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

26 May 2008

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

HKICPA CONSULTATION PAPER ON FINANCIAL REPORTING BY PRIVATE COMPANIES

Comments to be received by 30 September 2008

The Hong Kong Institute of Certified Public Accountants' Council (Council) is seeking comments on the Consultation Paper which have been posted on the Institute's website at:
www.hkicpa.org.hk/professionaltechnical/accounting/exposuredraft/content.php.

The Council has become aware that the application of Hong Kong Financial Reporting Standards (HKFRSs) by many private companies imposes a reporting burden on those companies without a corresponding benefit in the increased usefulness of the information provided to the users of the financial statements of those companies. The Council also notes that many other jurisdictions adopting International Financial Reporting Standards limit their application to listed companies. The Council also considers that the present Rewrite of the Companies Ordinance being conducted by the government, together with the anticipated change to auditing standards extending the use of a "true and fair view" to financial reporting frameworks other than HKFRSs provides an ideal opportunity to address concerns of preparers and users of financial statements. Accordingly, this Consultation Paper is seeking views as to whether the reporting burden on private companies should be reduced by introducing a financial reporting framework for large private companies.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the Consultation Paper to be considered, they are requested to be received by the Institute on or before **30 September 2008.**

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.

May 2008
Consultation Paper

Response Due Date
30 September 2008

Consultation Paper

Financial Reporting by Private Companies

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

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The Exposure Draft can also be found on the HKICPA's website at:
http://www.hkicpa.org.hk/professionaltechnical/accounting/exposuredraft/content.php

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

CONSULTATION PAPER
FINANCIAL REPORTING BY PRIVATE COMPANIES

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Consultation Paper: Financial Reporting by Private Companies

A. INTRODUCTION

1. Hong Kong Financial Reporting Standards (HKFRSs) have been fully converged with International Financial Reporting Standards (IFRSs) for annual reporting periods commencing 1 January 2005. Since that time, Hong Kong has had two frameworks for financial reporting:

   (a) HKFRSs which apply to the majority of entities preparing financial statements; and

   (b) Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (SME-FRF&FRS) which may be applied by Hong Kong incorporated companies eligible for reporting relief under section 141D of the Companies Ordinance and by other entities that meet the eligibility requirements in the SME-FRF.

2. The Council of the Hong Kong Institute of Certified Public Accountants has become aware that the application of HKFRSs by many private companies imposes a reporting burden on those companies without a corresponding benefit in the increased usefulness of the information provided to the users of the financial statements of those companies. The Council also notes that many other jurisdictions adopting IFRSs limit their application to listed companies. The Council also considers that the present Rewrite of the Companies Ordinance being conducted by the government, together with the anticipated change to auditing standards extending the use of a "true and fair view" to financial reporting frameworks other than HKFRSs provides an ideal opportunity to address concerns of preparers and users of financial statements.

3. The primary purpose of financial statements is to provide information that meets the needs of the users of those financial statements. In the case of listed companies, key users of financial statements are relatively easy to identify and include investors, potential investors, financial institutions and analysts. In the case of private companies, financial statements are not publicly filed. The Companies Ordinance requires the preparation of financial statements as a protection for members especially minority interests. As a result, the key users of private company financial statements are the Inland Revenue Department, providers of funding such as financial institutions and members who are not involved in the day-to-day management of the company.

4. This Consultation Paper is seeking views as to whether the reporting burden on private companies should be reduced. Any change in reporting requirements will affect preparers, auditors and users of financial statements, and so the Council is actively seeking their views on the proposals contained in this Consultation Paper. In particular, the Council is seeking the views of:

   (a) *preparers* of financial statements as to whether a fuller menu of reporting options will create opportunities for them to reduce costs without reducing the usefulness of their financial statements;

   (b) *auditors* of financial statements as to the impact on their practices; and

   (c) *users* of financial statements as to whether the proposals meet their information needs.

B. STRENGTHS AND WEAKNESSES OF HKFRSs AND SME-FRF&FRS

HKFRSs

5. HKFRSs are fully converged with IFRSs. The first of the objectives for IFRSs identified in the International Accounting Standards Board's (IASB) "Preface to IFRSs" is:

> "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions." (paragraph 6(a)).

6. By applying high quality financial reporting standards, entities present high quality comparable financial information which helps in improving the efficiency of the economy as all participants in the market have access to transparent information as a basis for making informed decisions. Uncertainties or ambiguities can be reduced, thereby potentially reducing an entity's cost of capital.

7. As a major financial centre, Hong Kong obtains significant benefits in applying a global set of financial reporting standards as it enhances comparability of financial information across borders and reduces international compliance costs.

8. However, IFRSs (and HKFRSs) are primarily geared towards the needs of users of the financial statements of listed entities and inevitably, they

   (a) *are complex*, because they need to properly represent the complexity of transactions undertaken by the very large entities issuing securities in the international capital markets. In addition, some standards contain very detailed requirements and the impact only becomes apparent when they are applied;

   (b) *change frequently and become increasingly more complex* because new types of transactions continue to arise and existing types of transactions change. As well as adding new standards, improvements to existing standards may be necessary as new transactions identify weaknesses or inconsistencies in existing standards;

   (c) *do not address issues specific to Hong Kong* because they are designed to suit all jurisdictions and therefore cannot consider only the needs of a single jurisdiction such as Hong Kong;

   (d) *are designed for highly sophisticated investors* operating in the global capital markets and, therefore, may not meet the needs of other users of financial statements. For example, fair values may be more relevant to investors who have no relationship with the management of a company than to owners who are involved in the management of the company; and

   (e) *require significant disclosures* that are beyond the needs of users of private company financial statements.

SME-FRF&FRS

9. The SME-FRF&FRS may be used by:

   (a) companies incorporated in Hong Kong under the Companies Ordinance that meet the conditions specified in section 141D and elect to prepare financial statements showing a true and correct view; and

   (b) entities other than companies incorporated in Hong Kong under the Companies Ordinance that meet the conditions in the SME-FRF and elect to prepare financial statements in accordance with the SME-FRF&FRS.

10. The SME-FRF&FRS was developed to address issues specific to Hong Kong, in particular, small and medium-sized entities are normally simple in operation and owner-managed and the users have different information needs of their financial statements.

11. The most pervasive limitation on the application of section 141D of the Companies Ordinance by a private company is that the Companies Ordinance does not extend the reporting relief to a private company with a subsidiary or a parent company incorporated under the Companies Ordinance. Many Hong Kong incorporated companies are part of a group structure and are thus not eligible for simplified reporting under the Companies Ordinance.

12. The SME-FRF&FRS may be applied by any entity, other than a Hong Kong incorporated company, provided that the company:

   (a) does not have public accountability, which means in this context that it has not issued publicly traded securities and is not regulated by the Banking Ordinance, the Insurance Companies Ordinance or the Securities and Futures Ordinance;

   (b) all of its owners agree to the application of the SME-FRF&FRS; and

   (c) the company meets the specified size criteria.

13. Because the Companies Ordinance and the SME-FRF provide different bases for applying the SME-FRF&FRS, a large private Hong Kong incorporated company that is not part of a Hong Kong incorporated group may apply the SME-FRF&FRS while other entities are restricted by the size test. This anomaly is expected to be addressed as an outcome of this consultation and the Rewrite of the Companies Ordinance.

14. The present version of the SME-FRS is a single entity cost-based standard. As a result, the SME-FRS:

   (a) does not cater for groups, and any subsidiaries are recognised at the cost of the investment, potentially leading to under-reporting of the extent and nature of the assets and liabilities of a group. Similarly, associates and joint ventures are recognised on the cost basis. The Council has developed an exposure draft to address these issues; and

(b) is unable to provide information about current values where the cost of a transaction does not reflect the risks and rewards / rights and obligations embodied in that transaction. This particularly applies to transactions including derivatives where the costs are frequently minimal or zero and may bear no relation to the benefits and risks embodied in the transaction.

Implications of the present arrangements

15. Diversity of organisational structures of private companies results in different information needs of users of financial statements. With the increasing complexity of business and increasing demands of the capital markets for transparent financial information, the number and complexity of financial reporting standards have increased significantly over the years. Complex financial reporting standards are sometimes necessary to achieve a fair presentation of the transactions and events that businesses become involved with, especially in the case of complex transactions.

16. The application of the two existing frameworks has the effect that companies may now be applying inappropriate frameworks for their operations or providing less useful information for users of their financial statements.

17. Under SME-FRS, it is possible that a private company incorporated in Hong Kong with sophisticated transactions, including extensive amounts of open positions of derivatives, could report to its members and other parties interested in its financial position using a simple cost-based model. This would not provide the information that an investor or other provider of funding would need in order to make informed decisions. It also prevents companies from measuring items at fair value, (e.g. investment properties and financial assets must be recognised at cost) despite many considering that, in certain circumstances, fair value provides more relevant information to users and better reflects economic reality.

18. In contrast, a simple company holding an investment in its subsidiary is required to apply full HKFRSs. As a result, comprehensive disclosures in the financial statements may be of little or no value to the users of its financial statements.

C. THE OPPORTUNITY FOR CHANGE

19. Three developments have come together at this time to enable a review of the present position:

(a) the Government of the Hong Kong Special Administrative Region is reviewing the Companies Ordinance and considering changes to the present section 141D regime;

(b) the IAASB issued an Exposure Draft on ISA 800 (Revised and Redrafted) "Special Considerations – Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" that allow an auditor to give a "presents fairly" view on reports on financial statements prepared in accordance with a comprehensive basis of accounting other than IFRS (or HKFRS); and

(c) the IASB has issued an Exposure Draft of a proposed IFRS for SMEs that may provide an appropriate solution to financial reporting by some or all private companies.

20. With regard to the first development, in March 2007 the Government issued a Consultation Paper under the Companies Ordinance Rewrite project entitled “Accounting and Auditing Provisions”. This Consultation Paper proposed changes to the qualifying criteria for applying section 141D which would enhance the accessibility of simplified reporting for private companies including:

    (a) removing the prohibition on companies that are part of a group being permitted to apply simplified reporting under section 141D;

    (b) permitting a small private company to apply the provisions of section 141D automatically without the need for shareholders’ approval; and

    (c) permitting large private companies, other than regulated companies such as those conducting banking, insurance, stock-broking and deposit-taking activities, to apply section 141D provided that at least 75 per cent of shareholders agree and no shareholders object.

21. With regard to the second development, consequential revisions to the Hong Kong Standards on Auditing to adopt the developments in International Standards on Auditing would support an auditor expressing an unqualified opinion that the financial statements give a true and fair view, even when those financial statements are prepared other than in accordance with HKFRSs, provided they are prepared in accordance with a specific comprehensive reporting framework that, amongst other characteristics, is designed to provide a fair presentation. The benefit of this change may be that companies will be able to prepare financial statements that provide the true and fair view required by the Companies Ordinance without needing to apply HKFRSs.

22. The third development is the Exposure Draft issued by the IASB regarding a proposed IFRS for SMEs. This proposed standard might provide a basis for reducing the reporting burden imposed on private companies as the proposed standard includes a number of simplifications to IFRSs. If the final IFRS for SMEs is deemed suitable for Hong Kong private companies, it could be adopted in Hong Kong exactly as developed by the IASB or it could be adapted for Hong Kong circumstances as the need for international convergence of financial reporting by private companies is less than that for listed companies.

D. SCOPING A SOLUTION

23. The Council, as issuer of financial reporting standards under the Professional Accountants Ordinance, questions whether all of the information financial reporting standards require under HKFRSs is relevant to users of private company financial statements. For example, fair values may be more relevant to investors who have no relationship to the management of the company than to owners who are involved in the management of the company. The Council questions whether it continues to be appropriate to burden private companies that are accountable to only a few users with the extensive financial reporting requirements designed primarily for listed companies. The Council is also aware that concern is raised as to whether smaller private companies face disproportionately high compliance costs relative to larger companies.

24. The Council takes the view that some reporting relief should be made available to these companies.

> ***Question 1***
>
> *Do you agree that relief from applying full HKFRSs should be permitted for private companies? Please explain your reasons.*

25. Based on the Council's view that some reporting relief should be available, the next issue to consider is whether all private companies should apply the same set of financial reporting standards.

26. Small private companies are frequently owner-managed and their operations are generally very simple. In the case of the majority of small private companies, their financial statements are used as the basis for reporting to the Inland Revenue Department and supporting borrowings from financial institutions. Their financial statements may be less relevant to the equity holders of the company as the owners of a small private company are frequently closely involved with the company's operations and do not use the financial statements in understanding the operations of the company or in determining their investment strategy in relation to the business.

27. The Council takes the view that the SME-FRF&FRS meets the reporting requirements of most small private individual companies. Further, the Council takes the view that the SME-FRF&FRS is able to meet the reporting requirements of most small private groups of companies. Accordingly, the Council has decided that the SME-FRF&FRS should be amended so that small groups of companies that satisfy the eligibility requirements are able to prepare consolidated financial statements in accordance with the SME-FRF&FRS and to provide specific requirements related to the measurement of associates and joint ventures. An exposure draft on this has already been developed for consultation. These proposed amendments to the SME-FRF&FRS will also support the government's consultation in relation to extending the application of section 141D of the Companies Ordinance to small private groups.

> ***Question 2***
>
> *Do you agree that the SME-FRF&FRS is an appropriate reporting option for small private companies and groups? Please explain your reasons.*

Large Private Company Reporting Framework

28. This then leaves as the key question the appropriate reporting framework for large private companies. The Council is proposing a consultation addressing the possible frameworks (or combinations of frameworks) if respondents to this consultation support the development of a large private company reporting framework. The most likely options for a large private company reporting framework are:

    (a) HKFRSs;

    (b) SME-FRF&FRS; or

    (c) Large private company framework.

HKFRSs

29. The benefit of retaining HKFRSs for large private companies is that preparers, users and auditors are already familiar to some extent with the standards as they have put extensive resources into developing the skills to understand and apply the standards. However, continuing to require large private companies to apply HKFRSs means that large private companies will:

    (a) continue to apply increasingly complex standards such as HKAS 12 *Income Taxes* where the information may be of little value to users of their financial statements;

    (b) be exposed to the increasing disclosure demands of HKFRSs, such as the introduction of HKFRS 7 *Financial Instruments: Disclosures* for the 2007 reporting season;

    (c) need to remain alert to frequent changes to HKFRSs, which are likely to increase the complexity of HKFRSs as large listed companies develop more complex transactions;

    (d) continue to incur the cost of engaging qualified professionals to prepare their financial statements; and

    (e) incur additional time and cost to access the necessary training to cope with the increasingly complex and voluminous requirements of HKFRSs.

30. The Council is of the view that large private companies should be provided with a choice of a simpler reporting option. That is, the Council is not proposing a mandatory transition to a different reporting framework. Council's proposal is that large private companies should be given a choice of reporting frameworks from which one will be selected that suits the needs of users of their financial statements.

Question 3

Do you agree that large private companies should be provided with an option to choose a simpler reporting framework than HKFRSs? Please explain the reasons for your view.

SME-FRF&FRS

31. A solution to providing large private companies with a simpler reporting option is to allow them to apply the SME-FRF&FRS.

32. The SME-FRF&FRS is a simple framework and standard specifically designed to meet the reporting needs of users of the financial statements of small private companies. As a result, it may not meet the needs of users of financial statements of large private companies (including Inland Revenue Department, supplier of funds and minority shareholders) without some enhancement to address the more complex transactions undertaken by larger private companies. For example, relevant enhancements may include:

    (a) requiring derivatives to be measured at fair value where cost does not adequately convey the benefits and obligations impounded in each derivative (such a change would require a change to the fundamental principles embodied in the SME-FRF&FRS);

(b) creating detailed requirements for the recognition and measurement of employee benefits and share-based payment; and

(c) providing significant amounts of additional guidance to assist in the application of the principles in the SME-FRF&FRS to more complex situations (which would remove the simplicity that is a cornerstone of the way in which the SME-FRF&FRS is written).

33. Increasing the requirements and length and complexity of the SME-FRF&FRS may have the effect of transferring an excessive reporting burden from large private companies to small private companies. That is, enhancing the SME-FRF&FRS so that it meets the needs of large private companies may have the unintended consequence of making it less user-friendly for small private companies, which is the market it was originally designed to serve.

34. As a result, the Council is of the view that:

(a) the SME-FRF&FRS does not meet the reporting needs of the users of the financial statements of large private companies; and

(b) the SME-FRF&FRS should not be expanded to meet those needs.

Question 4

Do you agree with the view of Council stated in paragraph 34 above? If not, why not?

Large private company framework

35. HKFRSs are complex and voluminous, demand increasingly more disclosures and are subject to frequent change. This is considered a burden for many large private companies. On the other hand, the SME-FRF&FRS is too simple. Accordingly, it is considered that a large private company framework is the appropriate solution.

36. A large private company financial reporting framework should have the following characteristics:

(a) *stability* so that the standard(s) changes no more frequently than every two years, thus providing a stable platform, in comparison with HKFRSs where changes occur frequently;

(b) *simple* to understand and apply, so that the information appropriately meets the needs of users of financial statements without including the degree of complexity that is appropriate for large listed companies; and

(c) *address issues specific to Hong Kong* and focus on transactions commonly undertaken by large private companies in Hong Kong.

37. Possible approaches to developing financial reporting standards for large private company include:

    (a) HKFRSs with reduced disclosures;

    (b) IFRS for SMEs; and

    (c) IFRS for SMEs with additional simplifications such as simplifying the proposed requirements for recognition of deferred tax.

38. Using HKFRSs with reduced disclosures has the benefit that large private companies will apply the same recognition and measurement requirements as listed companies, thus providing a direct link to full HKFRSs. This may suit those companies that are planning to move towards a listing, as they will become familiar with HKFRSs without the disclosure burdens. It may also suit large private companies that are subsidiaries of companies applying HKFRSs, as their figures can be included in the group financial statements without adjustments. However, this will provide little benefit for private companies that do not fall into either of those two categories, and it is proposed that any private company could continue to elect to apply HKFRSs.

39. Applying the IFRS for SMEs will provide a simple route for issuing and updating the standard. However, the suitability of this approach cannot be finally determined until the draft IFRS for SMEs is finalized by the IASB.

40. Amending and simplifying the final version of IFRS for SMEs will enable Hong Kong to develop a solution that is fully tailored to Hong Kong's needs. It will demand considerable input from all parties involved in financial reporting to ensure that the standard most suited to Hong Kong's needs is developed and maintained. This will require a large commitment on the part of preparers and auditors in commenting on the practicality of proposals and users of financial statements in commenting on the usefulness of the proposals.

41. The Council is of the view that the Institute should adopt or develop a large private company financial reporting standard. If this is the view of the reporting community in Hong Kong, further consultation will address the nature of such a standard.

Question 5

Do you agree that the Institute should adopt or develop a large private company financial reporting framework? Do you have a preliminary view as to which of the above options is appropriate? Please explain your views.

E. LARGE PRIVATE COMPANY FRAMEWORKS - IMPLICATIONS

42. The Council is proposing the following framework for private company reporting:

    (a) large private companies can select either HKFRSs or a large private company standard; and

    (b) small private companies can select either HKFRSs or a large private company standard or SME-FRF&FRS.

43. The implications of the reporting model differ between preparers, auditors and users of financial statements.

(a) *Preparers* will need to make a selection of the framework that is appropriate in their circumstances. They will then retain this framework until either their circumstances change (for example, a small company has become large and remained large for over two years in which case it may no longer qualify for reporting under SME-FRF&FRS) or they elect to change their framework (for example, a large private company is preparing for listing and elects to move to HKFRSs).

(b) *Auditors* will need to become familiar with the range of frameworks selected by their clients. It is likely that practitioners will be required to equip themselves with all three frameworks as they may have clients applying all of them.

(c) *Users* of company financial statements with interests in a range of companies may find that they need to develop familiarity in all three frameworks. This is unlikely to be a problem because large users such as the Inland Revenue Department and financial institutions are likely to have the depth of expertise to understand the frameworks relevant to their needs. However, shareholders may need to have some knowledge of all three frameworks in order to choose the appropriate one for their companies.

44. The Council is interested to hear from constituents as to the effect on them of adopting the proposed large private company framework.

Question 6

Please identify whether you use financial statements as a preparer, auditor and/or user and the effect on you in all of these cases of the proposed introduction of a large private company framework.