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Dual compliance: What it means to you

Here are ways to ensure compliance with both HKFRSs and IFRSs

As International Financial Reporting Standards are accepted in more and more jurisdictions, there are increasing benefits for companies in claiming compliance with IFRSs.

The European Union set the pace by mandating IFRSs for all public companies beginning 2005. The U.S. Securities and Exchange Commission recently changed its rules in order to accommodate foreign private issuers filing their financial statements prepared in accordance with IFRSs without reconciliation to Generally Accepted Accounting Principles of the United States (US GAAP). Therefore, being able to assert compliance with IFRSs is particularly relevant to companies using Hong Kong Financial Reporting Standards that are listed in the U.S., or wish to list in the U.S. and Europe.

Background

The SEC has approved rule amendments for financial years ending after 15 November 2007 under which financial statements from foreign private issuers prepared under IFRSs will be accepted without reconciliation to US GAAP. However, the SEC will only accept financial statements that comply with IFRSs issued by the International Accounting Standards Board and therefore financial statements prepared under national or regional variations of IFRSs, including HKFRSs, will still require reconciliation to US GAAP.

In order to be eligible for SEC's relief, an issuer must unreservedly and explicitly state in the notes to the financial statements that the financial statements are in compliance with IFRSs issued by the IASB and the audit opinion must also state that the financial statements comply with IFRSs issued by the IASB.

In addition, there is another positive news for preparers of financial statements under HKFRSs. The Commission of the European Communities issued on 22 April 2008 a report on convergence between IFRS and third country national GAAPs and on the progress towards the elimination of reconciliation requirements that apply to community issuers under the rules of these third

countries, confirming that Hong Kong has fully adopted or implemented IFRSs. In this case the commission concluded that there should be an explicit and unreserved statement of compliance with IFRSs in the audited financial statements.

Furthermore, the Institute's IFRS licensing agreement with the International Accounting Standards Committee Foundation requires the Institute to request preparers to also state that financial statements prepared in accordance with HKFRSs are in compliance with IFRSs (if this is the case) and that this compliance is also reflected in any audit report where appropriate.

Compliance with HKFRSs and IFRSs

In essence, for the majority of companies, financial statements prepared in accordance with HKFRSs are for all intents and purposes identical to financial statements prepared in accordance with IFRSs. However, this does not automatically entitle such companies to include an unreserved statement of compliance with IFRSs in their financial statements. Instead, existing preparers applying HKFRSs that wish to claim compliance with IFRSs must also apply IFRS 1 *First-time Adoption of International Financial Reporting Standards* in the period when they first claim compliance. This requirement is clear in paragraph 3(a)(ii) of IFRS 1 which indicates that IFRS 1 needs to be applied when an entity presented its most recent previous financial statements "in conformity with IFRSs in all respects, except that the statements did not contain an explicit and unreserved statement that they complied with IFRSs."

IFRS 1 contains specific transitional provisions, which may or must be applied in the first year that an entity makes an explicit and unreserved statement of compliance with IFRSs. These transitional provisions in IFRS 1 override any transitional provisions that may be contained in individual IFRSs. The transitional provisions in IFRS 1 are based on a general principle that the accounting policies adopted in the first reporting period under IFRSs shall be applied with full retrospective adoption (IFRS 1.7). IFRS 1 then provides certain limited exemptions and exceptions to this principle, which allow, or in some cases require, a different approach (IFRS 1.13-34B).

As a result of the transitional provisions in IFRS 1, it is possible that certain treatments that are acceptable under a continuing application of HKFRSs are unacceptable in the financial statements of a first-time adopter of IFRSs. These differences may arise due to differences in transitional provisions that were included in HKFRSs when they were first issued in Hong Kong prior to 2005.

However, differences may also arise between transitional provisions in IFRS 1 and those in any of the new IFRSs and amendments that Hong Kong has copied from the IFRSs since 2005, or will copy in the future. For example, IFRS 1 contains transitional provisions relating to share-based payments that are different from those that were included in IFRS 2 *Share-based Payment* when it was first issued. Therefore, an entity that adopted HKFRS 2 (which is a copy of IFRS 2) still needs to meet the requirements of IFRS 1 when adopting IFRSs for the first time, even though the transitional provisions for IFRS 2 and HKFRS 2 are identical.

In order to facilitate existing users of HKFRSs to understand the possible differences in financial information that might arise between the adoption of the transitional provisions of the respective HKFRSs and the application of IFRS 1, the Institute's financial reporting standards committee has developed a table of comparison to guide an entity along the way to achieve dual compliance.

Ways to achieve dual compliance

The comparison table has been developed based on the assumption that consolidated financial statements for the year that ended 31 December 2007 are being prepared. Under the new rule, a foreign private issuer in its first year of reporting under IFRSs is provided an accommodation to file two years rather than three years of statement of income, changes in shareholders' equity and cash flows prepared in accordance with IFRSs. Accordingly, these financial statements contain one year of comparatives, such that 1 January 2006 would represent the date of transition to IFRSs in accordance with IFRS 1. Pronouncements issued under IFRSs and HKFRSs that were effective for financial years ended 31 December 2007 have been taken into account.

Where differences are identified between the transitional provisions in IFRS 1 and those adopted at the time the current HKFRS accounting policy was adopted, an entity may choose either to adopt IFRS 1 exemptions or to change existing HKFRS accounting policies (subject to the requirements of paragraph 14 of HKAS 8 *Accounting Policies, Change in Accounting Estimates and Errors*) to achieve dual compliance.

Preparers need to exercise professional judgment in assessing the impact of the potential areas of difference in their financial statements. If the variance is material and cannot be resolved through one of the above routes, an entity will not be able to claim dual compliance with HKFRSs and IFRSs.

The comparison table explains in detail the areas of difference and the options available to preparers. In summary, the HKFRS-based financial statements can still achieve dual compliance if the following areas of difference are properly addressed:

(i) Differences that may be avoided through adopting IFRS 1 exemptions:

- Property, plant and equipment – fair value or revaluation as deemed cost
- Investment property – fair value or revaluation as deemed cost
- Business combinations – translation of fair value adjustments and goodwill
- Business combinations – method of accounting and intangible assets
- Share-based payment – equity settled share-based payment transactions

(ii) Differences that may be avoided through changing HKFRS accounting policies (subject to the requirement under HKAS 8.14(b)):

- Borrowing costs – benchmark treatment
- Defined benefit plans – actuarial gains and losses
- Property, plant and equipment/ investment property/intangible assets – exemption for charitable, government subvented and not-for-profit organizations
- Leases – determination of the length of lease term in respect of Hong Kong land leases
- Revenue – pre-completion contracts for the sale of development properties.

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In some circumstances, no remedial action is available to avoid differences in application of HKFRSs and IFRSs. Potential areas of difference include:

- Property, plant and equipment – exchange of assets
- Leases – measurement of finance leases
- Defined benefit plans – transitional liability
- Non-current assets held for sale and discontinued operations – measurement differences
- Financial assets and liabilities – fair value hedge accounting
- Financial assets and liabilities – prior derecognition.

Audit opinion on dual compliance

In order to omit the US GAAP reconciliation under the SEC's rules, the report of the independent auditor must state that the consolidated financial statements comply with IFRSs. HKSA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* does not have any specific provision, which prevents an auditor from providing an opinion on financial statements that have been prepared in accordance with more than one financial reporting framework. It is therefore acceptable for an auditor to issue an opinion on financial statements that have been prepared in accordance with both HKFRSs and IFRSs provided that each of the frameworks are complied with individually.

The auditors should consider each financial reporting framework separately. If a matter results in failure to comply with one of the frameworks, but does not cause a failure to comply with the other framework, the auditor should express an unqualified opinion on the framework that is properly complied with and a qualified opinion or an adverse opinion on the other framework that is not.

The comparison table and example notes to the financial statements can be accessed from *www.hkicpa.org.hk/professionaltechnical/accounting/dueprocess/dueprocess.php*

This article has been prepared by the Institute's standard setting department in consultation with the financial reporting standards committee (FRSC).