德勤·關黃陳方會計師行

Certified Public Accountants
26/F, Wing On Centre
111 Connaught Road Central
Hong Kong

香港中環干諾道中111號
永安中心26樓

Tel : (852) 2852 1600
Fax : (852) 2541 1911
mail@deloitte.com.hk
www.deloitte.com.hk

電話 : (852) 2852 1600
傳真 : (852) 2541 1911
mail@deloitte.com.hk
www.deloitte.com.hk

Deloitte
Touche
Tohmatsu

30 October 2002

Hong Kong Society of Accountants
4th Floor, Tower Two, Lippo Centre,
89 Queensway
Hong Kong

Attention: Deputy Director, Accounting

Dear Sir,

RE: CONSULTATION PAPER ON A PROPOSED FRAMEWORK FOR DIFFERENTIAL REPORTING

We refer to the above Consultation Paper and welcome the opportunity to comment thereon.

We have set out below a summary of our views on the major issues requiring consideration in respect of the introduction of a differential reporting regime. We have addressed the specific consultation issues set out in the Consultation Paper in Appendix I to this letter.

Developments in the international arena

Given the Society's stated policy of convergence with International Financial Reporting Standards, we are concerned that the Society is proposing to develop the Framework for Differential Reporting in advance of the publication of any proposals in this regard by the International Accounting Standards Board (IASB). By taking such pre-emptive steps, the Society may inadvertently cause smaller reporting entities to incur additional costs.

Any differential reporting rules eventually issued by the IASB may differ from the Hong Kong rules, both in terms of qualification for exemptions and the detailed exemptions available. When the IASB rules are adopted by the Society, in line with its stated policy of convergence, additional costs may be incurred by reporting entities in redrafting financial statements in accordance with the IASB rules.

We would urge the Society to be aware of this potential effect and to direct its efforts to encouraging the timely finalisation of the IASB rules for differential reporting.

The need for differential reporting

We have read with interest the comments in the background discussion to the Consultation Paper regarding the need for a differential reporting regime in Hong Kong.

We are in agreement with the principle that financial reporting requirements should not be imposed on reporting entities where the cost of complying with such requirements exceeds the benefits derived by users of the financial statements. Therefore, we would be supportive of measures that were likely to be effective in reducing the costs of preparation of financial statements where those costs were not justified by incremental benefits.

However, we strongly believe that the regime envisaged by the proposed Framework will not be effective in achieving that objective. The justification for reducing the "accounting standards overload" is always argued in the context of a very small company – the much quoted 'Ma & Pa companies'. However, the potential cost-savings for such enterprises are greatly overstated – in fact we believe that they are negligible. For enterprises with very simple operations, the impact of complex accounting standards on their financial statements has always been minimal. The proposed measurement and disclosure exemptions will have no impact on their financial statements – and, therefore, there will be no cost-saving. Therefore, we believe that the Society is in danger of creating an expectation gap by justifying the new regime on the basis of cost-savings that will never materialise. We believe that this does a great disservice to general practitioners who will be under pressure to reduce fees for financial statements prepared under the new regime, even though there has been no significant reduction in the time taken to prepare those financial statements.

The more important question for such 'Ma and Pa' companies is whether they should be required to prepare financial statements that show a true and fair view in the first place i.e. should the Society lobby to remove the requirement for such companies to prepare true and fair view financial statements from the Companies Ordinance. The appropriateness of such a move is a separate debate. However, it would undeniably result in cost-savings for such companies, as it would effectively remove the requirement for the involvement of a qualified accountant in either the preparation or audit of financial statements. Our view, as we have previously stated in our submissions on company law reform proposals, is that such a move should not be contemplated without looking at the broader picture. Many of these micro-companies owe their existence to the tax advantages applicable to corporate structures. If the tax laws were amended to be more tax neutral, then the advantages for many of these companies would disappear and 'Ma and Pa' would gladly forego the formalities of corporate administration in favour of a less regulated unincorporated structure. It is in support of such more far-reaching and effective reforms that we believe the HKSA should be directing its efforts.

At the other end of the scale, the discussion paper proposes to permit even the largest closely-held private companies to avail of the measurement and disclosure exemptions. We disagree with this proposal. Many private closely-held companies are very significant reporting entities to which lenders, creditors, customers and employees may be significantly exposed and for which a comprehensive financial reporting regime is essential. By focusing on the information needs of owners (i.e. allowing for exemptions for owner-managed businesses irrespective of size), the interests of these other parties are neglected. This is clearly at odds with the Society's acknowledgement in the Proposed Revised Framework for the Preparation and Presentation of Financial Statements that such external parties have information needs that should be served by general purpose financial statements. If the decision is made to proceed with the differential reporting regime, we believe that whatever size thresholds are arrived at should be regarded as absolute limits i.e. that the criteria for closely-held companies should be that they are both closely-held and of small size.

Suggest criteria for differential reporting exemptions

We have set out in the Appendix our detailed views on the proposed criteria.

In summary

- we agree with the 'no public accountability' criteria;

- we do not agree with the requirement that all owners be members of the governing body. We believe that this fails to take account of the circumstances of many family companies where a number of family members may be shareholders, but only 'Ma and Pa' are directors. This may occur, for example, where children have moved overseas, but they each continue to have an interest in the business. We believe that this condition should be replaced with a requirement for unanimous written approval from all of the shareholders; and

- we have no comment on the proposed size criteria, except to say that they seem rather arbitrary and that we believe that more research should be carried out into the number of companies that are likely to be affected.

Our major objection in relation to the proposed criteria is that companies that are closely-held will qualify for exemptions, irrespective of their size. As stated above, we believe that the exemption of larger closely-held companies is inappropriate given the potentially significant interests of other stakeholders such as lenders, creditors and employees.

Therefore, in order to qualify for exemption, we believe that entities should meet all three conditions i.e. no public accountability, unanimous agreement of shareholders and small size.

Proposals for differentiation

We note the proposed exemptions in respect of existing Standards, and have set out in Appendix II our detailed comments thereon. There are a small number with which we disagree.

Our overall reaction to the proposed exemptions, however, is that they do not appear to us to be significant enough to justify a separate regime. Most of the Standards for which full exemption is proposed are already not applicable for small companies. The proposed disclosure exemptions in other Standards are generally minimal, and will have little effect in practice.

We believe that significant cost-savings could only be achieved by (i) removing the requirement for the financial statements to show a true and fair view, as discussed above; or (ii) removing the requirement to prepare consolidated financial statements. Both of these measures would require a change in the law and, as previously stated, it is in the consideration of these matters that we believe the Society should be directing its efforts.

We would also note that we believe that the proposed Framework is deficient in that it does not explain what criteria were used to identify the proposed exemptions. Nor does it provide any guidance for standard-setters as to the criteria that should be used in arriving at future exemptions.

The integrated or the separate approach

We strongly support the use of the integrated approach, at least pending any decisions made in the international arena in respect of differential reporting.

We believe that the separate approach gives rise to disproportionate costs in terms of the use of standard-setting resources. In addition, it would give rise to delays between the finalisation of SSAPs and the revision of the separate standard for differential reporting.

Should you have any queries on the above, please contact Stephen Taylor at this office.

Yours faithfully

Deloitte Touche Tohmatsu

Appendix I

Differential Reporting – Specific Consultation Issues

1 Do you consider that there is a need for differential reporting in Hong Kong?

See our comments in the covering letter. We believe that there is a need for differential reporting – but for a very restricted category of reporting entity. Significant reductions of the burden on such entities could only be achieved by changes to the law.

We do not believe that the introduction of a differential reporting regime on the scale described in the Consultation Paper is justified because the benefits that will derived will be minimal.

Notwithstanding our views as stated above, in order to be of assistance to the Society in its consideration of other issues, the remainder of our responses below assume that the decision is made to proceed with the proposed regime.

2. Do you consider that differential reporting should be based on a benefit:cost criterion?

Yes, we agree that it should be based on a benefit:cost criterion

3. Do you consider that the following surrogates for the benefit:cost criterion are appropriate?

a. public accountability;
b. separation of owners and governing body;
c. size.

We agree with public accountability and size as surrogates for the benefit:cost criterion.

However, we do not agree with the inclusion of the separation of owners and governing body as a surrogate in this regard.

We do not agree with the imposition of a condition that all of the owners of the entity should be members of its governing body. We understand that the intention is to cover the circumstances of closely-held private companies, which we support. However, we believe that the condition as currently stated fails to take account of the circumstances of many family companies where all of the shareholders are family members, but they may not all be members of the board of directors. For example, 'Ma and Pa' may wish to have each of their children retain an interest in the company but, perhaps because they are overseas or otherwise unavailable to participate in management, not all of those children are directors.

If this condition were retained, it might result in entities being required to appoint additional directors in order to avail of the exemptions which, perversely, would result in increased costs and administrative burden for the company

We believe that this condition should be replaced with a requirement that availing of the exemptions should be approved unanimously by the shareholders of the company. We note that this is the condition that is imposed under the Canadian differential reporting regime.

4. **Do you consider that access to differential reporting should not be restricted solely to small entities?**

   No. We consider that access to the differential reporting regime should be restricted to small entities.

   The proposals, as currently stated, appear to give undue weight to the information needs of shareholders, and neglect the needs of lenders, creditors, employees and other stakeholders. In its proposed revisions to the Framework for the Preparation and Presentation of Financial Statements (paragraph 9), the Society acknowledges the different needs of investors, employees, lenders, suppliers and other trade creditors, customers, governments and other agencies, and the public.

   Although the financial statements of private companies in Hong Kong are not publicly available, they are routinely made available to lenders, government agencies etc. These stakeholders are entitled to assume that no material information has been omitted from the financial statements. It is true that these stakeholders (e.g. banks) may have sufficient influence to enable them to require special purpose financial statements to be prepared but, again, this would result in additional costs for the reporting enterprise. Therefore, the basic condition should be that an entity's general purpose financial statements should satisfy the normal information needs of each of the entity's significant stakeholders.

   We accept that the interests of these outside stakeholders decrease with the size of the reporting entity, and we therefore accept that disclosure exemptions may be acceptable for small entities. However, to allow closely-held companies to avail of the exemptions, irrespective of size, is, we believe, inappropriate.

5. **Small groups, that are not otherwise publicly accountable, would still prepare consolidated financial statements because of legal requirement under the Companies Ordinance. Do you agree with this? Would you support the HKSA lobbying for a change in the law?**

   Yes, we agree that the Society cannot exempt small groups from preparing consolidated financial statements without a change in the law.

   Yes, we would support the Society's lobbying for such a change in the law.

6. **Do you consider the public accountability criteria detailed in paragraphs 24 and 25 are appropriate?**

   We agree that the first condition for exemption should be that there is no public accountability, and we believe that paragraph 24 of the proposed Framework adequately expresses this condition. We believe that the effect of paragraph 24 is that only the categories of entities listed therein will be considered to be publicly accountable under the proposed Framework.

We therefore question the purpose and meaning of paragraph 25 (and also the related discussion in paragraph 29). Paragraph 24 does not define government agencies etc. as having public accountability for the purposes of the proposed Framework. Therefore, paragraphs 25 and 29 seem out of place. We suggest that they are either removed or substantially redrafted in order to make their meaning clear.

7. **Do you consider that an entity should be deemed to be small if it does not exceed any two of the following criteria?**

   a. **total revenue of HK$50 million;**
   b. **total assets of HK$50 million;**
   c. **50 employees.**

We have no comment on the particular thresholds, but we are concerned that the Society has not performed adequate research in order to arrive at their conclusions in this regard. The Consultation Paper describes a combination of overseas thresholds, anecdotal evidence from the Working Party and an arbitrary adjustment to the asset threshold.

Consistent with our earlier comments, if the Society is justifying the new regime in the context of cost-savings, then they should have some evidence of the number of entities likely to be affected. In particular, in consideration of whether or not to place an absolute size restriction on the availability of exemptions, the Society should make a realistic assessment of the degree of exposure to outside stakeholders.

We understand that it is difficult to obtain publicly-available information in respect of private companies. However, we believe that the search for information warrants more effort than appears to have been exerted so far.

In this regard, we would draw the Working Party's attention to the recent establishment of the Society's Research and Surveys Committee, and would recommend that the feasibility of performing meaningful research be discussed with that committee.

8. **Do you consider that differential reporting exemptions should apply immediately if an enterprise qualifies on a basis other than that covered by paragraph 34?**

Taking into account our comments above in respect of the need for an absolute size limit, we agree that differential reporting exemptions should apply immediately where an entity which is small either:

a. loses its public accountability in the current period, provided that the unanimous approval of its shareholders is obtained; or

b. not having any public accountability, obtains the unanimous written approval of its shareholders for the first time in the current period.

Conversely, we believe that exemptions should become immediately unavailable where the entity assumes public accountability or a shareholder dissents.

However, as regards the size thresholds, we would suggest that the Framework require the thresholds to be breached/met for two consecutive years before the status of the entity changes. This would mitigate against changes in status on the basis of exceptional results/circumstances in a particular year. We believe that frequent changes of status will be costly for reporting entities.

9. **Do you support the selective application of differential reporting exemptions (paragraph 37) or, alternatively, should entities that choose differential reporting be required to apply all of the applicable exemptions and alternative treatments?**

We consider that entities should be permitted to apply the differential reporting exemptions selectively. The availability of exemptions is determined using a cost:benefit criterion. A reporting entity could be entitled to exemptions but could, because of particular industry characteristics or the stated needs of particular external stakeholders, determine not to avail of a particular exemption because it is felt that the information is particularly useful to users of financial statements. Such entities should not be discouraged from providing information above the minimum requirements.

10. **Do you consider that the differential reporting exemptions appearing in Appendix 1 of the Framework are appropriate? Are there any other exemptions that should be considered for differential reporting purposes?**

Please refer to the comments in our covering letter regarding the amount of benefit that can realistically be expected to be derived from exemptions of this limited nature.

Given that smaller/unlisted entities are already exempted from most of the Standards in respect of which full exemption is proposed, the citation of exemptions under the proposed differential reporting regime is misleading.

For the specific disclosure exemptions recommended for other Standards, we believe that they are largely ineffective since they deal primarily with circumstances that will rarely apply to smaller entities.

Our detailed comments on the specific exemptions proposed are set out in Appendix II. We have a number of objections, the strongest of which relates to the proposal to exempt smaller entities from the requirement to disclose related party transactions, provided that shareholder approval is obtained. We consider that this is a very important issue, since related party transactions may have a very significant impact for owner-managed businesses. We do not agree with the proposed exemption, and do not agree that the exemption should be available with the agreement of shareholders (who are the very individuals likely to have been involved in the transactions). We believe that it is necessary for the interests of lenders, creditors and employees that these details be disclosed.

In any case, we suspect that the inclusion of this proposal will significantly reduce the likely support for the proposed regime, since it is unlikely that interested parties such as the Internal Revenue Department would accept this particular proposal.

On a general point, we believe that the draft Framework is deficient in that it does not identify the criteria that were applied in arriving at the proposed exemptions and, perhaps more importantly, it does not provide any guidance for standard-setters as to the criteria that should be applied in arriving at future exemptions.

Finally, on a point of detail, we note that the proposals do not appear to consider the disclosure requirements imposed by Interpretations issued by the Urgent Issues and Interpretations Sub-Committee of the Financial Accounting Standards Committee. The proposals should be extended to address such disclosure requirements.

11. At the present time, the HKSA Council would propose that differential reporting exemptions be set out within the main body of each SSAP (the integrated approach, similar to that adopted in Canada and New Zealand). Do you have any comment on that proposal?

We believe that some clarification is required in this regard. Although not clearly stated, we believe that the separate approach would result in a separate SSAP stating the requirements that are applicable to entities qualifying for differential reporting (similar to the UK's Financial Reporting Standard for Smaller Entities). We do not support this separate approach as we believe that it would give rise to disproportionate costs in terms of the use of standard-setting resources. In addition, it would give rise to delays between the finalisation of SSAPs and the revision of the separate standard for differential reporting.

We are strongly supportive of the use of the integrated approach (where the same Standards apply to all entities, with specific exemptions being made in each Standard for entities qualifying for differential reporting). We believe that this is the most appropriate approach, at least pending any decisions made in the international arena in respect of differential reporting.

However, from an administrative perspective, we do see advantages in producing a single separate document listing all of the exemptions available, rather than dealing with those exemptions in each individual Standard. This would still follow the basic integrated approach, but would be more convenient in terms of having a single point of reference. Also, it would mean that where changes were made to the differential reporting exemptions in existing Standards, it would not be necessary to issue revised Standards.

12. Do you have any other comments on the Framework?

Yes

Language/style

We would recommend that the document as a whole be re-examined with a view to improving its language and style. In making this comment, we note that the Proposed Framework is essentially a copy of the Framework for Differential Reporting issued by the Institute of Chartered Accountants of New Zealand, with some specific modifications where considered necessary in a Hong Kong context.

In our view, the language and style of the document is very different from other Standards and Bulletins issued by the Society. The writing style is quite formal, and very concise, with a level of precision that may be difficult to understand, particularly for readers for whom English is not their first language. This comment applies throughout the document – but, as illustrations, we would particularly draw your attention to paragraphs 3, 25,29.

Once the principles of the Framework have been agreed, we believe that it should be redrafted in its entirety, with the objectives of understandability and the use of 'plain-English' being paramount.

Disclosure of availing of differential reporting exemptions

We believe that entities availing of differential reporting exemptions should be required to disclose that they have done so. Presumably, this disclosure would be made adjacent to the entity's statement of compliance with Hong Kong generally accepted accounting principles (HKGAAP), as required by SSAP 1 *Presentation of Financial Statements*.

We would encourage the Society to include some illustrative wording in the Framework. In particular, we believe that it is important to illustrate that this is not a qualification of the statement of compliance with HKGAAP (i.e. that the financial statements do continue to comply with HKGAAP), but rather a clarification of how HKGAAP has been applied.

Specific drafting points

Paragraph 2(b) – should refer to those who "develop Statements of Standard Accounting Practice (SSAPs)" rather than those who "prepare and set Statements of Standard Accounting Practice (SSAP)", to achieve consistency with paragraph 1(a) of the *Proposed Revised Framework for the Preparation and Presentation of Financial Statements* issued in September by the HSKA.

Paragraph 4 – does a reference to an effective date, with an alternative for early application, make any sense in the context of a voluntary framework? We do not believe so. The Framework should be effective from the date of issue.

Paragraph 5 – the definition of "owner", to include any party that has the right to participate in the appointment of the governing body, has the effect of including any external parties (e.g. lenders) that have a right to appoint a member of the board. We do not believe that this is appropriate.

Paragraph 5 – the definition of "total revenue" is out of place in the Hong Kong reporting regime. It makes no reference to the definition of revenue included in SSAP 18. It uses terms such as "output appropriations" whose meaning is not clear. By including "cost recoveries" it can be taken to include e.g. bad debt recoveries, and the reversal of impairment losses. This definition needs to be thoroughly re-examined.

Paragraph 5 – the definition of "total employees" is incomplete. Although we appreciate the Society's desire for brevity, one cannot use such an expression without being very explicit as to how it is to be calculated.

Paragraph 9 – we believe that the final sentence should be removed. The expressions "fair presentation" and "fairly presents" are not used in a Hong Kong context.

Appendix II

Comments on Proposed Exemptions from Existing Standards

All non-listed entities are already exempt from SSAPs 5, 25 and 26.

Smaller entities are already exempt from SSAP 15. Consistent with the discussion in our covering letter and in Appendix I, we do not support any change in the size thresholds without appropriate research as to the number of reporting entities likely to be affected.

The benefits of many of the proposed exemptions are illusory, since they deal with circumstances that would rarely have applied to smaller entities in any case, or else the costs of compliance are minimal.

The only real effects of the proposals are:

- exemption from SSAP 12 *Income Taxes*;
- exemption from SSAP 33 *Discontinuing Operations*. This Standard would very rarely be applicable to small entities in any case;
- exemption from related party disclosures with the unanimous written consent of shareholders. As discussed in Appendix I, we strongly object to this proposed exemption and believe that it will not be acceptable to other users of the financial statements e.g. the Inland Revenue Department;
- exemption from substantially all of the disclosure requirements of SSAP 14 *Leases;* and
- exemption from substantially all of the disclosure requirements of SSAP 34 *Employee Benefits.*

The exemption from SSAP 12 is significant, but hardly in itself significant enough to justify a separate regime.

The exemptions from SSAP 14 are 34 are quite extensive but, because there are no exemptions from the measurement rules, we question whether they will result in any savings other than some word processing time.

We disagree with the following proposed exemptions:

Ref.	Description	Comment
SSAP 1.56	Analysis of asset and liabilities between amount receivable/ payable before and after 12 months.	We consider that this exemption is inappropriate. Liquidity is one of the fundamental concerns for users of any financial statements. This requirement provides key information in respect of the anticipated timing of future cash flows.
SSAP 2.29	The nature and amount of a change in accounting estimate that has a material effect.	We do not agree with this proposed exemption because we believe that this provides scope for undisclosed manipulation of results (e.g. changing the estimates for bad debts, inventory losses etc). In addition, we believe that the exemption will be ineffective, since the requirement of SSAP 2.15 (to disclose items of income and expense necessary for an understanding of the performance for the period) continues to apply.
SSAP 9.16	Date of authorisation of financial statements, who authorised and whether owners or others have the power to amend the financial statements after issuance.	The requirement for signature of the financial statements is in the Companies Ordinance (s129B(1)). Documentation of the date of approval is essential from an auditors' perspective, in order to establish the date to which the directors' accept responsibility. The existence of a power to amend by the owners will have rare application in practice.
SSAP 12	Full exemption	We agree with the proposal to permit the use of the taxes payable method, but consider that there should be a requirement to disclose details of the entity's tax liabilities, tax charge etc.
SSAP 20	Related party disclosures – full exemption with unanimous written agreement of shareholders.	We disagree with the proposed exemption – see our comments in Appendix I.
SSAP 22.30(d), (e)	Disclosure of the reversal of any write-down of inventories, and of the circumstances giving rise to such a write-down.	We believe that where there is a material reversal, this is salient information.

Ref.	Description	Comment
SSAP 31.117/118	Disclosure of details of impairment losses or reversals that are material, whether individually or in aggregate.	We believe that, where applicable, disclosure of this information is essential to an understanding of the financial statements. Therefore, we believe that the exemption will be ineffective because SSAP 2.15, as discussed above, will continue to apply.
SSAP 34	Detailed information on pension schemes.	We believe that the detailed disclosures regarding defined benefit plans and equity compensation benefits will rarely impact on the financial statements of smaller entities. However, where they do, they can be significant to the financial statements and, therefore, we believe, should be subject to stringent disclosure requirements.