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From: K. C. Tsang & Co.

Sent: Tuesday, August 31, 2004 3:44 PM

To: P.T. Comment Letter

Subject: SME-Comments on GSBWG's proposals

31 August 2004

To: Technical Director (Financial Reporting)
Hong Kong Society of Accountants

From: K.C. Tsang

Please refer to the attachment for the comments on GSBWG's proposals.

Rgds

30 August 2004

To: Technical Director (Financial Reporting)
Hong Kong Society of Accountants

From: K.C. Tsang

Re: Comments on GSBWD's proposals

Listed below are my comments concerning GSBWG's proposals. Please note that if the issue(s)/points in the issue(s) are not mentioned, it means no comments/in agreement.

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

- The size limits should not be used because public accountability is the most important factor. The draft document issued by ISAR does not have size limits, they should have the reasons behind. Please do consider their views.

- For simplicity and to avoid future complications of shifting between SME-FRS and full GAAP that may cause a lot of problems, the cancellation of the two limits of HK\$50 million re total revenue and totals assets is suggested. The two limits are fixed arbitrary figures, they have the shortfall of not taken into account of inflation and deflation ,and other relevant constantly changing factors *timely*. Although SME-FRF mentioned that the size criteria may be reviewed from time to time, the adjustment of the limits timely by objective means and the announcement of the adjusted limits at the right time is a difficult task practically. The two limits may place some SMEs in difficult positions (e.g. some SMEs of total revenue ranging from HK\$35 million to HK\$49 million at present may have the danger of exceeding HK\$50 million in the coming next two years because of inflation, or due to business fluctuations but that effect is not ongoing e.g. a popular movie such as “Star War” may create a sudden enormous demand for Star War toys, as a result, a trading firm of toys to U.S.A. as the main outlet may suddenly have turnover exceeding the HK\$50 million limit but this may only last for two consecutive years when the fever has gone. “Prior year adjustment” is always a painful and time consuming process because of the inherent difficulties in data collection and quantification, the two limits of HK\$50 million will place SMEs in the threat of undue shifting of application of full GAAP and SME-FRS, and hence the awful “prior year adjustment”.

- Paragrah 4.4.2 mentioned about the limit of 50 employees, but it does not make clear that 50 is at the end of an accounting period or an average number. If it is an average number, please specify a formula to calculate the average.

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

- Paragraph 4.4.2 mentioned that 87% of Hong Kong companies had total revenue of HK\$50 million or less, but do you have a statistics of how many companies are within the range of HK\$40 to HK\$50 million. If an limit has to be fixed, a higher limit should be determined instead of just HK\$50 million so as to give relief to those SMEs, say ranging from HK\$40 to HK\$49.99 million, the possibility of touching the HK\$50 million limit in one year, but drop below HK\$50 million in the next year due to *normal* business fluctuation from time to time.

- I don't understand why total assets should be fixed at HK\$50 million, the same as the revenue limit i.e. the turnover ratio of revenue to total assets = 1. Please consider whether it is a representative ratio for SMEs.

- Paragraph 4.4.2 does not give a clear definition of “total revenue”, does it mean normal business turnover + *irregular* revenue (e.g. the *gross or net* revenue from sale of property, plant and equipment, compensation obtained etc.) which may be substantial that can make a SME exceed the specified limit.

- Unanimity of owner agreement – referring to paragraph 4.4.3, please clarify whether the unanimous agreement is required to be agreed upon *every year*. Please compare that with the requirement of s.141D. Suggested that a standing agreement is valid, as this is more practicable and can avoid the accidental death, illness, insanity, sudden disappearance etc. of a minority shareholder than can spoil the whole lot.

Issue 1 – The need for a SME Financial Reporting Framework

“Do you consider that the draft SME-FRF that accompanies this paper to be adequate”:

- Financial Reporting Standard (SME-FRS) does not include “Sections” for:
 - a. Construction contracts - in fact, many SMEs in Hong Kong are subcontractors for construction works. What should be the accounting standard that should be adopted by SMEs to account for construction or other works that are similar in nature as that mentioned in SSAP 23 “Construction Contracts”.
 - b. Accounting for investment properties – same as in a. above, many SMEs in Hong Kong are property investment companies for rental income purpose. Should include a standard for clarification of accounting treatment that is equivalent to SSAP 13 “Accounting for investment properties”.

Issue 5 – Statutory requirements applicable to SME financial reporting

- Please also review the information required under the Companies Ordinance relating to “Report of the Directors” for companies applying s.141D. “Directors’ interests” need not be disclosed and that conflicts with Section 15 “Related-party disclosures”. S.141D also required that the agreement in writing by all the shareholders shall not be done with respect to *more than one financial year*. Please consider whether the mentioned areas require amendments.
- To clarify the meaning under paragraphs 5.6 and 4.5.5 “where the small group satisfied all the qualifying criteria specified in the SME-FRF”. It has the interpretation that if a holding company has 3 subsidiaries , then the limits for the small group are:

Total revenue of HK\$150 million;
Total assets of HK\$150 million; and
150 employees.

Issue 6 – Applicable financial reporting requirements

- *5.8 Hybrid of the two* – in some situations, it is permissible to apply hybrid of the two approach e.g. as mentioned under “issue 1” above, SME-FRS is silent about “Construction contracts” and “Accounting for investment properties” or in some other areas which may be of relevance. In such situation, a SME would have no other choice but to adopt a hybrid of the two approach. Furthermore, it is anticipated that the simplified approach of SME-FRS may have shortfalls under certain circumstances, the adoption of certain standards, if appropriate, under the full GAAP or a hybrid of the two approach may fill the gap and give a clearer view.
- *5.9 Consolidated financial statements applying main GAAP* - this will in breach of the original objective of cost: benefit as tremendous costs and efforts will be required in converting the financial statements of its subsidiaries into main GAAP. Very often, consolidated financial statements are required by bankers and to a lesser extent, by shareholders of the holding company because consolidated financial statements can eliminate inter-company unrealized profits, transactions and balances, and therefore can give an actual picture of the operating results and financial position of the SME group. For the purpose of elimination of inter-company profits, transactions and balances, a simplified approach should be adopted instead of the full GAAP. So, why not incorporate one more simplified version “Consolidated financial statements and accounting for investments in subsidiaries” under SME-FRS to satisfy the general purpose of SMEs.

Issue 6 – Applicable financial reporting requirements - Continued

- ***5.10 First adoption of the SME-FRS*** - with the cost: benefit always in mind, I suggest that the comparative figures need not be restated so as to give a special concession to SMEs in the first year of application. Instead, all the effects of prior year adjustments relating to the first-time application of SME-FRS to that reported under previous GAAP can be accounted for in the opening balance of retained profits and reserves, and explain, in simple terms, the nature and amounts involved in respect of each components that make up the total effect.
- ***5.11 Other comments on the contents of the draft SME-FRS***

Amendments and review of SME-FRS – unless there are significant loopholes, suggested that the SME-FRS should only be amended periodically, say for every 5 years. This can avoid causing undue nuisances and most important, the awful “prior year adjustment” to SMEs.

Section 15 “Related party disclosures” – many SMEs do not like the application of this standard as this can lead to disclosures of confidential information that are detrimental to their businesses, the usefulness of the application of this standard to SMEs is very much in doubt. Suggested that this standard can be bypassed if all the owners/shareholders have agreed in writing *every year* not to apply Section 15 in a financial year (i.e. not a standing agreement).

Owners of SMEs normally have full understanding of what is going on in their business concerning related parties, particularly if a company only has one shareholder and the directors is the same person. Please note that s.141D does not require the disclosure of directors’ interests. If not applying s.141D, disclosure requirement by the Companies Ordinance is only up to directors’ interests level and not the extensive requirements as required by Section 15. SSAP 20 only has a very short history, it only became standard for accounting periods beginning on or after 1 October 1997. Before that, a “true and fair” report could be absolutely issued even without its application. Besides, the usefulness of SSAP 20 is limited, as auditors need not form an opinion on whether the related party transactions are at market values, and the impact on the results of the financial statements if they are transacted at market values.

Auditors and owners of SMEs may feel very frustrated in doing something that is not meaningful, but this has to be done solely because of the existence of the inappropriate mandatory accounting standard.

In some cases, it is very difficult to identify and prove by auditors which transactions are in fact related party transactions, auditors have to depend on the fidelity of clients to make full disclosures. A practical point should also be noted that for many small enterprises, because of the education background of managements, they do not really understand the extensive definition meaning of related party, the dependence on their disclosures actually placed auditors at risk.

From the point of view of managements/owners of SMEs, the main objective of forming limited companies under the Companies Ordinance is to obtain the benefit of limited liabilities. To enjoy the right of limited liabilities, they are willing to perform the reciprocal duties imposed by the Companies Ordinance, but not to perform unnecessary works, incur unnecessary costs and make harmful disclosures concerning their businesses that can reasonably be bypassed.

Rgds