Consultation draft of SME Financial Reporting Framework and Financial Reporting Standard (Revised) has been issued for comment

The new Hong Kong Companies Ordinance (Cap. 622) was enacted in July 2012. As a result, in addition to companies that currently satisfy the criteria set out in section 141D of the old Companies Ordinance (Cap. 32), eligibility to apply the Small- and Medium-Sized Entity Financial Reporting Framework and Financial Reporting Standard for statutory purposes has been expanded under the new ordinance to include the following entities:

- Small guarantee companies;
- Small private companies; and
- Larger "eligible" private companies;

as defined in the new Companies Ordinance, with reference to meeting certain size tests and, in the case of larger "eligible" private companies, obtaining shareholder approval.

These additional types of non-public companies may also qualify for simplified reporting if they have subsidiaries, provided that the group of which they are a parent, when taken as a whole, falls within the qualifying criteria, and that each company within that group also falls within the qualifying criteria. This means that when the new Companies Ordinance comes into effect, the SME-FRF and SME-FRS may also be applied in the preparation of consolidated financial statements by some private companies or companies limited by guarantee. In the course of developing this consultation draft, the Institute has incorporated the proposals from the 2008 exposure draft (which included new sections dealing with business combinations, consolidated financial statements, investments in associates, investments in joint ventures and cash flow statements), modified to reflect the comments received on that draft duly considered by the Institute's financial reporting standards committee.

Compared to the existing SME-FRF and FRS, the consultation draft has incorporated the following changes:

- Inclusion of a summary of the criteria for "qualifying entities" with cross-references to the new Companies Ordinance;
- The accounting requirements are expanded to cover consolidated financial statements, business combinations and investments in other entities accounted for by application of the equity-method;
- Guidance on presenting a cash flow statement has been included – the preparation of a cash flow is optional. However, if a cash flow statement is presented then this guidance should be followed;
- Additional guidance material has been added on the non-exempt disclosure requirements in the new Companies Ordinance and certain other provisions of the new ordinance relevant to the SME-FRF and SME-FRS. (This guidance is not yet complete as the administration is still finalizing some of the regulations. This is expected to be completed by the end of 2013);
- Guidance has been added on the concept of "realized profits and losses" and the relationship between these and "recognized profits and losses" reported under the SME-FRS (section 79B of the old ordinance, together with related sections, has been brought forward into the new Companies Ordinance substantially unaltered);
- Specific disclosure requirements have been added to cover the first year that a company transitions from, for example, full HKFRS to SME-FRS;
- Additional disclosure requirements have been added to the Income Taxes section to disclose tax rates and unused tax losses;
- New guidance has been added on determining the "reporting currency" of an entity (which is based on the concept of functional currency in full HKFRS);
- The definition of "related party" has been updated to align with the latest definition in full HKFRS;
- The definitions of "active market" and "fair value" have been updated to be consistent with HKFRS 13 *Fair Value Measurement*;
- Guidance on determining whether an entity is acting as an agent or principal has been added (this guidance was missing as it had been added to HKAS 18 *Revenue* after the SME-FRS was first issued);
- Some minor housekeeping has been done (e.g. definitions added to the glossary that were previously only in the text, and other inconsistencies removed).

The Institute's financial reporting standards committee is not seeking further comments on matters addressed previously in the 2008 exposure draft or these other consequential changes. However, section 381(2) of the new Companies Ordinance provides scope for the SME-FRS to specify circumstances in which one or more subsidiaries may be excluded from consolidation that the consultation draft proposes to take advantage of.

Under section 381(2) of the new Companies Ordinance, where a company falls within the reporting exemption for the financial year (i.e. qualifies for the SME-FRF and SME-FRS), one or more subsidiaries may be excluded from the consolidated financial statements in compliance with the accounting standards applicable to the statements (in other words, if the SME-FRF or SME-FRS permits the exclusion).

In this regard, paragraph 19.1 of the consultation draft proposes to permit one or more subsidiary undertakings to be excluded from the consolidated financial statements of a qualifying company when:

- Their exclusion measured on an aggregate basis is not material to the group as a whole; or
- Their inclusion would involve expense or delay out of proportion to the value to members of the company.

Paragraph 19.1(b) brings forward the relief, currently available in section 124(2)(b)(i) of the old Companies Ordinance, which would otherwise no longer be available under the new ordinance.

However, it should be noted that if a parent company were to take advantage of paragraph 19.1(b), material information could be omitted from that company's consolidated financial statements, such that they would not give a complete picture of the group as a whole. To ensure that this exemption is not invoked against the members' wishes an additional safeguard has been included in paragraph 19.1 such that a parent may not exclude a subsidiary from consolidation on the grounds of undue expense and delay out of proportion to the value to members of the company unless the members of the company have been informed in writing about, and do not object to, this exclusion.

As this proposal was not included in the 2008 exposure draft nor is there an express mandatory requirement in the new Companies Ordinance, the consultation question relates to whether it is appropriate to include the above relief in the revised SME-FRF and FRS.

The new Companies Ordinance is expected to come into force from early 2014, pending completion of subsidiary legislation to facilitate its implementation. In this connection, the effective date of the revised SME-FRF and FRS has yet to be determined until the date of commencement of the new Companies Ordinance is announced and thus early adoption will not be permitted.

The Institute welcomes comments on the matter addressed in the exposure draft. Please provide your comments to Simon Riley, director of standard setting, by 25 October.

This article is contributed by the Institute's standard setting department.