

Comments on Consultation Paper on a Proposed Framework for Differential Reporting
Submitted by the Department of Accountancy of the The Hong Kong Polytechnic University

The Consultation Paper sets out the need for and provides an outline of a Framework for Differential Reporting in Hong Kong. The proposed framework is based on a benefit and cost approach which provides the justification to implement an integrated differential reporting system for small entities in Hong Kong. An Entity will enjoy differential reporting exemptions if it is not publicly accountable (as defined in the Consultation Paper) and it meets the laid down criteria in respect of separation of owners and governing body of an entity and its size. The Consultation Paper also provides a detailed description of full exemption, partial exemption from and full compliance with SSAPs under the proposed Framework.

With regard to the Consultation Paper, we have the following observations and comments:

1. In principle, it is agreed that Hong Kong should introduce Differential Reporting on the grounds of improving the cost-effectiveness of financial reporting for small entities in Hong Kong. We also agree that the cost-benefit criterion should be the major factor when considering and developing a Differential Reporting Framework for small entities in Hong Kong. We believe an integrated approach is also appropriate for Hong Kong as a full basis for differentiation would be costly to develop at this point of time given that the IASB has already embarked on some research in this area. Our overall view is that, regardless of whether a full basis or a differentiated basis will be finally adopted in Hong Kong, the proposed exemptions in terms of accounting disclosure and measurements should not be *substantially* at the expense of the true and fair view of financial statements for all types of entries of whatever size (**Issues 1 and 2 refer**).
2. The non-separation of owners and governing body is adopted as one of the criteria for the Differential Reporting exemption. The Consultation Paper proposed that at the balance sheet date, all of its owners are also members of its governing body.

It may be of concern that in some instances, the interest of the minority shareholders of an entity may be jeopardized because of the possible denial of access to financial information by the majority shareholders if Differential Reporting is adopted. Hence, it is suggested that the Canadian approach which requires the consent of all owners for the application of the Differential Reporting should be considered (**Issue 3 refers**).

3. We are of the view that differential reporting should be restricted solely to small

entities (**Issue 4 refers**).

4. For the purpose of showing a true and fair view of a groups operations and financial status, and to eliminate relevant inter-group dealings and unrealized profits for a group entity, small groups should continue to prepare consolidated financial statements as required by the Companies Ordinance. We are also concerned about the possibility that if no consolidation is required for small groups, entities may use subsidiaries to circumvent the revenue or asset criteria as laid down for claiming the Differential Reporting exemptions (**Issue 5 refers**)
5. We refer to paragraphs 24 and 25 on public accountability criteria. It is suggested that the entity giving out the public funds should be given an option to decide whether the entity receiving such funds should adopt differential reporting. Alternatively, the factor whether such funds is the main or significant source of cash inflows for a particular entity should be one of the criteria to determine the entity's public accountability status (**Issue 6 refers**).
6. The size test - In all the three developed countries referred to in the Consultation Paper, the threshold values for assets in the size test are double of the corresponding threshold values for revenue. This relativity is based on the rationale that the stream of revenue flow is measured over a year's period, while the stock of assets is just a snapshot at a certain point in time. For the vast majority of business entities, the former would be larger than the latter.

In the proposed framework, however, this relativity is not maintained on the grounds of 'high' property values in Hong Kong. However, this argument is shaky on at least two counts. First, it assumes that most, if not all, SMEs have property investments, which is yet to be established. Second, it slights the experience of the reference countries which are at a similar, if not more advanced, stage of economic development as Hong Kong and which have GDPs per capita comparable to that of Hong Kong.

In essence, under the current proposed size criteria, only the ones on revenue amount and employee number will have force. In other words, the asset value criterion will be redundant.

Furthermore, Paragraph 30 of proposed framework suggests that an entity is regarded as small if it does not exceed any two of three criteria: total revenue of \$50 million, total assets of \$50 million, and 50 employees. Paradoxically, an entity will be qualified as a small entity if it has just \$50 million assets and 50 employees, regardless of the fact that it earns total revenue of \$500 million or even more. In order to ensure that a more realistic size test applies, it is recommended that the entity should meet ALL the three size criteria and that the asset threshold can be lowered to a level that takes into account the usual asset and

revenue relativity in other jurisdictions and the recent asset devaluations as witnessed in the Hong Kong property market (**Issue 7 refers**)

7. We consider that differential reporting exemptions should apply immediately once an enterprise qualifies as a small entity. Regarding selective application of differential reporting exemptions, it is believed that selective application will give flexibility for entity to choose and disclose information to an extent that it considers relevant and useful to the readers of its financial statements, and hence it is more cost-effective. On other hand, the drawbacks of allowing flexibility is it will reduce the comparability of financial statements prepared by small entities. The alternative of adopting a mid-way approach is to propose and specify certain minimum exemptions that should be adopted altogether (**Issues 8 and 9 refers**)
8. Are the differential reporting exemptions in Appendix 1 of the framework appropriate? Our comments are:
 - a) All entities should prepare a cash flow statement. The present exemption criteria in SSAP 12 should be reviewed.
 - b) Relaxing of the measurement rule in respect of Deferred Tax Accounting

There is no justification provided in the Consultation Paper for the proposed relief of SMEs from deferred tax requirements. This is not just an issue of “simplification of measurement rules”, but rather a matter with implications for the true and fair view of financial statements.

Is it the position of the Working Group that a nil provision approach is appropriate for smaller enterprises? If so, what are the supporting reasons? Does the Working Group require that SMEs should adopt tax depreciation rates in order that deferred tax becomes negligible? If so, with an initial allowance of 60% and annual allowance of at least 10%, the depreciation charge for the first year of plant and machinery will be 70% or more. Will that be a fair reflection of the depreciation charge for most SMEs?

- c) Consideration may be given to more measurement simplifications, as allowed in the Canadian, New Zealand and UK systems (p. 7), which may have more significant impact on benefit and cost (**Issues 10 and 11**).

Prepared by:

Prof. Michael Firth, Dr. Stella Cho, Mr. Francis Lam and Dr. C.K. Ho
Department of Accountancy of the Hong Kong Polytechnic University
28 October 2002