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Our. Ref.: C/FASC

23 September 2002

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Exposure Draft of Proposed Improvements
to International Accounting Standards

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide you with our comments on the exposure draft of Proposed Improvements to International Accounting Standards ("exposure draft").

We set out in the attachment our response to the questions raised in your Invitation to Comment together with our comments on additional matters identified.

The HKSA has a policy of converging its Statements of Standard Accounting Practice with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. Accordingly, the accompanying comments reflect the views not only of members of the FASC but of constituents in Hong Kong who provided comments to the HKSA.

If you have any questions on our comments, please contact our Deputy Director - Accounting, Mr. Simon Riley, in the first instance.

Yours faithfully,

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
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WCC/SR/al

Hong Kong Society of Accountants' comments on the Exposure Draft of Proposed Improvements to International Accounting Standards

Introduction

The HKSA has a policy of converging its Statements of Standard Accounting Practice with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. Accordingly, the accompanying comments reflect the views not only of members of the FASC but of constituents in Hong Kong who provided comments to the HKSA.

In principle, we support the Board's objectives in the Improvements project to reduce or eliminate alternatives, redundancies and conflicts within existing Standards and to make other improvements to them. However, we find that, in some cases, the proposed changes to existing Standards in the exposure draft are beyond just 'improvements' made within the remit of the Improvement project. We also note that there are a number of instances where a significant proposed change to an existing Standard is not highlighted in the Invitation to Comment. Commentators therefore may not have taken notice of all the significant proposed changes in the exposure draft, in particular when coupled with the lack of marked-up drafts in IAS 1, IAS 21, IAS 24 and IAS 33. We believe that, by failing to seek specific comments on all the significant proposed changes in the exposure draft, the Board increases the risk that soon after the revised Standards have been issued interpretations by IFRIC or further amendments to Standards will be required.

In addition, we would draw particular attention to our comments on IAS 1 with regard to the proposed elimination of the disclosure of the place or country of incorporation of an entity and the use of the term "fair presentation" as set out on page 3 of the attachment. We strongly disagree with the proposed elimination of the disclosure of the place or country of incorporation, as we believe that this is an important source of information. We also have a strong view that the term "true and fair view" should be used instead of "fair presentation" in IAS 1 since we believe that the term "true and fair view" is more consistent with the principle-based international accounting standards.

<u>IAS 1, Presentation of Financial Statements</u>

Question 1

Do you agree with the proposed approach regarding departure from a requirement of an International Financial Reporting Standard or an Interpretation of an International Financial Reporting Standard to achieve a fair presentation (see paragraphs 13 - 16)?

We agree with the basic principles of a true and fair override as set out in paragraphs 13 to 16 except for the proposal not to require an adjustment to the primary statements in jurisdictions where an override is prohibited by the relevant regulatory framework. We are of the view that the IASB should continue to set standards that are independent of any national regulatory framework. To do otherwise would hinder the comparability of IAS compliant financial statements prepared in different jurisdictions. Also, it might result in multi-listed companies publishing two or more sets of consolidated financial statements that are fundamentally different, yet purport to achieve a fair presentation in accordance with IASs.

In addition, we do not consider that inappropriate accounting treatments that result in misleading primary financial statements can be rectified solely by disclosure. However, in the case where the IASB decides to proceed with this approach, we suggest that the IASB discuss this with the IAASB before finalising the proposal as we would see the need for auditors to modify their audit reports in such circumstances to conclude that the primary statements are misleading and do not achieve a fair presentation.

Question 2

Do you agree with prohibiting the presentation of items of income and expense as 'extraordinary items' in the income statement and the notes (see proposed paragraphs 78 and 79)?

Yes.

Question 3

Do you agree that a long-term financial liability due to be settled within twelve months of the balance sheet date should be classified as a current liability, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue (see proposed paragraph 60)?

We support this in the context of the Framework. However, there are counter arguments that financial statements should present "forward looking" information which would make it important to consider the position up until the time the financial statements are authorised for issue. Accordingly, this may indicate that there are some flaws in the Framework.

Question 4

Do you agree that:

(a) A long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the balance sheet date, even if the lender has agreed after the balance sheet date, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach (see paragraph 62)?

Same comment as for question 3 above.

(b) If a lender was entitled to demand immediate repayment of a loan because the entity breached a condition of its loan agreement, but agreed by the balance sheet date to provide a period of grace within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as non-current if it is, due for settlement, without that breach of the loan agreement, at least twelve months after the balance sheet date and:

(i) The entity rectifies the breach within the period of grace; or
(ii) When the financial statements are authorised for issue, the period of grace is incomplete and it is probable that the breach will be rectified (see paragraphs 63 – 64)?

No. We consider that the approaches taken in paragraph 62 and 63 are inconsistent. Paragraph 62 indicates that if, at the balance sheet date, there is a breach of the covenant then the liability must be classified as current, even if the lender agrees not to demand repayment after the balance sheet date. Paragraph 63, however, indicates that if, at the balance sheet date, there is a breach of covenant then the debt can be treated as non-current if the lender has agreed a grace period and the breach is either rectified after year-end or it is probable that the breach will be rectified.

We are of the view that a consistent approach should be adopted by the IASB. It should select one principle: either post balance sheet changes to loan terms should result in reclassification, or they should not (the latter is as proposed in (a) above). We consider classification in the circumstances set out in (b) should be governed by the date on which the grace period ends. Thus, if the period of grace is less than 12 months a loan should be classified as current, but if the period of grace is more than 12 months a loan should be classified as non-current.

Question 5

Do you agree that an entity should disclose the judgments made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements (see proposed paragraphs 108 and 109)?

See comment on question 6 below.

Question 6

Do you agree that an entity should disclose key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see paragraphs 110-115)?

We see the utility of these disclosures. However, we consider that mandating these disclosures in IASs would likely result in boilerplate text. Accordingly, we are of the view that these disclosures are better suited to the requirements of an MD&A.

Other comments on IAS 1

Existing paragraph 102(a): Proposed elimination of the disclosure of an entity's country of incorporation and the address of its registered office (or principal place of business, if different from the registered office). Retained disclosure relating to the domicile and legal form of an entity (in proposed paragraph 117(a)).

Legally, "domicile" means "the place where, for official purposes, one is considered to live". However, an entity may interpret this term as the entity's country or place of incorporation while some may interpret this term as the entity's principal place of business. We suggest adding clarification of the meaning of "domicile" or adopting a term whose meaning can be more objectively determined. Moreover, we consider that it is meaningful to retain the disclosure of an entity's country or place of incorporation because under certain legal or statutory requirements, an entity may have to disclose certain information in addition to those required by IAS. This can help users to better understand the additional disclosures made by an entity. In addition, disclosure of an entity's country or place of incorporation would provide knowledge of which jurisdiction a user would be able to take action against the entity. Such disclosure is also important for corporate governance purposes as it specifies the law relating to shareholders' rights. In Hong Kong, we believe that this is an important source of information and intend to retain this requirement under our Statement of Standard Accounting Practice even if the IASB decides to go ahead with the proposal of eliminating this disclosure.

True and Fair / Fair Presentation

We note that the term "fair presentation" is used instead of "true and fair view" in IAS 1. Through our previous enquiry with your staff, we understand that the terms 'fair presentation' and 'presented fairly' derive from the United States of America and must be followed by the words 'in accordance with generally accepted accounting principles applying in the United States (US GAAP)'. Hence, one cannot (easily) override a standard to achieve a fair presentation. While we believe that the term 'fair presentation' is appropriate to be used under the rule-based US GAAP, we consider that "true and fair" is a better term to be used in IASs because it would be more consistent with principle based accounting standards.

Going concern

IAS 1 at present establishes a minimum foreseeable future of not less than twelve months from the balance sheet date for management's assessment of whether the going concern assumption is appropriate. We note that this is mirrored in the requirements in International Standard on Auditing ISA 570 in respect of an auditor's assessment of going concern.

We would like to express our support for the foreseeable future requirement being extended to cover a period of not less than twelve months after the financial statements are approved.

ISA 570 cannot require the auditor to look at the issue of going concern in isolation and it is not practicable to require the auditor to assess going concern over a minimum period that is longer than that required of an entity's management. We would consider it to be financial statement users' interests that the assessment of going concern covers the period not only up to the next balance sheet date but to a time that one would expect to more closely approximate the publication of next year's financial statements.

In recommending that IAS 1.19 be amended to this effect, we would also recommend that the IASB liaise with the IAASB for a similar change to be made to ISA 570.

IAS 2, Inventories

Question 1

Do you agree with eliminating the allowed alternative of using the last-in, first-out (LIFO) method for determining the cost of inventories under paragraphs 23 and 24 and IAS 2?

Yes.

Question 2

IAS 2 requires reversal of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss (paragraph 31).

Do you agree with retaining those requirements?

Yes.

IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors

Question 1

Do you agree that the allowed alternative treatment should be eliminated for voluntary changes in accounting policies and corrections of errors, meaning that those changes and corrections should be accounted for retrospectively as if the new accounting policy had always been in use or the error had never occurred? (see paragraphs 20, 21,32 and 33)

See comment on question 2 below.

Question 2

Do you agree with eliminating the distinction between fundamental errors and other material errors (see paragraphs 32 and 33)?

We support the requirement that all changes in accounting policy should be made retrospectively.

However, we do not support the proposed changes regarding the correction of errors, as we believe that it would provide a fertile ground for manipulation and abuse. We believe the proposed definition of errors is too wide and would create a risk that errors in judgement or estimation would be treated as errors. We also believe the proposed treatment for errors (i.e. retrospective restatement) should not be extended to unconnected errors that are not individually material but which could be material in aggregate.

IAS 10, Events After The Balance Sheet Date

Inconsistency between IAS 10, IAS 32 and IAS 37

We disagree with the illustration made in example 12 of Appendix C to IAS 37. In certain jurisdictions like Hong Kong, the board of directors has only the legal right to propose (but not "declare") final dividends. Shareholders' approval of dividends "proposed" by the board of directors at the annual general meeting is, in most cases, a mere formality to satisfy the local legal requirement. Accordingly, there may be cases where an entity may be able to justify the recognition of dividend liability based on the concept of "constructive obligations" (according to IAS 37.10 and IAS 37.14) providing that the board of directors proposes the dividends **before** the balance sheet date (a past event). We therefore consider that the example 12 added to Appendix C fails to take into account the above situation.

IAS 15, Information Reflecting the Effects of Changing Prices

We concur with the proposed withdrawal of this Standard.

IAS 16, Property, Plant and Equipment

Question 1

Do you agree that all exchanges of items of property, plant and equipment should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably (see paragraphs 21 and 21A)?

See comment on question 2 below.

Question 2

Do you agree that all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably? (See the amendments in paragraphs 34-34B of IAS 38, *Intangible Assets*, proposed as a consequence of the proposal described in Question 1.)

(Note that the Board has decided not to amend, at this time, the prohibition in IAS 18, *Revenue*, on recognising revenue from exchanges or swaps of goods or services of a similar nature and value. The Board will review that policy later in the context of a future project on the Recognition of Revenue.)?

We do not consider that the exchanges of items of property, plant equipment and intangible assets should be dealt with in isolation as part of the revision to IAS 16 and consequential revision to IAS 38. We believe that the issue of accounting for exchange of assets would best be addressed by a comprehensive project on accounting for non-monetary transactions in general. This would cover accounting for exchanges of assets, goods and services as well as providing guidance on both how fair value should be measured in these circumstances and how revenue should be recognised on such exchanges.

In spite of the above, we consider that the existing guidance on exchange of assets should be enhanced. In particular, we believe that there is a need to clarify how one determines the “fair value” of dissimilar assets that are to be brought onto the balance sheet.

Question 3

Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal (see paragraph 59)?

We do not agree with the proposal. We believe that, when an asset is held for disposal, allocation of cost is no longer appropriate and therefore depreciation should cease at that point even though impairment tests under IAS 36 would still apply.

We believe that plant that is temporarily idle should be depreciated if the basis of depreciation is a simple time allocation. No depreciation should be provided if a unit of production basis is used and the total service potential of the plant is not reduced while lying idle.

Other comments on IAS 16

Paragraph 41: When should depreciation commence?

IAS 38.79 states that amortisation should commence when the asset is available for use. However, there is no similar guidance in IAS 16 as to when an entity should commence charging depreciation. According to proposed IAS 16.15(b), an entity will, in a normal situation, commence the operational use or trial test of an item of PP&E when the PP&E is “capable of operating in the manner intended by management”. There have been questions as to whether the phrase “capable of operating in the manner intended by management” would mean the same as “available for use” when determining when to start charging depreciation. If these phrases are intended to be synonymous, we recommend that wording similar to IAS 38.79 should be added in IAS 16.41 for the sake of clarity.

Paragraph 59: How should an item of PP&E held for disposal be presented in the balance sheet?

It is not clear in the exposure draft how an item of PP&E held for disposal should be presented in the financial statements. According to existing IAS 1.57(b), an asset that “is held primarily for trading purposes or for the short-term and expected to be realised within twelve months of the balance sheet date” should be classified as a current asset. Hence, under existing IAS, PP&E held for disposal at the balance sheet date should be classified as a non-current asset.

However, under the proposed IAS 1.54(c) “when an asset is expected to be realised within twelve months of the balance sheet date”, PP&E held for disposal would be classified as a current asset.

After this revision, an entity may argue that PP&E held for disposal at the balance sheet date should be classified as current asset as the proposed IAS 1.54(c) is satisfied. However, readers may be confused by this treatment as PP&E is acquired and held primarily for long-term purposes. Accordingly, we suggest that guidance similar to the provisions on transfers in IAS 40 should be added in IAS 16 for the sake of clarity.

IAS 17, Leases

Question 1

Do you agree that when classifying a lease of land and buildings, the lease shall be split into two elements – a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, *Leases* and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs 3-10 of IAS 17.

We support this as part of a short term fix to the problem encountered in many jurisdictions, including Hong Kong, where the existing IAS 17 does not permit a leasehold property to be classified as an investment property under IAS 40 or as a property under IAS 16 even if the terms of the lease, in substance, differ very little from buying the property outright. However, we see practical difficulties in splitting a lease of land and buildings into a lease of land and a lease of buildings and we consider that the guidance given in proposed new paragraphs 11A – 11C might create artificial distinctions. We also have reservations about the need for splitting a lease of land and buildings given that an entity should be allowed to account for a transaction based on its substance rather than its form. We believe that a more comprehensive review of IAS 17, in particular the conceptual basis for lease accounting, should be made by the IASB as a matter of priority.

Question 2

Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?

Yes. However, we note that this proposal is inconsistent with the proposed change to paragraph 17 of IAS 39 where the transaction costs will be limited to incremental external costs.

Other comments on IAS 17

General

We support the proposed revision to IAS 17 as a short-term fix to allow certain leasehold properties to be accounted for under IAS 16 or IAS 40 as appropriate. We note that there are a number of significant issues relating to the existing accounting of leases, such as those identified in the earlier G4+1 discussion paper on leases. Accordingly, we see the need to revisit IAS 17 as a separate project, in particular the conceptual basis for lease accounting, as a matter of priority.

Proposed paragraph 11B

We agree that if lease payments cannot be allocated reliably between the land and buildings elements, the entire lease is classified as a finance lease. However, we suggest this point should be further clarified by highlighting that in such cases, the entire leasehold land and buildings could be treated as PP&E or investment properties (as appropriate). Consequently, they may be carried at cost less depreciation or revalued amounts under IAS 16 or at cost less depreciation or fair value under IAS 40.

Transitional arrangements

It is not clear from the exposure draft as to whether an entity will be required to apply the proposed changes to IAS 17 retrospectively. Since the proposed changes will have an impact on many entities, we believe that this should be made clear in the Standard.

IAS 21, The Effects of Changes in Foreign Exchange Rates

Question 1

Do you agree with the proposed definition of functional currency as "the currency of the primary economic environment in which the entity operates" and the guidance proposed in paragraphs 7-12 on how to determine what is an entity's functional currency?

Yes. However, we have concerns over the guidance proposed in the exposure draft. We would like to see examples to illustrate the guidance proposed. In the case of a group, we believe that the guidance is not clear as to whether the group as a whole is required to determine its own functional currency, especially in cases where subsidiaries prepare reports in (potentially a number of) different functional currencies. We also note that, in some jurisdictions, there is an official exchange rate as well as a black market exchange rate and we are unsure as to whether the proposal will require, or provide guidance on, the specific rate to be used.

Question 2

Do you agree that a reporting entity (whether a group or a stand-alone entity) should be permitted to present its financial statements in any currency (or currencies) that it chooses?

Yes, while the determination of one functional currency (or more) is, we believe, a matter of fact, it would not be appropriate for the IAS to impose restrictions on whether a reporting entity may present its financial statements in a different currency.

Question 3

Do you agree that all entities should translate their financial statements into the presentation currency (or currencies) using the same method as is required for translating a foreign operation for inclusion in the reporting entity's financial statements (see paragraphs 37 and 40)?

Yes.

Question 4

Do you agree that the allowed alternative to capitalise certain exchange differences in paragraph 21 or IAS 21 should be removed?

Yes.

Question 5

Do you agree that

(a) goodwill and

(b) fair value adjustments to assets and liabilities

that arise on the acquisition of a foreign operation should be treated as assets and liabilities of the foreign operation and translated at the closing rate (see paragraph 45)?

We see two alternative methods to deal with goodwill that arise on the acquisition of a foreign operation but these methods give rise to different results. One is to apply impairment testing on the goodwill where any impairment will go through the income statement but which will not be capable of reversing. The other is to apply currency realignment testing where any changes will go through reserves and which may reverse depending on future movements in foreign exchange rates. We believe that there are merits in both methods and note the discussion in paragraphs A25 and A26 of the proposed Basis for Conclusions. However, it is not apparent to us that the method proposed is founded on a clear statement of principle.

Other comments on IAS 21

Definition of foreign operation

Given that certain provisions in the exposure draft do not cater for branches, we believe that there is a need to clarify whether the definition of a foreign operation in paragraph 6 requires it to be a separate legal entity or a division so long as it has separate operations, books and records.

Monetary assets

We believe that further guidance is needed for determining whether an asset is a monetary asset for the purpose of applying the proposal, in particular in the case of an equity instrument.

Paragraph 52: Disclosure

We believe that, when there is a change in the functional currency, disclosure of the circumstances giving rise to the change should be required.

Paragraph 53 and 55: Disclosure

We believe that there is a need to make clear in the disclosure set out in paragraph 55 that the requirements of paragraph 53 need also be applied in that circumstance.

<u>IAS 24, Related Party Disclosures</u>

Question 1

Do you agree that the Standard should not require disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations? (see paragraph 2)?

'Management' and 'compensation' would need to be defined, and measurement requirements for management compensation would need to be developed, if disclosure of these items were to be required. If commentators disagree with the Board's proposal, the Board would welcome suggestions on how to define 'management' and 'compensation'.

We do not agree with the proposal, as we see no justification for such exemption.

Question 2

Do you agree that the Standard should not require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a wholly-owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs (see paragraph 3)?

(Note that this proposal is the subject of alternative views of Board members, as set out in Appendix B).

Yes. However, we consider that disclosure of the reliance of such exemption should be made in the separate financial statements of a parent or a wholly-owned subsidiary.

Other comments on IAS 24

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 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.

Definition of close family

While we agree that there is a need for a definition of close family, we have reservations about providing a narrow group of examples in the Standard as it will likely result in preparers limiting themselves to these examples in their considerations.

Paragraph12: Disclosure

Proposed paragraph 12 of the exposure draft proposes to require disclosure of the relationships between parents and subsidiaries irrespective of whether there have been transactions between those related parties. We believe that this proposed disclosure would result in a change to the existing requirement under paragraph 20 of the existing Standard, as the proposed disclosure is now based on a parent/ subsidiary relationship rather than a control relationship, and the change could well have some significant consequences which are beyond those solely for a change in terminology used. Given that this proposed change is not highlighted anywhere in the exposure draft for comment, we recommend that the Board should consider very carefully the consequences of making this change before proceeding to adopt this new proposal in order to avoid any unintentional complication.

<u>IAS 27, Consolidated and Separate Financial Statements</u>

Question 1

Do you agree that a parent need not prepare consolidation financial statements if all the criteria in paragraph 8 are met?

Yes.

Question 2

Do you agree that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity (see paragraph 26)?

We believe that this proposal will have an impact on other areas of the accounting of business combinations, such as deemed acquisitions or disposals. Accordingly, we consider that this proposed change should be addressed in Phase II of the Business Combinations project, where recognition and measurement of minority interests will be considered, rather than as an isolated revision to IAS 27.

Question 3

Do you agree that investments in subsidiaries, jointly controlled entities and associates that are consolidated, proportionately consolidated or accounted for under the equity method in the consolidated financial statements should be either carried at cost or accounted for in accordance with IAS 39, Financial Instruments: Recognition and Measurement, in the investor's separate financial statements (paragraph 29)?

Yes.

Do you agree that if investments in subsidiaries, jointly controlled entities and associates are accounted for in accordance with IAS 39 in the consolidated financial statements, then such investments should be accounted for in the same way in the investor's separate financial statements (paragraph 30)?

Yes.

Other comments on IAS 27

Paragraph 23: Gains or losses on the disposal of the subsidiary

Proposed paragraph 23 of IAS 27 states that the difference between the proceeds from the disposal of the subsidiary and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relate to the subsidiary recognised in equity in accordance with IAS 21, is recognised in the consolidated income statement as the gain or loss on the disposal of the subsidiary. We believe that text should be made clear that the carrying amount of the subsidiary as of the date of disposal also include any unamortised goodwill relate to the subsidiary regardless of whether the goodwill was previously carried as an asset or eliminated against reserves.

Venture capital organisations

We consider that IAS 27 should exclude from its scope investments that otherwise would be subsidiaries held by venture capital organisations, mutual funds, unit trusts and similar entities that are measured at fair value in accordance with IAS 39, when such measurement is well established practice in those industries, given that similar proposals are included in IAS 28 and IAS 31 in respect of associates and joint ventures held by these entities. However, in order to avoid any abuse, we believe that the terms of venture capital organisations, mutual funds, unit trusts and similar entities should be clearly defined in the Standard.

Exclusion of temporary subsidiaries

We note the proposed requirement of paragraph 13 concerning the exclusion of subsidiaries acquired where control thereof is intended to be temporary. We believe that the proposed criterion for excluding from consolidation a subsidiary that is acquired and held exclusively with a view to its subsequent disposal within twelve months is too restrictive. We consider that certain flexibility should be given for this proposed criterion. In Hong Kong, our existing guidance on this is that the investor should expect at the time of acquisition that disposal will take place within one year of the date of acquisition in order not to consolidate a subsidiary. However, if the disposal has not been achieved by the end of the first annual accounting period commencing after the acquisition, the treatment may be continued only if the parent has identified or is continuing to actively seek a purchaser and the extended period can be justified on the basis of particular circumstances of the subsidiary and the prevailing economic environment. In such a case, disclosure of the particular circumstances and the company's plans of the subsidiary should be made. We believe that this treatment allows for the real life situations and should prevail over the "clear cut" treatment of twelve months. This treatment has been applied in Hong Kong for more than two years and we are not aware of any abuse thereof in practice. We therefore recommend that this treatment be adopted by the IASB in respect of temporary subsidiaries, associates and joint ventures under IAS 27, IAS 28 and IAS 31, respectively.

SIC 12 – Special Purpose Entities

We consider that SIC 12 should be incorporated into IAS 27 as part of this exercise given that there is still no fixed timeframe for the project on revising SIC 12. To do otherwise may provide a connotation that there are problems with the guidance in SIC 12.

IAS 28, Accounting for Investments in Associates

Question 1

Do you agree that IAS 28 and IAS 31, Financial Reporting of Interests in Joint Ventures, should not apply to investments that otherwise would be associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities if these investments are measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice in those industries (see paragraph 1)?

Yes. However, we believe that it is important to add in a clear definition of venture capital organisations in the Standard to avoid any doubt, potential for abuse or creation of artificial distinctions.

Question 2

Do you agree that the amount to be reduced to nil when an associate incurs losses should include not only investments in the equity of the associate but also other interests such as long-term receivables (paragraph 22)?

We disagree with the proposal described in paragraph 22. Since the investor's interest in an associate will be defined as the carrying amount of the investment plus items that, in substance, form part of the investor's equity investment of the associate, this proposal may give rise to abuse in determining what is "quasi-equity" and what is not. There could well be situations where an associate is incurring losses but remains sufficiently solvent to pay loan finance as it falls due. But this proposal would effectively require such loan finance to be written down when that is deemed to be "quasi-equity".

Other comment on IAS 28

Paragraph 27 – Disclosure

While we support the proposed disclosure of summarised financial information of associates, we believe the current drafting of the disclosure in paragraph 27 (b) is unclear as to whether the disclosure will require disclosing the aggregated amounts of the "total" or "share of" assets, liabilities, revenues and profit or loss of associates. If the Board's intention is to require disclosure of the "share of" assets, liabilities, revenues and profit or loss of associates, we believe that further guidance is required as to whether inter-company balances should be eliminated when making such disclosure. If the Board's intention is to require disclosure of the "total" assets, liabilities, revenues and profit or loss of associates, we believe that such disclosure would be meaningless. Accordingly, we would suggest that such disclosure to be replaced by an aggregated disclosure of the associates' current assets, long-term assets, current liabilities, long-term liabilities, contingent liabilities, income and profits or losses where the investment in one or more associates is material.

<u>IAS 33, Earnings Per Share</u>

Question 1

Do you agree that contracts that may be settled either in ordinary shares or in cash, at the issuer's option, should be included as potential ordinary shares in the calculation of diluted earnings per share based on a rebuttable presumption that the contracts will be settled in shares?

We express no view on this proposal.

Question 2

Do you agree with the following approach to the year-to-date calculation of diluted earnings per share (as illustrated in Appendix B, examples of 7 and 12)?

a) The number of potential ordinary shares is a year-to-date weighted average of the number of potential ordinary shares included in each interim diluted earnings per share calculation, rather than a year-to-date weighted average of the number of potential ordinary shares weighted for the period they were outstanding (i.e. without regard for the diluted earnings per share information reported during the interim periods).

b) **The number of potential ordinary shares is computed using the average market price during the interim periods reported upon, rather than using the average market price during the year-to-date period.**

c) **Contingently issuable shares are weighted for the interim periods in which they were included in the computation of diluted earnings per share, rather than being included in the computation of diluted earnings per share (if the conditions are satisfied) from the beginning for the year-to-date reporting period (or from the date of the contingent share agreement, if later).**

No. We believe that there is no clear statement of principle in the Standard itself in order for us to support these proposals.

IAS 40, Investment Property

Question 1

Do you agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease provided that:

(a) **The rest of the definition of investment property is met; and**
(b) **The lessee uses the fair value model set out in the IAS 40, paragraphs 27-49?**

Yes.

Question 2

Do you agree that a lessee that classifies a property interest held under an operating lease as investment property should account for the lease as if it were a finance lease?

Yes.

Question 3

Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course?

Yes.

Other comment on IAS 40

The fair value model of investment property

We note that there is an apparent inconsistency between the accounting treatment for investment property carried under the fair value model of IAS 40 (i.e. gains or losses arising from changes in fair value reported through the income statement) and the accounting treatment proposed for available for sale instrument, which is the category that is most akin to an investment property, under the exposure draft of proposed amendments to IAS 39 where the changes in fair value must be reserve accounted. Given the proposed amendments to IAS 39 reflect the latest development, we suggest that the IASB should consider amending the accounting treatment for investment property under the fair value model of IAS 40 in order to bring it in line with IAS 39.