

Comments on the Exposure Draft of Proposed Amendments to Small and Medium sized Entity Financial Reporting Framework (SME-FRF) And Proposed Sections Of Small And Medium-Sized Entity Financial Reporting Standard (SME-FRS)

Question 1: Do you agree that the SME-FRF and SME-FRS should be amended to cover groups? If not, why not?

Comments: Yes. It provides more financial information for the SMEs to raise capital and investments.

Question 2: Do you agree that the size criteria set out in paragraph 24 of the SME-FRF appropriately identify a "small group" in Hong Kong? If not, why not?

Comments: Yes. The two out of three criteria are flexible enough to have those really significant SMEs in it. Those that are really small would be still outside it but they are not economically significant.

○ Question 3: Do you agree that at the company level, investments in associates and interests in jointly controlled entities should be accounted for using the cost method? If not, why not? Do you agree that when an investor / a venturer presents consolidated financial statements, investments in associates and interests in jointly controlled entities should be accounted for using the equity method? If not, why not?

Comments: Yes. It is better to keep it simple.

Question 4: Should a complete set of financial statements prepared under the SME-FRS be required to include a cash flow statement? If not, why not?

Comments: Yes. It would help the SMEs in understanding the significance of the cash flow and provide more crucial meaning to the financial statements.

○ Question 5: If a cash flow statement is required, do you agree that either the direct method or indirect method can be used for reporting cash flows from operating activities, as set out in paragraph 22.7 of the SME-FRS? If not, why not?

Comments: A choice is given. This will be confusing and comparison among a group of companies will be difficult. The Direct Method is useful to predict but it does give away too much proprietary information that the business owner may have second thoughts using. My guess is that the majority of SME will continue to go along with the indirect method and making the ones choosing direct methods standing out on its own and incomparable.

The second question is that: the ED allows for both methods and one SME can change from one to another and making comparison difficult for the financiers. Should there be some restriction in keeping consistency?

Most SMEs do not provide this Cash Flow statement as their monthly and year end financial statements and they will rely on their auditor to do so.

Question 6: Are there any disclosure requirements included in sections 18 to 22 of the SME-FRS that you consider are too onerous for SMEs and therefore should be excluded? If so, what are they and why?

Comments: There are some provisions that are quite onerous for companies having an interest in an enterprise in PRC. These are mainly manufacturers. Currently most of these investments are excluded from the balance sheet and held by the owner as a private investment. The provisions here do not encourage them to bring them into the Balance Sheet.

The difficulties concerning operation are:

Uniform reporting date

19.7 The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements should be prepared as of the same reporting date unless it is impracticable to do so.

19.8 When, in accordance with paragraph 19.9, the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a reporting date different from that of the parent, adjustments should be made for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements. The length of the reporting periods and any difference in the reporting dates should be the same from period to period.

Comments:

This is a serious issue for companies owning a subsidiary in the PRC as all PRC entities have year end on December 31 and their parents in HK year end may be at March 31 or June 30.

The PRC entities cannot be changed and so the HK parent must change. The result is there may be a rash of changing accounting dates for HK companies. This is the easier method. Ample timing must be given as the time taken to change accounting dates will be quite substantial.

If accounting dates are remaining the same, the resulting adjustment will then be using nine months results from this year and then three months from next year with all year end accruals be done at the end of the three months.

The work is substantial and many SMP might have staff problems at the moment. Many business owners would have the SMPs qualifying the auditor report than stock-taking in the PRC because of the costs concerned and the readiness of the PRC accounting records.

At the moment most of these would be subsidiaries are off balance sheet as they are held in personal names. The SME owners will have second thoughts to bring them in the balance sheet.

Uniform accounting policies

19.9 Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events and conditions in similar circumstances. If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements.

Comments:

We all know that depreciation rates in PRC are dictated by the State Tax Bureau, not chosen by the enterprises. They would not allow any assets to be depreciated in less than 10 years and most fixed assets are depreciated in PRC with minimum 11 years. This is contradicting to the generally accepted principles in HK with 5 years as useful lives.

In consolidation, it would require an adjustment asset by asset calculated in the PRC way and then re-calculated in the parent company's HK accounts. This adjustment is then done in the consolidation accounts only.

This requires a good record keeping of the fixed asset register but as I know this is not quite up to the standard required for this to be done in many cases. Most SMEs would have to rely on their auditor to provide this adjustment entry. The SMPs will have a lot of difficulties to assess this adjustment. This may make the year end problem more severe.

Secondly the PRC accounting regulations do not allow specific bad debts provision so easily. The enterprises must apply and have the permission from the State and Local Tax Bureau before a write-off is done. The time period is not a short one because a lot of paper and proof must be submitted. The debt had to be very bad, not doubtful before approval is given. Meanwhile, such would be carried in the books or being written off in the consolidation accounts. I am worried that some SMEs would start to walk away from our generally accepted rates in order to have uniform depreciation rates with their enterprises in PRC as they are where their money is invested.

Then the set up expenses write offs are amortised over a long period, usually the investment period approved by the PRC authority. This is much longer than
Will they be treated just like intangible asset and then their value reviewed for impairment every year just like intangible assets? If so, it would be too onerous.

Conclusion

I welcome such change. In the longer run, this initial pain would subside and the SMEs balance sheet would look stronger and be in a better position to raise finance from financial institutions and investors.

Eric Fok

Member of Professional Accountants in Business Committee