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SME-FRS Update

Revised Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard

Introduction

The new Hong Kong Companies Ordinance, Chapter 622 of the Laws of Hong Kong, (the "New CO") came into operation on 3 March 2014. It contains an optional reporting exemption for certain private companies and companies limited by guarantee under Section 359 of the New CO. The Revised Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (the "Revised SME-FRF and FRS") issued by the HKICPA in March 2014 are the accounting standards to be followed by those Hong Kong incorporated companies which are entitled to, and decide to, take advantage of this reporting exemption.

For details of the conditions and size tests for a Hong Kong incorporated company in order to fall within the reporting exemption under Section 359 of the New CO, please refer to our update on the new Hong Kong Companies Ordinance.

An entity which is not a company incorporated under either the New CO or the old Companies Ordinance e.g. a BVI company, subject to any specific requirements imposed by the law of the entity's place of incorporation and subject to its constitution, qualifies for reporting under the Revised SME-FRF when the entity meets the same requirements that a Hong Kong incorporated entity is required to meet under Section 359 of the New CO.

The accounting requirements in the Revised SME-FRS are expanded to cover consolidated financial statements, business combinations and investments using the equity method.

Effective Date

The Revised SME-FRF and FRS are effective for a qualifying entity's financial statements that cover a period beginning on or after 3 March 2014. Earlier application is <u>not</u> permitted.

The following sections in this update summarise the major revisions or additions to the Revised SME-FRF and FRS

Disclosure Requirements of Transitioning from Different GAAP (for example HKFRSs) to the Revised SME-FRS

The following new disclosures are required in the year of transition:

- The fact that this is the first year of adopting the Revised SME-FRF and FRS.
- The previous accounting framework adopted.
- A reconciliation of net assets as reported in the previous annual financial statements and net assets reported under the Revised SME-FRS, showing separately:
  - any items derecognised because they do not meet the recognition criteria under the Revised SME-FRF and FRS;
  - any items recognised for the first time because they meet the recognition criteria under the Revised SME-FRF and FRS but were not recognised under the previous accounting framework; and
  - the amount by which any items have been re-measured as a result of adopting the measurement requirements of the Revised SME-FRF and FRS.

  The reconciliation should be presented for the opening balances of the current period and any comparative period presented which have been restated as a result of transitioning to the Revised SME-FRF and FRS.
- If any opening balances have not been restated because it would require undue cost or effort to do so, this fact.

中汇 ZHONGHUI

Guidance on Realised Profits and Losses

The following guidance is added:

- A company may only make a distribution out of profits available for distribution, which are its accumulated realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital. Such distributable profits are to be computed at the company-level, irrespective of whether the company prepares consolidated financial statements.
- In accordance with Accounting Bulletin 4 "Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance" issued by the HKICPA, a profit shall be treated as realised only when realised in the form of:
  - cash; or
  - other assets, the ultimate cash realisation of which can be assessed with reasonable certainty.
- Further guidance on the concept of realised profits and losses can be found in Accounting Bulletin 4 and the accompanying Staff Summary issued by the HKICPA. The guidance is primarily intended to address a wide variety of differences between recognition requirements under HKFRSs and the concept of realised profits and losses. Although the same principles for defining realised profits and losses will apply whether a company follows HKFRSs or the Revised SME-FRS, in practice as the Revised SME-FRS does not permit upwards revaluation of assets and does not contain specific requirements relating to more complex financial instruments, many of the differences identified in Accounting Bulletin 4 will not be applicable to financial statements prepared in accordance with the Revised SME-FRS.

Amended or New Definitions

Some definitions are amended in order to align with or be consistent with HKFRSs. Examples are: ▶ Active market ▶ Fair value ▶ Related party	Some new definitions are added due to the new sections on business combinations, consolidation, associates, joint arrangements and cash flow statements. Examples are: ▶ Acquisition date ▶ Business ▶ Business combination ▶ Financing activities ▶ Investing activities ▶ Joint arrangement ▶ Non-controlling interest

Section 1

Presentation of Financial Statements

The following items should be disclosed separately on the face of the consolidated statement of financial position:

- Investments using the equity method.
- An allocation of reserves between:
  - non-controlling interest; and
  - reserves attributable to equity holders of the parent.

The following items should be disclosed separately on the face of the consolidated income statement:

- Share of profit or loss of associates and joint ventures using the equity method.
- An allocation of profit or loss for the period between:
  - profit or loss attributable to non-controlling interest; and
  - profit or loss attributable to equity holders of the parent.

Section 4

Intangible Assets (other than Goodwill)

An intangible asset should be recognised if, and only if:

- in the case of an intangible asset acquired in a business combination, its fair value is readily apparent or otherwise can be measured reliably without undue cost; and
- in all other cases, it is probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.

The rebuttable presumption of the useful life of an intangible asset from the date when the asset is available for use will not exceed is changed from 20 years to 10 years.

Section 6

Investments

This section should not be applied in accounting for investments in associates or joint ventures accounted for using the equity method as they are dealt with in section 20 “Investments in Associates” and section 21 “Interests in Joint Ventures and Other Forms of Joint Arrangements” respectively.

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Impairment of Assets

Section 9

The scope of this section extends to investments in subsidiaries, associates and joint ventures.

An impairment loss should not be reversed unless its fair value is readily apparent or the asset's recoverable amount can otherwise be measured reliably without undue cost. The minimum factors of external and internal sources of information to be considered for reversal of impairments are removed.

The following requirements for impairment of goodwill are added:

- Goodwill should be allocated to the component(s) of the entity that benefit from the goodwill (generally the lowest level within the entity at which the goodwill is monitored for internal management purposes).
- At the end of each period the entity should assess whether there is any indication that goodwill may be impaired. In addition to considering the indicators of impairment in paragraph 9.2 of this section, the entity should also consider whether:
    - since acquisition, the acquired entity to which the goodwill relates has performed significantly worse than expected;
    - the acquired entity to which the goodwill relates is being restructured, held for sale or abandoned; or
    - significant impairment losses have been recognised for other assets of the acquired entity to which the goodwill relates.
- If there is an indication that goodwill has been impaired, the entity should follow a two-step process to determine whether to recognise an impairment loss:

Step 1:

- measure the recoverable amount of the component including the goodwill;
- compare the recoverable amount of the component with its carrying amount; and
- if the recoverable amount of the component is less than its carrying amount, recognise the difference as an impairment loss in accordance with Step 2.

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Step 2:

- write down the goodwill by the impairment loss determined in Step 1 and recognise the impairment loss in profit or loss; and
- if the amount of the impairment loss determined in Step 1 exceeds the goodwill, the excess should be allocated to the identifiable non-cash assets of the component on the basis of their relative carrying amounts and recognised in profit or loss.

Section 9 (Con't)

- If there is a non-controlling interest in the component to which goodwill has been allocated, the carrying amount of that component comprises:
  - both the parent's interest and the non-controlling interest in the identifiable net assets of the component; and
  - the parent's interest in goodwill.

  The carrying amount of such a component does not include any goodwill attributable to the non-controlling interest. Therefore, in order to ensure that the carrying amount of the component used in Step 1 is computed on a consistent basis compared to its recoverable amount computed in Step 1, it is necessary to gross up the carrying amount of goodwill to include the goodwill attributable to the non-controlling interest. This computation is illustrated in Part C of Appendix 1 of the Revised SME-FRF and FRS.
- An impairment loss recognised for goodwill should not be reversed in a subsequent period.

Section 10

Provisions, Contingent Liabilities and Contingent Assets

For a contract that is onerous, a provision should be recognised and measured at the best estimate of the unavoidable cost of meeting the obligation under the contract less any economic benefits expected to be received under it. The unavoidable cost of meeting the obligation under the contract is the lower of:

- the cost of exiting the contract (e.g. any penalties that would be payable on early cancellation); and
- the cost of fulfilling the contract.

Section 14

Income Taxes

The following new disclosures are required:

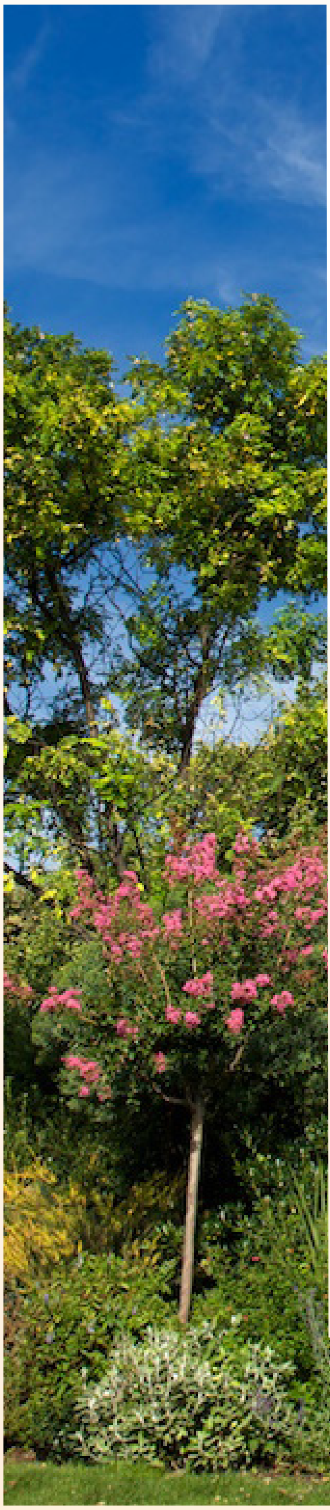
- Applicable tax rates and jurisdictions in which the tax expense arose.
- Amount of unused tax losses available to be carried forward against future taxable profits and the expiry dates of those losses.

The Effects of Changes in Foreign Exchange Rates

Section 15

New guidance has been added on determining the reporting currency of an entity which is based on the concept of the functional currency in HKFRSs.

Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation should be treated as assets and liabilities of the foreign operation. They should be expressed in the reporting currency of the foreign operation and should be translated at the closing rate.



Business Combinations and Goodwill

Section 18

This section should be applied in accounting for business combinations except for business combinations under common control. If a business combination under common control is not accounted for in accordance with the accounting requirements of this section, it should be accounted for in accordance with one of the following methods:

- Merger accounting in accordance with Accounting Guideline 5 "Merger Accounting for Common Control Combinations" issued by the HKICPA.
- At book values as stated in the financial statements of the acquired entity or in the consolidated financial statements of the previous parent.

All business combinations should be accounted for by applying the purchase method which involves the following steps:

- Identifying an acquirer.
- Measuring the cost of the business combination.
- Allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities assumed.

Cost of a business combination is the aggregate of the fair values, at the acquisition date, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree. Other costs attributable to effecting the business combination should be recognised as expenses in the income statement in the periods in which the costs are incurred and the services are received.

Section 18 (Con't)

An adjustment to contingent consideration should be included in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably. After the acquisition date, changes to the estimated amount of contingent consideration should only be treated as an adjustment to the cost of the combination when the changes arise as a result of new information about the facts and circumstances that existed at the date of acquisition which becomes known within twelve months after the acquisition date or to correct an error.

The acquirer should allocate the cost of a business combination by recognising the acquiree's identifiable assets and liabilities at their acquisition date fair values. Any difference between the cost of the combination and the acquirer's interest in the net fair value of the identifiable assets and liabilities should be accounted for as goodwill or gain on a bargain purchase, similar to those under HKFRSs.

The acquirer should recognise separately the acquiree's intangible asset if its fair value is readily apparent or otherwise can be measured reliably without undue cost or effort.

After initial recognition, the acquirer should measure goodwill acquired in a business combination at cost less any accumulated amortisation and impairment losses. Goodwill should be amortised on a systematic basis over the best estimate of its useful life with a rebuttable presumption of not exceeding 5 years from initial recognition.

The amortisation method used should reflect the pattern in which the future economic benefits arising from goodwill are expected to be consumed. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense. The amortisation period and the amortisation method should be reviewed at least at the end of each financial year if the useful life of goodwill exceeds 5 years.

There are disclosure requirements for business combinations effected during the period and after the end of the reporting period but before the financial statements are authorised for issue.

Section 19

Consolidated and Company-Level Financial Statements

An entity which is a parent at the end of the financial year is required to present consolidated financial statements except when:

- it is a wholly-owned subsidiary of another entity; or
- it meets all of the following conditions:-
    - it is a partially-owned subsidiary of another entity;
    - at least 6 months before the end of the financial year, the directors notify the members in writing of the directors' intention not to prepare consolidated financial statements for the financial year, and the notification does not relate to any other financial year; and

  - ♦ as at a date falling 3 months before the end of the financial year, no member has responded to the notification by giving the directors a written request for the preparation of consolidated financial statements for the financial year; or

- ► all of its subsidiaries qualify for exclusion from consolidation as stated below.

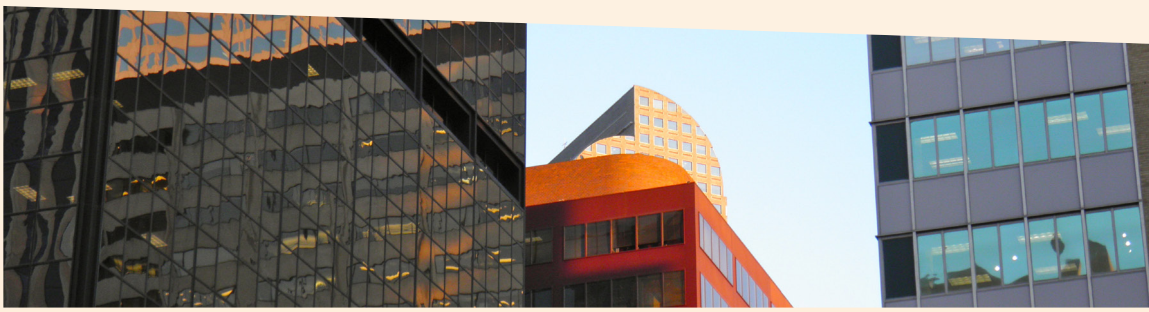
If a parent is exempt from preparing consolidated financial statements and does not prepare such financial statements, it should prepare company-level financial statements. Investments in subsidiaries, associates and joint ventures in the company-level financial statements are accounted for using the cost model.

All subsidiaries should be consolidated except when:

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

A parent may not exclude a subsidiary from consolidation on the grounds of 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. In order to satisfy this condition:

- ► The notification to the members of the company must:
  - ♦ state which financial year that the notification relates to (and the notification must not relate to more than one financial year);
  - ♦ specify the subsidiary or subsidiaries proposed to be excluded; and
  - ♦ state the directors' reasons for believing that the inclusion of the subsidiary or subsidiaries in the consolidated financial statements may involve expense and delay out of proportion to the value to the shareholders.
- ► In the case of an entity which needs to obtain shareholder approval in order to qualify for the reporting exemption, the notification to the members of the company proposing to exclude one or more subsidiaries from consolidation must be included as part of the notice to obtain the necessary shareholder approvals required to qualify for the reporting exemption and must be subject to the same approval and objection processes as apply to that approval.
- ► In all other cases the notification must be sent to the members before the date of approval of the financial statements and must allow the members of the company a period of no less than one month to raise objections, unless all the members of the company confirm that such a period is not necessary.
- ► Within the time frame allowed above, no member has indicated to the company that they disagree with the directors' assertion that the inclusion of the subsidiary or subsidiaries would involve expense and delay out of proportion to the value to members of the company.



Section 19 (Con't)

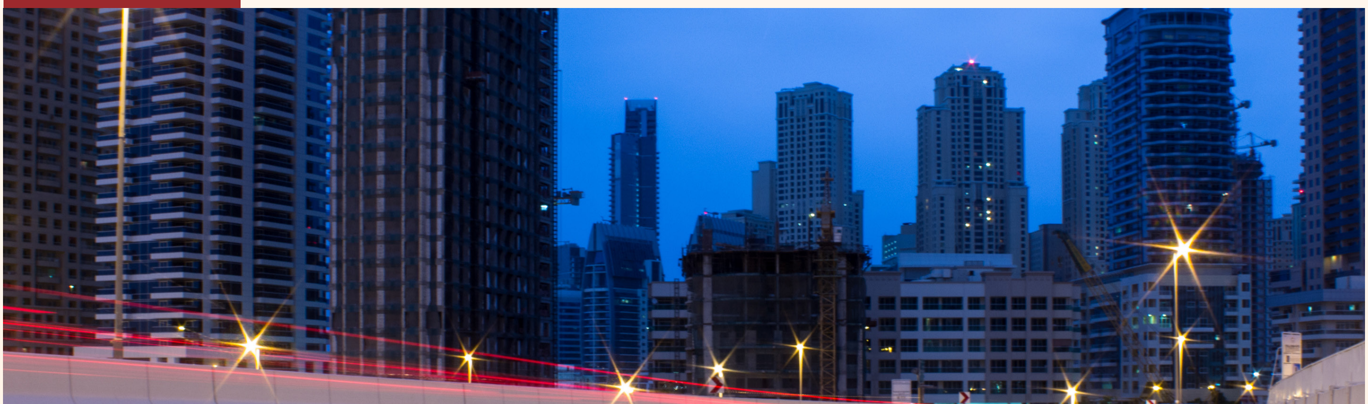
A subsidiary is an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The consolidation procedures are similar to those under HKFRSs.

The difference between the proceeds from the disposal of the subsidiary and its carrying amount as of the date of disposal is recognised in the consolidated income statement as the gain or loss on the disposal of the subsidiary. This gain or loss includes the cumulative amount of any exchange differences that relate to the subsidiary recognised in equity in accordance with section 15 except when undue cost or effort is needed to arrive at such cumulative amount of exchange difference and disclosure is made in the financial statements for such exclusion on a transaction by transaction basis.

If an entity ceases to be a subsidiary but the former parent continues to hold some equity shares, those shares should be accounted for as an investment in accordance with section 6 from the date the entity ceases to be a subsidiary, provided that it does not become an associate or a joint venture. The carrying amount of any investment retained in the former subsidiary at the date that the entity ceases to be a subsidiary should be regarded as the cost on initial measurement of an investment.

There are disclosure requirements about the consolidation, particulars of subsidiaries included in and excluded from consolidation.



Section 20

Investments in Associates

An associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. The concept of significant influence is similar to that in HKFRSs.

There is an accounting policy choice between the benchmark treatment and the allowed alternative treatment:

- The benchmark treatment is to account for the investments in associates using the cost model.
- The allowed alternative treatment is to account for the investments in associates in the consolidated financial statements using the equity method.

The application of the equity method is similar to that in HKFRSs.

There are disclosure requirements about the associates.

Interests in Joint Ventures and Other Forms of Joint Arrangements

Section 21

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity through an entity that is separate from the parties and subject to joint control. The concept of joint control is similar to that in HKFRSs.

There is an accounting policy choice between the benchmark treatment and the allowed alternative treatment:

- The benchmark treatment is to account for the investments in joint ventures using the cost model.
- The allowed alternative treatment is to account for the investments in joint ventures in the consolidated financial statements using the equity method.

The application of the equity method is similar to that in HKFRSs.

There are disclosure requirements about the joint ventures.

Cash Flow Statement (optional)

Section 22

An entity which prepares and presents its financial statements in accordance with the Revised SME-FRS is not required to include a cash flow statement. However, if an entity voluntarily includes a cash flow statement in those financial statements, then this cash flow statement should be prepared in accordance with the requirements of this section.

The requirements for the preparation of a cash flow statement are similar to those in HKFRSs.

Appendices

Guidance on determining whether an entity is acting as an agent or principal is added. This guidance is the same as that in the Appendix to HKAS 18 "Revenue".

An illustrative example of measuring and recognising impairment allocation when there is a non-controlling interest is added.

A table of non-exempt disclosure requirements in the notes to financial statements under the New CO for financial statements using the Revised SME-FRS is added.

The illustrative company-level financial statements under the Revised SME-FRS are amended. A set of new illustrative consolidated financial statements under the Revised SME-FRS is added.

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