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

19 August 2013

To: Members of the Hong Kong Institute of CPAs
All other interested parties

LIMITED INVITATION TO COMMENT ON CONSULTATION DRAFT OF SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING FRAMEWORK AND FINANCIAL REPORTING STANDARD (REVISED)

Comments requested to be received by 25 October 2013

The Hong Kong Institute of Certified Public Accountants' (HKICPA) Financial Reporting Standards Committee (FRSC) is seeking comments on one of the proposed revisions to the HKICPA's 2008 Exposure Draft of the Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (Revised) (SME-FRF & SME-FRS), which has been posted on HKICPA's website at:
http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/ed-pdf-2013/ed_sme13.pdf

Background to the proposed revisions to the SME-FRF and SME-FRS

In July 2012 a new Hong Kong Companies Ordinance (CO), Cap. 622, was enacted. The new CO is expected to come into force from early 2014 to replace the old CO (Cap. 32).

One of the objectives of the new CO is to simplify the reporting requirements for non-public companies by expanding the categories of private companies and companies limited by guarantee which may be exempt from the requirement for their financial statements to show a true and fair view. In place of this requirement, these entities will be required under the Companies Ordinance to prepare financial statements in accordance with the applicable accounting standards issued or specified by the HKICPA. In this regard, the applicable accounting framework and standards are the SME-FRF and SME-FRS.

Specifically, in addition to companies that currently satisfy the criteria set out in section 141D of the old CO, eligibility to apply the SME-FRF & SME-FRS for statutory purposes has been expanded under the new CO to include the following entities:

- Small guarantee companies;
- Small private companies; and
- Larger "eligible" private companies;

as defined in the new CO, with reference to meeting certain size tests and, in the case of larger "eligible" private companies, obtaining shareholder approval.

These additional types of non-public companies may also qualify for simplified reporting if they have subsidiaries, provided that the group of which they are a parent, when taken as a whole, falls within the qualifying criteria, and that each company within that group also falls within the qualifying criteria. This means that when the new CO comes into effect, the SME-FRF and SME-FRS may also be applied in the preparation of consolidated financial statements by some private companies or companies limited by guarantee.

Please refer to paragraph 22 to 42 of this Consultation Draft for further information on the qualifying criteria.

In 2008, the HKICPA issued an Exposure Draft in anticipation of the new CO, which included new sections dealing with business combinations, consolidated financial statements, investments in associates, investments in joint ventures and cash flow statements (section 18 to 22). In the course of developing this latest Consultation Draft the HKICPA has incorporated the proposals from the 2008 Exposure Draft, modified to reflect the comments received on that ED duly considered by the FRSC. In particular, the HKICPA has noted that the 2008 proposal to require a cash flow statement to be included in the SME financial statements did not receive widespread support and therefore, while the Consultation Draft retains the section on cash flow statements, this section is for guidance only and compliance will not be mandatory.

In addition, this Consultation Draft takes into account developments in the terminology and guidance available in full HKFRS since the 2008 Exposure Draft, to the extent relevant to the SME-FRF and SME-FRS, as well as reflecting the new qualifying criteria introduced in the new CO.

The FRSC is not seeking further comments on matters in the SME-FRF or SME-FRS addressed previously in the 2008 Exposure Draft or these other consequential changes referred to above. However, for reference purposes:

- the appendix to this invitation to comment contains further details of the changes to the 2008 Exposure Draft incorporated in this Consultation Draft; and

- the Consultation Draft includes edit marks to show:

  - the changes made to the original SME-FRF, the glossary, sections 1 to 17 of the SME-FRS, the appendix and the company-level illustrative financial statements; and

  - for sections 18 to 22 (being the sections which deal with business combinations, consolidated financial statements, investments in associates, investments in joint ventures and cash flow statements), the changes proposed in relation to the 2008 Exposure Draft.

The illustrative consolidated financial statements are a new addition and therefore no edit marks are incorporated for the whole of this part.

The 2008 Exposure Draft can be accessed at:
http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/ed-pdf-2008/I2C-SME-ED.pdf.

Limited invitation to comment

As explained above, the FRSC is not seeking further comments on matters in the SME-FRF or SME-FRS addressed previously in the 2008 Exposure Draft or other consequential changes made as a result of developments in full HKFRS and the requirements of the new CO.

However, section 381(2) of the new CO provides scope for the SME-FRS to specify circumstances in which one or more subsidiaries may be excluded from consolidation. The Consultation Draft includes a provision which proposes to take advantage of section 381(2). As this proposal was not included in the 2008 Exposure Draft nor is it a requirement of the new CO, the HKICPA invites comments on whether this proposal is appropriate.

Details of the proposal and invitation to comment are as follows:

Provisions in the old CO

Under section 124(2) of the old CO, group accounts need not deal with a subsidiary of the company if the company's directors are of the opinion that it is impracticable, or would be of no real value to members of the company, in view of the insignificant amount involved, or would involve expense or delay out of proportion to the value to members of the company to include that subsidiary. If the directors are of such an opinion about each of the company's subsidiaries, group accounts shall not be required.[1]

Provisions in the new CO

Under section 381(2) of the new CO, where a company falls within the reporting exemption for the financial year (i.e. qualifies for the SME-FRF and SME-FRS), one or more subsidiaries may be excluded from the consolidated financial statements in compliance with the accounting standards applicable to the statements (in other words, if the SME-FRF or SME-FRS permits the exclusion).

In this regard, paragraph 19.1 of the Consultation Draft proposes to permit one or more subsidiary undertakings to be excluded from the consolidated financial statements of a qualifying company when:

(a) their exclusion measured on an aggregate basis is not material to the group as a whole; or

(b) their inclusion would involve expense or delay out of proportion to the value to members of the company.

Paragraph 19.1(a) is consistent with the general concept of materiality set out in paragraph 1.9 of the SME-FRS and also with the provisions of section 381(3) of the new CO, which are applicable to companies which are not entitled to follow the SME-FRF and SME-FRS.

Paragraph 19.1(b) brings forward the relief which is currently available in section 124(2)(b)(i) of the old CO, which would otherwise no longer be available under the new CO. The intention is to provide limited relief to eligible companies, consistent with the power given to the HKICPA by virtue of section 381(2) of the new CO and the definitions relating to applicable accounting standards in section 380(8) of the new CO. However, it should be noted that if a parent company were to take advantage of paragraph 19.1(b), material information could be omitted from that company's consolidated financial statements, such that they would not give a complete picture of the group as a whole. To ensure that this exemption is not invoked against the members' wishes an additional safeguard has been included in paragraph 19.1 such that a parent may not exclude a subsidiary from consolidation on the grounds of undue expense and delay out of proportion to the value to members of the company unless the members of the company have been informed in writing about, and do not object to, this exclusion.

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[1] There are two further grounds for exclusion set out in section 124 of the old CO. However, the use of these grounds is restricted in that the company would first need to obtain the approval of the Hong Kong Financial Secretary.

The Consultation Question

Do you consider it is appropriate to include in the SME-FRF & SME-FRS an option to relieve a group from consolidating one or more subsidiary undertakings if the company's directors are of the opinion that their inclusion would involve expense or delay out of proportion to the value to members of the company? Why or why not? If not, what alternative approach would you propose and why?

Invitation to Comment

To allow your comments on the Consultation Draft to be considered by the FRSC, they are requested to be received by the Institute on or before 25 October 2013.

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

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

Appendix

Summary of Main Changes proposed in the Consultation Draft of SME-FRF & SME-FRS as compared to the existing standard

- Inclusion of a summary of the criteria for "qualifying entities" with cross-references to the new CO;

- The accounting requirements are expanded to cover consolidated financial statements, business combinations and investments in other entities accounted for by application of the equity-method;

- Guidance on presenting a cash flow statement has been included – the preparation of a cash flow is optional. However, if a cash flow statement is presented then this guidance should be followed;

- Additional guidance material has been added on the non-exempt disclosure requirements in the new CO and certain other provisions of the new CO which are relevant to the SME-FRF & SME-FRS (This guidance is not yet complete as the Administration is still finalising some of the Regulations – this is expected to be completed before the end of 2013);

- Guidance has been added on the concept of "realized profits and losses" and the relationship between these and "recognised profits and losses" reported under the SME-FRS (section 79B of the old CO, together with related sections, has been brought forward into the new CO substantially unaltered);

- Specific disclosure requirements have been added to the SME-FRF to cover the first year that a company transitions from e.g. full HKFRS to SME-FRS;

- Additional disclosure requirements have been added to the Income Taxes section to disclose tax rates and unused tax losses;

- New guidance has been added on determining the "reporting currency" of an entity (which is based on the concept of functional currency in full HKFRS);

- The definition of "related party" has been updated to align with the latest definition in full HKFRS;

- The definitions of "active market" and "fair value" have been updated to be consistent with HKFRS 13 *Fair Value Measurement*;

- Guidance on determining whether an entity is acting as an agent or principal has been added to the appendix (this guidance was missing as it had been added to HKAS 18 *Revenue* after the SME-FRS was first issued);

- Some minor housekeeping has been done on the other parts of the SME-FRS (for example definitions added to the glossary that were previously only in the text, and other inconsistencies removed).

Summary of Main Changes proposed in the Consultation Draft of SME-FRF & SME-FRS as compared to the 2008 Exposure Draft

- The guidance on the common control exemption for business combination accounting has been expanded by pointing preparers in the direction of Accounting Guideline 5 *Merger Accounting for Common Control Combinations* or book value accounting for these transactions;

- Additional guidance has been added on the 12 month "measurement period" allowed for adjustments in a business combination (consistent with HKFRS 3 *Business Combinations*);

- The guidance on step-by-step acquisitions and disclosure for post balance sheet business combinations has been deleted as considered too complex and/or unusual for the SME-FRS;

- Consistent with the simplified approach taken to intangible assets acquired in a business combination, the requirements for when an impairment loss needs to be reversed have been simplified (i.e. in both cases the requirement need not be followed if fair value information is not readily available);

- The exemption criteria from preparing consolidated financial statements has been aligned fully with the criteria in the CO and non-consolidated financial statements are referred to consistently as "company-level" rather than "separate" as being a clearer term for these;

- The term "non-controlling interests" instead of "minority interest" has been used and the process for allocating losses to the non-controlling interests has been aligned with full HKFRS;

- The approach to grossing-up goodwill for non-controlling interests when computing if there is an impairment loss has been clarified in section 9. In addition, a worked example is included in the appendix to show how this computation is carried out;

- An "undue cost or effort" exemption has been included for recycling the foreign translation reserve to profit or loss on disposal;

- The equity method for investments in associates and joint ventures had been given as an alternative policy choice in the consolidated financial statements – the benchmark treatment is to use the cost method for either or both of these types of investments, being the same as for all other investments; and

- The concept of joint ventures has been aligned more closely to HKFRS 11 *Joint Arrangements* by making a distinction between joint ventures and "other forms of joint arrangement". This does not materially change the accounting requirements in the SME-FRS compared to the exposure draft.