

IASB STANDARDS FOR SMALL AND MEDIUM-SIZED ENTITIES

Memorandum of comment submitted in September 2004 to the International Accounting Standards Board concerning the discussion paper, 'Preliminary Views on Accounting Standards for Small and Medium-sized Entities'

Contents

Paragraphs

Introduction	1 - 2
Overall Assessment	3 - 4
The Importance of the Project	5 - 6
Eligibility	7 - 9
A More Radical Approach	10 - 15
Responses to Specific Questions	16 - 41

INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales (the ICAEW) welcomes the opportunity to comment on the discussion paper '*Preliminary Views on Accounting Standards for Small and Medium-sized Entities*' published for comment in June 2004 by the International Accounting Standards Board (the IASB/the Board). The ICAEW is the largest accountancy body in Europe, with more than 125,000 members operating in business, public practice and within the investor community. The ICAEW operates under a Royal Charter, working in the public interest.
2. We have reviewed the discussion paper and set out below a number of comments and suggestions for consideration by the Board. We deal first with significant matters before commenting on the specific issues raised in the consultation paper.

MAJOR POINTS

Overall Assessment

3. We strongly support the development by the IASB of financial reporting standards suitable for use by smaller reporting entities required by national law to prepare financial statements that conform to a specified set of generally accepted accounting principles ('GAAP financial statements'). However, in our view the approach adopted by the Board will fail to meet the needs of the majority of small businesses. Significant changes are needed to ensure that the outcome of the current project is standards suitable for application by small and medium-sized entities (SMEs).
4. We comment below in more detail on:
 - the importance of the project and of the involvement of the IASB (paragraphs 5-6);
 - the merits of the Board seeking to define the qualitative characteristics of entities for which the proposed SME standards would be suitable, but leaving all decisions on eligibility to national jurisdictions (paragraphs 7-9); and
 - the need for a more radical simplification of full International Financial Reporting Standards (IFRS) in deriving SME standards, potentially involving substantial changes to the Framework, a reduction in disclosure to a minimum and significant simplification of measurement principles, with emphasis on the use of historical cost rather than fair values (paragraphs 10-15).

The Importance of the Project

5. We strongly support the current IASB project on accounting by SMEs and commend the high priority given to the project by the Board. There is a significant level of demand for a high quality set of international standards derived from IFRSs for use by the millions of businesses around the world that do not raise funds on the capital markets and are not otherwise of economic significance. In Great Britain alone there are over 1,700,000 limited companies, of which fewer than 2,000 are listed entities. Whilst we accept that the IASB should focus on the capital markets, the goodwill and authority enjoyed by the Board provide an unprecedented opportunity to establish a widely-used accounting framework for such entities. This will encourage best accounting practice on a global scale and be advantageous to:
- investors and lenders seeking to make comparisons between financial information published by entities in the same sectors;
 - regulators and organisations such as the World Bank;
 - groups with subsidiaries in more than one jurisdiction; and
 - the many SMEs that trade across national borders.
6. If the Board proves unable to deliver a high quality set of SME standards in the near future, the result is likely to be a proliferation of competing sets of standards based to a greater or lesser degree on IFRSs - a highly unwelcome development as the Board is uniquely placed to issue authoritative standards. The Board should therefore consider whether further resources should be devoted to the project. For example, a sub-group of the IASB, familiar with SME issues, should be established, chaired by a member of the Board, to accelerate the current process and permit the Board to devote its energies to the capital markets.

Eligibility

7. Establishing clear eligibility criteria is inevitably problematic and to some extent arbitrary, especially if size criteria are used. We therefore support the use of a qualitative and high level approach to identifying the characteristics of entities for which the new standards would be suitable. However, the Board's approach in setting out more detailed criteria is generally too prescriptive. We believe that the IASB should limit its role to issuing standards and accept that national jurisdictions should determine detailed eligibility criteria, as explained below in paragraphs 18, 24, 25 and 26. The Board should only indicate - as clearly and simply as possible - the characteristics of the entities it had in mind in developing the standards.
8. In our view, the Board might distinguish broad classes of reporting entity, such as:
- Entities that have securities listed for trading in public securities markets or are unlisted but are regarded within a national jurisdiction as of high

economic significance by reference, for example, to a regional economy or particular markets; and

- Other entities - the vast majority around the world - required to produce GAAP financial statements, typically of interest only to the owner-managers themselves, lenders and tax authorities.

9. The first group of entities should use full IFRSs. The second need not, since the primary uses to which their financial statements are put - whether for decision-making, accountability or other purposes - are likely to be very different in kind. As in practice the movement of individual entities between these populations is limited, facilitating an easy transition to full IFRSs – whilst desirable in principle - should not be a primary objective of the Board when establishing a set of SME standards. In particular, the cost of accounting adjustments is unlikely to be a major factor when companies first seek to raise capital on the market.

A More Radical Approach

10. We agree that *prima facie* the objectives of general purpose financial statements (as articulated in paragraph 12 of the Framework) are of universal application. However, as highlighted in the Board's news release of 24 June 2004, IFRSs have been "*developed primarily for use in international capital markets*", and so are aimed at investors without specific reference to the very different users - and uses - of the financial statements of privately-owned (and usually - but not always - smaller businesses). In particular, information of importance to investors and others seeking to forecast future cash flows and assess whether a business is capable of sustainable growth in economic value will inevitably differ markedly from the information of relevance to users of SME financial statements, who will often be more interested in indications of solvency rather than value.
11. The use of IFRSs by smaller businesses – which often have limited access to accounting expertise - would result in significant extra costs as well as a reduction in the usefulness of their financial reporting. In a UK context, we have accepted that the full alignment of IASB standards and national GAAP - which we strongly advocate in principle - cannot be achieved on a cost-effective basis until a suitable accounting regime for smaller entities has been established. In our view, the current proposals will not satisfy the demand in the UK or other jurisdictions for SME standards developed by the IASB. If the standards are regarded as too complex, many jurisdictions may retain separate national reporting requirements, and the potential benefits available from internationally recognised standards for SMEs will not be achieved.
12. Once greater clarity has been established regarding the needs of users and preparers, the Board's project should go on to involve a radical simplification of IFRSs for smaller entities, focused on the objective of simplicity in SME financial reporting and leading to a single source of stand-alone guidance that is concise and accessible. We agree in principle that the starting point for the development of the SME standards should be the Framework and the principles and related mandatory guidance from IFRSs. This would underpin the quality

and credibility of the SME standards and will be cost-effective. However, we believe that substantial changes to the investor-focused Framework and standards will be appropriate: simply identifying a limited range of number of exemptions from full IFRSs and publishing individual SME standards very closely aligned to the contents and structure of full IFRSs is unlikely to change the SME accounting landscape.

13. We would support in principle the development and early exposure of a separate Framework that focuses on financial reporting by SMEs, exploring users needs and cost:benefit issues and any consequential modifications required to the existing Framework. In our view, the application of rigorous cost:benefit analysis, a proper identification of the users of SME general purpose financial statements and an understanding of the needs of those users will - in a not inconsiderable number of cases - lead to the adoption of simplified methods of measurement methods and principles centred on the use of historical cost rather than fair values. Historical cost is not only an economical way of producing financial statements; it also provides a focus on near-term cash flows and an accessible account of how directors have used the resources entrusted to them. These two features are particularly useful to users of SME financial statements, and in this context may outweigh any deficiencies of historical cost accounting - still in practice the basis of much management and external reporting. We therefore welcome the recognition in paragraph 83 that the rebuttable presumption of no change might be relatively easily rebutted in the case of measurement principles. If too few measurement differences are permitted, there is a risk that the take-up of the new standards will be low or that compliance with the SME standards will not be enforced rigorously.
14. As explained in more detail in paragraphs 27-29 below, the objective of simplicity in SME financial reporting will not be satisfied if preparers are required to refer to full IFRSs on each occasion that the SME standards do not address a particular accounting recognition or measurement issue. This will increase the complexity of SME accounting without any corresponding benefit for users. Preparers should only be required to look to IFRSs as a source of guidance when seeking to establish generally accepted practice in relation to a particular accounting issue. This would be necessary only infrequently if a separate SME Framework were to be developed.
15. The SME standards should include a range of illustrative examples regarding more difficult accounting issues. The examples should be succinct and particularly relevant to the circumstances of less sophisticated entities. In addition, wherever possible, simplified language should be used, although we consider that consistency with the language of full IFRSs is generally desirable, as paraphrasing the full standards may lead to unintended differences in meaning or interpretation.

RESPONSES TO SPECIFIC QUESTIONS

Question 1a

Do you agree that full IFRSs should be considered suitable for all entities? If not, why not?

16. No. As explained above in paragraphs 10-11, the use of IFRSs by smaller businesses would result in significant extra costs as well as a reduction in the usefulness of their financial reporting.

Question 1b

Do you agree that the Board should develop a separate set of financial reporting standards suitable for SMEs? If not, why not?

17. Yes. As explained above in paragraphs 5-6, we strongly support the current IASB project on accounting by SMEs and commend the high priority given to the project by the Board.

Question 1c

Do you agree that IASB Standards for SMEs should not be used by publicly listed entities (or any other entities not specifically intended by the Board), even if national law or regulation were to permit this? Do you also agree that if the IASB Standards for SMEs are used by such entities, their financial statements cannot be described as being in compliance with IFRSs for SMEs? If not, why not?

18. We believe that the Board should be less prescriptive. We agree that the Board should indicate the intended scope of its standards. However, whilst it is unlikely - at least in more developed economies – that IASB standards for SMEs would be used by publicly listed entities, it is not appropriate for the Board to seek to restrict the discretion of national jurisdictions in this regard. If, perhaps in a less developed economy, a small listed entity is permitted to use the new standards and complies fully with their requirements, its financial statements should be described as in compliance with IASB standards for SMEs.

Question 2

Are the objectives of IASB Standards for SMEs as set out in preliminary view 2 appropriate and, if not, how should they be modified?

19. No. We explain above in paragraph 12 the importance of the principle of *simplicity* in SME financial reporting, which should be highlighted in objective (d). We also explain in paragraph 9 that facilitating an easy transition to full IFRSs (objective (e)) should not be a primary objective of the Board when establishing a set of SME Standards. Objectives (a), (b) and (d), suitably modified, are of far greater importance.
20. We also consider that objective (b) should also refer to the importance of stewardship, and that objective (c) is not properly described as an objective, and may prove to be a hindrance if recognised as such.

Question 3a

Do you agree that the Board should describe the characteristics of the entities for which it intends the standards but that those characteristics should not prescribe quantitative ‘size tests’? If not, why not, and how would an appropriate size test be developed?

21. Yes. As explained above in paragraph 7, we agree with the approach of attempting to describe the characteristics of entities eligible to apply SME standards, but not prescribing quantitative size tests, given the global reach of the proposed standards. Local regulators should determine eligibility to use the standards.

Question 3b

Do you agree that the Board should develop standards that would be suitable for all entities that do not have public accountability and should not focus only on some entities that do not have public accountability, such as only the relatively larger ones or only the relatively smaller ones? If not, why not?

22. We explain in paragraphs 10-14 above that in developing the proposed SME standards the Board needs to focus more clearly on the vast majority of relatively small entities that prepare GAAP financial statements.

Question 3c

Do the two principles in preliminary view 3.2, combined with the presumptive indicators of ‘public accountability’ in preliminary view 3.3, provide a workable definition and appropriate guidance for applying the concept of ‘public accountability’? If not, how would you change them?

23. In general, we support the ownership-based concepts underlying the public accountability principle and the presumptive indicators of public accountability. We explain above in paragraph 8 the distinction we would draw between economically significant entities and other entities.
24. We do not agree that utilities and other entities that discharge an essential public service responsibility are *ipso facto* publicly accountable. National authorities should determine whether this is the case.

Question 3d

Do you agree that an entity should be required to use full IFRSs if one or more of the owners of its shares object to the entity’s preparing its financial statements on the basis of IASB Standards for SMEs. If not, why not?

25. No. In principle we agree that a proportion of the owners of the shares of an entity should have the right to demand that full IFRSs are used. However, a threshold of one shareholder is inappropriate, and in any case it should be left to national jurisdictions to determine any threshold, the rights of owners and the mechanics of any voting requirements.

Question 3e

Do you agree that if a subsidiary, joint venture or associate of an entity with public accountability prepares financial information in accordance with full IFRSs to meet the requirements of its parent, venturer or investor, the entity should comply with full IFRSs, and not IASB Standards for SMEs, in its separate financial statements? If not, why not?

26. No. This approach seems unnecessarily prescriptive and runs counter to the objective of providing financial statements that meet the needs of users. Producing two sets of financial information will involve additional costs, but the decision should be left to national authorities or to the groups themselves.

Question 4

Do you agree that if IASB Standards for SMEs do not address a particular accounting recognition or measurement issue, the entity should be required to look to the appropriate IFRS to resolve that particular issue? If not, why not, and what alternative would you propose?

27. In our view this issue is of central importance, and the Board's intentions are not explained with sufficient clarity. As discussed above in paragraph 14, the financial reporting burden on entities that are not publicly accountable will remain high if they are required to refer to full IFRSs on each and every occasion that SME standards do not address a particular accounting recognition or measurement issue. This will increase the complexity of SME accounting without any corresponding benefit for users.
28. In principle we prefer alternative (b) in paragraph 41 - which is essentially the approach that has worked with considerable success in the context of the UK Financial Reporting Standard for Smaller Entities (FRSSE) - to alternative (a). The entity would be required to look to appropriate IFRSs only as a source of guidance when seeking to establish generally accepted practice in relation to a significant accounting issue. This would be necessary and appropriate only infrequently if a separate SME Framework were to be developed, as suggested above in paragraph 13.
29. If alternative (a) is adopted notwithstanding our concerns, this should certainly be on an issue-by-issue basis, rather than a standard-by-standard basis. However, this issue needs to be reconsidered once the likely shape of the new standards, and the impact of differences between the frameworks, is clearer.

Question 5a

Should an SME be permitted to revert to an IFRS if the treatment in the SME version of the IFRS differs from the treatment in the IFRS, or should an SME be required to choose only either the complete set of IFRSs or the complete set of SME standards with no optional reversion to individual IFRSs? Why?

30. No. We strongly oppose permitting SMEs to choose whether to apply the accounting treatment in an SME standard or, where different, the treatment in the related IFRS. If there are important differences in measurement between full

IFRSs and SME standards, an unfettered right to revert to full individual IFRSs may provide opportunities for accounting arbitrage and seriously impair comparability in SME financial reporting. It would also be contrary to the objective of simplicity in SME standards.

Question 5b

If an SME is permitted to revert to an IFRS, should it be:

- (a) required to revert to the IFRS in its entirety (a standard by standard approach);*
- (b) permitted to revert to individual principles in the IFRS without restriction while continuing to follow the remainder of the SME version of the IFRS (a principle by principle approach); or*
- (c) required to revert to all of the principles in the IFRS that are related to the treatment in the SME version of that IFRS while continuing to follow the remainder of the SME version of the IFRS (a middle ground between a standard by standard and principle by principle approach)?*

Please explain your reasoning and, if you favour (c), what criteria do you propose for defining 'related' principles?

31. This issue would need further consideration if significant measurement differences between the SME standards and full IFRSs were permitted. If the SME standards produced by the Board were limited primarily to reductions in disclosure, we would consider that option (a) is excessively prescriptive and lacks conceptual logic. We would prefer option (b) to option (c) as application and enforcement would be more straightforward.

Question 6

Do you agree that development of IASB Standards for SMEs should start by extracting the fundamental concepts from the Framework and the principles and related mandatory guidance from IFRSs (including Interpretations), and then making modifications deemed appropriate? If not, what approach would you follow?

32. As explained above in paragraph 12, we agree in principle that the starting point for the development of IASB SME standards should be the Board's Framework and standards but consider that substantial changes are necessary and appropriate for SMEs.

Question 7a

Do you agree that any modifications for SMEs to the concepts or principles in full IFRSs must be on the basis of the identified needs of users of SME financial statements or cost benefit analyses? If not, what alternative bases for modifications would you propose, and why? And if so, do you have suggestions about how the Board might analyse the costs and benefits of IFRSs in an SME context?

33. We agree with this approach. A clear understanding of the users of SME financial statements and their information needs is required before the approach can be implemented successfully.

Question 7b

Do you agree that it is likely that disclosure and presentation modifications will be justified on the basis of user needs and cost benefit analyses and that the disclosure modifications could increase or decrease the current level of disclosure for SMEs? If not, why not?

34. Yes. Experience in the UK indicates that significant reductions in disclosure are possible without undermining the integrity of SME accounting. FRSSE financial statements provide their primary users with more understandable information and are also easier and cheaper to produce.

Question 7c

Do you agree that, in developing standards for SMEs, the Board should presume that no modification would be made to the recognition or measurement principles in IFRSs, though that presumption could be overcome on the basis of user needs and a cost benefit analysis? If not, why not?

35. It is reasonable for the Board to set a higher hurdle for modifications to recognition and measurement principles. However, as discussed in paragraph 13 above, we welcome the recognition in paragraph 83 that the rebuttable presumption might be relatively easily rebutted in the case of measurement principles. In our view, research is likely to demonstrate that the basis of measurement appropriate to SME accounting differs significantly from the requirements of full IFRSs.

Question 8a

Do you agree that IASB Standards for SMEs should be published in a separate printed volume? If you favour including them in separate sections of each IFRS (including Interpretations) or some other approach, please explain why.

36. The SME standards should represent a low-maintenance and stand-alone source of guidance, and for ease of use should be published in a separate volume, updated no more than once a year and available in both printed and electronic form. Inclusion of SME standards within each IFRS and Interpretation would be inconvenient for SME preparers.

Question 8b

Do you agree that IASB Standards for SMEs should be organised by IAS/IFRS number rather than in topical sequence? If you favour topical sequence or some other approach, please explain why.

37. The current number sequence of IASs and IFRSs lacks any logical foundation and we see no reason to replicate it in the SME standards. We would prefer the material to be reorganised by topic, which would improve the accessibility and coherence of the standards. This would result in the production of a single SME standard rather than a set of standards, an outcome we would welcome.

Question 8c

Do you agree that each IASB Standard for SMEs should include a statement of its objective, a summary and a glossary of key terms?

38. The SME standards should be as concise as possible. If separate standards are developed (rather than a single SME standard), we do not believe that a statement of objectives in each standard would be necessary, and assume that the separate volume of SME standards would contain a single glossary.

Question 9

Are there any other matters related to how the Board should approach its project to develop standards for SMEs that you would like to bring to the Board's attention?

Due Process

39. We encourage the IASB to engage in extensive field-testing of proposals before an exposure draft is published. Also, in view of the likely length and significance of the proposals, and the rather different constituency concerned with the proposals, we suggest that at least 120 days is allowed for public comment.

Relaxations for Other Entities

40. IFRSs are designed primarily to meet the needs of users of the accounts of entities that raise funds on the capital markets. Unlisted entities that use full IFRS should therefore be provided with a wider range of disclosure exemptions and limited relaxations on measurement requirements, provided on a cost:benefit basis within each separate IFRS. We note that some existing IFRSs already differentiate between listed and unlisted companies, such as IAS 14 and IAS 33. Some additional disclosure and presentation exemptions might be appropriate for wholly-owned subsidiaries that use full IFRSs, such as an exemption from presenting a cash flow statement under IAS 7.
41. We recommend that each new IFRS exposure draft identifies possible relaxations and exemptions for unlisted companies from the full requirements of the proposed IFRS, and that a separate IASB project be established in due course to review the requirements of existing standards.

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