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

Our Ref.: C/FRSC

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21 December 2011

Companies Bill Team
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong

Dear Sirs,

Companies Bill Consultation Paper on the qualifying criteria for private companies to prepare simplified financial and directors' reports

The Hong Kong Institute of Certified Public Accountants (The Institute) is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. The Institute is committed to acting in the public interest and upholding the highest standards of financial reporting and welcomes the opportunity to provide you with comments on the captioned consultation paper.

The Institute supports the policy intention of the Companies Bill Team to save compliance costs for private companies while at the same time maintaining an appropriate level of transparency of companies' business through financial reporting.

The Institute has the following comments on each of the options as stated in the consultation paper:

Option 1: Large private companies/groups should not be allowed to adopt simplified reporting (i.e. no change to the proposal in the Companies Bill)

The Institute supports this option whereby large private companies/groups should not be allowed to adopt simplified reporting. Our key rationale is that when the Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (SME-FRF&FRS) was issued in 2005 in order to provide relief for smaller Hong Kong companies from the burden of the more complex financial reporting requirements in the full Hong Kong Financial Reporting Standards (HKFRSs), SME-FRF&FRS was developed based primarily on cost-and-benefit considerations and therefore is a historical cost accounting framework. In principle, a historical cost accounting framework does not reflect, with the expected degree of transparency and consistency, the state of affairs of large sizeable companies or groups of companies with more complex business and accounting environments.

However, we consider it appropriate that the size criteria for the use of SME-FRF&FRS should be increased to more currently relevant levels, taking into account inflation and the fact that many Hong Kong owned groups have labour-intensive manufacturing operations in the Mainland. Having sought the Bills Team's endorsement for increasing the limits in the proposed Schedule to the Companies Bill, on 6 December 2011 we issued a consultation paper which proposes doubling the current limits to HK$100m

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assets, HK$100m revenue and 100 employees, while maintaining the “two out of three” approach. We consider that this will provide relief to most SMEs in Hong Kong while still ensuring that only entities for which the simplified reporting framework was designed are eligible to use that framework. Our consultation paper can be accessed at
http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/ed-pdf-2011/nov/cp-sizecr.pdf.

You will also be aware that in 2010 the Institute issued HKFRS for Private Entities as a reporting option with the intent to relieving larger private companies/groups of the requirements to apply full HKFRSs. HKFRS for Private Entities is based on the International Financial Reporting Standard for Small and Medium-sized Entities issued by the International Accounting Standards Board. We believe that HKFRS for Private Entities is more suitable for use by private companies/groups with larger size and sophistication, being based on full HKFRSs while allowing a degree of relief from some of the more detailed accounting and disclosure requirements of full HKFRSs.

Option 2: Allowing large private companies/groups with members' approval to adopt simplified reporting

The Institute does not support option 2 which proposes to allow adoption of SME-FRF&FRS by any private company/group regardless of size provided consent is given by 75% of shareholders with no member objecting.

We have considered this proposal carefully and set out in a position paper that has been approved by the Institute Council why it is not in the public interest. Please refer
--- to the attached **Annex** for the position paper.

In addition, we note that paragraph 15 of your consultation paper states that under the current section 141D of the Companies Ordinance a private company with members' approval, irrespective of its size, is already allowed to prepare simplified reports. The consultation paper further elaborates that there is a case for allowing large private companies/groups with members' approval to adopt simplified reporting as it does not appear that the current regime has created problems. We do not agree with such reasoning. Currently companies that have a parent company registered under the Ordinance and/or one or more subsidiaries, are not eligible to use section 141D to take advantage of simplified reporting. Section 141D is currently only allowed for a single company. We consider that this indicates that size criteria are implicitly taken into account in assessing the applicability of Section 141D as carrying out large scale and complex businesses in Hong Kong using a single company structure would not be common.

Option 3: Allowing large private companies/groups with members' approval to adopt simplified reporting, subject to certain size criteria being met

The Institute is also not supportive of option 3 which proposes that large private companies/groups can opt to use SME-FRF&FRS if members holding at least 75% of the voting rights so resolve and no other members object subject to their size not exceeding a higher threshold of any two of HK$300/500 million assets, HK$300/500 million revenue and 100 employees. Our concerns expressed above in response to option 2 also apply to this proposal. We believe that full HKFRS or HKFRS for Private

Entities is more suitable for use by private companies/groups of these sizes. Furthermore, as set out in the Institute's abovementioned Consultation Paper dated 6 December 2011, and based on comparisons with other jurisdictions, we consider that doubling the current limits of SME-FRF&FRS to HK$100m assets, HK$100m revenue and 100 employees, while maintaining the “two out of three” approach, is a more appropriate indicator of the maximum size of entity that this particular historical cost accounting framework was developed for.

We hope our comments are useful for your consideration.

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

Yours faithfully,

Chris Joy
Executive Director

CJ/AW/jn

Encl.

Position Paper

Proposed changes to legislation to allow use of SME-FRS for private companies of any size with the consent of 75% of all shareholders

The Institute does not support proposals to allow adoption of SME-FRS by any private company regardless of size provided consent is given by 75% of shareholders. As the professional body responsible for setting financial reporting standards and registering and regulating accountants in Hong Kong, the Institute is committed to acting in the public interest and upholding the highest standards of financial reporting.

Accordingly, the Institute believes that it is appropriate to limit eligibility of private companies to use SME-FRS by reference to size criteria rather than allow the potential for all private companies to use SME-FRS subject to approval of 75% of all shareholders.

We understand that supporters of the proposal argue that all private companies that (a) do not have public interest, (b) are shareholder-managed and (c) do not have a need to borrow external funds should be able to use SME-FRS. All of these points need to be further assessed to determine whether they do in fact support the proposal.

(a) The proposal makes no suggestion as to how public interest would be identified in a private company leaving an implication that there is no public interest in any private company. We take the view, supported by the widespread existence of size criteria for use of simplified accounting frameworks in other jurisdictions, that it is an entirely credible proposition that when any entity exceeds certain size criteria it becomes economically and socially significant and therefore does attract public interest. The proposal also does not address the fact that many large private companies will be involved in activities and transactions every bit as complex as listed companies e.g. use of financial instruments and complex valuations. In our view such matters should be accounted for under a framework that has been developed to properly measure and disclose them i.e. Hong Kong Financial Reporting Standards (HKFRS or HKFRS for Private Entities).

(b) The proposal potentially allows financial statements to be prepared under a simplified framework that is not agreed to by 25% of the company's shareholders, which is a significant minority. We are concerned that there are likely to be a number of private company shareholders who do not understand the technical complexities of certain transactions or activities and therefore decisions on the use of an accounting framework may be made without a full understanding of the consequences. We believe that only allowing the use of SME-FRS for companies above a certain size will ensure protection for minority or non-technically skilled shareholders of companies that are likely to engage in complex or specialised activities or transactions.

(c) Borrowing requirements may change over time and therefore may have to switch between accounting frameworks from year to year. This is not desirable and may result in additional burdens on companies that have to re-state previous period information from SME-FRS to HKFRS.

We also believe that there are a number of matters concerning the use of SME-FRS that need to be fully understood to ensure that decisions on potential changes to eligibility of companies to use SME-FRS are made in a properly informed manner. Our observations are set out below.

The original design of SME-FRF&FRS was not intended for sizeable companies with more complex financial affairs

1. SME-FRF&FRS was developed essentially for SMEs, which generally have much simpler accounting requirements, as an alternative to the full HKFRSs, based primarily on cost-and-benefit considerations. As such, the SME-FRF&FRS, in principle, will not reflect, with the expected degree of transparency and consistency, the state of affairs of sizeable companies or groups of companies with more complex business and accounting environments. Please refer to the SME-FRS factsheet as enclosed as **Appendix 1** for details of SME-FRS does not address important areas that may well affect larger private companies.

2. We are of the view that if large private companies are involved in business activities and transactions of similar nature and complexity as listed companies they should be required to use the same accounting framework to ensure appropriate measurement and disclosure. Therefore if the proposal to allow private companies and groups of any size to prepare financial statements using the SME-FRF&FRS were accepted, additional accounting guidance may need to be included in the SME-FRS to make it comprehensive enough to be suitable for the largest of companies which had become eligible to use it, and their more complex financial affairs. This added length and complexity would in turn reduce the benefits of the SME-FRF&FRS for those SMEs which are smaller in size and for whom it was originally intended.

SME-FRF&FRS is not designed to result in financial statements which give a true and fair view

3. Due to the simple design and intention of SME-FRF&FRS, the reporting obligation on entities following the SME-FRF&FRS is to ensure that the financial statements have been properly prepared, in all material respects, in accordance with the requirements of the SME-FRF&FRS. Entities and their auditors are not required to consider whether the financial statements include sufficient disclosure and appropriate accounting policies in order to show a true and fair view.

4. Similar to our view in point 2 above, consideration would need to be given to whether the disclosures included in the SME-FRS are sufficient to be suitable for the largest of companies which were eligible to use it, and their more complex financial affairs. This added disclosure burden would in turn reduce the benefits of the SME-FRF&FRS for those SMEs which are smaller in size and for whom it was originally intended.

Our proposal to limit eligibility for simplified financial reporting by reference to size criteria is consistent with and no more stringent than other jurisdictions

5. Our view is that it is appropriate to apply size criteria to exempt the large majority of private companies in Hong Kong which have straightforward operations. At the time when the current limits of $50m assets, $50m turnover and 50 employees were set in 2005 we understood that this could potentially exempt more than 80% of private companies incorporated in Hong Kong, including many property holding companies. It should be noted that an entity is still eligible to use the SME-FRF&FRS if it fails one of the size criteria. For example, a property holding company may still be regarded as eligible for the SME-FRS&FRF if the property is worth more than $50m, provided that the company does not have more than 50 employees and does not generate more than $50m annual turnover.

6. We consider it appropriate that thresholds are increased to more currently relevant levels, taking into account inflation and the fact that many HK owned groups have labour-intensive manufacturing operations in the Mainland. Having sought the Bills Team's endorsement for increasing the limits in the proposed Schedule to the Companies Bill, we have on 6 December 2011 issued a consultation paper which proposes doubling the current limits to $100m assets, $100m turnover and 100 employees, while maintaining the "two out of three" approach. We consider that this will provide relief to most SMEs in HK while still ensuring that only those entities for which the simplified reporting was designed are eligible to use that framework. Our consultation paper can be accessed at http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/ed-pdf-2011/nov/cp-sizecr.pdf.

7. The Institute noted that, for example, in the UK and other jurisdictions like China and Singapore, companies and groups may apply simplified reporting frameworks only if they meet size criteria. There is no provision for companies and groups that do not meet the size criteria to opt for simplified reporting, subject to shareholder consent. We believe that proposed size criteria expansion for simplified financial reporting are not more stringent than the other jurisdictions. Please refer to the relevant requirements in UK, Singapore and China as enclosed as **Appendix 2** for reference.

8. Regionally, a number of jurisdictions are moving towards the adoption of full IFRSs and IFRS for SMEs, upon which the HKFRSs and HKFRS for Private Entities are based. Therefore, Hong Kong's position as an international financial centre, and a leading light of good corporate governance and transparency within the region, could be disadvantaged if our new company law were to provide for more extensive adoption of SME-FRS by sizeable and economically significant private companies/groups.

Maintenance of financial discipline and corporate governance

9. The Institute is aware of the argument that, if shareholders are satisfied with the information available to them, and major creditors can ask for more information if they wish to as a condition of extending credit, then why should groups or larger private companies not be able to reduce their costs by taking advantage of a simplified financial reporting framework.

10. We are of a view that the adoption of the accounting framework/standard, which is suitably designed for and appropriate to the size and sophistication of the business, is important for maintaining a reasonable level of financial discipline and corporate governance. In our view this is also crucial for maintenance of the competitiveness of Hong Kong's business environment and should be accepted as a price to pay for the protection of conducting business through a limited liability corporate entity. As illustrated in paragraphs 5-8, we believe that size requirements to determine the application of an appropriate accounting framework in Hong Kong are consistent with and no more stringent than other jurisdictions.

HKFRS for Private Entities is more suitable for use by SMEs with larger size and sophistication

11. Since 30 April 2010, entities that do not have public accountability have had the option of adopting HKFRS for Private Entities for financial reporting purposes, which are less onerous than the full HKFRS. The HKFRS for Private Entities is based on IFRS for SMEs issued by IASB.

By eliminating some accounting treatments permitted under full HKFRSs, removing topics and disclosure requirements that are not generally relevant to Private Entities, and simplifying requirements for recognition and measurement, the HKFRS for Private Entities substantially reduces the volume of the standard available for application by Private Entities when compared with the full set of HKFRSs. It is also considered that the HKFRS for Private Entities is a stable financial reporting platform with less frequent amendments than HKFRSs.

We believe that HKFRS for Private Entities is more suitable for use by SMEs with larger size and sophistication, to allow entities a degree of relief from accounting requirements under full HKFRSs.

12. Please refer to the "HKFRS for Private Entities in your pocket" publication, which is jointly published by the Institute and Deloitte, for highlights of the standard as well as the key differences with the full HKFRSs for reference. The document can be accessed at: http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Audit/2011Publications/cn_audit_HKFRS_PrivateEntitiesPocket_280411.pdf.

13. The Institute's Standard Setting Department has also produced a high level comparison between HKFRS for Private Entities and SME-FRF&FRS for users' reference. The document can be accessed at: http://www.hkicpa.org.hk/file/media/section6_standards/standards/hkfrs-pe-info-center/other-ts/2010/hlv-pe-sme-fdf-frs.pdf.

14. Please refer to the Institute's Statement of Intent on the issuance of HKFRS for Private Entities for further information on the reasons behind the issuance of HKFRS for Private Entities as a financial reporting option in Hong Kong. The document can be accessed at: http://www.hkicpa.org.hk/file/media/section6_standards/standards/hkfrs-pe-info-center/stat-intent.pdf

Annex
Appendix 1

SME-FRS Fact Sheet

Fair presentation

Compliance with SME-FRS would not result in financial statements giving a true and fair view as SME-FRS is only a cost based model and therefore not robust enough to be classified as a fair presentation framework. This is suitable for small micro companies but not medium or larger sized private companies.

Financial instruments

SME-FRS does not contain separate section on financial assets and financial liability. Only forward contracts are addressed under Section 15 *The Effects of Changes in Foreign Exchange Rates* of SME-FRS. Accordingly, if a company enters into a transaction related to derivative or other complex financial instruments, SME-FRS does not contain the relevant accounting or disclosure requirements. Therefore if a large company with complex transactions uses the SME-FRS, a lot of the transactions will not be properly accounted for under SME-FRS.

Long-term investments

SME-FRS adopts the cost less accumulated impairment losses for long-term investments only (investments in associates and interests in joint ventures), whereas equity method and proportionate consolidation (for joint ventures only) are required under HKFRS.

Investment property/property, plant and equipment/intangible assets

SME-FRS only allows cost-depreciation-impairment model for investment property, property, plant and equipment and intangible assets whereas HKFRS permits fair value model for investment property and revaluation model for property, plant and equipment and intangible assets.

Borrowing costs

SME-FRS allows (but not mandatorily require) capitalisation of borrowing cost at preparer's discretion, whereas HKFRS mandatorily require capitalise of borrowing cost directly attributable to the acquisition, construction or production of a qualifying asset.

Other omitted topics

SME-FRS is silent in the accounting for the following:

- Share-based payment
- Employee benefits
- Deferred taxation
- No distinction between functional and presentation currency
- Hyperinflation
- Lessor accounting
- Specialized activities – agricultural activities, extractive activities and service concession arrangements

Comparison with other jurisdictions

Singapore

1. 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.

2. 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 **<u>S$10M (approximately HK$61.7M)</u>**;
- Total gross assets of not more than **<u>S$10M (approximately HK$61.7M)</u>**; and
- Number of employees not more than **<u>50</u>**.

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

3. 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:

<u>Companies other than small companies</u>

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

4. 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 Mifld 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.

5. 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

6. 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.

7. 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.

8. 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.

9. 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.