAS 18 (~~SSAP 18~~) *Revenue*

Background

1. Property development projects are usually long term projects. In many cases, property developers would enter into contracts to sell the properties in advance of the completion of the development. These contracts usually involve the payment of a deposit by the purchaser, which may be refundable only if the developer does not complete the development in accordance with the contracted timeframes and specifications, or if there is some other breach of a contractual condition or statutory obligation. The balance of the purchase price is normally paid either at contractual settlement or in stages up to contractual settlement.
2. Property developers currently adopt various policies for recognising revenue arising from pre-completion contracts for the sale of development properties. The stage of completion method is a commonly used policy. Concern has been expressed as to whether the pre-completion contracts would satisfy the definition of construction contracts in HKAS 11 ~~or SSAP 23, as appropriate~~, and, if not, whether the stage of completion method would be acceptable under Hong Kong Financial Reporting Standards. Concern has also been expressed, in the absence of authoritative guidance, that diverse or unacceptable practices would undermine the relevance, reliability or comparability of financial statements.

Scope

3. This Interpretation provides guidance on the applicable accounting standard(s) to be followed in recognising revenue arising from the pre-completion contracts for the sale of development properties.

Issue

4. The issue addressed in this Interpretation is which accounting standard(s) shall be followed in recognising revenue arising from pre-completion contracts for the sale of development properties.

Conclusions

5. Pre-completion contracts for the sale of development properties do not meet the definition of construction contracts set out in HKAS 11 ~~or SSAP 23, as appropriate~~, if the contracts in question are not specifically negotiated for the construction of the properties. Accordingly, these contracts fall outside the scope of HKAS 11 ~~or SSAP 23, as appropriate~~, and, as a result, the stage of completion method as required under ~~these Standards~~ HKAS 11 shall not be used to recognise revenue arising from such contracts.
6. Property developers shall apply HKAS 18 ~~or SSAP 18, as appropriate~~, in recognising revenue arising from pre-completion contracts for the sale of development properties that do not fall within the scope of HKAS 11 ~~or SSAP 23, as appropriate~~, and, accordingly, recognise revenue only when all of the criteria specified in paragraph 14 of HKAS 18 ~~or paragraph 13 of SSAP 18, as appropriate~~, are met.

Effective date

7. An entity shall apply this Interpretation to pre-completion contracts for the sale of development properties entered into on or after 1 January 2005. Earlier application is encouraged. Retrospective application of this Interpretation to pre-completion contracts for the sale of development properties entered into before 1 January 2005 (or date of initial application of this Interpretation, if earlier) is permitted but not required. If an entity applies this Interpretation:

- (i) for a period beginning before 1 January 2005; and/or
- (ii) retrospectively to pre-completion contracts for the sale of development properties entered into before 1 January 2005 (or date of initial application of this Interpretation, if earlier),

it shall disclose those facts. The marked up changes in this Interpretation reflect the changes consequential on the issue of HKAS 11 and HKAS 18 which replaced SSAP 23 and SSAP 18, respectively, with effect for accounting periods beginning on or after 1 January 2005 (with earlier application encouraged). Given that there are no material differences between the above HKASs and SSAPs as far as this Interpretation is concerned, this Interpretation continues to apply after the changes.

Transition

8. If an entity chooses not to apply this Interpretation retrospectively to pre-completion contracts for the sale of development properties entered into before 1 January 2005 (or date of initial application of this Interpretation, if earlier), it shall continue to account for those contracts using the method of accounting used prior to the application of this Interpretation.

References

- HKAS 16 (~~SSAP 17~~) *Property, Plant and Equipment*
- HKAS 17(~~SSAP 14~~) *Leases*

Background

1. HKAS 17 requires the lease payment under a land lease classified as an operating lease to be recognised as an expense on a straight-line basis or other systematic basis over the lease term. HKAS 17 also provides that, if the lease payment for a property cannot be allocated reliably between the land and building components, the entire lease should be classified as a finance lease, unless it is clear that both elements are operating leases. In the case where the entire lease is classified as a finance lease, the related leasehold property interest can be accounted for using the cost or valuation model under HKAS 16 if such property interest meets the definition of property, plant and equipment under HKAS 16. Under the cost or valuation model in HKAS 16, the depreciable amount of that leasehold property interest should be allocated on a systematic basis over its useful life and the lease term would normally provide an indication of the useful life of that property interest.
2. Lease term is defined in HKAS 17 as the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option. In the light of the current land policy of the Government of the Hong Kong Special Administrative Region (the HKSAR Government), concern has been expressed as to how the length of the lease term of a Hong Kong land lease should be determined for the purpose of applying the requirements under HKAS 16 and HKAS 17, as appropriate. Concern has also been expressed, in the absence of authoritative guidance, that diverse or unacceptable practices would undermine the relevance, reliability or comparability of financial statements.
3. This Interpretation provides guidance on the determination of the length of the lease term of a Hong Kong land lease for the purpose of applying the amortisation (depreciation) requirements under HKAS 16 and HKAS 17, as appropriate.
4. This Interpretation does not address the assumptions that should be made when arriving at the current fair value of a property for accounting purposes.

Scope

5. This Interpretation applies where a property is classified as being held under an operating lease in accordance with HKAS 17.
6. This Interpretation also applies where the lease payment for an owner-used property cannot be allocated reliably between the land and building components on a fair value basis at the inception of the lease and thus the property is classified as a finance lease and accounted for using either the cost or valuation model under HKAS 16.

Issue

7. This Interpretation addresses the issue of how the length of the lease term of a Hong Kong land lease should be determined for the purpose of applying the amortisation (depreciation) requirements under HKAS 16 and HKAS 17, as appropriate.

Conclusions

8. The lease term of a Hong Kong land lease for the purpose of applying the amortisation (depreciation) requirements under HKAS 16 and HKAS 17, as appropriate, shall be determined by reference to the legal form and status of the lease. Renewal of a lease is assumed only when the lessee has a renewal option and it is reasonably certain at the inception of the lease that the