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Date	6 September 2002	Ref	Fax.IASB Improvement ED
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Subject	IASB Exposure Draft "Proposed improvements to International Accounting Standards"		

Please see attached.

Albert Li
Partner

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Our ref AKKL/20

6 September 2002

Dear Sir

IASB Exposure Draft "Proposed improvements on International Accounting Standards"

Further to our letter dated 3 September 2002 in connection with the above exposure draft ("ED"), we set out below additional comments on the ED which form part of section 2 "Responses to the IASB's invitation to comment" of our letter.

2.11 IAS 40 "Investment property"

Question 1 – Definition of investment property

We agree with the proposal as a leased property may be held to earn rentals or for capital appreciation purposes and the Board's proposed approach will permit better reporting of such activity.

Question 2 – Property interest held under an operating lease should be accounted for as a finance lease where such interest is classified as investment property

We agree that the exception is a practical way of addressing the situation where substantially all of the risks and benefits of use of a leased property are with the lessee and the leased property otherwise would qualify as an investment property.

Question 3 - Choice between the cost model and the fair value model

We agree with the IASB's view that IAS 40 has not been in use long enough to encourage widespread development and reliable fair values of investment properties on a regular basis.





In addition, we take this opportunity to revise certain of our comments included in our letter dated 3 September 2002. The revised comments are set out below.

2.1 IAS 33 “Earnings per share”

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

One likely result of the approach proposed is that the frequency of interim reporting will impact EPS. Using the warrant data from example 12 in Appendix B, an entity that reports on a quarterly basis will include additional 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. This is inconsistent with the principle that frequency of reporting should not impact measurement and that measurements for interim reporting purposes should be made on a year-to-date basis (IAS 34.28).

3.5 IAS 17 “Leases”

Leasehold interest in land

We note that as per Appendix A to IAS 40, the Board decided against amending paragraph 11 of IAS 17 to deal with the situation where the terms of long term leases are such that they differ very little from buying a property outright and instead decided to permit entities to account for property held under operating leases as if it were held under finance leases. Whilst we would prefer an amendment to IAS 17 to allow entities to properly account for such leases in accordance with their substance rather than form, we consider the approach taken in IAS 40 to be a practical solution.

On the basis of the above and as per our comments on IAS 16 above, we strongly recommend that if IAS 17 is not to be amended, IAS 16 is amended along similar lines to IAS 40 to solve a similar problem faced by the many entities in Hong Kong, and elsewhere in the world, that hold properties for own use under long term leases some of which have remaining terms of over 900 years.

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 eliminating 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 many companies in an economy such as China, that was and still is a planned economy. This is because in those economies most companies are still state owned, including banks, insurance companies, airlines, supermarkets, trading companies, hotels etc. By definition, state owned enterprises have a common owner, the state, and would therefore be regarded as being related to one another in accordance with proposed paragraph 9(a)(i) of the ED. It follows then that without any further guidance from the IASB, any state owned business



enterprise would appear to have a significant portion of its business dealings meeting the definition of related party transactions.

We are particularly concerned at the following consequences of the removal of the exemption in IAS 24.4(d):

- *as a result of the definitions in proposed paragraph 9(a)(i) of the ED, state owned enterprises would be required to label transactions as being with “related parties” in accordance with their form rather than substance. This is contrary to the presentation of a true and fair view*

Simply because entities are ultimately state owned, this does not mean that the transactions between state owned entities are influenced by a common controller to the same extent as with privately or publicly owned groups.

For example, in China state owned enterprises were traditionally under the control of the respective ministries, and therefore generally there was not one single body that in practice exercised control over all of them. In addition, 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) retain only a regulatory role, having ceased their business role over their formerly “controlled entities”. Each of these formerly controlled entities has its own independent management and board of directors to make final decisions on its financial and operating policies. As a result, state owned entities which are still controlled by state bodies may not in substance have a controlling entity in common with other state owned entities, and some state owned entities may not in substance even be controlled by the state at all. Furthermore, these state owned entities may in fact be competing against one another.

In such circumstances, we believe that describing transactions between all state owned entities as related party transactions could be significantly misleading.

- *the remaining exemption under the proposed paragraph 11(c) is too narrow in its application and would result in inconsistencies*

We recognise that the exemption that would still be 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 would eliminate the disclosure of some of the transactions with other state owned entities. However, as explained above, in countries such as China, that were and still are a planned economy, most state owned entities would have a significant portion of their business dealings with state owned enterprises which are not public utilities, government departments or agencies. It seems inconsistent to exempt certain transactions with government bodies from disclosure, when requiring disclosure of other transactions, which are equally in the course of normal dealings.



- *if the proposed IAS were complied with, the disclosure of "true" related party transactions could be significantly obscured*

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 entities described above. As mentioned above, if the proposed IAS were complied with, state owned entities would be disclosing a significant proportion of their normal business transactions as being related party transactions, thus obscuring the ones that were in reality affected by a related party relationship.

- *in order to comply with the proposed IAS, undue cost and effort may be required*

Requiring all state owned enterprises to capture and correctly identify all transactions with other state owned enterprises would put an undue burden on these companies as they would need to establish a system to track all transactions with other state owned enterprises. Furthermore, this may not be workable in practice because the reporting entity may not have the right or the means to obtain information concerning the ownership of all its customers and suppliers, particularly when they may (or may not be) part of a vast group of state owned enterprises which has hundreds of subsidiaries and associates. This would also seem inconsistent with the principle introduced in proposed paragraph 13 of the ED of revised IAS 8, that an entity should be exempt if it would require "undue cost or effort".

We are not of the view that all transactions between state owned enterprises should be exempted from IAS 24. However, we strongly recommend that the IASB consider clarifying (e.g. in proposed paragraph 11 of the ED) 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 to identifying true related party relationships of control and/or significant influence and related party transactions.

3.11 IAS 33 "Earnings per share"

Definition of "contingently issuable ordinary shares"

The definition of contingently issuable ordinary shares limits them to situations where little or no cash is to be paid for the shares. We are not aware of why this was done and there is no indication in paragraphs 45 to 50 that the shares that would be issued on meeting the conditions would be issued for little or no cash. We therefore encourage the Board to revise the definition in paragraph 4 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 in paragraphs 45-50 to see if the conditions are satisfied; and, if they are, to (b)



the anti-dilution provisions highlighted in paragraph 50(b). 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.

Also it would be helpful if the definitions in paragraph 4 could clarify whether warrants, options and contingently issuable ordinary shares, as separately defined, are all forms of potential ordinary shares.

Definition of “profit or loss from continuing operations”

We believe that the terms “profit or loss from continuing operations” and “net profit” used in paragraphs 8 and 26 should be defined in paragraph 4 to avoid confusion and differing interpretations. We note that some explanations are given in paragraphs 11 and 38 of the ED, but these do not seem sufficient as paragraph 11 does not mention the treatment of minority interests and paragraph 38 is not where a reader would expect to first find a definition of continuing operations.

We also note that paragraph 28 presumably needs amending to refer to “profit or loss from continuing operations” in the same way as in paragraphs 8, 10 and 26.

Increasing rate preference shares

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. However, the term “increasing rate preference shares” may also refer to preference shares with an accelerating dividend as described in the current version of paragraph 22 of IAS 32. We therefore 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, except in the case of group reorganizations under SSAP 27. 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 that is not a group reorganization. Acquisition accounting, therefore, applies in almost all



circumstances except where merger accounting is applicable under SSAP 27. Given the HKSA's position on this issue, modifications to paragraphs 20 and 56 of the ED, as were made when first adopting IAS 33 as SSAP 5 (see paragraphs 16 and 42), 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

Under IAS 35, if a discontinuing operation is recognised, the comparative amounts should also be restated to segregate the amounts relating to that discontinuing operation in prior periods. We believe that, in paragraphs 8, 26 and 56, the Board should clarify that an entity shall also restate basic and diluted EPSs in such circumstances.

Conditions for including contingently issuable shares in earnings per share calculation

We believe that the comment in paragraphs 21 and 45 about when contingently issuable shares are treated as outstanding (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.

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.

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 the calculation of 3rd quarter diluted EPS in Example 12 of Appendix B to address the following inaccuracy. The example implies that dilutive/anti-dilutive decision rests solely on whether the control number (ie profit from continuing operations, adjusted for preference dividends) is negative or positive ie it implies that simply because profit from continuing operations, adjusted for preference dividends, was positive, then the incremental shares from assumed conversions should be included in the calculation of diluted EPS. However, in accordance with paragraph 37 of



the ED, it is also necessary to consider whether the conversion would decrease the earnings per share from continuing operations. even if the control number is positive.

We apologise for the late submission of these additional/revised comments and trust that you will be able to give them due consideration.

Yours faithfully

A handwritten signature in black ink, appearing to be 'K. Wong'.