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Our ref FKHC/20

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Dear Sir

Exposure drafts ("ED") of Hong Kong Accounting Standards (HKASs)

In respect of the Invitation to comment on the "Exposure draft – Proposed convergence of Hong Kong Accounting Standards with International Accounting Standards", we have set out in the attached appendix our comments on the following draft HKASs:

- HKAS 17 "Leases"
- HKAS 23 "Borrowing costs"
- HKAS 24 "Related party disclosures"
- HKAS 31 "Interests in joint ventures";
- HKAS 40 "Investment properties"
- HKAS-Int 13 "Jointly controlled entities – non-monetary contributions by venturers"; and
- HKAS-Int 15 "Operating leases – incentives"

We would also make the general observation that the text of the proposed HKASs is inconsistent with the recently issued new HKFRSs, in particular HKFRS 5 "Non-current assets held for sale and discontinued operations". We presume that the consequential amendments identified in those standards will be made to the HKASs before finalisation and therefore we have not raised any specific comments in this regard.

We trust you find our comments helpful.

Yours faithfully

Comments on the individual exposure drafts

1. HKAS 17 “Leases”

1.1 *Request for a departure from IFRSs to continue to allow leasehold property interests to be carried at fair value*

We note that the ED of HKAS 17 has not retained the text that was included in paragraph 11 of the current SSAP 14 by the HKSA, concerning the allowed accounting treatment for Hong Kong leases of land and buildings. As a result, lessees of leasehold land and buildings will not be able to carry their property interests at fair value in the following situations:

- (a) the property interests do not otherwise qualify as investment properties; and
- (b) the lessee is able to identify the portion of the lease relating to the land, in accordance with HKAS 17.16.

A common example would be the owner of a self-constructed hotel, where the land premium paid can be easily identified and therefore the rules set out in HKAS 17.16 concerning how to split the land and the buildings element can be met. In such a case, if HKAS 17 were to be made effective in its current form the lessee would not be able to revalue the portion of the hotel relating to the land premium and would instead have to spread the cost of the land premium over the length of the lease. Furthermore, if there were likely to be difficulties in future years in separating the land portion from the building portion in any valuation of the property, the lessee would also be prevented from adopting the valuation model in HKAS 16 Property, plant and equipment (PPE) for the building portion.

There appears to be no justification to this significant change in accounting other than for the sake of harmonization with IFRSs. On the other hand we note that:

- (a) this would reduce the relevance of information being presented to users of the financial statements as lessees who previously carried such properties at up to date fair values will be required to restate such properties to historical cost; and
- (b) this would reduce the comparability of information between entities as it would increase the inconsistencies between the accounting treatments adopted for identical long-term properties, which were acquired or held in different circumstances. For example:
 - if the property was already constructed when acquired, then the lessee might assert that it was unable to reliably split the minimum lease payments (which in the case of Hong Kong property would generally be the purchase price) between the land and building elements in accordance with HKAS 17.16. In such a case,

the lessee would be able to classify the lease as a finance lease and choose the valuation model for the whole lease under HKAS 16;

- if the property was an investment property (for example, the hotel owner transferred management rights to another entity in exchange for a fixed return), then this property could be accounted for under HKAS 40's fair value model; and
- if the property was previously an investment property that had taken advantage of the concession in HKAS 40, but was now classified as own use PPE (for example, the management contract finished and the hotel owner took back the management rights), then this property must continue to be accounted for as a finance lease and therefore could be carried at valuation under HKAS 16 (as per HKAS 17.19(a)).

All of these consequences run contrary to the Framework, which identifies relevance and comparability as two of the qualitative characteristics of financial statements that make them useful to users.

We recommend that the HKICPA gives serious consideration to departing from IFRSs in this important respect. We suggest that a textual approach to this issue, which might minimise the extent of departure from IFRSs (and make it straightforward to identify), would be for the HKICPA to replicate the option allowed for investment properties and apply it to other non-current property leases. For example:

- a paragraph would be included in HKAS 17, immediately following HKAS 17.19, to include the equivalent guidance for an operating property lease to be accounted for as a finance lease under HKAS 16; and
- a paragraph would be included in HKAS 16, containing the equivalent text as in HKAS 40.6, requiring such leases (and all other properties in the same class) to be accounted for under HKAS 16's valuation through reserves model (i.e. HKAS 16.31, rather than HKAS 40.33).

In practice, for Hong Kong leases, such wording in the standards would have the desired effect of allowing the current accounting practice of revaluing leasehold properties to continue, whether they are investment properties or not.

1.2 *Request for an authoritative interpretation of “lease term” in respect of Hong Kong leasehold interests*

We request that the HKICPA provides additional guidance to Hong Kong companies on how to apply the concept of “lease term” under the proposed HKAS 17 in respect of the various types of land leases held in Hong Kong. For example:

- some leases are strictly speaking non-renewable. However, in the General Land Policy endorsed by ExCo and published on the Government’s web site¹, the Government has stated that it may renew these leases for a term of 50 years without premium. It states that the renewal is wholly at the Government’s discretion but also states that reasons for non-renewal would be, for example, that the land is required for a public purpose or is no longer being used for a purpose for which it was originally granted. An inference could be drawn from this that in the vast majority of cases the Government will renew these leases even though they are not obliged to do so; and
- the extension of the New Territories leases en masse in 1988 by way of the New Territories (Extension) Ordinance extended those leases only to 30 June 2047. The likelihood of renewal beyond that date without payment of significant amounts is high (as the refusal to extend, or the demand for significant amounts from every property owner, would have serious economic consequences) but it is not virtually certain as there are no legal rights to further extensions.

We consider that the uniqueness of the Hong Kong position, with respect to both the ownership of land in Hong Kong and the uncertainty presented by 2047, warrants the HKICPA developing guidance that can be applied consistently.

2. **HKAS 23 “Borrowing costs”**

2.1 *Typographical error in paragraph 30 (transitional provisions)*

There appears to be a typographical error in the second sentence of paragraph 30. We presume the text is intended to read as follows (struck through text is shown for information only):

“Alternatively, enterprises following the benchmark treatment shall apply the new policy prospectively and therefore would not adjust the financial statements for ~~should~~ capitalise only those borrowing costs that were ~~incurred after~~ capitalised before the effective date of the Standard.”

¹ www.info.gov.hk/landsd/general/landtenure.htm

3. HKAS 24 “Related party disclosures”

3.1 *Observation concerning the scope of HKAS 24*

We note that HKAS 24 contains the revised IAS 24 definition of related party. This definition differs from the current SSAP 20 as follows:

Currently, under SSAP 20, the reporting entity is regarded as related to entities under common joint control or common significant influence. However, the proposed definition in HKAS 24 appears to:

- exclude such entities when the investing party is a shareholder of the reporting entity (irrespective of the level of control that this shareholder has); but
- still includes such entities when the investing party is key management personnel, or is a close family member of key management personnel or of any controlling, jointly controlling or significantly influencing shareholder.

For example, according to the definitions in the draft HKAS 24, the following are examples of parties that are still identified as related and are no longer identified as related:

| <i>Still identified as “related” parties</i> | <i>No longer identified as “related” parties</i> |
|--|--|
| <p>Entities directly significantly influenced or jointly controlled by close family members of the reporting entity’s controlling shareholder:</p> <ul style="list-style-type: none"> - e.g. a company which is 20% owned by the wife of a controlling shareholder | <p>Entities directly significantly influenced or jointly controlled by the reporting entity’s controlling shareholder:</p> <ul style="list-style-type: none"> - e.g. fellow joint ventures and fellow associates |
| <p>Entities at least significantly influenced by close family members of a significant shareholder or key management personnel</p> <ul style="list-style-type: none"> - e.g. a company which is 20% owned by the husband of a shareholder who owns 40% of the reporting entity - e.g. a company which is 20% owned by the wife of a director | <p>Entities at least significantly influenced by a shareholder who has significant influence over the reporting entity</p> <ul style="list-style-type: none"> - e.g. a company controlled by a shareholder who owns 40% of the reporting entity |

It can be seen from these examples that the definition in HKAS 24 appears to exclude some important relationships while still including some arguably more remote ones. There is no explanation as to why such a distinction should now be made.

We appreciate that the HKICPA wishes to converge as far as possible with IFRSs. We therefore suggest that this matter is raised with the IASB and that in the meantime guidance is issued in Hong Kong indicating whether it is acceptable (or even encouraged) that where there have been material transactions with entities under common joint control or common significant influence, such transactions are disclosed as related party transactions.

4. HKAS 31 “Interests in Joint Ventures”

4.1 *Request for clarification as to whether the adoption of proportionate consolidation would meet the requirements of section 123 concerning company level financial statements*

Paragraph 30 of the ED of HKAS 31 requires a venturer to recognise its interest in a jointly controlled entity (“JCE”) using either proportionate consolidation method or equity method, unless the venturer is exempt under HKAS 31 by way of the same conditions as are applied to wholly owned, or virtually wholly owned, parents in HKAS 27.

As a result, a venturer without subsidiaries who did not meet these exemption criteria (a “non-exempt venturer”) would be required to prepare a set of non-consolidated financial statements that include the venturer’s interests in its JCEs under either the equity method or the proportionate consolidation method.

Following on from the above, the question arises as to whether the use of the proportionate consolidation method by Hong Kong incorporated companies in non-consolidated financial statements would serve the requirements of section 123 of the Hong Kong Companies Ordinance (“the Ordinance”).

Section 123 of the Ordinance requires companies to prepare financial statements showing a true and fair view of the state of affairs of the *company* at the balance sheet date and of the profit or loss of the *company* for the year then ended. In our view, the use of the proportionate consolidation method would distort the picture of the reporting company’s own financial position and results of its operations.

We therefore suggest that in order to achieve a consistent application of HKAS 31 to non-exempt venturers, the HKICPA should highlight this issue and state that if such non-consolidated financial statements are presented, it will be necessary for the venturer to present a second full set of company level only financial statements to satisfy the law. These separate financial statements would need to include a company level income statement, as section 123(5) only grants an exemption from the preparation of a company level profit and loss account to entities that have subsidiaries.

4.2 Request for clarification as to whether HKAS 31 has a consequential effect on the accounting for controlled entities that are not subsidiaries under the Companies Ordinance

We note that the proposed HKAS 31 allows venturers to choose whether to proportionally consolidate their interests in JCEs or to account for them using the equity method. However, even though permitting the use of the equity method, paragraph 40 of the proposed standard further states that "... *This Standard does not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity, ...*".

This comment in HKAS 31 raises the question as to whether it is still acceptable to equity account for those controlled entities which do not meet the definition of subsidiaries under the Companies Ordinance (HKAS 27.21A), or whether the HKICPA would expect proportional consolidation be the only acceptable method in such cases.

Given that accounting for these non-consolidated subsidiaries is a specific issue for Hong Kong investors, there is no answer or guidance available in IFRSs. We recommend that the HKICPA provides relevant guidance e.g. by adding to the Hong Kong specific paragraphs in HKAS 27 (21A and 21B), or by publishing an HKAS Interpretation, to address what the acceptable accounting treatments are in such circumstances.

4.3 Minor textual error in paragraph 28 of the ED of HKAS 31

We consider that it makes sense to insert "Hong Kong Financial Reporting Standards" into paragraph 28 of the ED of HKAS 31. The revised paragraph would read as follow (with the suggested new text underlined):

"A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other entities in conformity with Hong Kong Financial Reporting Standards or International Financial Reporting Standards."

5. HKAS 40 "Investment property"

5.1 Request for transitional provisions concerning the adoption of the cost model

We note that draft HKAS 40 does not include any particular transitional provisions for any changes of policies brought about by the introduction of HKAS 40. We are concerned that as a result, if an entity wishes to adopt the cost model for investment property, it would be required to restate to historical cost. As we have stated in relation to the restatement of operating leases to cost (see point 1.1 above), we do not consider that this is consistent with the objective of financial statements to provide relevant and comparable information to the users.

In this regard we draw your attention to paragraphs 16 to 18 of IFRS 1 "First time adoption of International Financial Reporting Standards". These paragraphs allow a

preparer to regard a valuation of its assets at the date of transition to IFRSs as a deemed cost amount, provided that the valuation is broadly comparable to fair value. Paragraph 18 explicitly states that this election is available to investment property where the entity elects to use the cost model under IAS 40. HKFRS 1 includes equivalent paragraphs, which presumably will be updated to refer to HKAS 40, rather than SSAP 13.

Given these provisions in HKFRS 1, the following example illustrates what the result would be if no special transitional provisions are included in HKAS 40:

Entities A and B have the following in common:

- they acquired investment properties in 1970;
- their current accounting policy is to carry these properties at fair value through reserves;
- they will be adopting HKAS 40's cost model for the first time on 1 January 2005 as they disagree with the impact that the fair value model will have on their income statements; and
- they are concerned that stating their properties at their 1970 prices, less depreciation, will be confusing to users of their financial statements and provide them with irrelevant information.

They differ only in that A has adopted HKFRSs for many years, whereas 2005 will be the first year of adoption of HKFRSs for entity B. The applicable requirements are therefore as follows:

| <i>Entity A</i> | <i>Entity B</i> |
|--|--|
| Entity A has to follow the requirements in HKAS 8 for a change in policy. It therefore has no choice but to restate its property to 1970 cost less subsequent depreciation | Entity B has to follow HKFRS 1. It therefore elects to deem its 31 December 2003 valuation to be cost under HKAS 40 (1 January 2004 is B's "date of transition" to HKFRSs) |

Our concerns at the above results are as follows:

- the significant difference in the balance sheets of the two entities arises because B's non Hong Kong GAAP valuation is given recognition while A's valuations, which were previously reported under SSAP 13, are discarded; and
- if entity A finds the above result unacceptable, it has an alternative route of choosing instead to adopt IFRSs as from 1 January 2005 and so having the same option under

IFRS 1 as is available to B as a first time adopter of HKFRSs. Therefore, the intended harmonisation of HKFRSs with IFRSs through HKAS 40 may have the unintended effect of encouraging followers of HKFRSs to move to IFRSs.

We recommend that the HKICPA includes transitional provisions in HKAS 40 which permit those entities that change from SSAP 13 valuations to the HKAS 40 cost model to regard the fair value at the “date of transition” to HKAS 40 (as defined in HKFRS 1 i.e. the beginning of the earliest period presented, such as 1 January 2004 for calendar year ends) to be the deemed cost under the cost less depreciation model. This transitional provision would be based upon the provisions of paragraphs 16 to 18 of HKFRS 1 and should therefore be an option, rather than a requirement.

5.2 *Concern over misunderstandings and unintended side effects of the impact on the income statement of the fair value model*

It is well known that both the HKICPA in previous years, and currently the property developers, have expressed serious concerns over the impact of the fair value model on the income statement. Whilst we are not requesting in this letter that the HKICPA depart from their current convergence plans, we also share those concerns. We therefore consider that when introducing the HKAS 40 fair model the HKICPA has a responsibility to be proactive in ensuring that misunderstandings and unintended side effects are minimised.

In particular, through education, pronouncements and liaison with the relevant parties, the HKICPA should take a lead in addressing the following concerns in respect of the introduction of the fair value model:

- shareholders and analysts misunderstanding the real impact of the change on shareholder value and distributable profits;
- the income statement no longer being comparable from one entity to the next, if each entity decides to draw sub-totals at different points in the income statement (for example, separating surpluses from temporary revaluation deficits and/or impairments, or separating unrealised revaluation movements from gains/losses realised on disposal); and
- regulators continuing to use the “profit for the year” amount in formulae that were devised before this measure included movements in the fair value of investment properties (for example, the measures in the Listing Rules used to identify the different classes of material transactions).

5.3 *Disagreement with the requirement to use an independent property valuer*

We note that the draft HKAS 40 has brought forward the requirement from SSAP 13 to use a qualified valuer every year and for that valuer to be independent every three years (HKAS 40.32A). We do not support this requirement as presented in HKAS 40 for the following reasons:

- the requirement in SSAP 13 did not apply to unlisted companies whose property interests fell below a certain threshold, or to properties which had been let out to other group companies. No such exemptions have been granted in HKAS 40, thus increasing the cost of compliance for non listed companies;
- IFRSs (including IAS 40) were developed primarily for listed companies and yet the IASB has not included such a requirement; and
- the accounting standard sets out the accounting requirement to state the property at fair value. Whether or not to use a valuer, and whether that valuer should be independent, is not an accounting principle and instead relates to the quality of judgements made by management in applying the HKAS 40 and arriving at reliable measurements.

If it is still considered appropriate that listed companies should use a qualified valuer, then we suggest it would be more appropriate for the requirement to be included in the Listing Rules, rather than in the HKAS.

5.4 *Request for authoritative guidance on the concept of “realised profits” with regards to the recognition of the revaluation movements in the income statement*

Section 79A(3) of the Hong Kong Companies Ordinance refers to realised (distributable) profits being determined “by reference to principles that were generally accepted with respect to the determination for accounting purposes of realised profits at the time when those accounts are prepared”. We therefore consider that for the avoidance of doubt the HKICPA should provide principles for the determination of when the amounts recognised in the income statement under the fair value model in HKAS 40 should be considered realised profits or realised losses.

6. *HKAS-Int 13 “Jointly Controlled Entities – Non-Monetary Contributions by Venturers”*

6.1 *Explanation of the source of HKAS-Int 13 needed*

Neither HKAS 31 nor HKAS-Int 13 explain to the reader that the HKSA had previously incorporated the text of the underlying SIC Interpretation into SSAP 21 (as paragraphs 39 to 41) when it last revised SSAP 21 in May 2001 and that therefore HKAS-Int 13 is not a new Interpretation. We recommend that either some introductory text is added or a note is

added after the “Effective date” sentence (in a similar way to HKAS-Int 21) to explain this.

6.2 *Minor textual error: paragraph 11 – reference to HKAS 16*

Paragraph 11 of HKAS-Int 13 includes the following text: “HKAS 16.22 says that ... no gain or loss is recognised on the transaction.” In the equivalent SIC Interpretation 13, this text has been struck-through (i.e. effectively deleted) as a result of the revision of IAS 16 in December 2003. The SIC-Interpretation also has a note explaining the IAS 16 requirements before and after the revision.

Therefore, some amendment needs to be made to the draft HKAS-Int 13 text to take account of this. However, given that this HKAS-Int is new in HKFRSs, and paragraphs 39 to 41 of SSAP 21 did not refer to the equivalent text in HKAS 16’s predecessor (SSAP 17), we consider that such struck-through text and the explanatory note as are in SIC 13 are not necessary in HKAS-Int 13. Accordingly, we would recommend that the HKICPA deletes the text entirely in the final HKAS-Int 13.

7. *HKAS-Int 15 “Operating leases – Incentives”*

7.1 *Explanation of the source of HKAS-Int 15 needed*

Neither HKAS 17 nor HKAS-Int 15 explain to the reader that the HKSA had previously incorporated the text of the underlying SIC Interpretation into SSAP 14 (as paragraphs 27 to 29 and 48 to 49) when it last revised SSAP 14 in February 2000 and that therefore HKAS-Int 15 is not a new Interpretation. We recommend that either some introductory text is added or a note is added after the “Effective date” sentence (in a similar way to HKAS-Int 21 and as recommended for HKAS-Int 13) to explain this.