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KPMG IN HONG KONG

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In this issue:

Common abbreviations defined:

HKICPA - Hong Kong Institute of Certified Public Accountants (previously known as Hong Kong Society of Accountants)

SSAP - Statement of Standard Accounting Practice

HKAS - Hong Kong Accounting Standard

HKFRS - Hong Kong Financial Reporting Standard

IFRS - International Financial Reporting Standard

IAS - International Accounting Standard

Further amendments to transitional provisions

The HKICPA has recently issued further amendments to the transitional provisions of the following standards:

- HKAS 16, *Property, plant and equipment and HKAS 40, Investment property*; and
- HKAS 39, *Financial instruments: recognition and measurement.*

These amendments are to the transitional provisions applicable as from the first accounting period beginning on or after 1 January 2005, or earlier date if the relevant standards have been adopted early. This issue of Financial Reporting Update (FRU) provides an overview of the amendments.

HKASs 16 and 40: additional transitional relief for not-for-profit organisations

The HKICPA has introduced new transitional provisions in HKAS 16 (HKAS 16. 80B) and HKAS 40 (HKAS 40.83A) specifically for charities and other not for profit organisations that had previously taken advantage of the exemption under SSAP 17, *Property, plant and equipment* (PPE) and SSAP 13, *Accounting for investment properties* from compliance with their requirements.

SSAPs 17 and 13 exempted charitable, government subvented and not-for-profit organisations whose long-term financial objective was other than to achieve operating profits (e.g. trade associations, clubs and retirement schemes) from compliance with their requirements provided that full disclosure of their accounting policies was made. However, these exemptions have not been retained in HKASs 16 and 40, which superseded SSAPs 17 and 13 respectively, with effect from annual periods beginning on or after 1 January 2005.

The new transitional provisions included in HKASs 16 and 40 permit those previously exempted entities who took advantage of the exemptions to deem the carrying amount of an item of PPE or an investment property immediately before applying HKAS 16 or HKAS 40 on its effective date (or earlier), as appropriate, as the cost of that item of PPE or investment property for the purposes of applying the requirements of HKAS 16 or the cost model in HKAS 40, respectively.

Where a carrying amount is used as deemed cost for subsequent accounting under HKAS 16, HKAS 16.80B requires this fact and the aggregate of the carrying amounts of each class of PPE presented to be disclosed. We understand this to mean that the amounts that have been deemed to be cost under this transitional provision as at the date of adoption of HKAS 16 should be

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disclosed on a class by class basis. Similar disclosures would also be made where deemed cost is used under HKAS 40, in accordance with the general requirements of HKAS 8.28 to disclose changes in accounting policies.

In practice, this transitional provision removes the need for such entities to re-trace the original cost of their assets still in use and/or to retrospectively calculate depreciation in accordance with HKAS 16's rules. This may be particularly beneficial when such entities previously adopted a policy of writing off all property, plant and equipment (PPE) or investment property on acquisition. In such cases, the carrying amount of the assets acquired before the effective date of the relevant HKAS can continue to be nil, if advantage is taken of this transitional provision.

HKAS 39: greater flexibility in choosing an appropriate reserve for opening balance adjustments in respect of available-for-sale securities

Overview

HKAS 39, *Financial instruments: recognition and measurement*, is effective for annual periods beginning on or after 1 January 2005. HKAS 39 contains a number of specific transitional provisions drafted by the HKICPA, which set out the extent to which opening balances should be adjusted in the first period of adoption. In all cases of adjustments arising from HKAS 39's new requirements, the restatement of comparative amounts is prohibited.

The most recent amendment to these transitional provisions, issued on 27 January 2006, relates only to one specific issue, namely which reserve may be adjusted for opening balance adjustments arising from the restatement to fair value for available-for-sale ("AFS") securities, as dealt with in HKAS 39.104(d).

HKAS 39.104(d) deals in general with the re-measurement to conform to the measurement bases under HKAS 39 of fair value or amortised cost, depending on the required or chosen asset or liability classification.

Before the January 2006 amendment, HKAS 39.104(d) stated that "any adjustment of the previous carrying amount should be recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which this standard is applied". This text has now been amended by the addition of the words "or, if appropriate, another category of equity" after the words "retained earnings".

The purpose of the change is to facilitate, where appropriate, the restatement of the opening balance of the fair value reserve, i.e. the component of equity which holds the movements in the fair value of AFS securities until the securities are impaired or disposed of (at which point the amount held in the reserve in respect of that investment is transferred to the income statement for the period in accordance with HKAS 39.55(b)).

The issue of the restatement of the fair value reserve arises when an entity chooses, or is required, on the first day of adoption of HKAS 39 (say 1 January 2005, for an entity with a December year-end) to re-classify investments held at that date as AFS securities.

Securities that may be classified as AFS securities include both debt and equity securities, whether listed or unlisted, but do not include those that were acquired originally for trading purposes. The exclusion of securities acquired for trading purposes from the AFS category under HKAS 39.9 and the restriction on subsequent re-classification at a later date under HKAS 39.50 are consistent with the approach under paragraphs 28 to 30 of SSAP 24, *Accounting for investments in securities*. Therefore, in our view, the transition to HKAS 39 from SSAP 24, in and of itself, does not provide reasonable grounds for a re-classification of a security originally acquired for trading purposes.

The questions of when is it appropriate to adjust the opening balance of the fair value reserve, and when is it not appropriate, are looked at more closely below, together with some guidance on whether listed entities can take a different approach in their full year financial statements compared to that taken at the interim.

When is it appropriate to make opening balance adjustments to the fair value reserve?

- *Opening balance adjustments to the fair value reserve may be appropriate when investments were previously classified as investment securities under SSAP 24's benchmark treatment or were classified as being held to maturity*

The extent of opening balance adjustments to the fair value reserve on the adoption of the HKAS 39 AFS policy depends on which policy was previously adopted by the entity under SSAP 24. As explained in further detail in issue 13 of Financial Reporting Update (FRU), opening balance adjustments on adoption of the AFS category will primarily arise in the following circumstances:

- under SSAP 24, the investments were previously classified as "investment securities" under the benchmark treatment and were therefore carried at cost less provision for losses which were other than temporary; or
- under SSAP 24, the investments were previously classified as "held to maturity" and were therefore carried at amortised cost.

The transition under the amended HKAS 39.104(d) in these circumstances would be as follows:

Investments that were previously classified as investment securities under SSAP 24

- *In our view, in most cases it is appropriate to reflect the opening balance adjustment to investment securities in the fair value reserve, as these adjustments should be transferred to the income statement on the subsequent disposal or impairment of the investment*

On transition to the HKAS 39 AFS classification, investment securities that were carried at cost less provision under the benchmark treatment in SSAP 24 need to be restated to fair value. In most cases this will result in an increase in the carrying value of the investment i.e. in a credit to equity, although it is possible that the restatement will involve reducing the carrying value i.e. in a debit to equity.

In our view, it is appropriate to record such restatements in the opening balance of the fair value reserve to the extent that the application of HKAS 39 would have resulted in the amounts being held in the fair value reserve at that date, had HKAS 39 been applied in previous years. This will generally be the case except in situations where the investment is impaired and the application of the HKAS 39 AFS policies would have resulted in the full deficit being recorded in the income statement in previous years. This situation is discussed further on pages 4 to 5 of this FRU.

Recording opening balance adjustments in the fair value reserve then facilitates proper reflection of gains or losses on subsequent disposal or impairment in accordance with the rules set out in HKAS 39.55(b).

For example, an equity investment which cost 80 several years ago was still carried at cost on 31 December 2004 under the SSAP 24 benchmark treatment for investment securities. On transition to HKAS 39 at 1 January 2005 its fair value was 100 and management classified the investment as AFS.

In accordance with the amended HKAS 39.104(d), in our view the opening balance of the fair value reserve should be credited with the 20 re-measurement adjustment.

Assuming that the asset is not impaired prior to disposal, on subsequent disposal of the asset, profits should be recognised in the income statement to the extent that the asset is sold for more than 80, in the same way as would have been the case had this investment always been recognised as an AFS security under HKAS 39. This is achieved by transferring the opening balance adjustment of 20, together with any subsequent movements in fair value, out of the fair value reserve and into the income statement, in accordance with HKAS 39.55(b).

Investments that were previously classified as held to maturity securities under SSAP 24

- *In our view, it is appropriate to reflect the opening balance adjustment to dated debt securities that were previously carried at amortised cost in the fair value reserve, because over time the opening balance adjustment will reverse through the fair value re-measurement, all other things being equal, as the security nears maturity*

When fixed interest dated debt securities were previously classified as held to maturity securities under SSAP 24, and management classifies them as AFS securities on transition to HKAS 39, an opening balance adjustment will be needed to restate these securities from their amortised cost to their fair value, if materially different.

Assuming there are no concerns relating to the credit-worthiness of the issuer, a difference between fair value and amortised cost will generally only arise when market interest rates have changed subsequent to when the security was first acquired. For example, when market interest rates have declined, all other things being equal the fair value of a fixed rate bond will go up.

Such discounts or premiums will gradually disappear as the bond nears maturity, since the fair value of the bond will tend towards the bond's redemption sum, the shorter the time there is left until maturity.

In our view, it follows that it is appropriate that the opening balance adjustments which arise from this differential in interest rates are reflected in the opening balance of the AFS reserve, so that over time, as these unrealised discounts or premiums are eroded by the fair value of the bond moving towards the redemption sum, so too will the balance of the fair value reserve move towards nil, all other things being equal.

In what circumstances would opening balance adjustments to the fair value reserve be inappropriate?

- *In our view, opening balance adjustments should not be made to the fair value reserve if they relate to amounts that have been recognised in the income statement in previous periods or would have been, had HKAS 39 been adopted at that time*

In our view, opening balance adjustments to the fair value reserve on the adoption of the HKAS 39 AFS category would not generally be appropriate in the following circumstances:

(a) under SSAP 24, the investments were previously classified as "other securities" under the benchmark treatment and therefore any movements in their fair value had already been recognised in the income statement in previous periods; or

(b) full retrospective application of the HKAS 39 AFS policy would have resulted in the amount of the opening balance adjustment being recognised in the income statement in previous periods.

Further details are as follows:

- *In the case of "other securities", the fair value movements have already been reported in the income statement and so, in our view, they should not be reported a second time under HKAS 39*

(a) "Other securities" under the benchmark treatment

In the case of (a), no opening balance adjustments are required as the investments are already carried at fair value, with all movements in fair value having been reported in income in previous years. As the transitional provisions of HKAS 39 prohibit any restatement of previous periods, in our view, these movements should not be reported a second time under the HKAS 39 AFS policy. In other words, in these circumstances the fair value at the date of transition to the AFS category should be treated as the cost of the investment for the purposes of the future application of the AFS policy under HKAS 39.55(b).

> *For example, an equity investment which cost 80 several years ago was carried at its fair value of 100 on 31 December 2004 under the SSAP 24 benchmark treatment for other securities. On transition to HKAS 39 at 1 January 2005 management classified the investment as being an AFS security as it was not acquired for trading purposes.*
>
> *In our view, the opening balance of the fair value reserve should not be restated as the fair value increase that arose prior to 1 January 2005 has already been reported in the income statement in previous periods.*
>
> *On subsequent disposal of the asset, in our view, profits should only be recognised in the income statement to the extent that the asset is sold for more than 100.*

- *In our view transitional adjustments would be recognised in retained earnings if the amounts would have been reported in the income statement had HKAS 39 been applied, for example where the financial asset was impaired prior to transition to HKAS 39*

(b) *Amounts that would have been recognised in the income statement in previous periods*

In our view it would be inappropriate to restate the AFS reserve if the adjustment is to reflect an amount that, under the HKAS 39 AFS policy, would have already been reflected in the income statement in previous years. In this case, although it is necessary to make an opening balance adjustment to restate the investment to its fair value, in our view the most appropriate reserve for this adjustment would be retained earnings, consistent with normal principles that are applied to the retrospective application of accounting policies.

Such circumstances may arise, for example, when provisions for doubtful recoveries of held to maturity debt securities were made on the basis of a credit risk assessment in accordance with SSAP 24.34, and the amount of the provision that was recognised at that time was not the full amount of the difference between carrying value and fair value, as would have been required had the HKAS 39 AFS policy been applicable (see HKAS 39.67).

Similar issues might arise when an investment security under the SSAP 24 benchmark treatment was carried at an amount lower than cost, to reflect an other than temporary diminution in value in accordance with SSAP 24.31, but the amount of the provision that was recognised at that time was not the full amount of the difference between carrying value and fair value.

What if the opening balance adjustments were already reported in interim results as being adjustments to retained earnings?

- *In our view, the presentation of the opening balance adjustments should be consistent with the latest HKICPA amendments, even if this is different from the approach taken at the interim*

In our view, the presentation in the full year financial statements should take into account the recent amendment to HKAS 39.104(d), and make the appropriate adjustments to the opening balance of the fair value reserve as discussed above, even if the interim report for that company showed all opening balance adjustments arising from the adoption of the AFS policy in retained earnings. Additional disclosure would be made to explain the difference, if any, in the presentation of the opening balance adjustments compared to that shown in the interim report.

As can be seen from the above, understanding and applying the transitional provisions for opening balances under HKAS 39 can present some challenges.

Care needs to be taken to identify appropriate policies for making opening balance adjustments and for subsequent profit or loss recognition on the investments that were held at the date of transition to HKAS 39. Care also needs to be taken to put in place adequate procedures to ensure that these new policies are applied consistently by those maintaining the financial records or, where records have been maintained on a different basis, that appropriate adjustments are made in the preparation of the financial statements.

Further information on HKAS 39 can be found in issues 7 and 13 of our FRU. In particular, issue 13 looks closely at the transitional provisions for HKAS 39 issued by the HKICPA in January 2005, and how they interact with SSAP 24's requirements, as well as highlighting other practical difficulties that may arise on transition, such as:

- how to deal with hedging arrangements set up under the previous HK GAAP; and
- how to reconcile the transitional provisions in HKAS 32 (which require restatement of comparatives) with the transitional provisions of HKAS 39 (which prohibit restatements).

If at any time you would like further assistance on working through these or other transitional issues as they apply to your operations, please talk to your usual KPMG contact.