CONSULTATION DRAFT

SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING FRAMEWORK (SME-FRF)

Scope

1. This Small and Medium-sized Entity Financial Reporting Framework (SME-FRF) sets out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS).

Users

2. Users of financial statements generally include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and, in some cases, the public. For SMEs, the most significant users are likely to be owners, government and creditors, who may have the power to obtain information additional to that contained in the financial statements. Management is also interested in the information contained in the financial statements, even though it has access to additional management and financial information.

Objectives

3. The objective of financial statements is to provide information about the financial position and performance of an entity that is useful to users of such information. Financial statements show the results of management's stewardship of and accountability for the resources entrusted to them.

Underlying assumptions

4. Financial statements are prepared on the accrual basis of accounting. They are normally prepared on the assumption that an entity is a going concern that will continue to operate for at least the foreseeable future.

Qualitative characteristics

5. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal characteristics are:

a. Understandability: It is essential that information provided in financial statements be readily understandable by users.

b. Relevance: To be useful, information must be relevant to the needs of users. The relevance of information is affected by its nature and materiality.

c. Reliability: Information is reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it is said to represent. In assessing reliability, substance over form, prudence, neutrality and completeness are also considered.

d. Comparability: Users must be able to compare the financial statements of an entity over time in order to identify trends in the entity's financial position and performance.

6. Constraints: The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Preparers and users of financial statements should be aware of this constraint.

7. In practice, trade-offs between qualitative characteristics are often necessary. Determining the relative importance of the characteristics in different cases is a matter of professional judgement.

Elements

8. An "asset" is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

9. A "liability" is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

10. "Equity" is the residual interest in the assets of the entity after all its liabilities have been deducted.

11. "Income" encompasses both revenue and gains. It includes increases in economic benefits during the accounting period in the form of inflows or enhancements of assets as well as decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

12. "Expenses" encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses are decreases in economic benefits.

Recognition

13. An item that meets the definition of an element should be recognised if (a) it is probable that any future economic benefit associated with the item will flow to or from the entity, and (b) the item has a cost or value that can be measured with reliability.

Measurement

14. The measurement base most commonly adopted by entities in preparing their financial statements is historical cost. This may be combined with other measurement bases for certain specific items, as referred to in the SME-FRS (for example, in Section 13 on the Effects of Changes in Foreign Exchange Rates).

15. Under the historical cost convention:

    a. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition; and

    b. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

    Assets should not be revalued nor should future cash flows be discounted in the measurement of assets and liabilities except when required or permitted by the SME-FRS.

Qualifying entities

16. An entity, other than a company incorporated under the Hong Kong Companies Ordinance, subject to any specific requirements imposed by the law or the entity's constitution, qualifies for reporting under this Framework (a qualifying entity) when the entity does not have public accountability (paragraphs 20 - 21), and:

    a. All of its owners agree to prepare the financial statements in accordance with the SME-FRS; and

    b. The entity is "small" in terms of paragraph 22.

17. If the entity is a company incorporated under the Hong Kong Companies Ordinance the company will qualify for reporting under this Framework solely on the basis of satisfying the criteria set out in s.141D of that Ordinance. Compliance with this Framework and the SME-FRS is necessary in order for financial statements to give a "true and correct view" when a Hong Kong

company prepares its financial statements in accordance with s.141D of the Companies Ordinance.

18. When an entity has not been small in terms of paragraph 22 and subsequently becomes small, the entity will not qualify for reporting under this Framework in terms of paragraph 16b until the entity has been small for two consecutive reporting periods.

19. Where an entity has previously qualified for reporting under this Framework in terms of paragraph 16, the entity will no longer qualify for reporting under this Framework in terms of paragraph 16b until the entity is no longer small for two consecutive reporting periods. .

Public Accountability

20. An entity has public accountability for the purposes of this Framework if:

    a. At any time during the current or the preceding reporting period, the entity (whether in the public or the private sector) is an issuer of securities, that is, its equity or debt securities are publicly traded or it is in the process of issuing publicly traded equity or debt securities;

    b. The entity is an institution authorised under the Banking Ordinance;

    c. The entity is an insurer authorised under the Insurance Companies Ordinance; or

    d. The entity is a dealer and/or an investment adviser authorised under the Securities and Futures Ordinance.

21. An entity does not have public accountability, for the purposes of this Framework, solely by reason of receiving public funds from another entity that has the power to tax, rate or levy to obtain public funds.

Size

22. An entity is small if it does not exceed any two of the following:

    a. Total revenue of HK$50 million;

    b. Total assets of HK$50 million;

    c. 50 employees.

    For the purposes of the application of the size criteria the total revenue and total assets are determined after the application of the SME-FRS. The size criteria may be reviewed from time to time.

Effective date

23. This Framework becomes effective for a qualifying entity's financial statements that cover a period beginning on or after [1 January 2005]. Earlier application is encouraged.

24. On the first-time application of the SME-FRS the financial statements and comparatives should be prepared in full compliance with the SME-FRS, except to the extent that it is impracticable to do so. A reconciliation of the equity reported on first-time application of the SME-FRS to that reported under previous GAAP should be presented.

25. This Framework supersedes Paragraph 6 and Appendix 2 of Practice Note 600.2 *Audit Approach to Companies Applying Section 141D of the Companies Ordinance*.