

Issues in Applying Hong Kong Interpretations

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Topics to be discussed

Hong Kong Interpretations

1. The Appropriate Policies for Infrastructure Facilities
2. The Appropriate Policies for Hotel Properties
3. Pre-completion Contracts for the Sale of Development Properties
4. Leases – Determination of the Length of Lease Term in respect of HK Land Leases

Simple but Comprehensive

Background Issues

Cases and Examples

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Topics to be discussed

Hong Kong Interpretations

1. The Appropriate Policies for Infrastructure Facilities

HK Interpretation 1

1. The Appropriate Policies for Infrastructure Facilities

- Background
- Requirements under current framework
- Conclusion in Interpretation



HK Interpretation 1



GZI Transport Ltd. stated in 2002 Annual Report:

- Goodwill on acquisition of subsidiary / associated company / jointly controlled entity engaged in the operation of toll highways or bridges occurring on or after 1 January 2001
 - is amortised on the basis of a sinking fund calculation over the period
 - for which the Group is granted the rights to operate the highways or bridges.

HK Interpretation 1 – Sinking Fund

- Some companies in HK have adopted Sinking Fund Method in depreciating their infrastructure facilities, in particular toll roads, in their financial statements purporting to be in compliance with HKFRSs.
 - Such companies disclosed an accounting policy that
 - the capital cost of an infrastructure asset was allocated by applying a sinking fund method whereby
 - the aggregate annual depreciation amounts, compounded at certain rates of return, up to the expiry of the infrastructure asset (e.g. toll road) concession periods,
 - will be equal to the total cost of the asset.



HK Interpretation 1 – Sinking Fund

Example

- A machine costs HK\$600,000 with an estimated useful life of 3 years?
- Calculate depreciation for the years under different depreciation methods.

	Year 1	Year 2	Year 3	Total
Straight-line basis	200	200	200	600
Reducing balance (at 70%)	420	126	38	584
Sum-of-year-digit	300	200	100	600
Sinking fund (compounded at 23.2%)	160	197	243	600
		(160 x 123.2%)	(197 x 123.2%)	

Sinking fund method allocates more depreciation to the later years.
 ➤ It is different from most depreciation methods (as above).

HK Interpretation 1 – Sinking Fund

- Some listed companies stated that they had used a sinking fund method



Henderson Investment Limited



HK Interpretation 1 – Cases

2002 Annual Report of Anhui Expressway Co. Ltd. stated that:

- **Depreciation** of toll roads and amortisation of land use rights in relation to toll roads are calculated to write off their cost on the basis of a **sinking fund calculation** whereby
 - annual depreciation amounts compounded
 - at an average rate of 7%, 6%, 3% and 4% per annum for Hening Expressway, 205 Tian Chang Section, Xuan Guang Expressway and Gao Jie Expressway respectively
 - will approximate the total carrying value of the toll roads and the land use rights
 - in relation to toll roads at the end of operating periods of respective toll roads.



HK Interpretation 1 – Cases



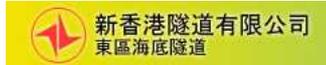
GZI Transport Ltd. stated in 2002 Annual Report:

- **Goodwill** on acquisition of subsidiary / associated company / jointly controlled entity engaged in the operation of toll highways or bridges occurring on or after 1 January 2001
 - is amortised on the basis of a **sinking fund calculation** over the period
 - for which the Group is granted the rights to operate the highways or bridges.

Sinking fund method even applied to goodwill!

HK Interpretation 1 – Cases

Depreciation on its tunnels



- **2002 Annual Report:**
 - Amortisation of vehicular tunnel (including land and buildings) is provided for over the franchise period on the basis of a sinking fund calculation whereby annual amounts compounded at the rate of 7% per annum will equal the net cost of the tunnel.
- **2003 Annual Report:**
 - Depreciation of the vehicular tunnel was provided with reference to projected usage of the tunnel through a sinking fund calculation.
- **2004 Annual Report:**
 - Depreciation of the vehicular tunnel was provided with reference to projected usage of the tunnel as compared to the actual tunnel usage.

Requirements under Current Framework

Framework paragraph 96 states that

- When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined
 - expenses are recognised in the income statement on the basis of **systematic and rational allocation procedures**.
- These allocation procedures are intended to recognise expenses in the accounting periods in which
 - the **economic benefits** associated with these items **are consumed or expire**.

This is often necessary in recognising the expenses associated with the using up of assets, such as

- property, plant, equipment,
- goodwill,
- patents and trademarks;

in such cases the expense is referred to as depreciation or amortisation.

Requirements under HKAS 16 and 38

HKAS 16.50 states that:

- The depreciable amount of an asset shall be allocated on
 - a systematic basis over its useful life.

HKAS 38.97 states that:

- The depreciable amount of an intangible asset with a finite useful life shall be allocated on
 - a systematic basis over its useful life.

HKAS 16.60 states that:

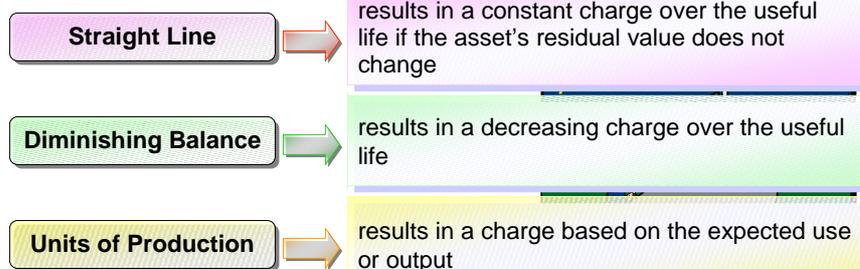
- The depreciation method used shall
 - reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

- The amortisation method used shall
 - reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
 - If that pattern cannot be determined reliably, the straight-line method shall be used.

Requirements under HKAS 16 and 38

HKAS 16.62 states that:

- A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life.
- These methods include:



Requirements under HKAS 16 and 38

HKAS 16.62 states that:

- The entity selects the method (depreciation method)
 - that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset.
- That method is applied consistently from period to period
 - unless there is a change in the expected pattern of consumption of those future economic benefits.



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Requirements under HKAS 16 and 38

Is Sinking Fund Method allowed?

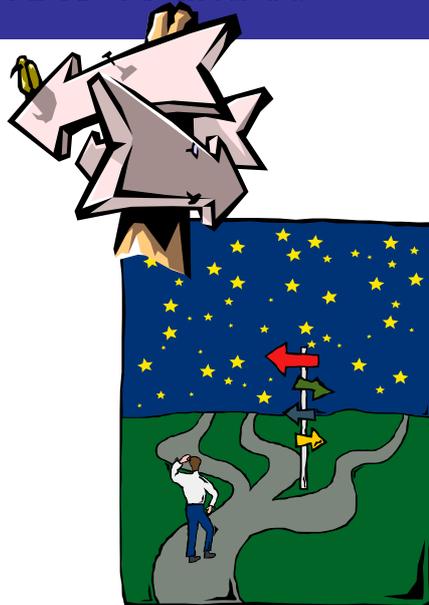
Sinking Fund

?

Straight Line

Diminishing Balance

Units of Production



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Clarification by HK Interpretation 1

- 2 broad schools of thought on the meaning of “consumption of economic benefits” of an infrastructure asset:

Time Based View

Supporters argue

- for the component approach and primarily straight-line depreciation method
- as they consider the passage of time determines the consumption of economic benefits for most components of toll roads.

Usage Based View

Supporters argue

- for the integral asset approach and units-of-usage depreciation method
- as they consider the usage or traffic flow determines the consumption of economic benefits for entire toll roads.

Conclusion by HK Interpretation 1

HK Int. 1 concludes that:

- The **Sinking Fund Method** is NOT an appropriate method of depreciating or amortising infrastructure assets,
 - regardless of whether the asset (or components thereof) is classified as
 - property, plant and equipment,
 - intangible assets or
 - operating lease prepayments.
- By definition, the sinking fund method
 - neither supports the view that consumption of economic benefits (such as in a Build-Operate-Transfer franchise) is determined by either the passage of time and/or usage.

Sinking Fund



Conclusion – Cases



2004 Annual Report of Anhui Expressway Co. Ltd. stated that:

- Depreciation of toll roads and land use rights in relation to toll roads is calculated to write off their cost on a units-of-usage basis whereby
 - depreciation is provided based on the share of traffic volume for a particular period over the projected total traffic volume throughout the periods for which the Group is granted the rights to operate those roads.
- It is the Group's policy to review regularly the projected total traffic volume throughout the operating periods of the respective toll roads.
- If it is considered appropriate, independent professional traffic studies will be obtained. Appropriate adjustment will be made should there be a material change.

Changed to units-of-usage basis

Conclusion – Cases



GZI Transport Ltd. revised its policy in 2003:

- Goodwill/negative goodwill on acquisition occurring on or after 1st January 2001 is amortised using the straight-line method over the maximum period of 20 years.
- Depreciation of tangible infrastructure is calculated to write off their costs on a units-of-usage basis based on the traffic volume for a particular period over the projected total traffic volume throughout the joint venture periods.
- Previously, interests in toll highways and bridges are amortised using the sinking fund method.
- The change in accounting policy results in a reduction of profit for the years ended 31st Dec. 2001 and 2002 of HK\$16,576,000 and HK\$15,281,000 respectively

Over 12% of the operating profit for 2001

Over 8% of the operating profit for 2002

Changed to units-of-usage basis

Conclusion – Cases



Amended before HK Int. 1 was issued (in 2003 Annual Report):

- Depreciation of expressways, tunnel and bridges construction costs is calculated to write off the cost thereof over their estimated useful lives using a method whereby
 - an aggregate annual depreciation amounts, compounded at average rates ranging from 4.8% to 6.8% per annum, up to the expiry of the underlying expressway concession periods of 25.5 to 30 years, will be equal to the total construction costs of the expressways, tunnel and bridges.
- The aforementioned average rates are based on the traffic volumes and forecast annual growth rates of the traffic volume over the respective expressway concession periods.
- This method is more commonly referred to as the **unit-of-usage method**.

Changed to units-of-usage basis

Conclusion – Cases



Refer back to 2002 Annual Report:

- Depreciation of expressways, tunnels and bridges is provided by using the **sinking fund method** whereby
 - an aggregate annual depreciation amounts, compounded at average rates ranging from 4.8% to 6.8% per annum, up to the expiry of the underlying expressway concession periods of 25.5 to 30 years, will be equal to the total construction costs of the expressways, tunnel and bridges.

What's the difference?



Transitional Arrangements

HK Interpretation 1

- becomes effective on 1 October 2004.
- where the application of this Interpretation constitutes [a change in accounting policy](#), it should be accounted for as a change in policy in accordance with
 - [SSAP 2 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies](#), or
 - [HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors](#) as applicable.



Transitional Arrangements – Cases

2003 Annual Report stated that:

- Depreciation of toll roads and toll bridges is provided for on sinking fund method or straight-line method.
- For the sinking fund method, annual depreciation amounts compounded at rates ranging 2% to 13% per annum will equal the costs of the relevant toll roads and toll bridges at the expiry of the relevant joint venture periods.

2004 Annual Report stated that:

- In December 2003, the HKICPA further clarified that depreciation of toll roads should reflect the consumption of economic benefits from the associated assets and should be either time or usage based.
- On the basis that the recognition principles previously adopted by the Group under the sinking fund depreciation method was by reference to the economic usage of assets, the directors concluded that there is no material impact to the accounts as a result of this further clarification from the HKICPA.

Transitional Arrangements – Cases

	Compounding rate							
Year	1%	5%	6%	7%	8%	9%	10%	13%
1	10	10	10	10	10	10	10	10
10	11	16	17	18	20	22	24	30
20	12	25	30	36	43	51	61	102
25	13	32	40	51	63	79	98	188
30	13	41	54	71	93	122	159	346



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Topics to be discussed

Hong Kong Interpretations

1. The Appropriate Policies for Infrastructure Facilities
2. The Appropriate Policies for Hotel Properties

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HK Interpretation 2

2. The Appropriate Policies for Hotel Properties

- Background
- Requirements under current framework
- Conclusion in Interpretation



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HK Interpretation 2

SHANGRI-LA

Annual Report 2003 stated that:

- Investment properties, which include both hotel properties and other investment properties
- are stated at annual professional valuations at the balance sheet date.
- Investment properties are not depreciated
 - except where the unexpired term of the lease is 20 years or less, in which case depreciation is provided on the straight-line basis over the unexpired period of the leases.



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HK Interpretation 2

- Before the issuance of HKAS 40, a hotel property had been classified either
 - as property, plant and equipment (under SSAP 17) or
 - as investment property (under SSAP 13)
- Under SSAP 13, no depreciation might have been provided on the hotel property classified as investment property



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HK Interpretation 2 – Cases



THE HONGKONG AND SHANGHAI HOTELS, LIMITED
香港上海大酒店有限公司

Annual Report 2004 stated that:

- Investment and [hotel properties](#) with an unexpired lease term of more than 20 years are included in the balance sheet [at their open market value](#)
- It is the group's practice to maintain hotel properties such that the residual values [result in depreciation being insignificant](#).
- The related maintenance expenditure is dealt with in the income statement in the year in which it is incurred.
- Hotel furniture and fixtures is included in other fixed assets and is depreciated.



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HK Interpretation 2 – Cases

Annual Report 2004 stated that:



Great Eagle Holdings Limited

- Hotel properties
 - comprise interests in land and buildings and their integral fixed plant which are collectively used in the operation of a hotel and
 - are stated at their open market values based on professional valuations at the balance sheet date.
- It is the Group's policy to maintain the hotel properties in such condition that their residual value is not currently diminished by the passage of time and that any element of depreciation is insignificant.
- Therefore, no depreciation charge is recognised in respect of its hotel properties.
- The related maintenance and repairs expenditure is charged to the income statement in the year in which it is incurred.



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Requirements under HKAS 40

HKAS 40

When HKAS 40 is issued, the issue regarding appropriate classification of (particularly owner-operated) hotel property would be clarified.

- Amends the definition of investment property which is a property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease)
 - to earn rentals or
 - for capital appreciation or both,rather than for:
 - a) use in the production or supply of goods or services or for administrative purposes; or
 - b) sale in the ordinary course of business

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Requirements under HKAS 40

HKAS 40

When HKAS 40 is issued, the issue regarding appropriate classification of (particularly owner-operated) hotel property would be clarified.

- Introduces a new term, owner-occupied property
 - It is defined as a property held (by the owner or by the lessee under a finance lease)
 - for use in the production or supply of goods or services or
 - for administrative purposes
 - Being one of the examples that is NOT an investment property
 - In substance, it is a property under HKAS 16
 - Property, plant and equipment

Requirements under HKAS 40

HKAS 16 defines property, plant and equipment as

- tangible items that:
 - a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
 - b) are expected to be used during more than one period.

Both for rental, how to distinguish?



Requirements under HKAS 40

Cash Flow

- One of the key indicators in determining the classification between investment property and owner-occupied property

Investment Property

- held to earn rentals or for capital appreciation or both
- therefore, generates cash flows largely independently of the other assets held by an entity.

Owner-occupied property

- the production or supply of goods or services (or the use of property for administrative purposes)
- generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process

Requirements under HKAS 40

Cash Flow

Extent of Ancillary Services

- provided by an entity to the occupants of a property it holds is also considered

Ancillary services not significant

→ investment property
owner-occupied property ←
e.g. a owner-managed hotel is not an investment property

Significant ancillary services provided

If owner-managed hotel was classified as investment property before 2005, it should be reclassified as

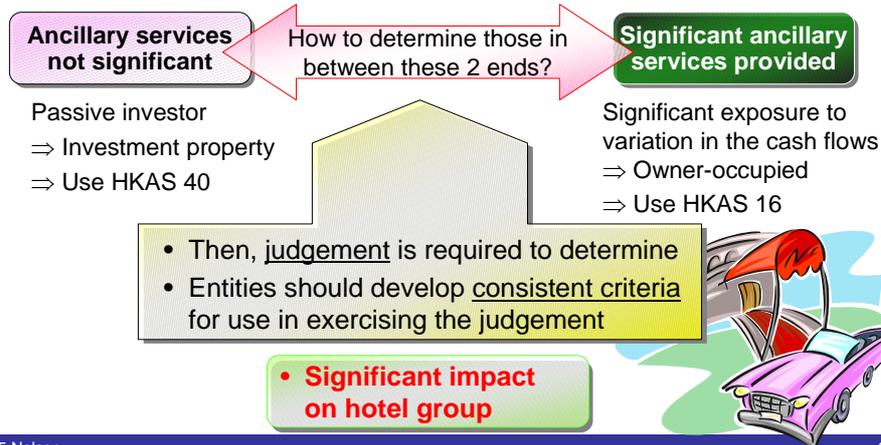
- property, plant and equipment (HKAS 16) or
- lease (HKAS 17)

- **Significant impact on hotel group**



Requirements under HKAS 40

- It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property
- for example, there may be a spectrum from one end to another:



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Requirements under HKAS 40

- When HKAS 40 is issued, the issue regarding appropriate classification of (particularly owner-operated) hotel property would be clarified.
- In consequence, an owner-operated hotel property
 - would be property plant and equipment, and
 - therefore should be accounted for under HKAS 16



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Conclusion by HK Interpretation 2

- HK Int. 2 clarifies that:
 - depreciation must be applied on owner-operated hotel
 - regardless of whether the hotel property is carried at impaired cost or revalued amount.
 - the depreciable amount of the hotel building would be depreciated over its remaining useful life, and
 - when the hotel property is located on land held under operating lease,
 - the carrying amount of the leasehold land would be amortised over the remaining life of the lease



Conclusion – Cases



Beijing Enterprises Holdings Ltd.

- Has early adopted all new HKFRS in 2004 and stated that:
 - Hotel properties were **previously**
 - not depreciated (except where the unexpired term of the lease is 20 years or less)
 - stated at their open market values on the basis of annual professional valuations performed at the end of each financial year
 - **Upon the adoption of HKAS 16 and HKAS 40**, hotel properties would be
 - stated at valuation less accumulated depreciation and any accumulated impairment losses
 - As a consequence of this change in accounting policy for hotel properties
 - an aggregate amount of **HK\$6,797,000** was charged to the consolidated profit and loss account for the year ended 31 Dec. 2004

Conclusion by HK Interpretation 2

- HK Int. 2 further stated that:
 - it is highly likely that the residual value (as defined in HKAS 16) of a building situated on leasehold land will be insignificant relative to the depreciable amount
 - the residual value of land held under an operating lease would typically be zero
- As stated under HKAS 16, the definition of residual value is revised and



Implication:

- If estimated residual value is higher than carrying amount
⇒no depreciation is required
- But feasible only if
 - the management clearly intends to dispose of the PPE before the end of its physical usage life
 - otherwise, the estimated residual value is
 - minimal or even zero
 - **HK Int. 2 clearly stated it**

Conclusion – Cases

Shangri-La Asia Ltd.

(extracted from 2003 Annual Report and Announcement of 17 Dec. 2004)



SHANGRI-LA

- Before 2005, its hotel properties are classified as investment properties, which are stated at annual professional valuations at the balance sheet date.
- It announced on 17 Dec. 2004 that its hotel properties “will no longer be accounted for as investment properties” from 2005
- It will adopt the following accounting policies retroactively:
 1. The underlying buildings and integral plant and machinery will be stated at cost less accumulated depreciation and impairment
 2. The underlying freehold land will be stated at cost less impairment
 3. The underlying leasehold land will be stated at cost and subject to annual operating lease rental charge (amortization of land cost)

Conclusion – Cases

Shangri-La Asia Ltd.



- 2004 Final Results Announcement of 31 Mar. 2005 further stated that, from 1 Jan. 2005:
Adoption of these new accounting policies will have the following significant consequences:
 - a) The net book value of fixed assets, the overall provision for deferred tax liabilities and the net asset value of the Group will be **reduced**
 - b) The annual depreciation and lease rental charges will **increase** and this will **reduce** the profit after tax attributable to the shareholders (PAT) and the earnings per share (EPS) of the Group.

Conclusion – Cases

Shangri-La Asia Ltd.



- Let's do some comparison for 2004 (in US\$'000)

Net assets at 31.12.2004

- as reported in 2004 Annual Report 3,109
- as announced on 26 Aug. 2005 2,379



Depreciation for the year ended 31.12.2004

- as reported in 2004 Annual Report 39,038
- as announced on 26 Aug. 2005 47,410



Transitional arrangements

- An entity shall apply Interpretation 2 for annual periods beginning on or after 1 January 2005.
- Earlier application is encouraged.
- Where the application of HK Interpretation 2 constitutes [a change in accounting policy](#), it should be accounted for as a change in policy in accordance with
 - **SSAP 2** *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, or
 - **HKAS 8** *Accounting Policies, Changes in Accounting Estimates and Errors* as applicable.



Topics to be discussed

Hong Kong Interpretations

1. The Appropriate Policies for Infrastructure Facilities
2. The Appropriate Policies for Hotel Properties
3. Pre-completion Contracts for the Sale of Development Properties

HK Interpretation 3



3. Pre-completion Contracts for the Sale of Development Properties

- Background
- Requirements under current framework
- Conclusion in Interpretation

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HK Interpretation 3



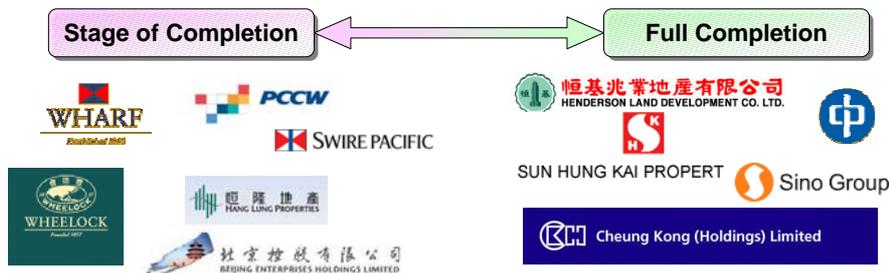
- Property development projects are usually long term projects.
- In many cases, property developers would enter into contracts to sell the properties in advance of the completion of the development
 - usually involve the payment of a deposit by the purchaser
 - payment may be refundable only
 - if the developer does not complete the development in accordance with the contracted timeframes and specifications, or
 - if there is some other breach of a contractual condition or statutory obligation.
- The balance of the purchase price is normally paid either at contractual settlement or in stages up to contractual settlement.

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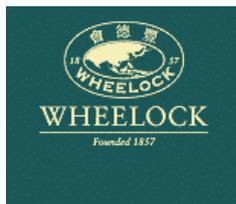
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HK Interpretation 3

- Property developers currently adopt various policies for recognising revenue arising from pre-completion contracts for the sale of development properties.
 - The stage of completion method is a commonly used policy.
 - Full completion method is another one used by some companies.



HK Interpretation 3 – Cases



Annual Report 2003/04 stated that:

- Profit on pre-sale of properties under development for sale
 - is recognised over the course of the development and
 - is calculated each year as a proportion of the total estimated profit to completion, the proportion used being the lower of
 - the proportion of construction costs incurred at the balance sheet date to estimated total construction costs and
 - the proportion of sales proceeds received and receivable at the balance sheet date to total sales proceeds in respect of the units sold.

Stage of Completion

HK Interpretation 3 – Cases

 Cheung Kong (Holdings) Limited

2004 Annual Report set out that:

- When properties under development are sold, income is recognised when the property is completed and the relevant occupation permit is issued by the Authorities.
- Payments received from the purchasers prior to this stage
 - are recorded as customers' deposits received and
 - are deducted from the value of stock of properties.

Full Completion

Concerns and Construction Contract

- Concern has been expressed as to
 - whether the pre-completion contracts would satisfy the definition of construction contracts in HKAS 11 *Construction Contracts* and
 - if not, whether the stage of completion method would be acceptable under HKFRSs.
- Concern has also been expressed, in the absence of authoritative guidance, that
 - diverse or unacceptable practices would **undermine**
 - the relevance, reliability or comparability of financial statements.

Qualitative Characteristics of
Financial Statements



Concerns and Construction Contract

- Concern has been expressed as to
 - whether the pre-completion contracts would satisfy [the definition of construction contracts](#) in HKAS 11 *Construction Contracts* and
 - if not, whether [the stage of completion method](#) would be acceptable under HKFRSs.

Definition fulfilled by property developers in HK?



- A construction contract is
 - a contract [specifically negotiated for the construction](#) of an asset or a combination of assets
 - that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

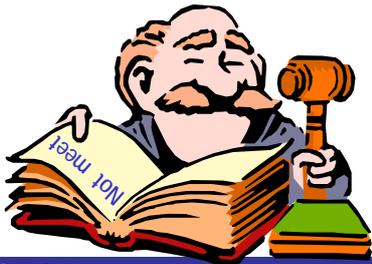
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Conclusion by HK Interpretation 3

- Pre-completion contracts for the sale of development properties
 - [do not meet the definition](#) of construction contracts,
 - if the contracts in question are [not specifically negotiated for the construction](#) of the properties.

Definition fulfilled by property developers in HK?



- Accordingly, these contracts
 - fall outside the scope of HKAS 11 and,
 - as a result, the [stage of completion method](#) as required under HKAS 11 [shall not be used](#) to recognise revenue arising from such contracts.

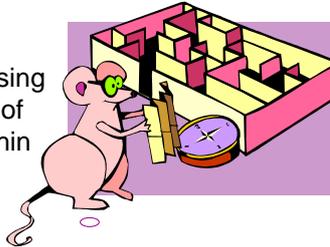
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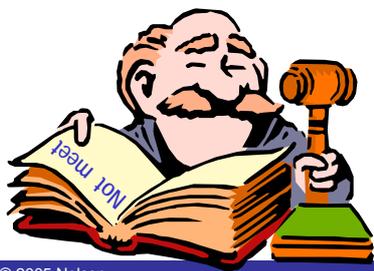
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Conclusion by HK Interpretation 3

- Property developers shall
 - [apply HKAS 18](#) in recognising revenue arising from pre-completion contracts for the sale of development properties that do not fall within the scope of HKAS 11, and
 - accordingly, recognise revenue only when [all of the criteria](#) specified in paragraph 14 of HKAS 18 are met.



All criteria in para. 14 of HKAS 18?



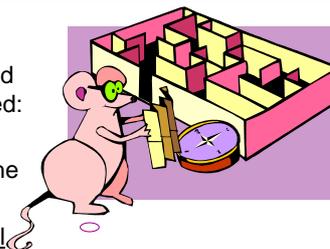
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HKAS 18 Revenue

HKAS 18 paragraph 14 sets out that:

- Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:
 - a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - c) the amount of revenue can be measured reliably;
 - d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - e) the costs incurred or to be incurred in respect of the transaction can be measured reliably

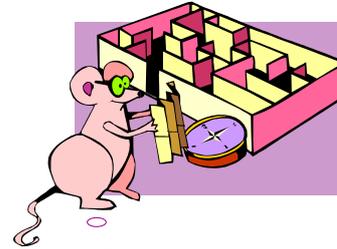


All criteria in para. 14 of HKAS 18?

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HK Interpretation 3



Implication
to them?

HK Interpretation 3 – Cases



Annual Report 2003/04 stated that:

- Profit on pre-sale of properties under development for sale is recognised over the course of the development and is calculated each year as a proportion of the total estimated profit to completion

But Annual Report 2004/05 changed to that:

- With the introduction of the HK Interpretation 3 “Revenue – Pre-Completion contracts for the sale of development properties” issued by the HKICPA,
 - the Group now recognises revenue arising from pre-sale of properties upon completion of the development of property.

Transitional Arrangements

- An entity shall apply Interpretation 3 to pre-completion contracts for the sale of development properties entered into on or after 1 January 2005.
- Earlier application is encouraged.
- Retrospective application of Interpretation 3 to pre-completion contracts for the sale of development properties entered into before 1 January 2005 (or date of initial application of Interpretation 3, if earlier) is permitted but not required.
- If an entity applies this Interpretation:
 - i) for a period beginning before 1 January 2005; and/or
 - ii) retrospectively to pre-completion contracts for the sale of development properties entered into before 1 January 2005 (or date of initial application of this Interpretation, if earlier),it shall disclose those facts.



Transitional Arrangements

- If an entity chooses not to apply Interpretation 3 retrospectively to pre-completion contracts for the sale of development properties entered into before 1 January 2005 (or date of initial application of this Interpretation, if earlier),
 - it shall continue to account for those contracts using the method of accounting used prior to the application of Interpretation 3.



Transitional Arrangements – Cases



Annual Report 2004/05 also stated that:

- The Group has relied on the transitional provisions set out in the Interpretation such that
 - the Group will continue to adopt the stage of completion of method to recognise revenue arising from pre-sale contracts entered into before 1 January 2005
 - while the completion method has been adopted or pre-sale contracts entered into after 1 January 2005.



Topics to be discussed

Hong Kong Interpretations

1. The Appropriate Policies for Infrastructure Facilities
2. The Appropriate Policies for Hotel Properties
3. Pre-completion Contracts for the Sale of Development Properties
4. Leases – Determination of the Length of Lease Term in respect of HK Land Leases

HK Interpretation 4



- Background
- Requirements under current framework
- Conclusion in Interpretation

4. Leases – Determination of the Length of Lease Term in respect of HK Land Leases

Leases under HKAS 17

HKAS 17 has been amended to align with IAS 17 (in respect of land and buildings) by

1. Deleting one sentence, and
2. Introducing several new paragraphs

In addition, a new locally developed interpretations was issued in May 2005

- *HK Interpretation 4 Leases – Determination of the Length of Lease Term in respect of Hong Kong Land Leases*

Leases – Deleting One Sentence

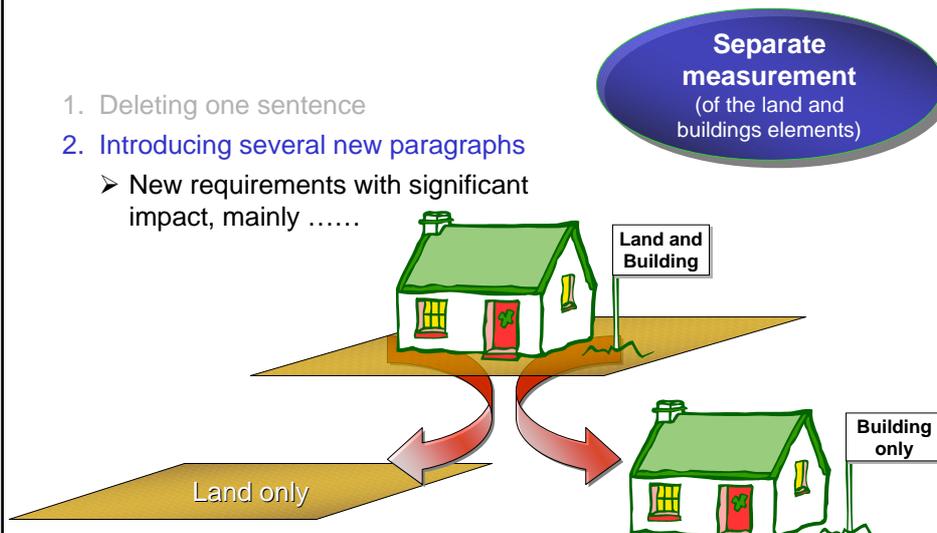
1. Deleting one sentence

Properties in HK are **leasehold interest** in land

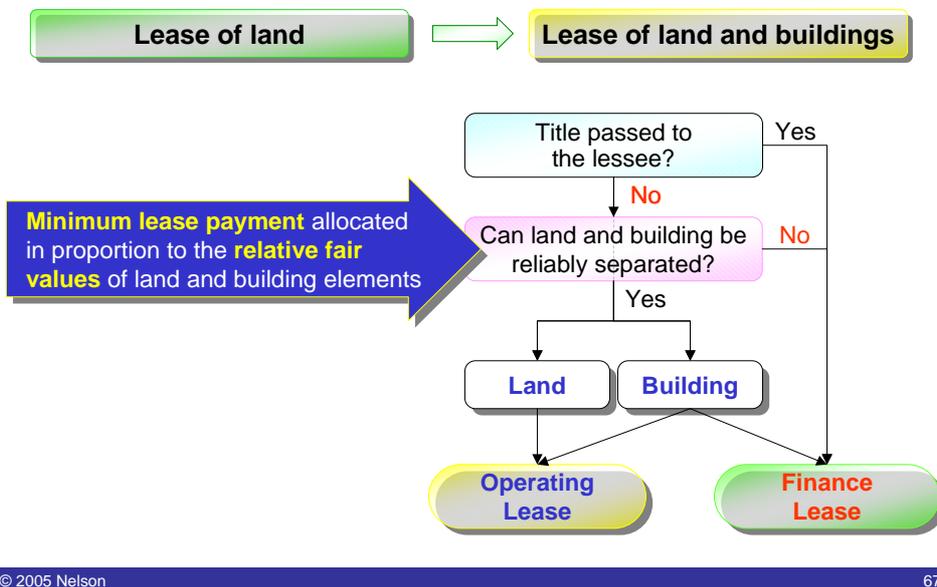
- Not freehold land → Not a “purchase” but a “lease”
- In the past, **SSAP 14** had an exemption:
 - ~~deemed all the risks and rewards incident to ownership of the “leasehold property” were transferred~~
 - ~~therefore, such interest was accounted for as a “purchase” in accordance with~~
 - ~~SSAP 13 Accounting for investment properties or~~
 - ~~SSAP 17 Property, plant and equipment, as appropriate~~
 - ~~instead of SSAP 14~~

Leases – Introducing New Paragraphs

1. Deleting one sentence
2. Introducing several new paragraphs
 - New requirements with significant impact, mainly



Leases – Separate Measurement



HK Interpretation 4

A new locally developed interpretations was also issued in May 2005

- HK Interpretation 4 *Leases – Determination of the Length of Lease Term in respect of Hong Kong Land Leases* (HK-Int. 4)

→ Clarified

- how the length of the lease term of a HK land lease should be determined
 - for the purpose of applying the amortisation requirements under HKAS 16 and 17

Have a review on such requirement on **HKAS 16 and 17** first



Requirements under HKAS 16

In HKAS 16

- In the case where the entire lease is classified as a finance lease
 - the related leasehold property interest can be accounted for using the cost or valuation model under HKAS 16 if such property interest meets the definition of PPE under HKAS 16.
- Under the cost or valuation model in HKAS 16, the depreciable amount of that leasehold property interest should be allocated on a systematic basis over its useful life
 - **Lease Term** would normally provide an indication of the useful life of that property interest



Requirements under HKAS 17

In HKAS 17

- Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the **Lease Term** (unless another systematic basis is more representative of the time pattern of the user's benefit)



Lease Term is defined as the non-cancellable period for which

- the lessee has contracted to lease the asset
- together with any further terms
 - for which the lessee has the option to continue to lease the asset, with or without further payment,
 - when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Lessee has the option

At the inception

Conclusion by HK Interpretation 4

HK-Int. 4 further interprets that:

- For the purpose of applying the amortisation requirements under HKAS 16 and 17
 - the lease term of a HK land lease shall be determined by reference to the legal form and status of the lease
 - renewal of a lease is assumed only when
 - the lessee has a renewal option and
 - it is reasonably certain at the inception of the lease that the lessee will exercise the option.



Lessee has the option

At the inception

Further

Options for extending the lease term that are not at the discretion of the lessee shall not be taken into account by the lessee in determining the lease term.

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Conclusion by HK Interpretation 4

As a result (HK-Int. 4 also specifically stated)

- Lessees shall not assume that the lease term of a HK land lease will be extended for a further 50 years, or any other period
 - while the HKSAR Government retains the sole discretion as to whether to renew
- Any general intention to renew certain types of property leases expressed by the HKSAR Government
 - is not sufficient grounds for a lessee to include such extensions in the determination of the lease term for amortisation

Lessee has the option

At the inception

Options for extending the lease term that are not at the discretion of the lessee shall not be taken into account by the lessee in determining the lease term.

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Conclusion by HK Interpretation 4

Example

- For the leases in the New Territories expiring shortly before 30 June 2047
 - The legal limit in these leases shall be assumed to be the maximum lease term
- For those leases which extend beyond 30 June 2047 (e.g. those with an original lease term of 999 years)
 - Lessees shall assume that any legal rights under the leases that extend the lease term to beyond 30 June 2047 will be protected for the full duration of the lease in the absence of any indication to the contrary

Options for extending the lease term that are **not at the discretion of the lessee** shall not be taken into account by the lessee in determining the lease term.

Transitional arrangements

HK Interpretation 4

- becomes effective on 24 May 2005.
- any changes resulting from applying Interpretation 4 shall be accounted for either
 - [as a change in an accounting policy](#) in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* or
 - [prospectively over the remaining lease term](#).



Issues in Applying Hong Kong Interpretations

5 September 2005



Some cases and reference presented today are listed in a website - <http://home.netvigator.com/~ncyl/>

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