

Financial Reporting Standard for Small and Medium-Sized Entities ("SME-FRS") Effective for Accounting Periods Commencing on or after 1 January 2005

This TechNews provides commentary on the SME-FRS issued by the Hong Kong Institute of Certified Public Accountants on 22 August 2005 for adoption by qualifying Small and Medium-sized Entities ("SME") with accounting periods commencing on or after 1 January 2005. The SME-FRS was developed to balance the cost of financial reporting compliance against the benefit derived by users of the financial statements of smaller entities. It relieves smaller entities from excessive reporting and disclosure requirements and the use of complex calculation and measurement bases as required under the Hong Kong Financial Reporting Standards ("the Full HKFRS"). Accordingly, all smaller entities should familiarise themselves with the SME-FRS or seek professional advice in order to ascertain if they meet the criteria of an SME, and if so, whether they would benefit in adopting it.

**The Full HKFRS includes Hong Kong Accounting Standards ("HKAS") and Hong Kong Financial Reporting Standards ("HKFRS") which are applicable for accounting periods commencing on or after 1 January 2005, and Hong Kong Statements of Standard Accounting Practice ("SSAP") which are applicable for accounting periods commencing prior to 1 January 2005.*

QUALIFYING ENTITIES

Qualifying entities comprise the following:

- (a) Hong Kong companies that prepare financial statements under section 141D of the Hong Kong Companies Ordinance ("the Ordinance"); and
- (b) Non-Hong Kong incorporated entities (subject to any specific requirements imposed by the law of the entity's place of incorporation) which do not have public accountability, and all its owners agree to prepare the financial statements in accordance with the SME-FRS; and is considered to be an SME in terms of its size.

A non-Hong Kong incorporated entity is considered to be an SME if it does not exceed any two of the followings in at least two consecutive years before qualifying for the SME regime:

- (a) Total annual revenue of HK\$50 million.
- (b) Total assets of HK\$50 million at the balance sheet date.
- (c) An average of 50 employees.

Section 141D of the Ordinance

A company incorporated under the Ordinance qualifies for reporting under the SME Financial Reporting Framework ("the Framework") if it satisfies the criteria set out in section 141D of



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the Ordinance. Section 141D provides that, where all its shareholders agree in writing, a private company can prepare accounts under this section to waive compliance with certain requirements. Shareholders' agreement to the adoption of the above however is to be obtained for each subsequent financial year.

This section does not apply to a Hong Kong private company which:

- (a) has any subsidiary or is a subsidiary of another Hong Kong incorporated company; or
- (b) carries on regulated activities under the Securities and Futures Ordinance, or is engaged in banking, insurance or money lending business; or
- (c) owns and operates ships or aircraft engaged in the carriage of cargo in and out of Hong Kong.

The accounts prepared in accordance with this section shall give a "true and correct view" of the state of the entity's affairs rather than a "true and fair view" under the Ordinance.

STRUCTURE OF THE SME-FRS

In general the SME-FRS is a simplified version of the Full HKFRS taking into account certain improvements resulting from the convergence of Hong Kong accounting standards with the International Accounting Standards in 2004. The SME-FRS was developed based on the historical cost accounting convention and originated from either HKASs or SSAPs.

The SME-FRS is comprised of the following four main areas:

- Definitions;
- Accounting standards divided into seventeen sections, each dealing with a separate topic setting out basic principles and specified disclosure requirements;
- Transitional arrangements and effective date; and
- Appendices.

The SME-FRS adopts historical cost as the principle basis of preparation. There would be no revaluation or discounting except when required or permitted by the SME-FRS. In the event that a transaction does not fall within the seventeen topics covered by the SME-FRS, there is no mandatory fall back to the Full HKFRS. In the event that the SME-FRS does not cover an event or transaction undertaken by the entity, management may consider the Framework for guidance and develop an appropriate accounting policy consistent with the historical cost accounting convention, for that particular event or transaction.

The SME-FRS cannot be adopted for the preparation of consolidated financial statements.

HIGHLIGHTS OF THE ACCOUNTING POLICIES TO BE ADOPTED AND THE DISCLOSURE REQUIREMENTS UNDER THE SME-FRS

Section 1 - Presentation of Financial Statements

A complete set of separate financial statements includes a balance sheet, an income statement, accounting policies and explanatory notes. No cash flow statement is to be prepared and changes in equity can be presented either in the notes to the financial statements or as a separate component of the financial statements.

The financial statements are to be prepared under the historical cost convention, the accruals, going concern and consistency bases and should contain the following disclosures:

- (a) the fact that the SME-FRS is adopted and the criteria on which the entity qualifies to apply the SME-FRS;
- (b) the domicile and legal form of the entity, its place of incorporation, the address of the registered office or principal place of business; and
- (c) the nature of the entity's operation and its principal activities.



Section 2 - Accounting Policies

Management should select and apply its entity's accounting policies so that the financial statements comply with all the requirements of the SME-FRS and are consistent with the historical cost convention.

Restating comparative information or quantifying the effect due to the following circumstances is not required if it involves "undue cost or effort":

- a change in accounting policy; or
- a change in accounting estimates; or
- a correction of a material prior period error.

Section 3 - Property, Plant and Equipment

Property, plant and equipment ("PPE") includes investment property and leasehold land. PPE is to be carried at cost less accumulated depreciation and any accumulated impairment losses. Land and buildings are separate assets and are dealt with separately even when they are acquired together. Leasehold land is depreciated over the lease term while buildings are depreciated over their expected useful lives.

An asset acquired in exchange for a dissimilar asset is to be measured at the fair value of the assets received. Subsequent expenditure relating to an item of PPE should be added to the carrying amount of the assets when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the entity.

Section 4 - Intangible Asset

An intangible asset should be recognised if and only if:

- (a) it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- (b) the cost of the asset can be measured reliably.

Intangible assets should be carried at cost less accumulated amortisation and any accumulated impairment losses. Amortisation is calculated on the straight-line basis over the useful life of the intangible asset or over a period reflecting the pattern in which the related economic benefits are recognised. There is a rebuttable presumption that the useful life will not exceed 20 years from the date the asset is available for use.

Section 5 - Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments under operating leases (net of any incentives received from the lessor) are expensed in the income statement on a straight-line basis over the period of the lease.

Leases of assets where the entity has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalised at the inception of the lease at the lower of the fair value of the leased assets or at the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of finance charges, are included in current and non-current liabilities. The interest element of the finance cost is recognised in the income statement over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. Leasehold interest in land is accounted for as PPE not as an operating lease. Assets held under finance leases are depreciated over the shorter of their useful lives or the lease term.



Section 6 - Investments

Investments include all investments in subsidiaries, associates, joint ventures and other investments. Investments should initially be measured at cost. If an investment is acquired in exchange for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up or, if the fair value of the asset given up is not reliably determinable, the fair value of the investment acquired.

Investments, other than held-to-maturity securities, should be carried at the lower of cost and net realisable value for current investments, and cost less accumulated impairment losses for long-term investments. Changes in the carrying amount should be recognised as income or expense in the income statement. Held-to-maturity securities should be carried at cost plus/less any discount/premium amortised.

Section 7 - Inventories

Inventories are stated at the lower of cost and net realisable value. Cost comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Cost is determined using the first-in first-out (FIFO) or weighted average cost method.

Section 8 - Construction Contracts

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

When the outcome of a construction contract cannot be estimated reliably, contract revenue should be recognised only to the extent of contract costs incurred that are likely to be recoverable, while contract costs should be recognised when incurred.

An entity should present:

- (a) as an asset, the gross amount due from customers for contract work for all contracts in progress for which costs incurred plus recognised profits exceed progress billings;
- (b) as a liability, the gross amount due to customers for contract work for all contracts in progress for which progress billings exceed costs incurred plus recognised profits.

Section 9 - Impairment of Assets

At each balance sheet date, an entity should consider whether there exists any indications of impairment and, if so, estimate the recoverable amount of all assets other than inventories, construction contracts and current investments. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount.

The recoverable amount is the greater of an asset's net selling price and future net cash flow expected from the continued use of that asset. In calculating the future net cash inflow, discounting would be permitted but is not required.

Section 10 - Provisions, Contingent Liabilities and Contingent Assets

Provision should be recognised when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
- (b) it is probable that an outflow of resources will be required to settle the obligation; and



- (c) the amount can be reliably estimated.

The amount recognised should be the best estimate of the amount required to settle the present obligation at the balance sheet date. No provision should be recognised for future operating losses.

An entity should not recognise a contingent asset or contingent liability.

Section 11 - Revenue

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. It should be measured at the fair value of the consideration received or receivable.

Revenue should be recognised on the following bases:

- (a) Sale of goods – when the entity has transferred to the buyer the significant risks and rewards of ownership of the goods and the collectibility of the related receivables is reasonably assured.
- (b) Rendering of services - by reference to the stage of completion of the specific transaction.
- (c) Interest – on a time-proportion basis.
- (d) Royalties – on an accruals basis in accordance with the substance of the relevant agreement.
- (e) Dividends – when the right to receive payment is established.

Section 12 - Government Grants and Other Government Assistance

Government grants are recognised when there is reasonable assurance that the entity will comply with the conditions attaching to them and that the grants will be received.

Grants relating to income are recognised in the income statement on a systematic basis to match with the related costs for which they are intended to compensate.

Grants relating to purchases of assets are either included in the balance sheet as deferred income or deducted from the carrying amount of the asset.

Disclosure should be made for the nature, extent and duration of other forms of government assistance from which an entity has directly benefited.

Section 13 - Borrowing Costs

This section provides benchmark and allowed alternative treatments:

Benchmark treatment

Borrowing costs are recognised as an expense in the period in which they are incurred.

Allowed alternative treatment

Borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, are capitalised as part of the cost of that asset. All other borrowing costs are recognised as expenses in the period in which they are incurred.

Section 14 - Income Taxes

Only current tax liabilities/assets measured at the amount expected to be paid or recovered from the taxation authorities are to be provided. No deferred tax asset or liability is recognised.



Section 15 - The Effects of Changes in Foreign Exchange Rates

Foreign currency transactions are translated into the reporting currency using the exchange rates prevailing at the dates of the transactions. Foreign currency monetary assets and liabilities are translated using the closing rates at the balance sheet date. Exchange differences arising on settlement, and from the translation at the closing rate of monetary items, are recognised in the income statement.

Assets and liabilities of a foreign branch, expressed in a currency other than that of the entity, are translated at the closing rate at the balance sheet date; whereas the income statement is translated at the average rate for the period or closing rate at the balance sheet date. All resulting exchange differences should be recognised as a separate component of equity.

Section 16 - Related Party Disclosures

Related parties include the parent, entities with joint control or significant influence over the entity, associates, joint ventures in which the entity is a venturer, key management personnel of the entity or the parent, and other related parties. In considering each possible related party relationship, attention is directed to the substance of the relationship rather than the legal form.

An entity should disclose the name of the parent, the ultimate holding entity, total remuneration of key management personnel and, as a minimum, the following:

- (a) the amount of the transactions;
- (b) the amount of outstanding balances, their terms and conditions and details of any guarantee given or received; and
- (c) provision for doubtful debts related to the amount outstanding and the amount charged to the income statement during the period.

Section 17 - Events After the Balance Sheet Date

An entity should adjust the amounts recognised in its financial statements only for adjusting events after the balance sheet date. For significant non-adjusting events, an entity should disclose its nature and an estimate of its financial effect or a statement that such an estimate cannot be made.

An entity should not recognise as a liability at the balance sheet date dividends declared after the balance sheet date.

An entity should disclose the date when the financial statements were authorised for issue and who gave that authorisation.

EQUIVALENT STANDARDS AND KEY DIFFERENCES

Table 1 sets out key differences between the SME-FRS and (i) the HKASs and (ii) the SSAPs.

The SME-FRS does not include all HKFRSs and certain areas covered by the HKASs, such as consolidation, industry specific topics, disclosures for listed entities and other complex issues such as financial instruments. Table 2 sets out the HKAS/HKFRSs not included in the SME-FRS with which compliance is not required if the SME-FRS is adopted.



TRANSITIONAL PROVISIONS

The SME-FRS contains transitional provisions, whereby all items previously recognised, derecognised or measured on bases inconsistent with the SME-FRS are to be derecognised, recognised or re-measured and dealt with as changes of accounting policies under the SME-FRS.

SWITCHING BETWEEN THE FULL HKFRS AND THE SME-FRS

The transition from the Full HKFRS to the SME-FRS is treated as a change of accounting policies under the SME-FRS. When switching from the SME-FRS to the Full HKFRS, for the first set of financial statements prepared after switching, HKFRS 1, "First time adoption of Hong Kong Financial Reporting Standards" is to be applied. As switching between the Full HKFRS and the SME-FRS would involve restatement of opening

balances and comparative amounts, frequent switching will cause extra cost and effort. Accordingly, before deciding to switch to the SME-FRS, an entity should consider the likelihood that it could adopt the SME-FRS for a sufficiently long period.

Points to be considered before transition to the SME-FRS include:

- the probability of obtaining all shareholders' consent each year;
- any future plans to acquire subsidiaries;
- for non-Hong Kong incorporated entities, the likelihood of meeting the size criteria each year;
- the likelihood that there are users, such as bankers and creditors, who would not be satisfied with financial statements prepared in accordance with the SME-FRS.

TABLE 1 - KEY DIFFERENCES BETWEEN THE SME-FRS AND HKASs / SSAPs

17 Sections in the Standard	Equivalent HKAS - Key Differences	Equivalent SSAP - Key Differences
Section 1 Presentation of Financial Statements	HKAS 1 <ul style="list-style-type: none"> • not applicable to preparation of consolidated accounts • cash flow statement not required; changes in equity can be presented in the notes or a separate statement • financial statements give a "true and correct view" rather than "true and fair view" 	SSAP 1 <ul style="list-style-type: none"> • not applicable to preparation of consolidated accounts • cash flow statement not required; changes in equity can be presented in the notes or a separate statement • financial statements give a "true and correct view" rather than "true and fair view" • current/non-current assets/liabilities defined • disclose legal form, principal place of business, registered office address, principal activities



17 Sections in the Standard	HKAS Equivalent - Key Differences	SSAP Equivalent - Key Differences
Section 2 Accounting Policies, Changes in Accounting Estimates and Errors	<p>HKAS 8</p> <ul style="list-style-type: none"> undue cost or effort exemption criteria for restating comparative figures is introduced versus impracticability criteria no disclosure required for new standards issued but not yet effective 	<p>SSAP 2</p> <ul style="list-style-type: none"> undue cost or effort exemption criteria for restating comparative figures is introduced versus impracticability criteria correct retrospectively material errors, not only fundamental, prior period errors
Section 3 Property, Plant and Equipment	<p>HKAS 16</p> <ul style="list-style-type: none"> includes investment property and leasehold land no fair value model and no revaluation comparative information for reconciliation of the carrying amount of PPE is not required separate recognition criteria for subsequent expenditure. This requires such expenditure to be recognised only when it is probable that future economic benefits in excess of the original standard will flow to the entity 	<p>SSAP 17</p> <ul style="list-style-type: none"> includes investment property no fair value model and no revaluation review useful life and depreciation method annually, not only periodically depreciation begins from when asset available for use until derecognised, even if not in active use derecognise part of assets when replaced
Section 4 Intangible Assets	<p>HKAS 38</p> <ul style="list-style-type: none"> no revaluation model rebuttable presumption of useful life not exceeding 20 years is retained comparative information for reconciliation of the carrying amount is not required 	<p>SSAP 29</p> <ul style="list-style-type: none"> no revaluation model in identifying intangible assets, reference to 'held for use' is irrelevant
Section 5 Leases	<p>HKAS 17</p> <ul style="list-style-type: none"> leasehold land accounted for as PPE, not operating lease 	<p>SSAP 17</p> <ul style="list-style-type: none"> no material differences
Section 6 Investments	<p>HKAS 39</p> <ul style="list-style-type: none"> only deals with investments, including investments in subsidiaries, associates and joint ventures other financial assets, financial liabilities and equity instruments not covered 	<p>SSAP 24</p> <ul style="list-style-type: none"> includes investments in subsidiaries, associates and joint ventures no alternative treatment, fair value is not adopted



17 Sections in the Standard	HKAS Equivalent - Key Differences	SSAP Equivalent - Key Differences
Section 6 Investments (cont')	<ul style="list-style-type: none"> divided into 3 categories only for subsequent measurement, namely current investment, long-term investment and held-to-maturity securities initial and subsequent measurements are at cost, fair value is not used derivative and hedge accounting are not covered no complex disclosures relating to financial risks 	<ul style="list-style-type: none"> effective interest rate method is introduced for amortisation of held-to-maturity debt securities initial and subsequent measurements are at cost, fair value is not used for current investment hedge accounting is not covered
Section 7 Inventories	HKAS 2 <ul style="list-style-type: none"> no material differences 	SSAP 22 <ul style="list-style-type: none"> no material differences
Section 8 Construction Contracts	HKAS 11 <ul style="list-style-type: none"> no material differences 	SSAP 23 <ul style="list-style-type: none"> no material differences
Section 9 Impairment of Assets	HKAS 36 <ul style="list-style-type: none"> recoverable amount is defined as "the greater of net selling price and its value in use", not "the greater of fair value less costs to sell and its value in use" in calculating value in use, discounting is permitted but not required lengthy explanation on how to derive future cash flow is not provided provision for reversals of impairment losses for goodwill is not provided. HKAS prohibits reversal of impairment losses for goodwill no separate disclosure requirements 	SSAP 31 <ul style="list-style-type: none"> in calculating value in use, discounting is permitted but not required no separate disclosure requirements provision for reversals of impairment losses for goodwill not provided impairment testing done annually instead of only when there is indication of impairment
Section 10 Provisions, Contingent Liabilities and Contingent Assets	HKAS 37 <ul style="list-style-type: none"> recognition and measurement bases on restructuring are not provided 	SSAP 28 <ul style="list-style-type: none"> recognition and measurement bases on restructuring are not provided



17 Sections in the Standard	HKAS Equivalent - Key Differences	SSAP Equivalent - Key Differences
Section 11 Revenue	HKAS 18 <ul style="list-style-type: none"> no material differences 	SSAP 18 <ul style="list-style-type: none"> no material differences
Section 12 Government Grants and Other Government Assistance	HKAS 20 <ul style="list-style-type: none"> no material differences 	SSAP 35 <ul style="list-style-type: none"> no material differences
Section 13 Borrowing Costs	HKAS 23 <ul style="list-style-type: none"> no material differences 	SSAP 19 <ul style="list-style-type: none"> benchmark treatment to expense all costs when incurred is introduced
Section 14 Income Taxes	HKAS 12 <ul style="list-style-type: none"> no deferred taxation is provided 	SSAP 12 <ul style="list-style-type: none"> no deferred taxation is provided
Section 15 The Effects of Changes in Foreign Exchange Rates	HKAS 21 <ul style="list-style-type: none"> the concept of functional currency is not adopted accounting treatment for forward contracts, not dealt with as derivatives under HKAS 39 	SSAP 11 <ul style="list-style-type: none"> using closing rate for translating the income statement of a foreign branch is allowed
Section 16 Related Party Disclosures	HKAS 24 <ul style="list-style-type: none"> no material differences minor difference in definition of close member of the family; refers to spouse rather than domestic partner 	SSAP 20 <ul style="list-style-type: none"> exemption for a company applying section 141D for disclosure removed consider substance of relationship rather than legal form related parties include key management personnel and disclosure includes total remuneration of key management personnel
Section 17 Events After the Balance Sheet Date	HKAS 10 <ul style="list-style-type: none"> no material differences 	SSAP 9 <ul style="list-style-type: none"> no requirement to disclose proposed dividend on the face of the balance sheet or in the notes to the accounts



TABLE 2 - HKAS & HKFRSs NOT INCLUDED IN THE SME-FRS WITH WHICH COMPLIANCE IS NOT REQUIRED IF THE SME-FRS IS ADOPTED

HKAS

- HKAS 7 Cash Flow Statements
- HKAS 14 Segment Reporting
- HKAS 19 Employee Benefits
- HKAS 26 Accounting and Reporting by Retirement Benefits Plans
- HKAS 27 Consolidated and Separate Financial Statements
- HKAS 28 Investments in Associates
- HKAS 29 Financial Reporting in Hyperinflationary Economics
- HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions (superseded by HKFRS 7)
- HKAS 31 Investments in Joint Ventures
- HKAS 32 Financial Instruments: Disclosure and Presentation
- HKAS 33 Earnings Per Share
- HKAS 34 Interim Financial Reporting
- HKAS 39 Financial Instruments: Recognition and Measurement
- HKAS 40 Investment Property
- HKAS 41 Agriculture

HKFRS

- HKFRS 1 First-time Adoption of Hong Kong Financial Reporting Standards
- HKFRS 2 Share-based Payment
- HKFRS 3 Business Combinations
- HKFRS 4 Insurance Contracts
- HKFRS 5 Non-current Assets Held for Sale and Discontinued Operations
- HKFRS 6 Exploration for and Evaluation of Mineral Resources
- HKFRS 7 Financial Instruments: Disclosure

Should you need further information or clarification regarding this TechNews, please do not hesitate to approach any of your usual Tricor contacts.

WE ARE MOVING...

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