

# HKFRSs / IFRSs UPDATE

2010/06

11 June 2010

## HKFRS FOR PRIVATE ENTITIES (HKFRS FOR PE<sub>s</sub>) - A NEW FINANCIAL REPORTING OPTION

### Introduction

#### IFRS for SMEs

On 9 July 2009 the International Accounting Standards Board (IASB) issued an International Financial Reporting Standard (IFRS) designed for use by small and medium-sized entities (SMEs). The IFRS for SMEs is the result of a five-year development process involving extensive consultation with SMEs worldwide.

The [IFRS for SMEs](#) responds to strong international demand from both developed and emerging economies for a rigorous and common set of accounting standards for SMEs that is much simpler than the full IFRSs. In particular, the IFRS for SMEs will:

- provide improved comparability for users of accounts;
- enhance the overall confidence in the accounts of SMEs; and
- reduce the significant costs involved of maintaining standards on a national basis.

The IASB's stated objective in creating the IFRS for SMEs is to create information from the "specific perspective of an SME" that would assist a broad range of users in making economic decisions. The financial statements should also reflect the stewardship function of management.

In order to achieve this goal, the IASB designed the IFRS for SMEs that is based on, but stands alone and is distinct from, the full IFRSs.

The IFRS for SMEs will be updated by an omnibus of changes, which the IASB will prepare on a three year cycle. However, prior to the first omnibus, the IASB have indicated that they will review the first two years of reporting under the IFRS for SMEs. Hence, the first omnibus may take longer than three years to issue in order to incorporate this review of financial statements.

### STATUS

Final

### EFFECTIVE DATE

Upon issue on 30 April 2010

### ACCOUNTING IMPACT

A new financial reporting option for private companies

## HKFRS for PEs and its effective date

On 30 April 2010 the [HKFRS for PEs](#) was issued as a new financial reporting option in Hong Kong with immediate effect, which is based on the IFRS for SMEs. PEs have the option of choosing the HKFRS for PEs in preparing their annual financial statements, and they are even permitted to use this new financial reporting framework to prepare their financial statements for prior period(s) where the relevant financial statements have not been finalised and approved.

As a result, Hong Kong now has three financial reporting frameworks:

- (a) HKFRS for PEs which may be applied by PEs;
- (b) Full HKFRSs which apply to the majority of companies before the issuance of the HKFRS for PEs; and
- (c) SME-FRF&FRS which may be applied by Hong Kong incorporated companies eligible for claiming relief under s141D of the Companies Ordinance and by other companies that meet the eligibility requirements contained in SME-FRF&FRS (Small GAAP).

## Differences between the HKFRS for PEs and the IFRS for SMEs

- (i) The term "SME" is widely used in Hong Kong and associated with the Small GAAP. For clarity and differentiation the new Standard is called "HKFRS for Private Entities". The term "SMEs" used throughout the IFRS for SMEs is therefore replaced by "Private Entities" in the HKFRS for PEs.
- (ii) The accounting for income taxes contained in the IFRS for SMEs closely follows proposals contained in the IASB Exposure Draft which was intended to replace IAS 12 "Income Taxes". Many respondents expressed their views that the proposed changes in the IASB Exposure Draft are not improvements but rather the introduction of complex new rules. Accordingly, IASB has expressed that it is unlikely that the project will proceed in its current form. As the commenting period of the IASB Exposure Draft ended on 31 July 2009, which is after the issue of the IFRS for SMEs by the IASB on 9 July 2009, the accounting for income taxes section of the IFRS for SMEs retained the proposals contained in the IASB Exposure Draft.

Given the effective rejection of the IASB Exposure Draft on accounting for taxes, in order to ensure ease of application by Hong Kong users, the HKFRS for PEs has replaced the recognition and measurement principles contained in Section 29 of the IFRS for SMEs with those contained in the extant version of HKAS 12, while retaining the relevant disclosure requirements contained in the IFRS for SMEs.

- (iii) The section on accounting for income tax contained in the HKFRS for PEs has been written to ensure no provision is required in relation to revaluation gains on investment properties to reflect the Hong Kong situation. This provision is incorporated in order to exempt recognition of deferred taxation in relation to revaluation gains of investment properties where such tax is never paid in Hong Kong to remove an anomaly currently in HKAS 12.

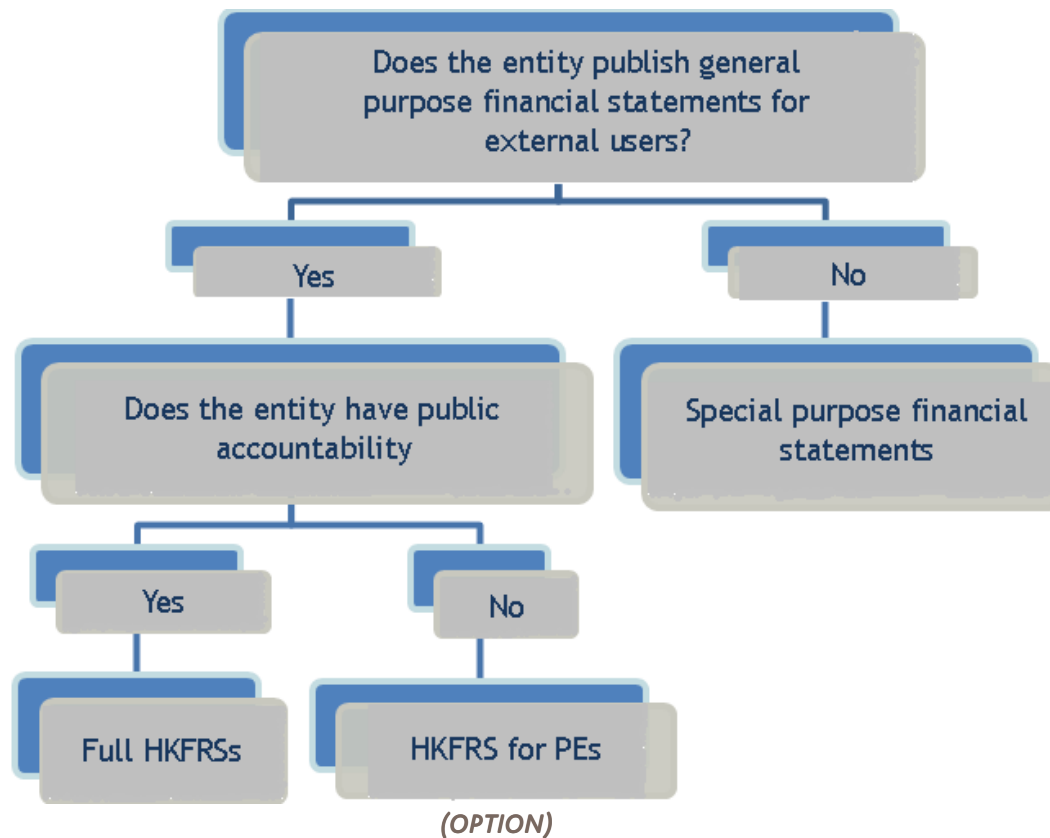
## Definition of PEs and scope of the HKFRS for PEs

A PE is an entity that:

- Does not have public accountability
- Publishes general-purpose financial statements for external users.

An entity has public accountability if:

- It files, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.
- It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.



The definition of a PE is therefore based on the nature of an entity rather than on its size.

Some entities may also hold assets in a fiduciary capacity for a broad group of outsiders because they hold and manage financial resources entrusted to them by clients, customers or members not involved in the management of the entity. However, if they do so for reasons incidental to a primary business (as, for example, may be the case for travel or real estate agents, schools, charitable organisations, co-operative enterprises requiring a nominal membership deposit, and sellers that receive payment in advance of delivery of the goods or services such as utility companies), that does **not** make them publicly accountable.

The HKICPA has issued a [Q&A](#) on the applicability of the HKFRS for PEs which suggests a thought process that entities should go through in determining whether or not they are eligible to use the HKFRS for PEs and contains eleven commonly asked questions together with answers.

### Checkpoint

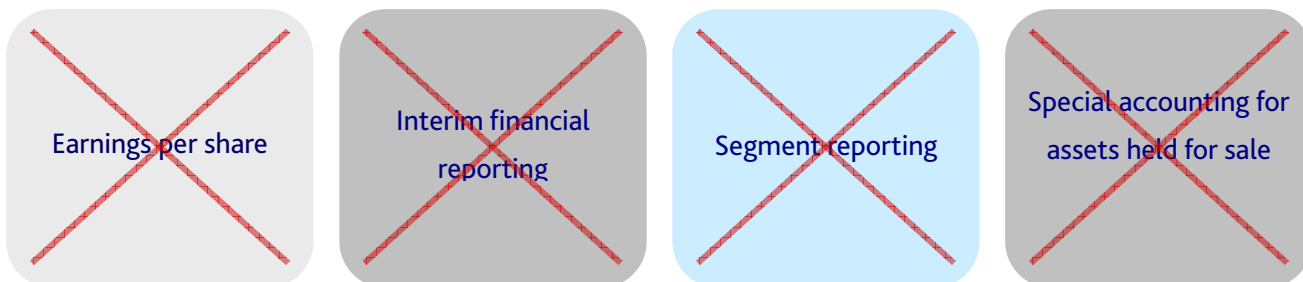
A subsidiary whose parent uses the full HKFRSs, or that is part of a consolidated group that uses the full HKFRSs, is not prohibited from using the HKFRS for PEs in its own financial statements if that subsidiary by itself does not have public accountability.

The subsidiary would, however, have to keep two sets of records because the parent entity would require the application of the full HKFRSs for consolidation purposes.

## Comparison with the full HKFRSs

### The omitted topics

The following topics have been completely omitted from the HKFRS for PEs, because they are not expected to be relevant for the majority of PEs:



### Checkpoint

The HKFRS for PEs states that a PE should select an accounting policy that results in relevant and reliable information, but what if the HKFRS for PEs does not address a transaction or other event or condition or provide a cross-reference back to another HKFRS?

Firstly, the PE should consider the requirements and guidance in the HKFRS for PEs dealing with similar and related issues. Secondly, the PE should consider the pervasive principles in the HKFRS for PEs. Lastly, consider the full HKFRSs (including Interpretations).

### Not an option

The HKFRS for PEs does not include the following options, because it is considered that PEs will choose to follow the simpler options as they will generally be less costly, require less expertise and achieve greater comparability with their peers.

If a PE feels strongly about using one or more of the complex options, it could elect to follow the full HKFRSs rather than the HKFRS for PEs.

#### Property, plant and equipment

- The revaluation model is not an option.
- Property, plant and equipment carried at cost less accumulated depreciation and impairment.

#### Intangible assets

- The revaluation model is not an option.
- Intangible assets carried at cost less accumulated amortisation and impairment.

#### Borrowing costs

- The capitalisation model is not allowed.
- All borrowing costs should be expensed.

#### Jointly controlled entities

- No proportionate consolidation.

#### Government grants

- Various options excluded.
- Only single simplified method retained, that is, recognition in income (at fair value) when the performance conditions are met.

#### Investment property

- Measurement is driven by circumstances rather than allowing an accounting policy choice between the cost and fair value models.

#### Financial instruments

- Available-for-sale and held-to-maturity categories are not available.

## Recognition and measurement simplified

<b>Financial instruments</b>	<ul style="list-style-type: none"> <li>Measured at: <ul style="list-style-type: none"> <li>cost or amortised cost; or</li> <li>fair value through profit or loss (FVTPL).</li> </ul> </li> <li>Simple principle for derecognition, because the 'pass-through' and 'continuing involvement' tests have been deleted.</li> <li>Hedge accounting requirements, including detailed calculations, are simplified and tailored.</li> </ul>
<b>Goodwill and other indefinite-life intangible assets</b>	<ul style="list-style-type: none"> <li>Can the useful lives be estimated reliably? <ul style="list-style-type: none"> <li>Yes – Amortise over their estimated useful lives.</li> <li>No – Amortise over 10 years.</li> </ul> </li> </ul>
<b>Investments in joint ventures and associates</b>	<ul style="list-style-type: none"> <li>Is there a published price quotation? <ul style="list-style-type: none"> <li>Yes – Fair value.</li> <li>No – Cost.</li> </ul> </li> </ul>
<b>R&amp;D costs</b>	<ul style="list-style-type: none"> <li>Must be recognised as expenses.</li> </ul>
<b>Borrowing costs</b>	<ul style="list-style-type: none"> <li>Must be recognised as expenses.</li> </ul>
<b>Property, plant and equipment</b>	<ul style="list-style-type: none"> <li>No annual review of residual values, useful lives and depreciation method, except presence of "indicator" requiring such a review.</li> </ul>
<b>Intangible assets</b>	<ul style="list-style-type: none"> <li>No annual review of amortisation period and amortisation method, except presence of "indicator" requiring such a review.</li> </ul>
<b>Defined benefit plans</b>	<ul style="list-style-type: none"> <li>All past service cost must be recognised immediately in profit or loss.</li> <li>All actuarial gains and losses must be recognised immediately, either in profit or loss or other comprehensive income.</li> <li>Projected unit credit method – only if can be applied without undue cost or effort.</li> </ul>
<b>Income taxes</b>	<ul style="list-style-type: none"> <li>Based on the existing requirements of HKAS 12 "Income Taxes" with simplification for deferred tax on investment property revaluation gains.</li> </ul>
<b>Assets held-for-sale</b>	<ul style="list-style-type: none"> <li>No separate held-for-sale classification. Instead, holding an asset (or group of assets) for sale is an impairment indicator.</li> </ul>
<b>Biological assets</b>	<ul style="list-style-type: none"> <li>Is fair value of biological assets readily determinable without undue cost or effort? <ul style="list-style-type: none"> <li>Yes – FVTPL model.</li> <li>No – Cost-depreciation-impairment model.</li> </ul> </li> </ul>
<b>Equity-settled share-based payments</b>	<ul style="list-style-type: none"> <li>Are observable market prices available for equity-settled share-based payments? <ul style="list-style-type: none"> <li>Yes – Fair value.</li> <li>No – Directors' best estimate of the fair value.</li> </ul> </li> </ul>

## Checkpoint

### Consolidated financial statements

The HKFRS for PEs requires preparation of consolidated financial statements in relation to all subsidiaries of the parent. A parent need not present consolidated financial statements if:

- the parent itself is a subsidiary and its ultimate parent (or any intermediate parent) produces consolidated general purpose financial statements that comply with the full HKFRSs, the full IFRSs, the HKFRS for PEs or the IFRS for SMEs; or
- it has no subsidiaries other than one that was acquired with the intention of selling or disposing of it within one year.

## Disclosure simplifications

The disclosure requirements in the HKFRS for PEs are substantially reduced when compared with the disclosure requirements in the full HKFRSs. The reasons for the reductions are of four principal types:

- they relate to topics covered in the full HKFRSs that are omitted from the HKFRS for PEs;
- they relate to recognition and measurement principles in the full HKFRSs that have been replaced by simplifications in the HKFRS for PEs;
- they relate to options in the full HKFRSs that are not included in the HKFRS for PEs; or
- on the basis of users' needs or cost-benefit considerations.

## **"To adopt or not to adopt" - considerations prior to adopting the HKFRS for PEs**

The HKFRS for PEs aims to simplify and reduce the potentially ever-increasing reporting requirements of the full HKFRSs. However, in determining whether to adopt the HKFRS for PEs, management is advised to consider the facts and circumstances of the PE, including but not limited to the following matters:

### **Must all PEs apply the HKFRS for PEs?**

No. The adoption of the HKFRS for PEs is an option for PEs. If compliance with the full HKFRSs is required, desired or preferred by a PE, the PE may continue using or adopt the full HKFRSs and need not adopt the HKFRS for PEs.

### **Will the financial statements of a PE meet the needs of users?**

PEs will have to consider whether financial statements prepared under the HKFRS for PEs meet the needs of their own specific users. The financial statements of PEs generally are not widely circulated, and the needs of individual users of those financial statements tend to be specific, but not necessarily the same.

The HKFRS for PEs is based on the same framework as the full HKFRSs. In developing the IFRS for SMEs, the IASB attempted to consider the needs of users of the financial statements of an SME. However, due to the specific needs of individual users, careful assessment will be needed by each SME to determine whether the IFRS for SMEs will meet their needs. The IFRS for SMEs concentrates on items such as short-term cash flows, liquidity, and balance sheet strength. The IASB concluded that the full IFRSs at times provided too much information for the needs of an SME user, while in other situations other needs were not being met by the full IFRSs.

The HKICPA has held meetings with the Inland Revenue Department of the HKSAR Government and representatives of Hong Kong Association of Banks since the issuance of the IFRS for SMEs. Both parties acknowledged the standard setting role of the HKICPA and have no objection in principle to relieving PEs from complying with the full HKFRSs in the preparation of financial statements.

### **Are there any long-term considerations that should be taken into account?**

The PE's long-term plans need to be considered; where such plans include becoming publicly accountable or a possible listing of debt or equity instruments, this could affect the choices made by the PE. A PE with such plans would be precluded from using the HKFRS for PEs in the future, as it would fail to meet the definition of a PE. This would then force the PE into a second conversion to the full HKFRSs.

Another consideration is whether a PE's holding company reports (or will report) under the full HKFRSs. In such cases, it may be easier for that PE to also report under the full HKFRSs in order to facilitate the consolidation process in its parent company – thereby avoiding the need for dual reporting.

### **Are there any cost impacts on adoption?**

Yes. Adopting the HKFRS for PEs may have various cost implications to consider, including:

- (a) **Upfront investment costs** may have to be incurred, such as those resulting from system changes, reformatting of the financial statements and additional staff training. These may be one-off costs which may be offset in future years by reduced training costs as the HKFRS for PEs is not updated every year.
- (b) **Preparation costs** for the financial statements may be reduced but the extent of reduction depends on the facts and circumstances of the PE.
- (c) **Consultation costs and costs of engaging experts** may be reduced because many complex areas in the full HKFRSs are simplified in the HKFRS for PEs. On the other hand, the absence of detailed guidance in the HKFRS for PEs may sometimes require additional consultations with experts.



## Is the first time adoption of the HKFRS for PEs complicated?

The process by which a PE adopts the HKFRS for PEs is dealt with in Section 35, and is based on HKFRS 1 "First-time Adoption of Hong Kong Financial Reporting Standards".

To summarise, the PE determines the date of transition. This is the date at the beginning of the earliest period for which the PE presents full comparative information. Generally, as most PEs provide one year of comparatives, a PE with a year ended 31 December 2009 would have a date of transition of 1 January 2008.

As in HKFRS 1, certain exceptions and exemptions are provided in order to facilitate a smoother transition into the HKFRS for PEs. However, there are additional disclosures specific to the year of adoption, including certain reconciliations from the previous GAAP reports to the financial statements prepared under the HKFRS for PEs.

## Are there any implementation guidance and support to smoothen the transition?

Both the websites of [IASB](#) and [HKICPA](#) contain useful resources and implementation guidance. In particular, the HKICPA has issued an illustrative set of financial statements which have incorporated the disclosure requirements of the Companies Ordinance. There is also a disclosure checklist based on the requirements of the IFRS for SMEs.

## Conclusion

The HKFRS for PEs offers an opportunity for PEs to adopt a reporting framework that may reduce their reporting burden.

Apart from the accounting differences between the HKFRS for PEs and the full HKFRSs (and also Small GAAP), there are many other issues that PEs must take into account before adopting the HKFRS for PEs. The considerations often relate to qualitative factors, and require management's judgment to be exercised before the conclusion can be reached that the HKFRS for PEs is the preferred route for the PEs.

## 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](mailto:StephenChan@bdo.com.hk)

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