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Consultation Paper

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Consultation Paper

Eligibility for the use of Small and Medium-Sized Entity Financial Reporting Framework and Financial Reporting Standard

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

The Consultation Paper can also be found on the HKICPA's website at:
http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

CONSULTATION PAPER
Eligibility for the use of Small and Medium-Sized Entity Financial Reporting Framework and Financial Reporting Standard

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A EXECUTIVE SUMMARY

1. This Consultation Paper sets out the reasons behind the Institute's preliminary recommendations on the size criteria for preparation of simplified financial and directors' reports (Simplified Financial Reports in terms of being able to apply the Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard) to be submitted for consideration by the Companies Bill Team and the Bills Committee of the Legislative Council.

2. This Consultation Paper is prepared to enable the Institute to understand more on the concerns and comments from stakeholders before formulating the Institute's final view on the issue. Please refer to Section E of this Consultation Paper for further details on the consultation issue.

B BACKGROUND

3. Since the adoption of HKFRS for Private Entities as a financial reporting option in April 2011, Hong Kong has three bodies of standards for financial reporting:

   (a) the Hong Kong Financial Reporting Standards (HKFRSs), which are based on full International Financial Reporting Standards (IFRSs), that may be applied by any reporting entities and must be applied by those entities not eligible to follow either of the other two bodies referred to below;

   (b) the Hong Kong Financial Reporting Standard for Private Entities (HKFRS for Private Entities), which is based on the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) with limited amendments to suit local circumstances, as a financial reporting option for Private Entities (see paragraph 5 for definition for Private Entities); and

   (c) the Small and Medium-sized Financial Reporting Framework and Financial Reporting Standard (SME-FRF&FRS) which may be applied by Hong Kong incorporated companies eligible for claiming relief under section 141D of the Companies Ordinance and by other entities that meet the eligibility requirements contained in SME-FRF&FRS (see paragraph 4 for explanation on eligibility criteria).

4. The SME-FRF&FRS was issued on 22 August 2005 in order to provide relief for smaller Hong Kong companies from the burden of the more complex financial reporting requirements while at the same time providing information useful to users (such as owners, tax authority and lenders). In particular, it provided a financial reporting framework for those stand-alone private companies eligible to take relief under section 141D of the Ordinance to supplement the 11th Schedule of the Ordinance. Entities that qualify for reporting under the SME-FRF and prepare financial statements in accordance with the SME-FRS include:

   - Hong Kong companies

     - Companies applying section 141D of the Companies Ordinance

       Section 141D restricts the type of companies that may adopt the relaxed reporting requirements. In particular, at the present time, companies that have a parent company registered under the Ordinance and/or one or more subsidiaries, would not qualify in terms of the criteria laid out in section 141D. Other entities engaging in certain types of business, including banking/deposit-taking companies, insurance companies and stock-broking companies are also not eligible. In addition, approval from all of the shareholders is required in writing each financial year.

- Overseas companies
  - ➢ No public accountability; and
  - ➢ The entity does not exceed any two of the following:
    - Total annual revenue of HK$50 million.
    - Total assets of HK$50 million at the balance sheet date.
    - 50 employees; and
  - ➢ All owners agree to apply the SME-FRS

5. For the purpose of HKFRS for Private Entities, Private Entities are entities that

- do not have public accountability and
- publish general purpose financial statements for external users. Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

An entity has public accountability if:

- its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
- it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

C COMPANIES ORDINANCE REWRITE – COMPANIES BILL GAZETTED ON 14 JANUARY 2011

6. In mid-2006, the Government launched a major and comprehensive exercise to rewrite the Companies Ordinance ("CO"). By updating and modernising the CO, the Government aims to make it more user-friendly and to facilitate the conduct of business to enhance Hong Kong's competitiveness and attractiveness as a major international business and financial centre.

7. After consulting stakeholders, the Institute provided the Companies Bill Team with our comments on the consultation paper on 11 August 2010 where the document can be accessed at www.hkicpa.org.hk/CO-2nd-submission. The consultation activities undertook by the Institute included:

- Member publications

  Members of the Institute were invited to provide their comments on the second phase consultation through the June 2010 issue of member communication (Techwatch).

- Public forum

  Public forums were held on 12 and 21 July 2010 where officials from the Government's Companies Bill Team were invited to provide an overview of the significant changes reflected in the consultation paper with emphasis on Part 9 of the accounting and auditing provisions in the Companies Bill and to discuss the proposed changes which may significantly affect practitioners.

8. The Companies Bill Team considered the comments received from various stakeholders, including the Institute, and accordingly revised the Companies Bill (Revised Bill) where the document was later gazetted on 14 January 2011. The Companies Bill was introduced into the Legislative Council on 26 January 2011. The Legislative Council formed a Bills Committee to scrutinize the Companies Bill.

9. Under the Revised Bill and compared to the existing section 141D, it is proposed that the criteria for small companies to prepare simplified financial and directors' reports (the Simplified Standards) should be relaxed along the following lines:

   (a) A private company (except for a banking/deposit-taking company, an insurance company or a stock-broking company) will automatically qualify for simplified reporting if it is a "small private company", i.e. a private company that satisfies any two of the following conditions:

   (i) The amount of total revenue for the financial year, as reflected in the company’s annual financial statements for the financial year, does not exceed $50 million;

   (ii) Total assets at the date of the statement of financial position for the financial year, as reflected in the company’s annual financial statements for the financial year, does not exceed $50 million; and

   (iii) Average number of employees during the financial year does not exceed 50

   (b) A private company that is the holding company of a "group of small private companies", i.e. a group of private companies that satisfies any two of the following conditions qualifies for simplified reporting:

   (i) The aggregate amount of the group’s total revenue for the financial year does not exceed $50 million;

   (ii) The aggregate amount of the group’s total assets at the date of the statement of financial position for the financial year does not exceed $50 million; and;

   (iii) The aggregate of the average number of employees of each company in the group during the financial year does not exceed 50

(c) "a small guarantee company" or a guarantee company that is the holding company of a "group of small guarantee companies" (total annual revenue must be not more than HK$25 million) also qualifies for simplified reporting.

Please refer to Division 2 "Reporting Exemption" of the Revised Bill at http://www.fstb.gov.hk/fsb/co_rewrite/eng/companiesbill/doc/Part%209(eng).pdf and Schedule 3 " Specified Qualifying Conditions for Sections 359 to 362" at http://www.fstb.gov.hk/fsb/co_rewrite/eng/companiesbill/doc/Schedule%203(eng).pdf for further information.

D HKICPA PROPOSAL ON SIZE CRITERIA FOR SIMPLIFIED FINANCIAL REPORTING

10. The size criteria for simplified reporting adopted by the Government are consistent with those contained in the SME-FRF. The Institute welcomes this support for the SME-FRF. However, the Institute is concerned that these criteria were first adopted in 2005 in respect of stand-alone entities and believes that before the new Companies legislation is finalised it is appropriate for these limits to be reconsidered in light of inflation and the relaxation of section 141D to include groups.

11. The Institute's Financial Reporting Standards Committee (FRSC) reconsidered the size criteria as proposed in the Revised Bill at its November 2011 meeting and endorsed the following recommendations:

(a) A private company (except for a banking/deposit-taking company, an insurance company or a stock-broking company) will automatically be qualified for simplified reporting if it is a "small private company", i.e. a private company that satisfies any two of the following conditions:

(i) The amount of total revenue for the financial year, as reflected in the company’s annual financial statements for the financial year, does not exceed **HK$100 million**;
(originally HK$50 million in Companies Bill and Revised Bill)

(ii) Total assets at the date of the statement of financial position for the financial year, as reflected in the company’s annual financial statements for the financial year, does not exceed **HK$100 million**; and
(originally HK$50 million in Companies Bill and Revised Bill)

(iii) Average number of employees during the financial year **does not exceed 100**
(originally no more than 50 employees in Companies Bill and Revised Bill)

(b) A private company that is the holding company of a "group of small private companies", i.e. a group of private companies that satisfies any two of the following conditions is qualified for simplified reporting:

   (i) The aggregate amount of the group's total revenue for the financial year does not exceed **HK$100 million net**;
   (originally HK$50 million in Companies Bill and Revised Bill)

   (ii) The aggregate amount of the group's total assets at the date of the statement of financial position for the financial year does not exceed **HK$100 million net**;
   (originally HK$50 million in Companies Bill and Revised Bill)

   (iii) The aggregate of the average number of employees of each company in the group during the financial year **does not exceed 100**
   (originally no more than 50 employees in Companies Bill and Revised Bill)

(c) "a small guarantee company" or a guarantee company that is the holding company of a "group of small guarantee companies" (total annual revenue must be not more than HK$25 million) is also qualified for simplified reporting.

12. When determining the above proposed size criteria, the Institute has considered the following:

Comparison with other jurisdictions

Singapore

13. The Accounting Standards Council of Singapore issued the Singapore Financial Reporting Standard for Small Entities (SFRS for Small Entities), which is based on IFRS for SMEs, as an alternative framework to the Singapore Financial Reporting Standard (SFRS). Since that time, Singapore has had two frameworks for financial reporting:

- SFRS, which is nearly identical to IFRSs and to be fully converged with IFRSs in 2012; and
- SFRS for Small Entities, which is based on the IFRS for SMEs.

14. An entity is eligible to the apply the SFRS for Small Entities if it is not publicly accountable, publishes general purpose financial statements for external users, and meets the definition of a 'small entity' (for each of the previous two consecutive financial reporting periods, with amended application to newly incorporated entities). An entity qualifies as a small entity if it meets at least two of the three following criteria:

- Total annual revenue of not more than **S$10M (approximately HK$61.7M)**;
- Total gross assets of not more than **S$10M (approximately HK$61.7M)**; and
- Number of employees not more than **50**.

In the case of an entity that has one or more subsidiaries and is required or chooses to prepare consolidated financial statements, the total annual revenue, total gross assets and total number of employees are determined on a consolidated basis, and not on the basis of the entity as a single economic entity.

United Kingdom

15. As in other member States of the European Union, UK companies listed on a stock exchange in the United Kingdom are required to follow IFRSs as adopted by the EU in their consolidated financial statements from 2005. All other UK companies, for their consolidated financial statements, are permitted to use IFRSs or to follow the accounting principles established by the United Kingdom Accounting Standards Board (UKASB), as follows:

Companies other than small companies

Unlisted companies other than small companies must follow:

- Financial Reporting Standards (FRS) issued by UKASB
- Statements of Standard Accounting Practice (SSAPs) adopted by UKASB
- UITF Abstracts issued by the Urgent Issues Task Force (UITF) of UKASB

Small unlisted entities

Small companies may elect to report under the Financial Reporting Standard for Smaller Entities (FRSSE), which gives exemptions from applying all other accounting standards.

The definition of a small company is contained in sections 382 and 383 of the UK Companies Act 2006. The qualifying conditions are met by a company in a year in which it does not exceed two or more of the following criteria:

- Turnover of **£6.5M (approximately HK$80M)**
- Balance sheet total of **£3.26M (approximately HK$40M)**
- Average number of employees **50**

Certain companies are excluded by section 384 from the "small company" criteria for reasons of public interest. These are any entity that is, or is in a group that includes:

- A public company;
- A small company that is an authorised insurance company, a banking company, an e-money issuer, a MifId investment firm or a UCITS management company or a company that carries on insurance market activity;
- A body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA State; or
- A person (other than a small company) who has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on a regulated activity.

16. A parent company shall not be treated as qualifying as a small company in relation to a financial year unless the group headed by it qualifies as a small group. The definition of a small group is contained in section 383 of the UK Companies Act 2006 and the qualifying conditions are met by a group in a year in which it does not exceed two or more of the following criteria:

- Aggregate turnover of **£6.5M net (or £7.8M gross)**
- Aggregate balance sheet total **£3.26M net (or £3.9M gross)**
- Average number of employees **50**

"Net" means after the set-offs and other adjustments required by Schedule 6 of the UK Small Companies and Groups (Accounts and Directors' Report) Regulation 2008 in the case of group accounts, and "gross" means without those set-offs and adjustments. A company may satisfy the relevant requirements on the basis of either the net or the gross figure.

Mainland China

17. New PRC GAAP (or Generally Accepted Accounting Principles) is closely based on IFRSs and has been adopted by many enterprises since it took effect on 1 January 2007. For example,

- A share listed companies, insurance companies, securities companies and fund management companies adopted New PRC GAAP as from 1 January 2007;
- Large state-owned enterprises adopted New PRC GAAP no later than 1 January 2008; and
- Financial institutions in the banking industry adopted New PRC GAAP no later than 1 January 2009.

18. New PRC GAAP is expected to be adopted by all medium and large sized enterprises. Once that target is achieved, the MOF is expected to abolish all Industrial Accounting Rules, Accounting Regulations for Business Enterprises and other related rules. This would result in a nationwide and unified accounting standard, aimed at promoting the sustainable development of enterprises, as well as improving capital markets. The specific details of the latest dates for adoption are, or will be, set out in rules issued, or to be issued, by the relevant regulatory authorities (e.g. local finance bureaux). The authorities that have already issued their rules include Guangzhou, Shanghai, Liaoning, Dalian, etc.. It is prudent to expect that those bureaux that have not yet issued notices will do so in the near future.

19. The current criteria for the classification of medium and large-sized enterprises are set out in “Notice on regulations on classification standards for small and medium-sized enterprises” (Gong Xin Bu Lian Qi Ye [2011] No.300). Specifically, medium and large-sized enterprises are those enterprises that meet all the following criteria in their respective industry.

Industry	**Employee**	**Operating income**	**Total assets**
Industrial[a] & Postal service	>=300 people	>=20 million CNY	-
Construction	-	>=60 million CNY	>=50 million CNY
Wholesale	>=20 people	>=50 million CNY	-
Retail	>=50 people	>=5 million CNY	-
Transportation[b]	>=300 people	>=30 million CNY	-
Lodging and food service	>=100 people	>=20 million CNY	-
Agriculture, forestry, husbandry and fishery	-	>=5 million CNY	-

Warehousing, Information transmission[c] & Software and IT service	>=100 people	>=10 million CNY	-
Real estate	-	>=10 million CNY	>=50 million CNY
Property management	>=300 people	>=10 million CNY	-
Leasing and business service	>=100 people	-	>=80 million CNY
Others[d]	>=100 people	-	-

(a) Including mining, manufacturing, power and heat generation and supply, gas and water production and distribution.

(b) Excluding railway.

(c) Including telecommunication, internet and related services.

(d) Including scientific research and technical service, management of water conservancy, environment and public facilities, household service, repairing and other services, social work, culture, sports and entertainment.

20. Currently, if an enterprise fails just one of the above criteria, the enterprise is classified as a small or micro-sized enterprise and can elect to adopt either New PRC GAAP or the Accounting Regulations for Small Enterprises. The only exceptions are those small or micro-sized enterprises with any one or more of the following characteristics:

- the small or micro-sized enterprise is in the form of a sole proprietorship or partnership enterprise;
- the small or micro-sized enterprise issues public stock or debentures; and
- the small or micro-sized enterprise's parent company or any of that parent company's subsidiaries is classified as a medium or large-sized enterprise.

These types of small or micro-sized enterprises are not permitted to adopt the Accounting Regulations for Small Enterprises and instead should follow the Standards applicable to the larger enterprises in their local district.

Government reference

21. In respect of the number of employees, the FRSC noted that manufacturing enterprises with fewer than 100 employees and non-manufacturing enterprises with fewer than 50 employees are defined as "SME" by Trade and Industry Department (TID) of the Government of Hong Kong Special Administrative Region for the purpose of its SME Loan Guarantee Scheme, SME Development Fund and SME Export Marketing Fund under the SME Funding Schemes. As at June 2011, there were about 300,000 SME (as defined by TID) in Hong Kong and they account for over 98% of the total business units in Hong Kong[1]. Most of the SMEs (as defined by TID) were in the import/export trade and wholesale industries, followed by the retail industry. They accounted for over 50% of the SMEs (as defined by TID) in Hong Kong.

The number of employees as incorporated in the proposed size criteria is no more stringent than that defined by the TID.

[1] "Business units" does not equate with "companies". Please refer to http://www.success.tid.gov.hk/english/lin_sup_org/gov_dep/service_detail_6863.html for further information.

22. When determining the proposed size threshold, the Institute's FRSC has considered the inflation in Hong Kong Dollar prices in the past years, including the high property prices in Hong Kong which may be relevant for the total assets threshold. The FRSC was also mindful of the Government's intent to enhance Hong Kong's competitiveness and attractiveness as a major international business and financial centre. On the other hand, the FRSC noted that entities are only required to meet at least two out of three of the size criteria to be eligible to prepare simplified financial (i.e. the use of SME-FRF&FRS) and directors' reports and that the magnitude of the proposed thresholds are no more stringent as compared with those for other jurisdictions described in paragraphs 13-20 above.

E CONSULTATION ISSUE

23. The Institute understands that the determination of size criteria to prepare simplified financial reports is important for practitioners, including both the professional accountants in business and auditors, and hence is prepared to relax the size criteria in the SME-FRF as recommended above and to request the Companies Bill Team and the Bills Committee of the Legislative Council to consider making equivalent amendments to the relevant Schedule in the final legislation.

24. This Consultation Paper is prepared to enable the Institute to understand more on the concerns and comments from stakeholders before formulating the Institute's final view on the issue. In particular, the Institute welcome comments on the following questions:

Question 1

Do you consider the Institute's proposed size criteria for the preparation of Simplified Financial Report as explained in paragraphs 10-22 are appropriate?

Question 2

If you consider the Institute's proposed size criteria above is inappropriate and have alternative proposals on the magnitude of the size criteria, please provide details of your proposal and the bases for your proposal.

25. Members and other stakeholders are requested to submit comments they may have on the Institute's proposed size criteria as set out above in writing to the Institute by 16 January 2012. Comments should be supported by specific reasoning.

26. Comments may be sent by mail, fax or e-mail to:

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