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From: EDWARD
Sent: Thursday, May 20, 2004 10:19 PM
To: P.T. Comment Letter
Subject: HKSA-CP2.doc/COMMENTS TO PROPOSED IMPLEMENTATION OF A SMALL & MEDIUM-SIZED ENTITY FINANCIAL REPORTING FRAMEWORK AND FRS

COMMENTS ON CONSULTATION PAPER ON A SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING FRAMEWORK AND FINANCIAL REPORTING STANDARD

20 May 2004

Consultation Issues

1) The need for a separate financial reporting framework for SME

The validity of expectation by SME's investors on SME financial reporting may be subject to their rational respective needs. It is not the matter of compliance of Company Law in Hong Kong and compliance of HKGAAP. In my opinion, research by surveying to SME will allow us to generalize the specific population need and the study of the nature of population. For example, evidence to SME's expectation to financial reporting in Hong Kong may tend to follow the central tendency/distribution to listed companies in Hong Kong or the opposite. The methodology may comprise one of the social science hypotheses. In fact, mean and variance may be necessary to estimate the SME's expectations.

At this moment, the bias over opinions from SMEGA and ISAR may create insufficiency and reservation over the local needs expectation. This may be a misled belief to need of SME. In theory, to auditors in Hong Kong, the need to SME financial reporting will allow them to discharge at ease to the obligation and duties in common law and in statutes. Perhaps, they act in good faith. Oversea judicial litigation may not be relevant to Hong Kong SME. By assumption, the need of SME financial reporting will not affect the quality of assurance to auditing under the statutory audit engagements. However, the degree of compliance quality of accounting in GAAP and in HKFRS of SME is essential.

In law, SME financial reporting will not affect the investors' interests, both majority and minority shareholders and the duties of managers or directors in acting good faith to efforts to the contracted SME. That means the risk of corporate failure resulting from SME financial reporting will be lower.

In finance, SME financial reporting should assist the SME investors to gain higher company value in terms of book asset value and the benchmarking market return of assets. In addition, SME should gain easier access to source of finance in capital market by the channel of SME financial reporting.

2) The principles underlying SME financial reporting

The use of cost and benefit analysis may need further research. Examples are the research over the degree of reliance to separate legal entity of SME to the level of difference financial reporting; the size of SME to level of financial reporting. In my opinion, based on criteria given, the size of SME may not correlate to the need of differential financial reporting to SME. More study will be necessary under the multi-regression method. However, I do not have research data on hand. The decision to SME financial reporting is the decision of SME investors. It all depends on the financial reporting strategy of SME. The SME investors make the final decision. To auditors, SME financial reporting is an option of engagements. In addition, SME financial reporting may be the derivative to sub-optimal audited financial statements. No criteria is better the strict criteria under cost and benefit as cost and benefit are unable to quantify at ease as value judgement or decision science. In finance, the optimal decision to selection of SME financial reporting may be the positive NPV to the SME.

3) Whether SME financial statements need give a true and fair view

In law, different place of incorporation by jurisdiction of SME creates different judgement to true and fair view. Auditors in Hong Kong consider SME financial reporting is adequate to true and fair view under the company law. Thus, these leads to different viewpoints to auditors' duties and liabilities under the company laws.

Auditors' difference to the satisfaction of company's law in Hong Kong may distract the decisions to the choice of auditors to SME. Thus, auditors' skills and experience to auditing service vary to the viewpoint of true and fair view. Court decisions are important to conclude SME

financial reporting. In my opinion, courts judgements will tend to bias over auditors negligence in tort and over remedies to SME in tort and in equity. In addition, future company law reform will cater for the need of SME.

To SME, true and fair view is essential to success of assessment to management quality for the benefit of investors. Thus, further research over the relationship of true and fair view in Hong Kong and SME GAAP is still necessary.

In law, public interests are less material to SME as the contracting parties are auditors and SME in Hong Kong only. Third party liabilities to SME auditors in tort and in statue will be very remote.

4) Which entities should qualify to prepare financial statements under the SME- FRF

Based on the above observation, who should be qualified to SME financial reporting is sub-optimal as decisions of investors and managers are critical.

5) Statutory requirements under the Companies Ordinance

The Memorandum and Articles, Table A and its sections in the Companies Ordinance did not mention the choice of GAAP and financial reporting except the sections about auditors and accounting records.

An interesting question about current need of SME over the Companies Ordinance remains unknown.

However, SME ' may be listed companies, regulated by Listing Rules and Securities and Futures Commission. Thus, question over selection criteria to SME financial reporting will be a subjective decision. Government' s viewpoint is useful to determine criteria.

6) Applicable financial reporting requirements

All questions about details of SME financial reporting requirements should be legislated in the Companies Ordinance. Example is given in Companies Acts 1985 in England.

Conclusion

The ultimate question to why financial reporting and auditing in Hong Kong is the only answer to the need of difference financial reporting to SME. However, we need to pay attention to the only question of financial reporting.

Financial reporting and auditing are more useful to limited liability companies with separate legal entities. SME may not be the criteria within the scope here.

The issue of separate legal entities has created volumes litigations in company law in history. Therefore, separate legal entities concept create the need of detailed financial reporting to protect or to safeguard the investors interests with relative high capital amount. The value issue of amount of asset and capital will be the only criteria to the choice of financial reporting and assurance. Managers and directors own statutory duties to the company in return for power granted by the M&A and/or Table A and investors and shareholders are the owner of the company. In fact, the debate among investors and their rights and obligations over difference financial reporting will be a good topic.

In perfect situation, the compliance of company law in Hong Kong is positively correlated to the compliance of GAAP and accounting standards in Hong Kong to ensure fairness to investors and to users of financial statements. SME financial reporting will not solve the problem of stewardship assumption and maintenance of capital in time. The question of why financial reporting and its difference remain to be seen. In addition, the issue of loophole to incorporation without a sound financial reporting framework may create unnecessary evils and litigations.

Thus, additional researches will give us further conclusive answers.

My preference, not unfair preference, over SME financial reporting remains positive. However, reform of Companies Ordinance is the prerequisite to the SME financial reporting.

Sincerely,

Edward Yeung

Edward Yeung, A08786, P02783