Our Ref.: C/FASG 17 November 2000

The Stock Exchange of Hong Kong Limited,
11/F., One International Finance Centre,
1 Harbour View Street, Central,
Hong Kong.

(Attn.: Ms. Karen Lee, Head of Listing Division)

Dear Madam,

Acceptance of International Accounting Standards ("IAS")
and Generally Accepted Accounting Principles in the U.S.A. ("US GAAP")

We refer to the announcement made on 23 October 2000 by the Exchange which outlines a proposal to allow:

(i) listed issuers and listing applicants, which have or are to have a primary listing on the Exchange, to adopt IAS ("the IAS proposal"); and

(ii) overseas incorporated listed issuers and listing applicants, which have or are to have a secondary listing on the Exchange, to adopt US GAAP ("the US GAAP proposal").

While we believe that, with some modification, the US GAAP proposal could probably be adopted without causing too many difficulties, ***the IAS proposal carries some significant regulatory risks if it is to be introduced at the present time***. Given the very short consultation period, our comments which are set out below are not comprehensive but are sufficiently important to warrant a very careful review of the proposal.

1. The IAS proposal

Environmental concerns

1.1 While we recognise and commend the desire of the Exchange to permit the use of IAS on the main board with the aim of enhancing the accessibility of financial statements to international investors, we are very concerned that such a move might be premature given the current state of development of IAS.

1.2 We recognise that adoption of IAS makes a lot of sense for developing and emerging economies which have little in the way of regulatory or accounting infrastructure. Hong Kong is an advanced economy and does not fall into that category. We also recognise that in continental Europe, where there is greater experience of IAS and where there is a regulatory environment sufficient to monitor and enforce compliance, this is a viable option. In Hong Kong, at present, however, we do not believe that the infrastructure is ready to support IAS on a large scale (although it may be within one or two years) and there are, or should be, significant regulatory concerns regarding adoption of the IAS proposal ***at this time.***

1.3 We also recognise, however, the need for Hong Kong not to "lose out" on potential cross-border listings. It may be that there could be a justification, ***in limited circumstances***, for permitting the IAS proposal only where genuine cross-border listings are to take place simultaneously in Hong Kong and another country which accepts IAS.

1.4 If the Exchange were to decide to adopt the IAS proposal for all main board issuers at the present time however, we believe that there would be a number of significant regulatory concerns which would need to be addressed, principally:

- lack of comparability of financial statements drawn up under IAS due to the availability of choices of different accounting treatments;
- the need to develop a regulatory infrastructure for monitoring and enforcing compliance with IAS;
- anomalous accounting treatments under IAS which could cause confusion in the marketplace; and
- problems regarding the interface between the Companies Ordinance and IAS.

<u>Lack of comparability inherent in IAS</u>

1.5 The IAS "Framework" discusses the issue of comparability as follows:

> "39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises."

An absence of comparability allows companies to choose accounting treatments according to what suits them best at a particular time. This can cause confusion to investors and it can result in inconsistent and inappropriate information being disseminated in the marketplace.

1.6 At the current time, as you are aware, IAS are still in a stage of development. Although the development has been sufficient for IOSCO to endorse 30 core standards for the purpose of cross-border offerings, we question whether this justifies the present proposal to permit <u>all</u> companies listed on the Exchange to adopt IAS at this time. One of the features of

IAS at the moment is that many standards permit a choice of two accounting treatments. In a few cases this may be reasonable but in other cases it arises of the difficulties in reconciling many different territories' legal and accounting practices. In these situations we believe that it is appropriate for one of the alternatives to be removed. This enhances comparability and reduces "cherry-picking". As you are aware, in our ongoing process of harmonising Hong Kong Statements of Standard Accounting Practice (SSAPs) with IAS, we have where possible removed choices of different accounting treatment. One consequence of allowing all companies listed on the Exchange to adopt IAS would be the re-opening of choices which we consider are unnecessary and/or inappropriate. This would reduce comparability and would risk causing confusion in the market place.

--- 1.7 We attach as an appendix to this letter a list of choices of accounting treatments which are permitted under IAS, but where the alternatives have been restricted under Hong Kong SSAPs. This list is substantial.

The need to develop a regulatory infrastructure

1.8 We have concerns over the lack of adequate regulatory infrastructure to support the ***widespread*** use of IAS by companies listed on the main board. If the use of IAS were to become widespread in Hong Kong very quickly, there would be a corresponding need for adequate monitoring of compliance. We believe that the machinery necessary for this does not yet fully exist in Hong Kong.

1.9 Although there are some individuals in Hong Kong who have considerable expertise and knowledge of IAS, this is not a generally available resource. Until such time (within the next year) as the more complex IAS on financial instruments, for example, are exposed in Hong Kong and subjected to public scrutiny, there would be difficulties in anybody claiming the same level of credibility in monitoring compliance with IAS that exists for Hong Kong SSAPs.

1.10 If there are many companies adopting IAS in the near future, it is likely that not only would their own capabilities be stretched, but so would those of the regulatory bodies which monitor compliance. This could lead to companies failing to apply IAS properly and a regulatory "gap" whereby the detection of such failures is delayed.

Anomalous accounting treatments under IAS

1.11 You are no doubt aware of the effect that adoption of IAS would have on financial reporting by companies which have investment properties (or indeed, other properties) located in Hong Kong. Under IAS, all property in Hong Kong would be dealt with as operating leases and it would not be permissible for long or medium term interests in leasehold land to be carried at market value in the balance sheet. This would result in all Hong Kong properties being carried as prepayments on operating leases at historical cost less amortisation.

1.12 In Hong Kong, where property investment is such a major feature of corporate life, the effect of adopting IAS would be a reduction in stated asset values and the obscuring of market valuations. This could result in balance sheets which are not clearly understood by the investing public and it could give rise to balance sheet manipulation by the unscrupulous who might wish to depress asset values for their own gain.

1.13 A further anomaly exists in the area of business combinations. At present IAS permits merger accounting (also known as the "pooling of interests method") for certain kinds of business combinations. Merger accounting has been widely manipulated (some would say abused) in some jurisdictions which permit it. By structuring business combinations in such a way as to permit merger accounting, companies can avoid accounting for goodwill and placing fair values on assets acquired on consolidation. This makes it much easier to maintain future earnings without having to amortise the fair value of the group's assets. In Hong Kong we do not permit merger accounting (except in very limited circumstances relating to the restructuring of an existing group). It is also public knowledge that both the IASC and the US FASB are planning to change their own rules to greatly restrict or eliminate merger accounting under IAS and US GAAP in future.

1.14 It seems to us clear that the anomalous treatment of either properties or merger accounting in Hong Kong under IAS could create opportunities for manipulation of balance sheets by the unscrupulous and cause confusion. We believe that further study of the property accounting issues (which will be done by the HKSA in the coming year) and waiting for the outcome of the IASC's own deliberations on merger accounting would be desirable before widespread adoption of IAS by Hong Kong listed companies is made permissible.

Anomalies between IAS and the Hong Kong Companies Ordinance

1.15 It is also worth noting that while overseas-registered companies could, if they so wished, adopt IAS, this choice would not be available to many companies incorporated in Hong Kong. The intended creation of a level playing field might be illusory as far as Hong Kong incorporated companies are concerned. This is because for the purposes of drawing up consolidated accounts, the Hong Kong Companies Ordinance is far more restrictive than IAS. Until such time as the Hong Kong Companies Ordinance is amended (and Government is currently working on this), some Hong Kong companies would not be able to comply with both IAS and the Companies Ordinance at the same time.

Conclusion on the IAS proposal

1.16 We trust that the analysis in the preceding paragraphs illustrates some of the less desirable effects that permitting adoption of IAS by all main board issuers could have. We consider that there are significant regulatory risks and that the proposal should be modified so as to restrict the proposal to a much smaller class of companies in the first instance. Such companies could be those which are genuinely seeking cross-border listings in markets which permit IAS for such purposes. Full adoption of IAS in Hong Kong would be better left until some of the choices and anomalies of existing IAS have been sorted out.

1.17 If, having considered the risks, the Exchange is prepared to accept responsibility for adopting the IAS proposal, we very strongly recommend that a reconciliation to Hong Kong SSAP's be made mandatory. This would at least enable users of financial statements to deduce the financial effects of a company's choice to use IAS. The reconciliation would be likely to include some very large numbers.

2. <u>The US GAAP proposal</u>

2.1 Although the regulatory infrastructure for monitoring and enforcing compliance with US GAAP does not exist in Hong Kong, this could be overcome in a practical manner (as indicated below) so long as the proposal is limited to issuers with a secondary listing on the Exchange.

2.2 In the United States of America, the Securities and Exchange Commission (SEC) has a substantial infrastructure for monitoring and enforcing compliance with US GAAP. This infrastructure could be used indirectly as a protection for Hong Kong investors provided that the US GAAP proposal is modified so that it applies only to issuers who have a secondary listing in Hong Kong but whose primary listing is in the USA. In this way, the financial statements would be subject to SEC regulation.

3. <u>Conclusion</u>

3.1 We are fully aware of the reason behind moving towards IAS, and for Hong Kong to remain competitive as an international financial centre, we should be more proactive and forthcoming in the process. We have no difficulty with this strategic objective. Our concerns, as described in this submission, are genuine and we would like to work with the other regulators and government in expediting the whole convergence process.

3.2 The concerns raised in this submission about the IAS proposal have been developed by the Society's Council and its Financial Accounting Standards Committee.

3.3 In view of the potential consequences of the IAS proposal on the credibility of Hong Kong listed company reports, we are copying this letter to the Financial Services Bureau, the Securities and Futures Commission and the Hong Kong Monetary Authority.

3.4 If you have any questions in relation to this letter please do not hesitate to contact Mr. James Fawls, the Society's Director of Professional

Standards, in the first instance.

Yours faithfully,

LEE KAI-FAT
REGISTRAR
HONG KONG SOCIETY OF ACCOUNTANTS

KFL/JF/jc
Encl.
c.c. Financial Services Bureau (Ms. Susie Ho)
Securities & Futures Commission (Mr. David Stannard)
Hong Kong Monetary Authority (Mr. David Carse)

Alternative Treatments that are available under IASs but not SSAPs

No.	**Reference; Topic**	**Treatment**
1.	IAS 1 "Presentation of Financial Statements" paragraph 86; Changes of Equity	An enterprise should present, as a separate component of its financial statements, (a) a statement of recognised gains and losses ***(Available under SSAP 1)***; or (b) a comprehensive statement of changes in equity ***(Not available under SSAP 1)***.
2.	IAS 2 "Inventories" paragraphs 21/23; Cost Formulas for Inventories	The cost of inventories, other than those that are not ordinarily interchangeable or produced and segregated for specific projects, should be assigned by: (a) <u>*Benchmark treatment*</u> ***(Available under SSAP 22)*** using the first-in, first-out (FIFO) or weighted average cost formulas; or *(b)* <u>*Allowed alternative treatment*</u> ***(Not available under SSAP 22)*** using the last-in, first-out (LIFO) formula.
3.	IAS 8 "Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies" paragraphs 34/38; Fundamental Errors	Either: (a) <u>*Benchmark treatment*</u> ***(Available under SSAP 2)*** the amount of the correction of a fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so; or (b) <u>*Allowed alternative treatment*</u> ***(Not available under SSAP 2)*** the amount of the correction of a fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information should be presented unless it is impracticable to do so.

4.	IAS 8 "Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies" paragraphs 49/54; Changes in Accounting Policies	A change in accounting policy should be applied retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonably determinable. Any resulting adjustment should be: (a) <u>*Benchmark treatment*</u> ***(Available under SSAP 2)*** reported as an adjustment to the opening balance of retained earnings. Comparative information should be restated unless it is impracticable to do so; or (b) <u>*Allowed alternative treatment*</u> ***(Not available under SSAP 2)*** included in the determination of the net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma comparative information should be presented unless it is impracticable to do so.
5.	IAS 22 (revised 1998) "Business Combinations" paragraphs 32/34; Allocation of the Cost of Acquisition, Minority Interests	The identifiable assets and liabilities recognised should be measured at: (a) <u>*Benchmark treatment*</u> ***(Not available under SSAP 30*)*** the aggregate of the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction to the extent of the acquirer's interest obtained in the exchange transaction and the minority's proportion of the pre-acquisition carrying amounts of the identifiable assets and liabilities of the subsidiary; or ***(b)*** <u>*Allowed alternative treatment*</u> ***(Available under SSAP 30*)*** at their fair values as at the date of acquisition Any minority interest should be stated at the minority's proportion of the fair values of the identifiable assets and liabilities recognized.

6.	IAS 23 “Borrowing Costs” paragraphs 7/11; Borrowing Costs	(a) <u>*Benchmark treatment*</u> ***(Not available under SSAP 19)*** Borrowing costs should be recognised as an expense in the period in which they are incurred; or (b) <u>*Allowed alternative treatment*</u> ***(Available under SSAP 19)*** Borrowing costs should be recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised in accordance with the following: Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.
7.	IAS 27(revised 1998) “Consolidated Financial Statements and Accounting for Investments in Subsidiaries” paragraphs 29/30; Investments in Subsidiaries, Parent's Separate Financial Statements	In a parent's separate financial statements, investments in subsidiaries (that are included in or excluded from the consolidated financial statements) should be either: (a) carried at cost ***(available under SSAP 32*)***; (b) accounted for using the equity method as described in IAS 28, Accounting for Investments in Associates ***(Not available under SSAP 32*)***; or (c) accounted for as available-for-sale financial assets as described in IAS 39, Financial Instruments: Recognition and Measurement ***(Available under SSAP 32* with reference to the treatment under SSAP 24)***.
8	IAS 28 (revised 1998) “Accounting for Investments in Associates” paragraph 12; Investments in Associates, Separate Financial Statements of the Investor where Consolidated Financial Statements are also Prepared	An investment in an associate that is included in the separate financial statements of an investor that issues consolidated financial statements and that is not held exclusively with a view to its disposal in the near future should be either: (a) carried at cost ***(Available under SSAP 10 (revised)*)***; (b) accounted for using the equity method ***(Not available under SSAP 10 (revised)*)***; (c) accounted for as an available-for-sale financial asset as described in IAS 39, Financial Instruments: Recognition and Measurement ***(Available under SSAP 10 (revised)* with reference to the treatment under SSAP 24)***.

9.	IAS 28 (revised 1998) "Accounting for Investments in associates" paragraphs 12; Investments in Associates, Separate Financial Statements of the Investor where Consolidated Financial Statements are not Prepared	An investment in an associate that is included in the financial statements of an investor that does not issue consolidated financial statements should be either: (a) carried at cost ***(Available under SSAP 10 (revised)*)***; (b) accounted for using the equity method if the equity method would be appropriate for the associate if the investor issued consolidated financial statements ***(Not available under SSAP 10 (revised)*)***; or (b) accounted for under IAS 39, Financial Instruments: Recognition and Measurement, as an available-for-sale financial asset or a financial asset held for trading based on the definitions in IAS 39 ***(Available under SSAP 10 (revised)* with reference to the treatment under SSAP 24)***.
10.	IAS 31 (revised 1998) "Financial Reporting of Interests in Joint Ventures" paragraphs 25/32; Consolidated Financial Statements, Reporting of a Venturer's Interest in a Jointly Controlled Entity	In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using: (a) <u>*Benchmark treatment*</u> ***(Not available under SSAP 21)*** one of the two reporting formats for proportionate consolidation; or (b) <u>*Allowed alternative treatment*</u> ***(Available under SSAP 21)*** the equity method.

Note: * Statement that will soon be issued by the Society.