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2 October, 2008

Dear Mr. Ong

HKICPA Consultation Paper on Financial Reporting by Private Companies ("the Consultation Paper")

We refer to the Institute's letter dated 25 May 2008 inviting comments on the Consultation Paper.

We welcome Council's initiatives in seeking to reduce the financial reporting burden of private companies in Hong Kong, which we believe is consistent with the spirit of the Re-write of the Companies Ordinance ("CO Re-write").

Timing of the consultation

We consider that the timing of the consultation is premature, with the CO Re-write and the re-drafting of the IFRS for SMEs still in progress. For example, whilst the CO Re-write proposes a distinction between listed and non-listed entities (or public interest entities and non-public interest entities) and provides the possibility of introducing more than one "true and fair" view, it will be unreasonable to interpret that the CO Re-write consultation document anticipates more than two levels of financial reporting. We believe that the "two-tier vs three-tier" debate involves significant public interest and therefore should be elevated to a higher level with participation from all stakeholders of private entities. In addition, we understand that the general view expressed by many commentators on the ED on IFRS-SMEs is that the ED is still too complicated and onerous. We also understand that IASB is deliberating on further simplification. Until the final outcome of the IASB deliberation is known, it is premature to conclude whether the final IFRS for SMEs standard is a suitable standard for private entities, whether large or small, in Hong Kong.

Post-implementation review of SME-FRF& FRS

The Institute's SME-FRF & FRS was introduced in autumn 2005 to provide relief from complying with the full IFRS that became HKFRS from that year onwards. To enable Hong Kong incorporated companies to apply the SME-FRF & FRS pending the amendment of the Companies Ordinance, the SME-FRF & FRS was introduced as a replacement of the Institute's previous interpretation of the "true and correct" view under section 141D of the Companies Ordinance. As the eligibility criteria under section 141D do not include size, a large number of private companies, irrespective of size, are entitled to apply the SME-FRF & FRS and in deed have chosen to apply SME-FRF & FRS. We consider that a comprehensive post-implementation review is due for the SME-FRF & FRS. The review should cover all aspects of the SME-FRF and SME-FRS including the qualitative and quantitative criteria, the number of private entities applying SME-FRF & FRS and the adequacy of the technical content in meeting the user needs. In particular, preparers and users of the financial statements of eligible private companies should be consulted as to (a) the reason for adopting / not adopting SME-FRF & FRS and (b) whether they consider the SME-FRF & FRS should be modified to meet their needs. The Institute should consider the results of this post-implementation review in forming any conclusion and proposal on the financial reporting regime in Hong Kong.

To the specific questions in the Consultation Paper, we offer our comments as follows:

Question 1

Do you agree that relief from applying full HKFRS should be permitted for private companies? Please explain your reasons.

We agree that relief from applying full HKFRS should be permitted for private companies. We agree with the reasons put forward by Council in the Consultation Paper.

Question 2
Do you agree that the SME-FRF& FRS is an appropriate reporting option for small private companies? If not, please explain your reasons.

We agree that the SME-FRF and FRS is an appropriate reporting option for small private companies. However that is not to say there is no room for improvement. For example, we consider that the disclosure requirements could be expanded to cover off balance-sheet items such as derivatives.

Question 3
Do you agree that large private companies should be provided with an option to choose a simpler reporting framework than HKFRSs? Please explain the reasons for your view.

We agree that all private companies, whether large or small, should be provided with an option to choose a simpler reporting framework than HKFRSs, provided protective measures are in place for the minority shareholders. The simpler reporting framework however only needs to satisfy the needs of the regular users. We consider that the list of users in the ED on IFRS-SMEs is too widely drawn and is not representative of the Hong Kong environment. For example, the provision of audited financial statements by a private company to a creditor, customer or credit agency as a condition of doing business is an exception rather than a norm in Hong Kong for private companies. In Hong Kong, there is no public filing of private company financial statements and the only regular external user is the Inland Revenue Department. We consider that a simple reporting framework is sufficient for that purpose. The information needs of non-regular users can be met by the users making direct request to the company concerned.

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Question 4

Do you agree with the view of Council stated in paragraph 34 above (i.e.(a) the SME-FRF & FRS does not meet the reporting needs of the user of the financial statement of large companies; and (b) the SME-FRF & FRS should not be expanded to meet those needs)*? If not, why?*

We do not consider that it is appropriate for Council to form a view at this early stage.

With regard to (a), we consider that it is premature for Council to form any view without conducting a survey amongst the stakeholders of private companies. A significant number of large private companies are entitled to apply SME-FRF & FRS by reason of section 141D and their reasons for applying, or not applying, SME-FRF & FRS are most relevant in formulating a conclusion on user needs. The Consultation Paper provides no empirical evidence to support Council's view in rejecting SME-FRF & FRS, or a modified version thereof, as a viable option.

With regard to (b), whether the SME-FRF & FRS should be expanded to meet the user needs depends on a number of factors. First of all, we are yet to have direct feedback from the users of SME financial statements as to what their needs are and whether their needs have been adequately met. (Please refer to our comments on (a) above.) Secondly, whether the expanded SME-FRF & FRS can meet the needs of the users depends on the degree of expansion. The Consultation Paper has not elaborated on the different possible ways of expanding SME-FRF & FRS (e.g. introducing disclosure requirements for off-balance sheet derivatives) and why they should not be considered. Thirdly, whether the SME-FRF & FRS should be expanded depends on whether there is a viable alternative (e.g. the final version of IFRS-SMEs) that could achieve a better balance between cost and benefits. We consider that the possibility of expanding SME-FRF & FRS was ruled out in the Consultation Paper without sufficient justification.

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> ***Question 5***
> *Do you agree that the Institute should adopt or develop a large private company financial reporting framework? Do you have a preliminary view as to which of the above options is appropriate? Please explain your views.*

We agree that the Institute should develop a private company financial reporting framework (Please refer to our response to ***Question 1***).

Of the three options advanced and the one option rejected by Council, we consider that it is premature to form any conclusion whilst IFRS-SMEs is still evolving. Although the IFRS-SMEs claims to be based on the same underlying principles as full IFRS, the former does contain a number of measurement simplications/options which would give rise to completely different balance sheet values and profit and loss results. We are however of the view that the ED version of IFRS-SMEs has not gone far enough, in terms of simplification, to convince the large private companies, which have already invested significant time and cost in adopting full HKFRS or have applied SME-FRS under section 141D since 2005, to reinvest additional time and cost to make yet another change. We believe that the HKICPA is faced with a dilemma: For the IFRS-SMEs to be able to provide genuine relief to large private companies, there have to be significant reduction not only in disclosure requirements but also significant exemptions from fair value measurements. However, this would result in three different measurement bases: (i) full fair value under HKFRS; (ii) hybrid (fair value and historical cost) under IFRS-SMEs and (iii) historical costs under FRS-SMEs. We believe that the existence of three different ways of measuring assets / liabilities and profit / loss would result in confusion amongst the users of private company financial statements.

If the Institute were to introduce a "large private company" reporting requirement without conducting the user survey that we suggested above, we think the Institute should consider the options in the following order:

1. HKFRSs with reduced disclosures (*with further modification as suggested below)
2. Expansion of SME-FRS
3. IFRS-SMEs with modification (*with further modification as suggested below)

HKFRSs and SME-FRS are based on clearly defined measurement bases, namely fair value basis and historical cost basis respectively, whereas IFRS-SMEs, despite the IASB's claim that it is based on the same underlying principles as full IFRS, is in fact a hybrid product and does not have a clearly defined measurement basis. External users are familiar with the historical cost convention and are now getting used to the fair value measurement basis. Any hybrid measurement basis is likely to give rise to confusion amongst the users.

* From our experience, group companies, in particular wholly-owned subsidiaries, that are required to report internally their HKFRS/IFRS financial information for consolidation purposes tend to adopt HKFRS/IFRS for their individual financial statements, *as they regard any form of simplified reporting requirements (including SME-FRS) for their individual financial statements as additional burden rather than a relief.* These companies frequently find the requirement for consolidated financial statements for a sub-group and the adoption of fair value measurement in their individual financial statements for inter-company transactions and balances, which are eliminated on consolidation, to be meaningless and onerous. We therefore further suggest that:

(1) Exemption from preparation of group accounts should be granted to a parent that is (a) a wholly-owned subsidiary; or (b) a partially owned subsidiary with consent from all its other members. We consider the "ultimate parent producing IFRS/HKFRS compliant financial statements" exemption criterion to be too onerous and have no conceptual basis.

(2) Exemption from fair value accounting for intra-group transactions and balances should be granted to companies within a group.

Question 6
Please identify whether you use financial statements as a preparer, auditor and/or user and the effect on you in all of these cases of the proposed introduction of a large private company framework.

We are auditors of financial statements. The proposed introduction of a large private framework will mean additional costs and efforts in training both our staff and our clients and development of checklist and audit programmes. We have to be conversant with three different set of reporting requirements in order to provide meaningful advice to our clients in their choice of reporting frameworks. Those clients who have choice under the three-tier system will also have to become conversant with up to three different sets of reporting requirements in order to make an informed decision on their choice.

Yours faithfully

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