Financial Accounting Standards Committee
Meeting summary – November 2003

The Society's Financial Accounting Standards Committee (Committee) met on 12 November 2003.

Present at the Committee's meeting were: Messrs. Roger Best (Chairman), Carlson Tong (Deputy Chairman), Paul F. Winkelmann (Deputy Chairman), William Crowe, Tommy Fung, Robert Gibson, Philip Hilliard, Andrew Huke, Quinn Y.K. Law, Nigel Reid, Tommy Tam, Tom Wu, Ms. Olivia Cheung, Ms. Susanna Lau and Mr. Simon Riley (HKSA Deputy Director, Accounting).

The Committee discussed the following items:

- ✓ Investment Property – proposed revision of SSAP 13
- ✓ IASB Improvements project
- ✓ Report from the Urgent Issues and Interpretations Sub-committee meeting held on 29 October 2003

<u>Investment Property – proposed revision of SSAP 13</u>

The Committee further considered the draft proposed revision to SSAP 13. The draft ED is based on IAS 40 but proposes to retain the current SSAP 13 requirements for:

- The use of a qualified independent valuer (not mandatory in IAS 40); and

- Reserve accounting of value changes on a portfolio basis (in IAS 40, changes in fair value are reported in the income statement).

The Committee noted that the IASB is presently engaged in a project that would propose to overhaul the nature and format of the income statement, partly in recognition that the present format does not fully accommodate the fair value model. Changes in fair value are included with other items comprising net profit or loss for the period and some consider that this does not provide an appropriate analysis of the entity's financial performance for a given period. The Committee agreed in principle that as much of SSAP 13 as possible will be converged with IAS 40 but that the provisions regarding changes in fair value, as currently applying in SSAP 13, would be retained until the IASB's project on reporting financial performance had been finalised. As a consequence, the impending ED would propose that changes in the value of investment properties should be treated as movements in an investment property revaluation reserve, unless the total of this reserve is insufficient to cover a deficit on a portfolio basis, in which case the amount by which the deficit exceeds the total amount in the investment property revaluation reserve should be charged to the income statement. Where a deficit has previously been charged to the income statement and a revaluation surplus subsequently arises, this surplus should be credited to the income statement to the extent of the deficit previously charged.

Because the draft ED would propose to retain the status quo in respect of changes in fair value, the treatment of transfers between categories of assets under the revised SSAP 13 will necessarily differ to that under IAS 40. The Committee confirmed its previous conclusions on this matter:

- For a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's cost for subsequent accounting under SSAP 17 or SSAP 22 should be its fair value at the date of change in use.

  Any difference between the fair value of the property at the date of change in use and its previous carrying amount should initially be recognised in accordance with the SSAP 13 provisions on reserve accounting described above and:

  (a) If the investment property revaluation reserve is in surplus on a portfolio basis but the fair value of the transferred property at the date of change in use is less than its cost, the difference between the property's fair value at that date and its cost should be included in net profit or loss for the period;

  (b) If the fair value of the transferred property at the date of change in use is greater than its cost, any revaluation surplus in respect of the transferred property shall not be available for portfolio accounting under the reserve accounting provisions described above. Consistent with the current treatment under SSAP 13, any investment property revaluation surplus realised on disposal would be recycled through the income statement. Subsequent to the date of change in use the asset may be depreciated, written down to net realisable value and/or impaired and, under the applicable SSAP (e.g. SSAP 17, SSAP 22 or SSAP 31), such an event will give rise to an expense. However, the Committee agreed that part of the (investment property) revaluation surplus attributed to the asset could be treated as being realised at that time and taken to the income statement as a credit that should not be netted off against the depreciation charge or impairment expense. Any subsequent reversal of an impairment loss (including write-down to net realisable value) for a transferred property would be accounted for under the applicable SSAP (e.g. SSAP 17 or SSAP 22) and not be accounted for under SSAP 13. Disclosure of the cumulative amount of the investment property revaluation reserve not available for portfolio accounting under SSAP 13 would be required.

- For a transfer from inventories to investment property that will be carried at fair value, the property's cost for subsequent accounting under SSAP 13 should be the lower of cost and net realisable value (as measured under SSAP 22) at the date of change in use. Where the fair value of the property at that date exceeds its previous carrying amount, the difference should be recognised in accordance with the SSAP 13 provisions on reserve accounting described above.

- When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, the property's cost for subsequent accounting under SSAP 13 should be the carrying amount at the date of change in use. Where the fair value of the property at that date exceeds its previous carrying amount, the difference should be recognised in accordance with the SSAP 13 provisions on reserve accounting described above.

The Committee considered that the above approach was consistent with the requirements currently applying under SSAP 17 and would also provide further guidance on the treatment of the investment property revaluation reserve upon transfer not presently dealt with in SSAP 17. The Committee also considered that:

- A revaluation surplus that arose when the asset was classified as investment property would continue to be accounted for under SSAP 13 even though the asset itself, post-transfer, is accounted for under a different SSAP; and

- Gains or losses arising from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the cost of the asset and, together with any revaluation surplus (attributed to that asset) realised on disposal, should generally be reported in the income statement.

The Committee briefly discussed the current requirement in SSAP 13 (paragraph 9) whereby investment properties are not subject to periodic charges for depreciation except where the unexpired term of the lease is 20 years or less, in which case depreciation must be provided on the then carrying amount over the remaining term of the lease. The current version of the draft ED does not carry forward this provision. A Committee member commented that by not carrying forward the current SSAP 13 '20 year rule' there could be a potential anomaly:

- The diminution in value of a leasehold property that is near the end of its lease will be offset against the Investment Property Revaluation Reserve until such time as the lease expires. At that point the original cost of the property will be expensed to the income statement in a single period and this has the potential to distort reported results for a period;

- Carrying forward paragraph 9 keeps the status quo consistent with the approach on certain other provisions in SSAP 13 and would avoid increasing the differences between IAS 40 and SSAP 13 (revised): The reduction in investment property value in the last 20 years of its lease will be expensed to the income statement under both IAS 40 and SSAP 13 if paragraph 9 were carried forward.

The Committee considered that the issue would be relatively short-term in nature and noted that there would be a further opportunity to discuss this issue when the Committee considers the draft Invitation to Comment on the ED. Whether the 20 year rule was carried forward or not, the Invitation to Comment would need to discuss the issues involved either by way of explaining the significant differences between the present SSAP 13 and the proposed revised version or by discussing the areas where the proposed revision of SSAP 13 would retain provisions that are not converged with IAS 40.

The Committee agreed that the ED would not be released for public comment until after the IASB had finalised pending changes to IAS 17 on Leases and IAS 40 on Investment Property. The Committee noted that the IASB had signalled an intention to finalise IAS 17 and IAS 40 by the end of the first quarter in 2004 and, if the IASB holds to this timetable, the Committee anticipated being able to release an ED for public comment during the second quarter of 2004 with the target of finalising the revised SSAP 13 to become applicable for financial statements covering periods beginning on or after 1 January 2005.

<u>IASB Improvements project</u>

The Committee noted that the IASB had begun to publish "provisional final" versions of revised IAS (as at the Committee's meeting date IAS 2, Inventories, IAS 10, Events After the Balance Sheet Date, and IAS 33, Earnings Per Share, have been published in 'provisional final' form) resulting from the Improvements ED released for comment in 2002 and that copies of the IASB Standards could be obtained by subscription from the IASB website.

As indicated in the Committee's invitation to comment on the IASB ED, once the IASB had finalised publication of all revised IAS resulting from the Improvements ED the Committee intends to recommend the adoption of revised SSAPs, so that the SSAPs maintain conformity with the IASB's Standards. The Committee also intends at the same time to develop an exposure draft proposing the convergence of Hong Kong SSAPs with International Financial Reporting Standards and the elimination of significant textual differences in SSAPs not revised from the Improvements project vis-à-vis the equivalent IAS.

<u>Report from the Urgent Issues and Interpretations Sub-committee meeting held on 29 October 2003</u>

The Urgent Issues and Interpretations Sub-Committee had recently discussed the following topics:

- ✓ The allocation of cost of transport infrastructure facilities
- ✓ Hotel property accounting
- ✓ Share issue costs

The allocation of cost of transport infrastructure facilities

An entity may enter into an agreement with a government to construct an infrastructure asset on a "Build, Operate and Transfer" franchise (the "BOT"). Under the BOT, 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 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.

The Committee discussed the appropriate accounting treatment for allocating the cost of the infrastructure asset across the franchise period.

Under paragraph 96 of Statement 2.01 "Framework for the Preparation and Presentation of Financial Statements", the allocation methods of depreciation / 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 and SSAP 29, the selection of depreciation / amortisation method should reflect the expected pattern of consumption of economic benefits from the assets. The Committee 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 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 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, the Committee does not rule out either of the two views before obtaining clarification from IFRIC.

The Committee noted that some financial statements purporting to be in compliance with Hong Kong SSAPs disclosed an accounting policy that the allocation of the capital cost of an infrastructural 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 toll road concession periods, will be equal to the total cost of the asset.

The Committee agreed that a 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 of a BOT franchise is determined by either the passage of time and/or usage.

In the case of an infrastructural asset accounted for under SSAP 17, the Committee noted that that SSAP requires the depreciable amount of an item of property, plant and equipment to be allocated on a systematic basis over its estimated useful life. Under paragraph 49 of SSAP 17, the depreciation methods include the straight-line method, the diminishing balance method and the sum-of-the-units method. The depreciation method on toll roads shall be selected based on the expected pattern of consumption of economic benefits. When accounted for as an intangible asset, SSAP 29 paragraph 89 states that there is rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under straight-line method.

Hotel property accounting

An interpretational issue had been referred to the sub-committee in respect of the appropriate accounting standard, and financial statement presentation, for owner-occupied hotel properties. The Committee acknowledged that under present SSAPs hotel property could be accounted for either as investment property or as property, plant and equipment depending on the circumstances relevant to a specific property. A hotel property must be accounted for under either SSAP 13 or SSAP 17 and therefore may not be presented in financial statements in a category other than either investment property or property, plant and equipment. The Committee considered that when SSAP 13 is revised to more closely align that SSAP with the equivalent IAS 40, the issue regarding appropriate classification of (particularly owner-occupied) hotel property would be clarified. The Committee considered that, after the revision of SSAP 13 to more closely align with IAS, all owner-occupied hotel property would be property plant and equipment and therefore should be accounted for under SSAP 17 and depreciated accordingly.

Share issue costs

The Committee noted that the International Interpretation SIC-17 on "Costs of an Equity Transaction" had not been adopted in Hong Kong primarily because SIC-17 was an interpretation of IAS 32 and that there was no comparable SSAP applying in Hong Kong. By virtue of SSAP 1 paragraph 23, however, the consensus in SIC-17 would be applied to determine the appropriate treatment for share issue expenses.

Date of Next Meeting

The Committee will next meet on 10 December 2003.

This meeting summary is provided for the information and convenience of those who wish to follow the Committee's deliberations. Except where indicated otherwise, all conclusions reported are tentative and may be changed at future meetings.

The IASB publishes summaries of its meetings and projects. These can be found on the IASB's website at http://www.iasb.org.uk.

The Committee welcomes comments on its technical agenda. Please e-mail us at commentletters@hksa.org.hk.