

Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard

The Questions and Answers (Q&As) below are developed by the GAAP for Small Businesses Working Group (Working Group) and the SME Financial Reporting Framework Sub-Committee (which replaced the Working Group as from May 2006) of the Institute. They should be read in conjunction with the Small and Medium-sized Entity Financial Reporting Framework (SME-FRF) and Financial Reporting Standard (SME-FRS).

This set of Q&As addresses some of the common issues on the application of the SME-FRF and SME-FRS.

The Institute welcomes your comments and feedback, which should be sent to commentletters@hkiicpa.org.hk, for the attention of Patricia McBride, Standard Setting.

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Q1: Can a Hong Kong incorporated company with subsidiaries apply the SME-FRS in preparing its financial statements?

A1: Pursuant to paragraph 16 of the SME-FRF, a company incorporated under the Companies Ordinance qualifies for reporting under the SME-FRF and therefore can apply the SME-FRS in preparing its financial statements if it satisfies the criteria set out in section 141D of that Ordinance. In accordance with section 141D(3)(a) of the Companies Ordinance, section 141D does not apply to a private company which has any subsidiary or is a subsidiary of another company formed and registered under the Companies Ordinance or an existing company. Therefore, a Hong Kong incorporated company with subsidiaries cannot apply the SME-FRS in preparing its financial statements.

Q2: Can a Hong Kong incorporated company with local/overseas investments (not considered as subsidiaries under the Companies Ordinance) apply the SME-FRS in preparing its financial statements?

A2: The Companies Ordinance does not preclude a company with local/overseas investments (not considered as subsidiaries under the Companies Ordinance) from applying section 141D of the Companies Ordinance in preparing its financial statements if it satisfies the criteria set out in section 141D, and accordingly such a company can apply the SME-FRS in preparing its financial statements.

Q3: Can a holding company incorporated outside Hong Kong with subsidiaries apply the SME-FRS in preparing its separate financial statements?

A3: A Company incorporated outside Hong Kong is not bound by the Companies Ordinance and should prepare its separate financial statements in accordance with the requirements imposed by the law of its place of incorporation. Pursuant to paragraph 17 of the SME-FRF, such an entity qualifies for reporting under the SME-FRF, subject to any specific requirements imposed by its place of incorporation and its constitution, when the entity does not have public accountability and all of its owners agree to prepare the financial statements in accordance with the SME-FRS and the entity is considered to be an SME in terms of its size under paragraph 24 of the SME-FRF.

Q4: Can a subsidiary or an intermediate holding company of a listed entity (an entity whose equity or debt securities are publicly traded) apply the SME-FRS in preparing its separate financial statements?

A4: Pursuant to paragraph 18 of the SME-FRF, an entity which is a subsidiary or an intermediate holding company of an entity qualifies for reporting under the SME-FRF for its separate financial statements if it also satisfies all the conditions set out in paragraph 17, that is,

- (i) the subsidiary / intermediate holding company is incorporated outside Hong Kong and the law of an entity's place of incorporation and its constitution do not prohibit the entity from preparing financial statements in accordance with the SME-FRS;
- (ii) the subsidiary / intermediate holding company does not have public accountability as defined under paragraphs 22 – 23 of the SME-FRF;
- (iii) all of its owners agree to prepare the financial statements in accordance with the SME-FRS; and
- (iv) the subsidiary / intermediate holding company is considered to be an SME in terms of its size under paragraph 24 of the SME-FRF.

Q5: Can a company apply the SME-FRS in preparing its financial statements if one of its owners' consent cannot be obtained?

A5: No. Unanimous consent has to be obtained for a company to apply the SME-FRS for the preparation of its financial statements.

Paragraph 16 of the SME-FRF specifies that a company incorporated under the Companies Ordinance qualifies for reporting under the SME-FRF if it satisfies the criteria set out in section 141D of the Companies Ordinance. Pursuant to section 141D(1) of the Companies Ordinance, a company applying section 141D should obtain agreement from all the shareholders of the company in writing that the financial statements of an entity are prepared in accordance with section 141D. This serves to protect the interests of the minority shareholders.

Similarly, pursuant to paragraph 17(b) of the SME-FRF, a non-Hong Kong incorporated company qualifies for reporting under the SME-FRF if all of its owners agree to prepare the financial statements in accordance with the SME-FRS.

Q6: *If a company does not qualify as an SME for the financial year ending 31 December 2005 and becomes an SME starting from the financial year ending 31 December 2006 and thereafter, when does the company start to qualify for reporting under the SME-FRF?*

A6: Pursuant to paragraph 20 of the SME-FRF, when an entity has not been considered to be an SME in terms of its size under paragraph 24 of the SME-FRF and subsequently becomes an SME, the entity will not qualify for reporting under the SME-FRF in terms of paragraph 17(b) of the SME-FRF until the entity has been determined to be an SME for two consecutive reporting periods. Accordingly, the company qualifies for reporting under the SME-FRF for its financial statements starting from the year ending 31 December 2008.

Q7: *If a company qualifies to be an SME for the financial year ending 31 December 2005 but is no longer an SME starting from the year ending 31 December 2006, when does the company cease to be qualified for reporting under the SME-FRF?*

A7: Pursuant to paragraph 21 of the SME-FRF, when an entity has previously qualified for reporting under the SME-FRF in terms of paragraph 17 of the SME-FRF, the entity will no longer qualify for reporting under the SME-FRF in terms of paragraph 17(b) of the SME-FRF until the entity is no longer an SME for two consecutive reporting periods. Accordingly, the company qualifies for reporting under the SME-FRF for the financial years ending 31 December 2006 and 2007 but has to transit to the HKFRS for its financial statements starting from the year ending 31 December 2008.

Q8: *For the purpose of the size test, should a company take into account the employees under a subcontracting agreement in determining the number of employees?*

A8: No. A company has to take into account the number of employees employed by itself only. "Employees" under a subcontracting agreement are not normally employees of the reporting company and therefore are not included in determining the size of an SME.

Q9: *If a company satisfies the qualifying criteria set out in the SME-FRF, is there a free choice for a company to select whether to prepare its financial statements in accordance with the SME-FRS or HKFRS?*

A9: Yes. A company qualifies for reporting under the SME-FRF has a free choice in preparing its financial statements either in accordance with the SME-FRS or HKFRS. However, a company whose financial statements comply with the SME-FRS should not be described as complying with HKFRS.

Q10: *How does a company transit from the SME-FRS to HKFRS when it no longer qualifies for reporting under the SME-FRF?*

A10: When a company no longer qualifies for reporting under the SME-FRF, it has to apply HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* for its first HKFRS financial statements.

Q11: If an entity, other than a company incorporated under the Companies Ordinance, qualifies as an SME for the financial year ending 31 December 2005, does it also need to satisfy the two years' rule as set out in paragraph 20 of the SME-FRF before it would qualify for reporting under the SME-FRF?

A11: No. An entity, other than a company incorporated under the Companies Ordinance qualifies for reporting under the SME-FRS if it satisfies all the criteria set out in paragraph 17 of the SME-FRF. Accordingly for an entity to qualify for reporting under the SME-FRS in the first financial period the SME-FRS becomes effective or is adopted before it becomes effective or on incorporation, it is not necessary to determine whether the entity was considered an SME for the previous two consecutive periods.

Q12: Based on the following data regarding the size of a non-Hong Kong incorporated entity, can the entity report under the SME-FRF in any of the years concerned?

YEAR	2005	2006	2007	2008	2009
Size	Not SME	SME	SME	Not SME	Not SME

A12: No. In year 2005, the entity does not satisfy the criteria under paragraph 17 of SME-FRF and thus cannot report under the SME-FRF. In years 2006 and 2007, the entity will not have been determined to be an SME for two consecutive reporting periods in accordance with paragraph 20 of SME-FRF and thus cannot report under the SME-FRF (see also Q6 and A6). In years 2008 and 2009, the entity will not satisfy the criteria under paragraph 17 of SME-FRF and therefore cannot report under the SME-FRF.

Q13: In the case where an overseas intermediate holding company does not meet the exemption for not preparing consolidated financial statements under HKAS 27 *Consolidated and Separate Financial Statements*, is there a need to make a qualification for failure to prepare consolidated financial statements in accordance with HKAS 27 in the auditor report of the individual financial statements prepared by the intermediate holding company using the SME-FRS?

A13: A qualification for failure to prepare consolidated financial statements in accordance with HKAS 27 need not be made in the auditor report of the individual financial statements of that overseas intermediate holding company applying the SME-FRS. This is because the financial statements prepared using the SME-FRS fall outside the scope of HKFRSs and thus are not required to comply with any HKFRS, including HKAS 27.

Q14: Can a Hong Kong incorporated company that has an investment in the PRC, which is under its control but does not meet the legal definition of subsidiary in the Companies Ordinance, apply the SME-FRS?

A14: A Hong Kong incorporated company that has a controlled entity but that entity does not meet the legal definition of subsidiary can still apply the SME-FRS. This is because that Hong Kong incorporated company would still satisfy the criteria for reporting under S141D of the Companies Ordinance by the reasoning of not having a legal subsidiary.