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Paul Pacter
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International Accounting Standards Board

30 Cannon Street, London EC4M 6XH,
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Frankfurt, September 24, 2004

Comments to DISCUSSION PAPER
"Preliminary Views on Accounting Standards for Small and
Medium-sized Entities"

Dear Mr. Pacter,

we appreciate the opportunity to comment on the named discussion paper dealing with the issue of accounting for SME and in the following we try to express my views and to give our comments to that topic in a hopefully understandable way. We may be allowed to start upfront with some general remarks.

Representing German Chartered Accountants dealing with international accounting by German companies already for more than 15 years we consider this being an extremely important issue. In our opinion this topic will be a crucial issue in respect to a worldwide acceptance of IFRS.

The development of accounting standards which address the needs of investors and participants in global capital markets has mostly been driven by the anglo-american countries mainly by the US and Great Britain. These countries have without doubt the mostly developed capital markets demonstrated by the capitalization and numbers of companies using these capital markets. Additionally there are institutions like the SEC having the power to enforce both the standard setting as well as the correct application of standards.

Looking at companies not using the capital markets, which may not necessarily be SME, the situation is a very different one. The level of regulation for instance in the US is much reduced for these companies. There are no specific accounting principles in place as the requirement for f/s in compliance with US GAAP is left to the participants (banks, shareholders/parent companies,...).

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Within the EU the role of SME and the level of regulation is very different. There are legal accounting and auditing requirements for the large majority of SME. The picture is different again if looking to the underdeveloped countries or to countries like China or Japan.

It appears to us, that a very strong input and influence is needed by the constituents from countries where SME play a very important economic role. As our my opinion it is crucial for the IFRS in general, that it can be achieved to take adequate care of considerations, which are not only driven by information needs of mostly professional investors and the capital markets.

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(Zabel)
Wirtschaftsprüfer

Issue 1. Should the International Accounting Standards Board (IASB) develop special financial reporting standards for SMEs?

Question 1a.

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

Response

We do not agree. The question of suitability can only be answered looking at the purpose of preparing f/s and the needs of the parties they are addressed to.

The capital markets require transparency, comparability and consistency for the best allocation of capital. Companies who need/want to attract new capital have to offer information. The relevant aspect for investors is return on capital invested and risk.

Outside of capital markets information and an allocation of capital based on the ratio of risk and expected return is not the only and often not the predominant aspect. An owner-management often need to build up more reserves than capital market-oriented/listed companies because it invests only its own limited money. Thus to retain earnings is of more importance for a secure substance/existence and for expansion. Possibilities for silent reserves are needed not only to avoid tax payments (if the linked to the tax basis) but to keep some groups of stakeholders from claiming dividends/salaries or other payments, which may harm the capital basis needed. There are usually ways for the stakeholders to get sufficiently informed, if there stake is large enough. If more information and transparency improves the cost of financing, there are plenty of ways for improvement, the best will be to voluntarily apply full IFRS.

As a consequence disclosures and recognition and measurement principles may need to be checked, whether there is a need for a suitable adjustment (examples may be: less restrictive rules in resp. to restructuring reserves, allowing useful lives for fixed assets as far as accepted for tax purposes, ...)

Question 1b.

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

Response

We agree. The extent may be needed to be discussed.

In our opinion it may not be necessary to develop a full set of own standards for SME but to check the existing standards in respect to the need for adjustment for SME.

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?

Response

We agree.

Issue 2. What should be the objectives of a set of financial reporting 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?

Response

As to (a): We do not fully agree:

High quality is surely a goal to be achieved, but it appears to us, that it conflicts in case of complex issues with the purpose of understandability (IAS 39,36,12,...). The goal of understandability should in our opinion be of superior importance, as SME standards are supposed to be applied by a total different set of applicants (small companies, third world countries, China, ...). Enforceability is therefore in Our opinion very difficult to achieve and I raise the question "Is there an increased need for enforcement for this group of applicants?". This may mainly apply, if it were very complex and costly to prepare correct IFRS by SME. Our view is: the more complex application of IFRS for SME is, the more need for enforceability is there and the less probable is it, that this can be achieved. Thus we vote for eliminating the enforceability objective.

As to (b): yes; this is the most important and crucial aspect (see Issue 1) and this objective needs in Our opinion to be addressed with the most emphasis

As to (c): yes; but perhaps with supplements to address differences in the user needs

As to (d): yes

As to (e): We do not agree: The more SME standards deviate from the "full IFRS" the more work a transition may produce; it is our view, that companies may move towards full IFRS if there is good reason or pressure by stakeholders to do so no matter how easy this than may be. We would not expect, that many applicants of SME IFRS will voluntarily move to full IFRS only because it is easy to do so. At the same time we expect, that this objective may hinder to set SME standards being materially easier to apply than the respective full IFRS. Thus we vote for eliminating this objective as a predominant one.

Proposal for modification/clarification:

IFRS for SMEs should

(f) provide accounting standards, which can be applied without significant outside expertise in financial models and valuation techniques; this could mean in the consequence, that fair value may be a measure for acquisition accounting but not for a continuing asset and liability measurement

(g) provide accounting standards, that do allow to build up and keep adequate reserves

(h) provide accounting standards, which are a stable platform under a long-term perspective

Issue 3. For which entities would IASB Standards for SMEs be intended?

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?

Response

Yes and no.

We agree, that the size should not be the only and predominant characteristic, as public interest and accountability may not only be a question of share size. I question however, that descriptive characteristics may allow for a clear and operational distinction. There will be the risk of too many different views in different countries and industries, which may harm the goal of comparability.

Our proposal is, to use the descriptions as presented however to add a paragraph including thresholds for small and large entities. The small ones will never and the large ones generally be regarded as being publicly accountable. Only for the group inbetween there will be a need for judgment according to the qualitative characteristics. The first 3 criteria of 3.3. (d) may be used to determine the size (like already used within in the EU). There could be differing limits by each country or groups of countries (like EU), the limits may need to be confirmed by the IASB.

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?

Response

Yes, we agree. However as small entities are often not required to be audited, it may not make much sense to mandatorily require the application of a comprehensive set of accounting standards. Thus it may be adequate to allow but not to require the application of the IFRS for SME by the group of small entities (see 3a.)

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?

Response

We do not agree and do not regard 3.2. and 3.3 as providing a workable definition, as there may be very different circumstances in third world countries or countries like China compared to the highly industrialised countries. At the same time there could be very small one-product companies with not many employees have a significant market share in a certain niche - are these publicly accountable? What about with their competitor with 20% market share and a number of other products being 5 times as large?

For our proposed changes see 3.a. above

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?

Response

We do not agree and propose to eliminate this requirement.

It is our consideration, that in practice this will be very difficult to achieve on the one hand and on the other hand I consider the full assent of all owners not necessary. There are sufficient legal considerations as to the rights of minority owners - it may be critical if private accounting standards become a means to request information they are otherwise not entitled to or can be requested from the other owners. Minority shareholders may get a substantive means for opposition, which could be used in ways which may have nothing to do with accountability questions.

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?

Response

We do not agree and propose to eliminate this requirement.

Typically subsidiaries, jv and assoc. do not need to prepare all information needed for full IFRS for the purposes of the parent. In many cases it may be much less depending on their size and importance/materiality. To require them to prepare full IFRS will be on the one hand a heavy burden for these companies, which may require a different type of organisation as current and as wished by the parent. On the other hand such requirement may significantly increase the extent of information of a group as a whole and of its respective entities. A large group may have small entities doing only R&D. There may be no need on a corporate level to address costs and details as to these activities. If the individual entity however is to prepare a full set of IFRS the notes need to include such information.

We would like to refer to question 3d. and the remarks in respect to the rights of shareholders/owners.

Issue 4. If IASB Standards for SMEs do not address a particular accounting recognition or measurement issue confronting an entity, how should that entity resolve the issue?

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?

Response

We agree as far as it is relating to existing SME standards, which may by purpose not address the respective issue. If however no SME standards are in place reference to the general IFRS may indicate the application of complex and restrictive accounting measures, which are not appropriate for SME. Thus it may be a mandatory requirement for the future, that there need to be SME Standards for all issues, IFRS are in place.

Issue 5. May an entity using IASB Standards for SMEs elect to follow a treatment permitted in an IFRS that differs from the treatment in the related IASB Standard for SMEs?

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?

Response

The possibility of a piecemeal application of SME Standards could become a difficult issue in our opinion. There need to be thoughts and rules for a transition to and from the regular IFRS and in respect to retrospective effects. There need to be respective thoughts and rules for audit opinions. Comparability between SME may get lost. Audits become more or less difficult from one to the next year, thus risks will change and this will be an issue for the audit fees.

Our proposal is, to allow in respect to recognition and measurement only either set of Standards. This decision can only be made at the first time application and can be reverted once at a later point in time. With respect to notes and disclosure, any SME would be allowed to apply a more detailed and intensive approach, which does not necessarily need to be fully in accordance with the regular IFRS. This could also include, that SME may provide additional information in the notes as to the application of regular IFRS recognition and measurement requirements on a voluntary basis. In this instance there would be no need to extend the audit opinion.

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?

Response

We vote for (a) as to recognition and measurement questions (see 5a.). That means an SME could apply the full IFRS without having to present all disclosures. This would, as already explained, assure a much higher degree of comparability and would avoid the need for a detailed set of transitional rules in both ways.

As to (c): the criteria of relation to appears to us being quite difficult to transform into operationality.

Issue 6. How should the Board approach the development of IASB Standards for SMEs? To what extent should the foundation of SME standards be the concepts and principles and related mandatory guidance in IFRSs?

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?

Response

We agree but would like to point to a possible need for modification.

It makes much sense to base the SME standards on existing concepts of the Framework and principles and guidance from IFRSs. There is a clear assumption of comprehensiveness and of sufficient consideration of different aspects after the relating due processes. However it appears to me being of very importance that especially the fundamental concepts are to be investigated, whether they are at the same time suitable for SME.

We refer as examples to the qualitative criteria of prudence. SME may have a different need in that respect. They may not have the same organisation, the same information or the same financial position to cope with the criteria of prudence as it is allowed to listed companies and as it is accepted by the capital markets. There may be a higher need for (also hidden) reserves (see remarks at the beginning), why not in an excessive way (QUESTION: where is the problem with excessive hidden reserves of non-listed companies? For management and personnel this is security, shareholders and banks should be able to identify these reserves).

[REMARK: A presentation of such f/s (outside of the capital markets) could still be considered "fair" at least for SME; we question whether SME f/s to be prepared to a large extent on fair market values and unrealised profits, which are difficult to determine and depend on subjective judgement while being much more volatile will achieve a higher degree of fairness in presentation (Our personal opinion!).]

Another reference we make to the constraint of "balance between benefit and cost". There may be a need for a different view in respect to SME for the named reasons. The benefit of an information for example of a detailed presentation of an acquisition may be different for non-listed companies than for the users of f/s of public ones. Respectively the question is to be answered whether the significant cost of a purchase price allocation by a third party expert is in balance with the benefit.

Once the fundamental concepts are determined being the same the principles of the IFRS and interpretations should also be applicable without modification. If they however are determined to be different, the principles and guidance may need to be modified.

If there were a consent on different concepts and principles in some areas the SME standards still could be based on the regular IFRS but may address (perhaps in bold letters) the points where differences are applicable.

Issue 7. If IASB Standards for SMEs are built on the concepts and principles and related mandatory guidance in full IFRSs, what should be the basis for modifying those concepts and principles 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?

Response

We agree.

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?

Response

We agree, we would be however surprised if there would be a substantiated need for an increased level of disclosure. May be a different detail of disclosure.

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?

Response

We do not fully agree. Our presumption is different, that there will be a need for a modification in recognition and measurement principles and that there is a probable need for identification, however not in general and for all topics. See comments made as opening remarks and to question 6.

Issue 8. In what format should IASB Standards for SMEs be published?

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.

Response

We agree to the publication in a separate printed volume. This seems to be much more practical.

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.

Response

We agree to organise it by IAS/IFRS number.

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?

Response

We agree, but we would additionally foresee explicit explanations of the differences compared to the regular standard. As the objectives and resulting the content of the standard will/may differ from the regular IAS/IFRS either the summary or a separate section should explain and present the differences.

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?

Response

Hereto we like to make a statement which does not deal with specific aspects of the SME topic rather a general one:

It is our strong belief, that the question of adequate accounting principles for SME is a topic which needs to receive a special focus and interest and its importance for the acceptance of IFRS in general may not be underestimated. It can not be regarded as being an issue similar to an individual IFRS and the intensity, timing and manpower involved may need to be different. Looking at the interest and importance of IFRS in the context of SME in Germany we would say, that it exceeds the one of the most individual IAS may be that of IAS 39/32.

However, there is a large number of individuals in Germany (like in other countries) which are at the moment merely not in a position to follow step with the rapid development towards international accounting and the development of the standards itself. In respect to SME standards we would therefore like to emphasize the need, to take enough time to get the right picture and to collect the voices of the ones, which are at the moment just not yet on that train but will be very much affected by the outcome of this discussion and the due process.

With best regards and good luck for this demanding project.

Martin Zabel