HKFRSs / IFRSs UPDATE

2010/18

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NEW FINANCIAL REPORTING FRAMEWORK FOR SMEs
HKFRS FOR PRIVATE ENTITIES: LESS IS MORE

Introduction

Further to the **BDO HKFRSs/IFRSs Update 2010/06 of June 11, 2010**, this Update further explores the new concepts and principles introduced by the HKFRS for PEs which are different from the full HKFRSs. These new concepts and principles have simplified the complexity of financial reporting without reducing the value of financial reporting by SMEs.

HKFRS for PEs New Concepts and Principles	
1.	Cost-benefit Considerations
2.	Simplified Accounting
3.	Presentation and Disclosure Simplifications

Cost-Benefit Considerations

In order to provide additional relief to preparers of financial statements under the HKFRS for PEs, an "undue cost or effort" principle has been introduced in some Sections of the HKFRS for PEs to replace the "impracticability" relief criterion in the full HKFRSs. Applying a requirement is considered to be "impracticable" when the entity cannot apply it after making every reasonable effort to do so. Although not defined, the notion of "undue cost or effort" focuses on the concept of balancing costs and benefits which, in turn, might require management's judgment of when a cost is considered to be excessive. In other words, the "undue cost or effort" principle implies that cost is always a key element to be considered.

Section	Subject	Relief
Sections 14 & 15	Investments in associates and joint ventures	Entity using the fair value model is required to use the cost model for any investment for which it is impracticable to measure fair value reliably without cost or effort
Section 16	Investment properties	Investment property whose fair value can be measured reliably without undue cost or effort shall be measured at fair value….An entity shall account for all other investment property as PPE using the cost-depreciation-impairment model
Section 21	Best estimate (disclosures about contingent assets)	If an inflow of economic benefits is probable (more likely than not) but not virtually certain, an entity shall disclose a description of the nature of the contingent assets at the end of the reporting period, and, when practicable without undue cost or effort, an estimate of their financial effect…

Section 28	Employee benefits - actuarial valuation method	If an entity is able, without undue cost or effort, to use the projected unit credit method to measure its defined benefit obligation and the related expense, it shall do so. If an entity is not able, without undue cost or effort, to use the projected unit credit method to measure its obligation and cost under defined benefit plans, the entity is permitted to make the following simplifications in measuring its defined benefit obligation with respect to current employees…
Section 34	Specialised activities – biological assets	An entity using this HKFRS that is engaged in agricultural activity shall determine its accounting policy for each class of its biological assets as follows: (a) The entity shall use the fair value model for those biological assets for which fair value is readily determinable without undue cost or effort. (b) The entity shall use the cost model for all other biological assets.

Simplified Accounting

The more useful simplifications are highlighted below which represent only some of the simplifications.

Borrowing costs and research and development costs expensed

For cost-benefit reasons, all charged as expenses as incurred and capitalisation is not allowed.

Financial instruments accounting simplified

Accounting complexity is reduced by limiting the classification categories, specifying a measurement attribute and limiting the use of other optional measurement attributes:

(a) Classification of financial instruments. Financial instruments that meet specified criteria are measured at cost or amortised cost, and all others are measured at fair value through profit or loss. The available-for-sale and held-to-maturity classifications in HKAS 39 are not available.

(b) Derecognition. The HKFRS for PEs establishes a simple principle for derecognition. That principle does not rely on the 'pass-through' and 'continuing involvement' provisions that apply to derecognition under HKAS 39. Those provisions are complex and relate to derecognition transactions in which SMEs are typically not engaged.

(c) Hedge accounting. The HKFRS for PEs focuses on the types of hedging that SMEs are likely to do, and requires periodic recognition and measurement of hedge ineffectiveness, but under less strict conditions than those in HKAS 39.

Simple accounting for PPE and intangible assets other than goodwill

For cost-benefit reasons, PPE and intangible assets other than goodwill are accounted for as follows:

(a) Only cost model is allowed

(b) Annual review of estimated useful lives, residual value, depreciation/amortisation method is required only when there is an indication of changes affecting the assets, not annually

(c) Impairment testing is required only when there is an indication of impairment, not annually

(d) All intangible assets are considered to have a finite useful life, and only if useful life cannot be reliably estimated, then it is presumed to be 10 years

Simple accounting for goodwill

For cost-benefit reasons, rather than conceptual reasons, goodwill is accounted for as follows:

(a) All assumed to have a finite useful life and are amortised over their estimated useful lives

(b) Only if useful life cannot be reliably estimated, then it is presumed to be 10 years

(c) Impairment testing is required only when there is an indication of impairment, not annually

(d) No impairment reversal is allowed

Cost method and fair value model allowed for associates and joint ventures

Recognising the special problems of SMEs in applying the equity and proportionate consolidation methods, and also the relevance of fair values for lenders, the cost method or fair value through profit or loss is permitted as an accounting policy choice which should be applied to the whole class of associates or joint ventures.

No special accounting for non-current assets held for sale

No separate held-for-sale classification for cost-benefit reasons, as it is felt that an accounting result similar to that of HKFRS 5 could be achieved more simply by including intention to sell as an indicator of impairment.

No recycling for exchange differences on monetary items

An exchange difference that is recognised initially in other comprehensive income is not reclassified in profit or loss on disposal of the investment in foreign subsidiary. Not requiring reclassification is less burdensome for SMEs because it eliminates the need for tracking the exchange differences after initial recognition.

Simplified share-based payments calculation

Expense for equity-settled share-based payments is measured on the basis of observable market prices, if available. If observable market prices are not available, SMEs should measure the expense using the directors' best estimate of the fair value of the equity-settled share-based payment.

Presentation Simplifications

On the basis of the needs of users of SMEs' financial statements and costs to smaller entities, the HKFRS for PEs has reflected the following simplifications of financial statement presentation:

(a) An entity should not be required to present a statement of financial position as at the beginning of the earliest comparative period when the entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

(b) An entity is permitted to present a single statement of income and retained earnings (SIRE) in place of separate statements of comprehensive income and changes in equity if the only changes to its equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy.

(c) All deferred tax assets and liabilities are classified as non-current assets or liabilities.

Disclosure Simplifications

The disclosure requirements in the HKFRS for PEs are substantially reduced, and the reasons for the reductions are of four principal types:

(a) Some disclosures are not included because they relate to topics covered in the full HKFRSs that are omitted from the HKFRS for PEs

(b) Some disclosures are not included because they relate to recognition and measurement principles in the full HKFRSs that have been replaced by simplifications

(c) Some disclosures are not included because they relate to options in the full HKFRSs that are not included in the HKFRS for PEs

(d) Some disclosures are not included on the basis of users' needs or cost-benefit considerations

The following is examples of disclosure reduction:

(a) Not required to disclose the fair value of the carrying amount for PPE and investment property on cost model

(b) Not required the vast majority of the disclosure requirements of HKFRS 7 "Financial Instruments: Disclosures"

(c) Not required to disclose all the estimates used to measure recoverable amount of cash generating units containing goodwill

(d) For disclosure relating to income taxes, only required to provide an explanation of the significant differences in amounts reported in the statement of comprehensive income and amounts reported to tax authorities

(e) For investments in associates, the following disclosures are omitted:

- summarised financial information for assets, liabilities, revenues and profit or loss
- share of contingent liabilities and the nature and extent of any significant restrictions on the ability of associates to transfer funds to the investor, if any

Concluding Remarks

The types and needs of users of SME financial statements are often different from the types and needs of users of public company financial statements and other entities that would likely use the full HKFRSs. The full HKFRSs are designed to meet the needs of equity investors in companies in public capital markets. Users of the financial statements of SMEs don't generally have those same needs. Rather, users of the financial statements of SMEs are more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage and solvency issues. Also, the full HKFRSs impose a burden on SME preparers in that the full HKFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as the full HKFRSs have become more detailed and subject to more frequent changes.

As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective. The HKFRS for PEs is therefore designed to meet that need. With the issuance of the HKFRS for PEs, many SMEs will have the option of using a much simplified, HKFRSs-based accounting framework to prepare their financial statements. Although it is more simplified, the HKFRS for PEs may better serve the information need of SME financial statements users.

BDO's support and assistance on HKFRSs

For any support and assistance on HKFRSs, please talk to your usual BDO contact or Stephen Chan, Partner and Head of Technical & Training at +852 2853 5820 or email StephenChan@bdo.com.hk

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