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檔案號碼： HQ 502/141 pt. IV

File No.:

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Chief Executive & Registrar

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11 August 2004

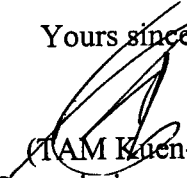
Dear Ms CHEUNG,

**Consultation Paper on
Proposed Introduction of a Financial Reporting Framework
for Small and Medium-sized Entities in Hong Kong**

Thank you for your letter of 18 May 2004.

Attached please find our comments on the above consultation paper for the Society's consideration.

Yours sincerely,


(TAM Kuen-chong)
for Commissioner of Inland Revenue

2004 AUG 14 AM 11:53

IRD'S RESPONSE TO THE SIX ISSUES RAISED IN THE CONSULTATION PAPER

Issue I - The need for a financial reporting framework for SMEs

We have no objection in principle for permitting SMEs to prepare financial statements on a basis different from main GAAP.

Issue 2 – The principles underlying SME financial reporting

We agree that it is difficult to measure the costs and benefits of financial reporting requirements. There is no objection in principle to simplify the measurement and disclosure requirements for SMEs. The historical cost measurement basis is acceptable to us. However, we are concerned that the simplification may go too far, in particular the disclosure requirements (e.g. related parties transactions and separate classification of assets and liabilities).

Issue 3 – Whether SME financial statements should give a true and fair view

At present, Hong Kong companies' financial statements prepared under s.141D of the Hong Kong Companies Ordinance need to give a "true and correct view". Such financial statements are all along acceptable for tax purposes. We therefore have no objection in principle that financial statements of SMEs do not give a "true and fair view".

Paragraph 4.3.4 of the Consultation Paper proposed that financial statements of SMEs should be "properly presented" (or words to that effect) "in accordance with the applicable financial reporting requirements" (the "third view"). We consider that this proposal may cause confusion to users. At present, we already have "true and fair view" (where s.141D does not apply) and "true and correct view" (where s.141D applies). The proposal will add one more view - the "third view".

"True and fair view" is a legal concept. In general the Courts would refer to the normal practices of professional accountants. We believe that the Courts would take the same approach for "true and correct view". Both expressions are not defined in

the Companies Ordinance. However it is generally accepted that in both cases the applicable accounting standards of the HKSA are the relevant tests. In our opinion, given s.141D will continue to exist (thus the legal requirement of "true and correct view" for s.141D companies remains), there is no need to have yet another view - the "third view". We suggest that SMEs (whether s.141D companies or not) should present "true and correct view" financial statements.

Furthermore, we would point out that paragraph 1.3 of the SME - FRS (i.e. financial statements *not* "having been prepared in accordance with accounting principles generally accepted in Hong Kong") may need further clarification in order not to create confusion to users. There may be doubt on whether a set of accounts not having been prepared in accordance with accounting principles generally accepted in Hong Kong would present a "true and correct view" in accordance with section 141D of the Companies Ordinance. There may also be doubt as to whether the profits shown in such an account is a proper determination of the taxable profits for the purposes of section 14 of the Inland Revenue Ordinance.

Issue 4 – Which entities should qualify under the SME-FRF

We agree with the definitions of "qualifying entities" in paragraphs 16 and 17 of the SME - FRF. However, with regard to the size criteria, we consider the ceilings of \$50 million total revenue and \$50 million total assets too high. As indicated in paragraph 4.4.2 of the Consultation Paper, more than 80% of Hong Kong entities may satisfy the \$50 million total revenue test. We would suggest a cautious approach. For example, the ceilings should be set at \$30 million at the beginning and revised (presumably upwards) a few years later.

We note that the size criteria will only apply to companies not incorporated under the Companies Ordinance. For companies incorporated under the Companies Ordinance, the criteria under section 141D will decide which company qualifies under the SME-FRF. Although size is not a criterion, section 141D excludes all group companies. Given this criterion remains, we are still satisfy the proposed scheme will contain the number of companies qualify for the SME-FRF. However, we learn from members of HKSA's working party in the recent meeting with us that there are proposal of amending section 141D by removing the group company limitation. If it were that case, companies satisfying the criteria of the revised section 141D will be substantially increased, and may cover large corporations that are not listed. This is certainly beyond the intended scope of setting up a framework for small and

medium-sized enterprises. Thus we are of the view that if the criterion that limits the group companies from qualifying for section 141D is removed or changed, there will be a need of introducing size as a criterion in determining the eligibility of locally incorporated companies adopting the accounting standards under SME-FRF.

Issue 5 – Statutory requirements applicable to SME financial reporting

We agree that s.141D of the Companies Ordinance should be retained. Regarding the proposed amendments to s.141D, our preliminary view is that, if the group restriction is removed, the criteria for qualifying entities (such as unanimous consent, size and lack of public accountability) should be applied on a group basis rather than on an individual company basis. Further, we do not see the need of changing the "true and correct view" requirement because practically it means the same thing as the "third view".

Issue 6 – Applicable financial requirements

The proposals in paragraphs 5.7 to 5.10 of the Consultation Papers are agreed, except that we suggest equity reconciliation be required not only on first-time application of the SME - FRS but also on subsequent applications (as free choice of adoption is allowed to SMEs).

OTHER ISSUES RAISED BY THE IRD ON THE FRAMEWORK

Transitional Arrangement

We think that when the new FRF and FRS for SME is implemented, qualifying companies will undergo a change in accounting practices from the GAAP to the so called "small GAAP". Even after the SME-FRF and FRS are adopted, from time to time there will be companies swapping from adopting GAAP to adopting "small GAAP" or vice versa due to the changes in option or circumstances. The swapping between the accounting practices will again give rise to transitional problems. There will be a need for some standard provisions dealing with transitional arrangements to be provided in the framework and statement to deal with the change.

Prior Period Adjustments

We are of the view that any prior period adjustments in respect of taxable items arising from the swapping of acceptable accounting practices (i.e. swapping from GAAP to “small GAAP” and vice versa in accordance with the SME-FRF and FRS) should be taken into account in the tax computation in the basis period in which the change takes place. This practice is in line with the case law (Pearse v Woodall-Duckham [1978] 51 TC 271).