CPA Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

30 November 2007

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft of a proposed *IFRS for Small and Medium-sized Entities*

The Hong Kong Institute of CPAs is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We believe that it is important to have a set of high quality standards for entities that do not have public accountability and support the IASB's initiative in developing a standard that takes into account the needs of the users of their financial statements and cost-benefit considerations.

Title of the proposed standard

We understand that it is the intention of the IASB that the proposed standard would be applicable to all entities that do not have public accountability regardless of the size of the entities. We therefore urge the IASB to consider retitling the proposed standard, such as "IFRS for Non-publicly Accountable Entities" or simply "IFRS for Private Entities", to better reflect its intended use. Although we strongly support a change of name for the proposed standard, we consider that any change to the identification of entities eligible to adopt the standard would warrant re-exposure.

Application to small entities

As the information needs of users differ for diverse range of entities that do not have public accountability, we doubt whether it is likely that a "one-size-fits-all" solution could be developed. We consider that the proposed standard should focus on, and be seen as focusing on, financial reporting by medium-sized entities that do not have public accountability and have external users of their financial statements. While appreciating that the Board has made significant progress in simplifying full IFRSs for use by entities without public accountability, we consider that the proposed standard is too complex for small entities.

We are in favour of a simple and brief set of accounting requirements for small entities, with broad principles of accrual basis accounting, specific recognition and measurement principles for basic transactions, and requiring only a balance sheet, an income statement and a cash flow statement with limited note disclosures; an approach which the IASB has rejected (see BC49). Our local feedback reveals that understandability and simplicity are

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of prime importance for users of financial statements of small entities. We therefore advocate the use of historical cost convention as the primary measurement base for standards that are intended to apply to small entities.

We have developed a financial reporting framework and standard for use by our small local entities . Small entities as defined in our SME Financial Reporting Framework enable over 80% of Hong Kong incorporated companies in terms of total revenue to utilise our SME Financial Reporting Standard. The local feedback expresses strong support of our local SME Financial Reporting Standard no matter how the proposed IFRS for SMEs is finalised. A copy of our local SME Financial Reporting Standard is available at: http://www.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/sme-frf&sme-frs.pdf.

--- In view of the above, our comments (see Appendix) on the 11 questions set out in the ED are prepared on the basis that the proposed standards are to be applied to entities which do not have public accountability and publish general purpose financial statements for external users, other than small entities. We acknowledge that, as stated in paragraph P13 of the ED, decisions on which entities are required or permitted to use the IASB's standards rest with national regulatory authorities and standard-setters. Our local feedback in fact does not support the adoption of the proposed IFRS for SMEs as it currently stands for entities falling below the size tests in our SME Financial Reporting Framework. Therefore, we are not planning to adopt the proposed standard for our small entities.

If you have any questions on our comments, please do not hesitate to contact me at patricia@hkicpa.org.hk.

Yours sincerely,

Patricia McBride

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Executive Director

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APPENDIX

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft
Proposed IFRS for Small and Medium-sized Entities

This Appendix to the submission is organised into two sections:
Part 1 – Responses to the specific questions raised in the Exposure Draft; and
Part 2 – Recommendations on matters not mentioned in specific questions.

Part 1 – Responses to the specific questions raised in the Exposure Draft

Q 1 – Stand-alone document

In deciding on the content of the proposed *IFRS for SMEs*, the IASB focused on the types of transactions and other events and conditions typically encountered by SMEs with about 50 employees. For such entities, the proposed IFRS is intended to be a stand-alone document, with minimal cross-references to full IFRSs.

With the objective of a stand-alone document in mind, are there additional transactions, other events or conditions that should be covered in the proposed standard to make it more self-contained? Conversely, is there guidance in the draft standard that should be removed because it is unlikely to be relevant to typical SMEs with about 50 employees?

We consider that the proposed IFRS for SMEs should be a complete standalone document, i.e. no fallback to full or specific topics in IFRSs and no cross-references to options available in IFRSs. To achieve the right balance between the size of the standard and ease of use, the IASB may consider incorporating the essential principles only into the proposed IFRS for SMEs.

Being a complete standalone document has a definite advantage in terms of the ease of use. Fallback or cross-reference to IFRSs will mean that users of the proposed standard will have to use full IFRSs, in addition to the proposed IFRS for SMEs. We consider that the proposed IFRS for SMEs should include all topics that are considered relevant to typical SMEs.

We do not find the IASB's notional 50 employees useful. In our experience, entities with large numbers of employees can conduct very simple transactions (especially in lesser-developed countries) whereas entities with very few employees can conduct very complex transactions. We have therefore disregarded any notion of "number of employees" in considering these issues.

<u>Q 2 – Recognition and measurement simplifications that the Board adopted</u>

The draft IFRS for SMEs was developed by:

(a) extracting the fundamental concepts from the IASB Framework and the principles and related mandatory guidance from full IFRSs (including Interpretations), and

(b) considering the modifications that are appropriate in the light of users' needs and cost-benefit considerations.

Paragraphs BC70 – BC93 of the Basis for Conclusions describe the simplifications of recognition and measurement principles contained in full IFRSs that have been made in the proposed *IFRS for SMEs* and explain the Board's reasoning.

Are there other recognition or measurement simplifications that the Board should consider? In responding, please indicate:

(a) the specific transactions, other events or conditions that create a specific recognition or measurement problem for SMEs under IFRSs;

(b) why it is a problem; and

(c) how that problem might be solved.

We welcome the recognition and measurement simplifications made in the proposed IFRS for SMEs. We suggest the IASB to consider further simplification as follows:

Section No. and Title	Problems and proposed solutions
11 Financial Assets and Financial Liabilities	• For hedge accounting, the proposed standards should make it clearer that it allows the use of the "short-cut method" whereby an entity assesses the prospective effectiveness of the hedge by comparing the critical terms of the hedging instrument and the hedged item at inception and is not required to perform any reassessment of effectiveness in subsequent periods. • The hedge accounting should also be extended to hedging instruments such as options and foreign currency assets/liabilities as they are very common hedging strategies adopted by SMEs. • Under section 11.7(c), equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably should be measured at cost less impairment. We suggest the cost approach should be extended to all non-quoted equities irrespective of whether the fair value can be measured reliably to save SMEs' valuation cost and reduce complexity.

Section No. and Title	Problems and proposed solutions
	• There is confusion on the determination of the impairment loss of equity instruments being measured at cost less impairment. According to paragraph 11.7, equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably shall be measured at cost less impairment. However, according to paragraph 11.22(b), the impairment loss for an instrument measured at cost shall be the difference between the asset's carrying amount and the asset's fair value. This is circular in that asking an entity to measure fair value in a situation where fair value cannot be measured is not possible. Even if this circularity is contained in full IFRSs, it should be removed from this standard.
17 Intangible Assets other than Goodwill & 18 Business Combinations and Goodwill	• SMEs should be allowed to amortise goodwill and all intangible assets as impairment testing requirements are complex and would come at a substantial cost for SMEs. We suggest exempting acquirers from the requirement to recognise all intangible assets held by the acquirers from the business combination since this may result in considerable additional valuation work being performed while the additional information may not be of great value to the financial statement users. We suggest that SMEs should be required to recognise intangible assets that were recognised as assets of the acquiree (other than goodwill) and permitted to recognise intangible assets that were previously internally generated and not recognised. • In applying the purchase method, the SMEs should be exempted from allocating the cost of a business combination by recognising the contingent liabilities at their fair value.
19 Leases	SMEs should be allowed to recognise a finance lease at a amount equal to the present value of the minimum lease payments, using their entities' own incremental borrowing rate as the applicable discount rate.

Section No. and Title	Problems and proposed solutions
26 Impairment of Non-financial Assets	Section 26 treats the recoverable amount as “selling price less costs to sell” whereas IAS 36 *Impairment of Assets* defines recoverable amount of an asset or a cash-generating unit as the higher of its fair value less costs to sell and its value in use. We suggest that the IAS 36 definition should be used. This is important where an enterprise plans to use an asset in a manner that is different from the market’s view of the best use, in particular where there is no deep and liquid market for the asset. The Basis for Conclusions on IAS 36 sets out the reasons for rejecting using either fair value or value in use as the only appropriate measurement for recoverable amount, which we would suggest the IASB to re-consider. The proposed treatment of using " selling price less costs to sell” as the recoverable amount is a more onerous requirement to apply in practice than the equivalent full-IFRS treatment as selling price less costs to sell can be more difficult to calculate than value in use and will require impairment to be recognised more frequently than under full IFRSs.
28 Income Taxes	This section does not include the initial recognition exemption in IAS 12.15(b) and IAS 12.24(b) where the taxable and deductible temporary differences arising from the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction affects neither accounting profit nor taxable profit are exempted from recognition. The lack of exemption under the proposed IFRS for SMEs would result in deferred tax being recognised in more situations than is required under IAS 12. In addition, such an arrangement would make the financial statements less transparent as mentioned in IAS 12.22(c). Accordingly, we suggest Section 25 includes the initial recognition exemption in paragraphs15(b) and 24(b) of IAS 12.
35 Specialised Industries	We consider that cost approach should be allowed in all cases where fair value is not determinable based on quoted prices so as to reduce costs for SMEs.

<u>Q 3 – Recognition and measurement simplifications that the Board considered but did not adopt</u>

Paragraphs BC94 – BC107 identify some recognition and measurement simplifications that the Board considered but decided not to adopt, for the reasons noted.

Should the Board reconsider any of those and, if so, why?

Section 28 *Income Taxes*

While not disagreeing that deferred taxes satisfy the requirements for recognition as assets and liabilities, we consider that further simplification in measurement is necessary. The requirements in Section 28 *Income Taxes* are too complex for SMEs.

Moreover, deferred tax is not a "real" tax receivable/payable in many cases (eg accelerated depreciation allowances). It is a recognition that the underlying asset or liability has particular characteristics (eg regarding future deductibility). However, the measurement does not take into account discounting. Accordingly, the balance sheet often does not measure the deferred tax or liability in a manner that makes intuitive sense. We consider that the benefits of the simplification from eliminating deferred tax outweighs the relevance of the number recognised under the proposed requirements. We are not convinced by the Board's conclusion as set out in BC102 that making a fundamental departure from the recognition principles in IAS 12 *Income Taxes* while requiring disclosure of the information that users of SMEs' financial statements find useful is not justified on a cost-benefit basis.

<u>Q 4 – Whether all accounting policy options in full IFRSs should be available to SMEs</u>

The draft *IFRS for SMEs* proposes that accounting policy options available under full IFRSs should generally also be available to SMEs. As explained more fully in paragraphs BC108 – BC115 of the Basis for Conclusions, the Board concluded that prohibiting SMEs from using an accounting policy option that is available to entities using full IFRSs could hinder comparability between SMEs and entities following full IFRSs. At the same time, the Board recognised that most SMEs are likely to prefer the simpler option in the proposed *IFRS for SMEs.* Therefore, the Board concluded that in six circumstances in which full IFRSs allow accounting policy options, the *IFRS for SMEs* should include only the simpler option, and the other (more complex) option(s) should be available to SMEs by cross-reference to the full IFRSs.

Do you agree with the Board's conclusions on which options are the most appropriate for SMEs? If not, which one(s) would you change, and why?

Should any of these options that would be available to SMEs by cross-reference to the full IFRSs be eliminated from the draft *IFRS for SMEs* and, if so, why?

In principle, we are of the view that financial reporting standards should not contain accounting policy options. However, since options are currently available in full IFRSs, we consider that the same options should also be available to preparers of SME financial statements. As discussed in our response to Question 1, for the proposed standard to be a stand-alone document, it is necessary to include all the options that are available in the body of the proposed standards. We therefore suggest that the options as referred to in BC 108 – BC 115 be added, i.e.

- Investment property – to add the fair value through profit or loss model
- Property, plant and equipment – to add the revaluation model
- Intangible assets – to add the revaluation model
- Presenting operating cash flows – to add the direct method
- Accounting for government grants – the capital approach, the income approach and all other approaches available under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- Borrowing cost – please refer to our response to Question 5

In addition, we also suggest that the following category/option be added:

- IAS 39 Financial Instruments: *Recognition and Measurement*
    - ➢ The "available-for-sale" financial asset category be added so that gain or loss arising from a change in the fair value of financial assets within the category can be recognised directly in equity. In this respect, we suggested that the IASB delete paragraph 11.1(b) and add the options/categories that are considered appropriate for use by SMEs to Section 11 instead such that the proposed IFRS for SMEs will be a standalone document.

- IAS 40 *Investment Property*
    - ➢ The option not to separately measure the land and building elements when the lessee's interest in both land and building is classified as an investment property and the fair value model is adopted.

While supporting including all the options in full IFRSs in IFRS for SMEs, we also consider it important that accounting treatments for transactions which have not yet been addressed by full IFRS should not be introduced. For example, paragraphs 9.21 – 9.22 addresses combined financial statements and paragraph 21.2 addresses unpaid share capital.

The problem with including treatments for items not addressed in full IFRS into the proposed IFRS for SMEs is that it effectively puts treatments for items not yet addressed in full IFRS into full IFRSs without due process. According to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 12, in the absence of a Standard or an Interpretation that specifically applies to a transaction, management shall use its judgement in developing and applying an accounting policy. In making the judgement, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards. This may imply that users of full IFRSs should follow the proposed IFRS for SMEs when developing its accounting policy since the proposed IFRS for SMEs is claimed to be developed from the IASB's conceptual framework and the principles of full IFRSs.

Q 5 – Borrowing costs

IAS 23 *Borrowing Costs* currently allows entities to choose either the expense model or the capitalisation model to account for all of their borrowing costs. In May 2006 the IASB published an Exposure Draft proposing to amend IAS 23 to prohibit the expense model and to require the capitalisation model. Section 24 *Borrowing Costs* of the draft *IFRS for SMEs* proposes to allow SMEs to choose either the expense model or the capitalisation model.

Do you agree or disagree with the proposal to allow SMEs to choose either the expense model or the capitalisation model for borrowing costs, and why?

As mentioned in our response to Q4, we consider that financial reporting standards should not contain accounting policy options. Since the expense model option is not currently available in full IFRSs, we do not consider it appropriate to introduce a "new" option in IFRS for SMEs.

Q 6 – Topics not addressed in the proposed *IFRS for SMEs*

Some topics addressed in full IFRSs are omitted from the draft *IFRS for SMEs* because the Board believes that typical SMEs are not likely to encounter such transactions or conditions. These are discussed in paragraphs BC57 – BC65 of the Basis for Conclusions. By a cross-reference, the draft standard requires SMEs that have such transactions to follow the relevant full IFRS.

Should any additional topics be omitted from the *IFRS for SMEs* and replaced by a cross-reference? If so, which ones and why?

As mentioned in Question 1, we do not support the idea of cross-referencing to full IFRSs. Topics that are considered generally relevant to SMEs should be included in the proposed standard. Where an entity encounters a transaction that is not specifically addressed in the proposed standards, it should follow the requirements in Section 10 for selecting an accounting policy.

We recommend that the following sections should be omitted entirely as they are not applicable to typical entities that do not have public accountability:

- Section 25 *Shared-based Payment*
- Section 29 *Financial Reporting in Hyperinflationary Economies*
- Section 31 *Segment Reporting*
- Section 34 *Earnings per Share*
- Section 37 *Interim Financial Reporting*

We recommend that Section 25 Share-based Payment should also be omitted because, based on our knowledge of private companies in Hong Kong and Mainland China, we understand that share-based payment is uncommon in this region.

<u>Q 7 – General referral to full IFRSs</u>

As noted in Question 1, the *IFRS for SMEs* is intended to be a stand-alone document for typical SMEs. It contains cross-references to particular full IFRSs in specific circumstances, including the accounting policy options referred to in Question 4 and the omitted topics referred to in Question 6. For other transactions, events or conditions not specifically addressed in the *IFRS for SMEs*, paragraphs 10.2 – 10.4 propose requirements for how the management of SMEs should decide on the appropriate accounting. Under those paragraphs, it is not mandatory for SMEs to look to full IFRSs for guidance.

Are the requirements in paragraphs 10.2 – 10.4, coupled with the explicit cross-references to particular IFRSs in specific circumstances, appropriate? Why or why not?

We agree with the hierarchy set out in the proposed IFRS for SMEs on what accounting policies should be used when there is no relevant guideline in the proposed standard. However, we do not agree to include explicit cross-references to particular IFRSs in the proposed IFRS for SMEs as mentioned in our response to Q1.

We understand that incorporating those standards and accounting options that are cross-referenced to IFRSs into the body of the proposed IFRS for SMEs will increase the volume of the SME standard. However, we would accept a slightly longer standard in the interests of having a complete standalone standard. In addition, we consider that it is possible for the IASB to substantially reduce the additional content through cutting out guidance not usually relevant to SMEs. For example, IAS 39 *Financial Instruments: Recognition and Measurement* has approximately 300 pages while the IASB has managed to reduce it to around 20 pages of simplified requirements in the IFRS for SMEs. We believe that if a balance is struck properly, the addition of the standards will not necessarily overload the proposed IFRS for SMEs.

<u>Q 8 – Adequacy of guidance</u>

The draft *IFRS for SMEs* is accompanied by some implementation guidance, most notably a complete set of illustrative financial statements and a disclosure checklist. A sizeable amount of guidance that is in full IFRSs is not included. Accordingly, additional guidance especially tailored to the needs of SMEs applying the proposed IFRS may be required.

Are there specific areas for which SMEs are likely to need additional guidance? What are they, and why?

We consider that more guidance on the pervasive recognition and measurement principles is required in order that an entity can determine the appropriate accounting treatment when it encounters situations or transactions that are not specifically addressed in the specific sections. This is particularly important for subsequent measurement of non-financial assets. Paragraph 2.42 states that most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. It then sets out the different measurement bases that are used in different sections in the proposed IFRS for SMEs. However, it does not give guidance on the principles to be considered when an entity has to determine a measurement base for a non-financial asset that is not specifically addressed in the proposed IFRS for SMEs. We believe that this guidance is essential; otherwise, this will effectively mean that an entity can choose any measurement base it wishes if it has a non-financial asset which is not specifically addressed in the proposed IFRS for SMEs.

Q 9 – Adequacy of disclosures

Each section of the draft *IFRS for SMEs* includes disclosure requirements. Those requirements are summarised in the disclosure checklist that is part of the draft implementation guidance *Illustrative Financial Statements and Disclosure Checklist.*

Are there disclosures that are not proposed that the Board should require for SMEs? If so, which ones and why? Conversely, do you believe that any of the proposed disclosures should not be required for SMEs? If so, which ones and why?

We generally agree with the Board's proposal to substantially reduce the disclosure requirements for SMEs when compared with the disclosure requirements in full IFRSs, other than those which cross-refer to full IFRSs. We suggest the IASB to consider further simplification as follows:

Section No. and Title	Suggestion
19 Leases	We do not agree with the proposal to require a lessor of an operating lease to disclose the future minimum lease payments at the end of the reporting period for each future year instead of for specified intervals as in IAS 17. We believe that the additional information would not bring significant value to the users of the financial statements.

Q 10 – Transition guidance

Section 38 *Transition to the IFRS for SMEs* provides transition guidance for SMEs that move (a) from national GAAP to the *IFRS for SMEs* and (b) from full IFRSs to the *IFRS for SMEs*.

Do you believe that the guidance is adequate? If not, how can it be improved?

We consider that the guidance is adequate. However, we note that some exemptions that are provided under IFRS 1 are not available in section 38. We suggest that all the exemptions allowed under IFRSs should also be allowed under the proposed IFRS for SMEs. Following is the list of exemptions that we suggest to include:

Subject	Proposed exemptions to be included
Investment in subsidiaries, associates and joint ventures	Options to measure the subsidiary's assets and liabilities at either a) the carrying amounts that would be included in the parent's consolidated financial statements based on the parent's date of transition to IFRSs or b) the carrying amounts required by the IFRS based on the subsidiary's date of transition to IFRSs.
Fair value or revaluation as deemed cost	The proposed standard only allows an entity to elect to measure an item of property, plant and equipment at the date of transition to IFRSs at its fair value and use its fair value as its deemed cost at that date. We suggest extending the exemption to investment property and intangible assets.
Leases	Section 38 implies that a first-time adoptor has to classify leases as operating or finance lease based on the circumstances existing at the inception of the lease and not those existing at the date of transition to IFRSs. Given the practical difficulties in going back potentially many years, we suggest that the proposed standard should provide an exemption to first-time adoptor to determine the lease based on the facts and circumstances existing at their date of transition.

Q 11 – Maintenance of the *IFRS for SMEs*

The Board expects to publish an omnibus exposure draft of proposed amendments to the *IFRS for SMEs* approximately every other year. In developing such exposure drafts, the Board expects to consider new and amended IFRSs that have been adopted in the previous two years as well as specific issues that have been brought to its attention regarding possible amendments to the *IFRS for SMEs.* On occasion, the Board may identify a matter for which amendment of the *IFRS for SMEs* may need to be considered earlier than in the normal two-year cycle.

Is this approach to maintaining the proposed IFRS for SMEs appropriate, or should it be modified? If so, how and why?

We agree that the Board should perform a regular review of the proposed IFRS for SMEs about every two years for potential improvements.

Part 2 – Recommendations on matters not mentioned in the specific questions

Basis for simplification

1. We support the IASB's attempt to simply or modify the recognition and measurement measurements in full IFRSs. However, we do not believe that the IASB has demonstrated clearly, either in the body of the proposed standard or the Basis for Conclusions, the rationale behind modifications to recognition and measurement principles in full IFRSs or removal of topics on the basis of either cost-benefit analysis or different user information needs. We suggest that the IASB should elaborate further in this respect.

Reference to pervasive principles

2. In respect of pervasive recognition and measurement principles, we suggest revising paragraph 2.32 which states that the pervasive recognition and measurement principles of the proposed IFRS for SMEs are derived from the IASB *Framework for the Preparation and Presentation of Financial Statements.* The paragraph should refer to paragraphs 10.2-10.4 which sets out the hierarchy of accounting policies to be applied, rather than to the IASB Framework. The paragraph in its current form would undermine the use of the pervasive principles set out in the proposed standard.

Measurement of investments in associates and joint ventures

3. We consider that the fair value through profit or loss model should be removed because this option is not included in full IFRSs for general application.

Organisation of the proposed IFRS for SMEs

4. The IFRS for SMEs is organised "topically", rather than in a meaningful order. For example, the accounting policies which are supposed to be the foundation of the standards are set out in section 10 rather than immediately after the concepts and pervasive principles. For the standard to be more user-friendly, we suggest that its sections should be restructured and grouped to provide an easier-to-use and more logical structure such as according to the degree of liquidity of assets/liabilities or categories of balance sheet and income statement.

5. The elements of a conceptual framework for SME financial reporting are largely included in Sections 1 and 2 but they are also dispersed in other sections such as section 10. We suggest consolidating all these elements into a single section which is equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements.

Glossary of terms

6. Definitions are important to practical application. We suggest the glossary should include all the terms in the full IFRS which are applicable in the proposed IFRS for SMEs, e.g. acquisition date, deemed cost, etc.