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7 November 2002

The Deputy Director
Hong Kong Society of Accountants
4th Floor, Tower Two, Lippo Centre
89 Queensway
Hong Kong

Dear Sir,

Consultation Paper on a Proposed Framework for Differential Reporting

We appreciate the opportunity to comment on the subject consultation paper. We set out our general comments in Part A below and our responses to the questions on pages 11 and 12 of the consultation paper in Part B below. The responses in Part B should be read in the context of the general comments.

Part A - General comments

We do not support the proposals and we consider that it would be undesirable for the Council to issue a Framework for Differential Reporting based on the draft contained in the consultation paper. We consider that the consultation paper has not demonstrated a strong need for differential reporting in Hong Kong. The consultation paper also does not indicate the extent of empirical research which has been carried out to support the various assumptions underpinning its proposals.

We note that "true and fair view" is a legal concept, however, we strongly believe that it would be inappropriate for the Society to promulgate a statement which attempts to establish that a "true and fair view" can be given by two different frameworks or sets of accounting principles which are inconsistent with each other in the recognition and measurement aspects. In addition, we consider that some disclosures, in particular those concerning related parties, are fundamental to giving a true and fair view regardless of the size of the company. In this respect, we consider that related party disclosures are essential for the truth and fairness (or fair presentation) of financial statements of "closely-held" companies. We would, therefore, oppose any moves to exempt small entities from the requirements of SSAP 20, "Related party disclosures".

We are also concerned at the apparent lack of representation of key user groups and regulatory authorities on the GAAP for Small Businesses Working Group. Any proposed fundamental changes to the system of reporting in Hong Kong such as these should be developed by the Society with significant participation of the Inland Revenue Department, the banking industry (from an accounts users perspective), the Companies Registry, and stakeholders in smaller businesses. These parties should be actively involved in the process and not merely as passive “consultees”.

Part B – Responses to specific questions in the consultation paper

1. Do you consider that there is a need for differential reporting in Hong Kong?

Although we do not rule out that there is potentially a need for differential reporting, we consider that the consultation paper has not provided sufficient evidence and arguments to support the introduction of differential reporting in Hong Kong. We recommend that formal empirical study be carried out in accordance with a rigorous and transparent research methodology to establish what the needs of users of financial statements of different kinds of entities are and what legislative and other changes might be appropriate to better meet those needs.

2. Do you consider that differential reporting should be based on a benefit: cost criterion?

We consider that a benefit: cost criterion should not be used to justify departures from the established recognition and measurement principles. However, provided that differential reporting only intends to simplify disclosures, we consider that the benefit: cost criterion is appropriate.

3. Do you consider that the following surrogates for the benefit: cost criterion are appropriate?

- (a) public accountability;*
- (b) separation of owners and governing body;*
- (c) size.*

As explained in our response to question 2 above, we consider that the benefit cost criterion is only appropriate for a differential reporting framework focusing solely on disclosures. On this basis, we consider that the three factors should be considered in the context of defining which entities could fall within this framework, but we do not consider that they can be treated as surrogates for the benefit: cost criterion.

4. Do you consider that access to differential reporting should not be restricted solely to small entities?

No. We consider that any differential reporting framework should be restricted to small entities only. The proposal of allowing certain large and medium sized owner-managed entities to take advantage of differential reporting ignores the needs of other stakeholders.

5. *Small groups, that are not otherwise publicly accountable, would still prepare consolidated financial statements because of legal requirement under the Companies Ordinance. Do you agree with this? Would you support the HKSA lobbying for a change in the law?*

We consider that financial statements of a small group will not give a true and fair view unless the subsidiaries are consolidated.

Regarding the point on changing the law, we consider that this question can only be answered after further empirical study of user needs.

6. *Do you consider the public accountability criteria detailed in paragraphs 24 and 25 are appropriate?*

No. We disagree with the rationale of paragraph 25. Surely any entity that receives substantial public funds should have public accountability?

7. *Do you consider that an entity should be deemed to be small if it does not exceed any two of the following criteria?*
(a) total revenue of %50 million;
(b) total assets of \$50 million;
(c) 50 employees.
(paragraph 30)

We consider that these thresholds are far too high and they are likely to include a very large number of substantial businesses. Further study is required.

8. *Do you consider that differential reporting exemptions should apply immediately if an enterprise qualifies on a basis other than that covered by paragraph 34?*

Yes.

9. *Do you support the selective application of differential reporting exemptions (paragraph 37) or, alternatively, should entities that choose differential reporting be required to apply all of the applicable exemptions and alternative treatments?*

No, we consider that any differential reporting framework should adopt an “all or nothing” approach.

In general terms, piecemeal compliance with accounting standards can lead to “cherry-picking” and is undesirable and open to abuse.

10. *Do you consider that the differential reporting exemptions appearing in Appendix 1 of the Framework are appropriate? Are there any other exemptions that should be considered for differential reporting purposes?*

As indicated in Part A above, we consider that many of the proposed exemptions are not appropriate if the accounts are expected to show a true and fair view. In particular, we do not agree with the proposals that modify or exempt entities from complying with recognition, measurement and presentation standards in existing SSAPs. We also do not agree with the proposed exemption from the requirements of SSAP 20, "Related party disclosures".

With regard to the other proposed disclosure exemptions, we would like to understand what criteria were used in selecting these. Presumably, it would be appropriate to apply some kind of cost/benefit analysis in deciding which disclosure requirements should be subject to exemptions and which should not. There is no indication in the consultation paper of what criteria have been considered in this analysis.

11. *At the present time, the HKSA Council would propose that differential reporting exemptions be set out within the main body of each SSAP (the integrated approach, similar to that adopted in Canada and New Zealand). Do you have any comment on that proposal?*

Although we agree in principle that any differential reporting exemptions should be set out within the main body of each SSAP (the integrated approach), we consider that this approach is only logical if the exemptions relate solely to disclosure aspects of the standards.

12. *Do you have any other comments on the Framework?*

Please refer to our general comments in Part A above. In addition, we recommend that the HKSA lobbies for a change in the law regarding the Section 141D exemption if it decides to move ahead with the differential reporting project.

We apologise for the late submission of our comments and trust that you will be able to give them due consideration. Should you have any questions concerning the above comments, please contact Paul F. Winkelmann at 2289 2900 or Tommy Fung at 2289 1829.

Yours faithfully

