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

3 June 2005

By E-mail (iasb@iasb.org) and by Post

Our Ref.: C/GSBWG

Mr. Paul Pacter
Director
International Accounting Standards Board,
30 Cannon Street,
London EC4M 6XH,
United Kingdom.

Dear Mr. Pacter,

IASB Staff Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities (SMEs)

The Hong Kong Institute of Certified Public Accountants welcomes the opportunity to provide you with our responses to the Staff Questionnaire.

--- We are pleased to set out in the attached Appendix the responses of the Institute's GAAP for Small Businesses Working Group to the Staff Questionnaire for your consideration. We generally consider that the questions are too simplistic and are concerned that the way that the questions were being drafted might lead to unintended or undesirable conclusions being drawn on the answers made.

For SMEs, the most significant users of their financial statements are likely to be owners, government and creditors, who may have the power to obtain information additional to that contained in the financial statements. Accordingly, we believe that the main objective of financial statements prepared by SMEs should be to show the results of management's stewardship of and accountability for the resources entrusted to it and not for business valuation. As a result, we consider that historical cost combining with other measurement bases for certain specific items, such as the Effects of Changes in Foreign Exchange Rates, would be the most appropriate measurement base for SMEs in preparing their financial statements. This is particularly so if the owners of an entity consent unanimously to the entity's financial statements being prepared on that basis as there would generally be no accountability issues.

We consider that, when an item is omitted from the SME Standards, the SMEs should be required to account for that item based on the principles established in the SME Standards rather than making reference to the applicable IFRSs.

In April 2005, we issued for consultation an Exposure Draft on the proposed Financial Reporting Framework (FRF) and Financial Reporting Standard (FRS) for SMEs, which was developed on the above basis. A copy of the Exposure Draft can be obtained from our website at http://www.hkicpa.org.hk/professionaltechnical/accounting/exposuredraft/smefrf-frs.pdf.

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We plan to finalise this Exposure Draft in the near future for use by those qualifying entities with effect from annual periods beginning on or after 1 January 2005. However, we shall keep a close watch of the international development and shall make revisions to our SME-FRF and SME-FRS where considered appropriate.

If you have any questions on our responses, please do not hesitate to contact me at schan@hkicpa.org.hk.

Yours sincerely,

Stephen Chan
Executive Director

SSLC/EH/al
Encl.

Hong Kong Institute of CPAs

Responses of the GAAP for Small Businesses Working Group to the IASB Staff Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities (SMEs)

Question 1: What are the areas for possible simplification of recognition and measurement principles for SMEs? In responding, please indicate:

- **the specific accounting recognition or measurement problem for an SME under IFRSs;**
- **the specific transactions or events that create the recognition or measurement problem for an SME under IFRSs;**
- **why is it a problem; and**
- **how that problem might be solved.**

Responses are set out below in bold and italic:

a. Measuring the cost of inventories under IAS 2.

There is no specific accounting recognition or measurement problem for SMEs.

b. Use of the percentage of completion method for contracts under IAS 11 and for service revenue under IAS 18.

There is no specific accounting recognition or measurement problem for SMEs.

c. Deferred income tax accounting under IAS 12.

It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. Those reasons are reproduced below for easy reference:

a. Users do not use or would not benefit from the resulting information.
b. It is too costly for SMEs to apply the recognition or measurement principle relative to the benefit of the resulting information.
c. It is too costly for auditors to audit the resulting information.
d. Measurement is too complex for an SME to do.

Deferred tax liabilities and deferred tax assets should not be recognised in the financial statements of SMEs.

d. Lease accounting under IAS 17.

There is no specific accounting recognition or measurement problem for SMEs. However, it is emphasised that the straight-line method or the sum of the digits method is appropriate to be used by SMEs in allocating the lease payments between the finance charge and the reduction of the outstanding liability when accounting for a finance lease.

e. Measurement of defined benefit plan or other post-employment benefit liabilities under IAS 19.

SMEs would seldom have defined benefit plans. If SMEs have such a plan, the measurement under IAS 19 would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Quesionnaire. In particular, the measurement of a defined benefit liability would require making estimates about demographic variables (such as employee turnover and mortality) and financial variables (such as future increase in salaries) and discounting the benefit using the Projected Unit Credit Method. In dealing with this, SMEs should be allowed to account for a defined benefit plan based on the contributions made during the period.

With regard to other post-employment benefit liabilities, such as termination benefit, there is no specific accounting recognition or measurement problem for SMEs.

f. Consolidation of subsidiaries under IAS 27.

IAS 27 should not be considered in isolation. It should be considered in conjunction with IFRS 3 and IAS 38. SMEs might have conceptual and practical difficulties in defining a subsidiary and applying the fair value treatments during the process of consolidation and in subsequent accounting. SME Standards should not be applied to the preparation and presentation of consolidated financial statements by a small group.

g. The equity method of accounting for investments in associates under IAS 28 and investments in joint ventures under IAS 31.

It would cause problems for SMEs. SMEs might have conceptual and practical difficulties in defining an associate or a joint venture and applying the fair value treatments under the equity method of accounting under IAS 28 and IAS 31.

h. Impairment approach to goodwill and intangibles for indefinite life assets under IAS 36.

It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. It would be more appropriate to include only a requirement for SMEs to perform an assessment for any impairment loss on those assets without specifying how such an assessment should be carried out because, for SMEs, the assessment of impairment loss is not expected to be too complicated.

i. Impairment of property, plant, and equipment under IAS 36.

It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. SMEs should be allowed to assess impairment of property, plant and equipment on an individual asset or a group of similar assets basis. The concept of cash generating units may be too difficult for SMEs to implement. SMEs should be allowed to

use estimates, averages and computational short cuts to provide reasonable approximations of the detailed computations for determining recoverable amount. Discounting should be permitted and not required for SMEs.

j. Recognition and measurement of provisions and contingent liabilities under IAS 37.

   There is no specific accounting recognition or measurement problem for SMEs.

k. Capitalisation of intangibles development costs incurred after commercial viability has been determined under IAS 38.

   There is no specific accounting recognition or measurement problem for SMEs in respect of the initial recognition of intangible development costs. However, there are problems for SMEs in respect of the subsequent measurement of those assets under IAS 38, in particular when fair value treatment is adopted.

l. Use of the effective interest method under IAS 39.

   It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. SMEs would have difficulties in determining the rate to be used in arriving at the fair value of a financial asset (e.g. a discounted note) and in allocating the premium or discount so arising over the contract period. SMEs should be allowed to use the cost less impairment method in accounting for a financial asset.

m. Fair value measurements under IAS 39.

   It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. Historical cost is the most appropriate measurement base for SMEs.

n. Accounting for foreign currency forward contracts under IAS 39.

   It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. In dealing with this, for SMEs, where a non-speculative forward contract is used as a hedge of a net monetary asset or liability, the gain or loss on the contract should be taken to the income statement and the discount of premium may be required to be either amortised over the period of the contract or taken to the income statement. Where a non-speculative forward contract is used as a hedge of a firm commitment no gain or loss need normally be recognised during the commitment period. At the end of that period any gain or loss will be added to, or deducted from, the amount of the relevant transaction. The discount or premium should be either amortised over the period of the contract or deferred with the gain or loss. Where a forward contract is speculative the gain or loss should be credited or charged to the income statement.

o. Derecognition and/or hedge accounting provisions of IAS 39.

It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. For example, in the case where a forward foreign currency contract is used to hedge against the net investment in a foreign branch, there are problems for SMEs to assess the effectiveness of the hedge. Accordingly, unless the SME Standards contain detailed guidance on how a specific hedge should be accounted for, hedge accounting should not be allowed for SMEs.

p. The fair value method of accounting for biological assets and agricultural produce at point of harvest under IAS 41.

It would cause problems for SMEs due to the reasons specified as (a) to (d) in paragraph 11 of the Staff Questionnaire. Historical cost is the most appropriate measurement basis for SMEs.

q. Measurement of share-based payments under IFRS 2.

Measurement of share-based payments under IFRSs is too complex for SMEs. In particular, it would be difficult for SMEs to obtain a measure of their share price volatility and there may not be a market price for their shares.

r. Other(s) – please elaborate:

In general, historical cost combined with other measurement bases for certain specific items, such as the Effects of Changes in Foreign Exchange Rates, would be the most appropriate measurement base for the SMEs in preparing their financial statements. When an item is omitted from SME Standards, SMEs should be required to account for that item based on the historical cost principles adopted in the SME Standards rather than making reference to the applicable IFRSs.

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Question 2: From your experience, please indicate which topics addressed in IFRSs might be omitted from SME standards because they are unlikely to occur in an SME context. If they occur, the standards would require the SME to determine its appropriate accounting policy by looking to the applicable IFRSs.

Response: In the light of the proposed mandatory fallback approach to be used, it is not appropriate to remove any topics addressed in IFRSs from the SME Standards. In particular, such a removal with the proposed mandatory fallback approach would not meet the objective of the SME project in providing recognition and measurement simplifications and disclosure reductions for a particular transaction or event undertaken by SMEs. It might also give a false impression that the requirements for SMEs are substantially less than the requirements under IFRSs but in fact they are the same.