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Technical Director (Financial Reporting)
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31 August 2004

Dear Sir

Consultation Paper – Proposed Implementation of a Small and Medium-Sized Entity Financial Reporting Framework (“SME-FRF”) and Financial Reporting Standard (“SME-FRS”)

On behalf of the ACCA (Association of Chartered Certified Accountants) HK, we would like to provide our comments in respect of various issues identified in the above consultation paper.

General comments

ACCA HK supports the idea of developing a separate set of financial reporting standards for Small and Medium-sized Entities (“SMEs”).

We note that at the time of issue of the above Consultation, the International Accounting Standards Board (“IASB”) has yet to issue its Discussion Paper on its “Preliminary Views on Accounting Standards for Small and Medium-sized Entities” (“Discussion Paper”). However, we understand that the HKSA GAAP for Small Business Working Group (“GSBWG”) will continue to monitor progress in IASB’s project.

We take this opportunity to highlight a few inconsistencies between the proposed SME-FRF and SME-FRS and IASB’s project.

In the Discussion Paper, the IASB has yet to include any proposed accounting framework or standards for SMEs. It only discusses the approach towards the developing of a separate accounting framework for SMEs.

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The IASB also indicates in its preliminary views in its Discussion Paper that the approach of mandatory fallback to International Financial Reporting Standards ('IFRSs') is preferred as it leads to consistent treatments by SMEs, and hence greater comparability of the SMEs' financial statements. However, in the proposed SME-FRS, it states under paragraph 1.2 of Section 1 Presentation of Financial Statements that where the SME-FRS does not cover an event or a transaction undertaken by an entity, management may consider an appropriate accounting policy for that particular event or transaction. In order to ensure comparability of the SMEs' financial statements, we believe that it is not appropriate to increase the number of choices for SMEs in terms of accounting treatments.

Another example where the proposed SME-FRF varies from the IASB's preliminary view relates to the starting point for developing accounting standards for SMEs. The IASB considers that IFRSs are the logical starting point for developing a set of accounting standards for SMEs to ensure the resulting standards could meet the objectives of building on the same conceptual framework, meeting user needs and allowing easy transition to full IFRSs. In contrast, the GSBWG has started the proposed SME-FRF and SME-FRS from considering users' needs and this approach results in a separate body of standards as proposed

This approach creates ambiguity in the accounting treatments. An example is that in Section 3 Property, Plant and Equipment, an entity should consider whether there exists any indicators of impairment which is determined by comparing the asset's carrying amount and its recoverable amount. We note that there is a simple definition of "recoverable amount" under the "Definition" section of the SME-FRS. While detailed explanations are included in the main GAAP on how to determine an asset's recoverable amount, the simple definition in the proposed SME-FRS provides inadequate guidance for SMEs in this respect. This could lead to inconsistent accounting treatments amongst the SMEs.

ACCA HK considers that it is more advantageous to adopt the IASB standards once it is finalised as having a common set of standards could help SMEs that trade across the borders. Moreover, in view of the convergence programme with IAS, it is expected that there will be convergence of the Hong Kong accounting standards for SMEs with the IASB standards for SMEs when the IASB finalises and issues such set of standards. This will create additional burden to SMEs who will then be required to adapt the IASB standards for SMEs especially when there are substantial differences between the two sets of standards.

Issue 1 – The proposed SME-FRF

We would like to highlight a few issues relating to the proposed SME-FRF.

Public accountability

We agree in principle that public accountability is one of the determining factors for an entity to be eligible to adopt the SME-FRS. However, the criteria set out in paragraph 20 of the SME-FRF in determining whether an entity is publicly accountable only refer to listed entities and entities being regulated in the special industries. While we agree to include examples as set out in paragraph 20 of the proposed SME-FRF as the presumptive indicators of public accountability, we consider that such a list may not cover all cases where public accountability exists.

We recommend principle-based guidelines be given on how an entity is defined as publicly accountable. In this regard, we refer to the paragraph 28 of the IASB's Discussion Paper where it states that "An entity has public accountability if:

- (a) there is a high degree of outside interest in the entity from non-management investors or other stakeholders, and those stakeholders depend primarily on external financial reporting as their means of obtaining financial information about the entity; or
- (b) the entity has an essential public service responsibility because of the nature of its operations."

We consider that this approach is consistent with the generally principle-based approach to standard-setting.

Size of entity

The quantitative size test could create loopholes for an entity with various commercial reasons to establish separated operating companies under one or more umbrella holding companies. With the proposed uplift of the group company restriction, such a structure will enable each entity within the group being eligible to adopt the SME-FRF.

In addition, the size criterion regarding number of employees is unclear. An example is whether part time or contract employees should be included in determining the total number of employees.

It is also noted under paragraph 22 of the SME-FRF that “for the purposes of the application of the size criteria the total revenue and total assets are determined after the application of the SME-FRS.” We consider it more appropriate to determine whether an entity is eligible before it applies the SME-FRF instead of the other way round.

The quantitative size test could also easily trigger an entity to qualify in one particular year but not another. This will create additional administrative burden to the reporting entity in its financial reporting process.

It also mentions under paragraph 22 of the SME-FRF that “the size criteria may be reviewed from time to time”. We consider that implementing a size restriction in the Companies Ordinance will make any change when required inflexible.

Effective date

It is proposed that the SME-FRF will become effective for a qualifying entity's financial statement that covers a period beginning on or after 1 January 2005. We do not consider that it is an appropriate timeframe given the proposals for the required amendments to the statutory requirements regarding the accounting and auditing sections of the Companies Ordinance, in particular regarding the “true and fair” view of the SME financial statements. Before any amendments to the Companies Ordinance are enacted, financial statements showing a “true and fair view” are still required under section 123 of the Companies Ordinance. As such, confusions would arise during the transitional period before any legal backing of the accounting and auditing requirements can be obtained.

Issue 3 – Whether SME financial statements need give a true and fair view

We do not agree to the proposal of adopting “properly presented” (or similar words to that effect) “in accordance with the applicable financial reporting requirements”. This gives users of the financial statements an impression of a lower level of audit assurance and could critically reduce the benefits to both the reporting entity and the users of the financial statements.

There are also situations where entities, such as travel agents, small construction companies as well as charitable organisations, are required to give “true and fair views” financial statements for the purposes of reporting to particular authorities.

On the other hand, ACCA HK considers that the true and fair concept should be adopted provided that the SME-FRF and SME-FRS are part of the Hong Kong Accounting Standards. As a reference, legal opinion was obtained in the UK that financial statements of a small company which apply the Financial Reporting Standard for Smaller Entities (“FRSSE”), a separate set of accounting standards for smaller entities, can also give a true and fair view.

Issue 4 – Which entities should qualify under the SME-FRF

Our comments regarding the definition of “public accountability” and the size test have been set out in the above.

In respect of whether unanimity of owner agreement is required, we are of the view that it will be unreasonable for an independent shareholder of a very small entity to dictate that an entity should publish their financial statements under the main GAAP even though the SME-FRS should be more relevant.

We would like to highlight the fact that for some particular transactions, such as change of the company’s name and amendments to the company’s Memorandum and Articles of Association, only majority of shareholders’ votes are required for the relevant resolutions to be passed. We therefore consider that majority shareholders’ consents will be adequate for the decision of adopting the SME-FRS.

Issue 5 – Statutory requirements applicable to SME financial reporting

As mentioned above, we do not agree to the proposal to amend the statutory reporting requirement to “properly presented” (or words to that effect) “in accordance with the applicable financial reporting requirements”.

We agree to the proposal to uplift the current group company restriction on applying the SME-FRF.

However, where an ultimate holding company within a small group chooses to disclose more information to its shareholders by preparing consolidated financial statements, this should not be deterred by requiring them to apply the main GAAP. We recommend that a set of accounting standards for consolidation of small groups should also be available.

We also note a proposal to implement transitional arrangements to cater for when a company may qualify in one particular financial year but not another.

However, it is not clear in either the proposed SME-FRF or SME-FRS what these transitional arrangements are.

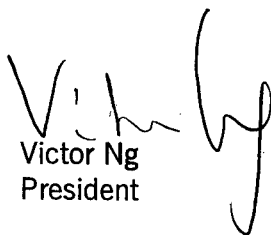
Issue 6 – Applicable financial reporting requirements

We agree that a qualifying entity should have a free choice as to whether to prepare financial statements under either the SME-FRS or main GAAP but it must apply one or the other, not a hybrid of the two.

In respect of the first time adopting of the SME-FRS, we note that a reconciliation of the equity reported on first-time application of the SME-FRS to that reported under previous GAAP should be presented. However, it is not clear whether any adjustments relating to the application of the SME-FRS in prior years should be treated as prior year adjustments in the company's financial statements.

Should you have any questions, please feel free to contact Sonia Khao or myself at 2524 4988.

Yours faithfully



Victor Ng
President