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Consultation Response

ACCOUNTING STANDARDS FOR SMALL AND MEDIUM-SIZED ENTITIES

A Discussion Paper from the IASB

Comments from ACCA

September 2004

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Overall Comments

The Association of Chartered Certified Accountants (ACCA) is pleased to have this opportunity to respond to the Discussion Paper (DP) setting out the preliminary views of the International Accounting Standards Board (IASB) on developing accounting standards for small and medium-sized entities (SMEs). Our responses are set out below as a two overall observations and then as responses to the specific questions raised in the DP.

ACCA welcomes the decision by IASB to give time and resources to the project of standards for SMEs and considers that the development of the standards should be a vital priority for the IASB as the take up of its standards spreads around the world. SMEs form the overwhelming bulk of numbers of business entities and of the general purpose financial statements produced. They also account for the majority of economic activity worldwide. They are therefore the biggest potential user of IASB's standards.

Over half of ACCA's 100,000 members work in or service SMEs.

We are particularly concerned by two aspects of IASB's preliminary views.

Firstly the preliminary views on the definition of SMEs and on the development of its SME standards, risk developing a set of standards that are going to be too lengthy and too complex for them to be understood, used and enforced around the world. The set of standards that seem likely to emerge from IASB's project based on the preliminary views in this paper would in effect meet the needs of larger unlisted companies. This is helpful to that limited extent and purpose, but will leave unsatisfied the demand that so clearly exists for

IASB to develop a set of standards which will be appropriate for the bulk of SMEs. Such a set of rules would

- Be designed with smaller entities in mind

- Not attempt to cover all possible subjects and issues, but employ the fall back to full IFRS to deal with less commonly occurring cases and with any demand for more explanatory material

- Assume disclosure reductions, measurement simplifications and options for recognition differences compared to full standards, based on user needs and cost-benefit considerations

- Be issued as a stand-alone volume which will be written and presented in a more straightforward and logical way.

Our second area of concern is that the IASB should not getinvolved in defining too closely the entities that should be allowed to use any SME standards that they develop. IASB should limit its scope considerations to those necessary to set the standards and not consider issues of public policy of who precisely should be entitled to receive accounts based on full IFRSs or on any SME standards. The critical factors are that SME standards would not be intended for those companies that

- have canvassed for investment funds from a wide range of parties by listing their shares or debt on public markets

- are large (though quantified thresholds are difficult for IASB to set on a global basis)

IASB should leave national jurisdictions to determine precisely which entities should be allowed to apply the different standards.

Question 1a. Do you agree that full IFRSs should be considered suitable for all entities? If not, why not?

We disagree that full IFRS are a suitable system of accounting standards for SMEs. The full version of IFRSs is primarily designed for users in the capital markets. Some of the standards are irrelevant to SMEs which may not engage on average in such complex transactions or such a range of transactions. Their depth of treatment often reflects anti-abuse measures which are not generally needed to the same extent in relation to unlisted companies. The disclosures demanded are often in excess of those needed by the users of SME financial reports which evidence suggests are very different[1]. The resulting complexity and length of full IFRSs means that they are harder to understand, use and enforce for SMEs and therefore as a system of accounting standards they are not suitable for SMEs.

We accept, however, that if an individual SME chose to prepare its financial statements using full IFRSs that would produce an appropriate result.

Question 1b. Do you agree that the Board should develop a separate set of financial reporting standards suitable for SMEs? If not, why not?

Yes, we agree that the Board should develop a separate set of financial reporting standards suitable for SMEs. In most countries SMEs (however these are defined) account for the vast bulk of number of reporting entities and for the bulk of economic activity. For the reasons noted in our answer to Q1a above we consider the full IFRSs

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[1] Jarvis, R. 1996, Users and Uses of Unlisted Companies' Financial Statements: A literature Review, ICAEW.

are not suitable for SMEs. On the other hand we do think that a global set of standards for SMEs would assist

- countries where resources are insufficient for independent national standard setting
- in the convergence of financial reporting in a country where full IFRSs are being applied by listed companies
- those SMEs engaged in cross-border trading by making their financial statements more readily understandable by their business partners and other users

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?

We agree that IASB Standards for SMEs should not be used by publicly listed entities because they would not be relevant and would not meet the needs of users of listed entities. We note that the way this is expressed in Preliminary view 1.2 is different to this question and to paragraph 13. Preliminary view 1.2 refers to all those with public accountability, whose definition we do not fully agree with (see Question 3c below).

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?

(a) provide high quality, understandable and enforceable accounting standards suitable for SMEs globally:

We generally agree but would question two issues.

- The reference to ‘understandable’: we expect that the levels of understanding and familiarity with accounting concepts and policies will be different between the users of the financial statements of listed companies and those of SMEs.

- The reference to ‘enforceable’: We agree that standards should be clear and capable of being enforced. We observe, however, that in many jurisdictions enforcement systems are more focussed on listed companies. In drawing up SME standards enforceability should be a less significant factor for the IASB.

(b) focus on meeting the needs of users of SME financial statements

We agree with this objective.

(c) be based on the same conceptual framework as IFRSs

The IFRS’s Framework is too oriented to large listed companies and needs to be amended to include references to fit SMEs and the users of their financial reports. See also our responses to Question 7 below.

(d) reduce the financial reporting burden on SMEs that want to use global standards

We agree with this objective.

(e) allow easy transition to full IFRS's for those SMEs that become publicly accountable or choose to switch to full IFRS

We do not agree with the definition of 'publicly accountable' (see question 3c below). While in principle we would not want to raise difficulties for any such transition, we note that the number of SMEs which become publicly accountable are so very small that this issue should not be an important factor in developing standards for SMEs.

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?

We agree that the Board in *setting* standards for SMEs should use qualitative criteria (particularly the differences in users associated with a public listing) in defining SMEs rather than a quantitative size test. The standards should, however, be developed bearing in mind the needs of the bulk of unlisted companies which are small or medium-sized (see our answer to Q3b below).

IASB should set standards for SMEs and, while indicating the characteristics of the entities for which they would be suitable, leave it to national jurisdictions to determine exactly how those characteristics should be turned into definitions in those countries and so which entities might be allowed to *apply* the SME standards. As the discussion paper notes, ultimately it is national jurisdictions that determine the applicability of IASB's standards. It is potentially going to create difficulties if the IASB choose to establish detailed rules for the scope of application which will then have to mesh with further overlaid national rules.

Question 3b. Do you agree that the Board should develop standards that would be suitable for <u>all</u> 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?

We do not agree with the definition of public accountability, as noted in our answer to Q3c below, which we would essentially replace with listed status for an entity's shares or debt.

In our view the IASB should try to address the needs of all SMEs. To do that sensibly it must accept that it cannot set standards to deal with every possible eventuality and that there will be a trade-off between the length/complexity of the standards on the one hand and their coverage on the other. IASB must therefore work with some variant of the 80:20 principle. IASB's SME standards should therefore

- aim to deal with the bulk but not all of the possible issues of SMEs

- bear in mind that any size/number profile of unlisted companies would be a flat pyramid (very few large entities, very many small ones).

It would be a mistake to deal with all SMEs by writing a set of standards that addresses comprehensively the issues of large unlisted companies. This would tend to be as inappropriate for the bulk of SMEs as full IFRSs. What is needed is a set of standards which aims to deal with the issues of the bulk of unlisted companies (that is everything other than the small top of the size/number pyramid), but which has some reference to full IFRS (see Q4. below) to address the other issues of the small number of large unlisted entities.

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?

We disagree that the concepts of public accountability and non public accountability would provide a workable definition. Generally, the overall effect is too complex and open to inappropriate application.

To capture the prime user needs of listed entities (players in capital markets) and the user needs of SME financial reports, the most appropriate differentiation in setting standards would be between listed and unlisted. The main constituents of unlisted entities are SMEs and the standard should therefore reflect their needs. It would then be up to national jurisdictions to decide what reporting standard regime that large unlisted entities should adopt.

Most of the presumptive indicators would have to be interpreted nationally in any event. For example

- Holding assets in a fiduciary capacity could apply to lawyers, estate agents, insurance brokers and travel agents for example, or indeed any entity taking payment in advance of goods or services.

- There can be very small banks, such as credit unions.

- Providing essential public services can range from electricity supply to bus services to school cleaning contracts.

IASB should not get too much involved in defining these too closely. This will neither be helpful when the national rules for eligibility of the standards are overlain on them, nor is it necessary for *setting* the standards.

In summary in defining the group of entities for IASB's standard setting purposes, in paragraph 28 we would leave the public accountability principle with just part (a) and not add part (b). In paragraph 31 we would leave the presumptive indicators as listing and economic significance, that is (a) and (d). IASB could provide guidance to national jurisdictions that they might require entities in categories (b) and (c) - fiduciaries and public service providers - to apply full IFRS.

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?

We disagree that an entity should be required to use full IFRS's if one or more of the owners of its shareholders object to the entity's preparing its financial statements on the basis of IASB for SMEs. Our reasons are as follows.

- It is doubtful if owner-managers or other shareholders of SMEs would understand the distinction between the two standards. The evidence suggests that they are likely to rely on their external accountant for making accounting choices of this nature.

- An independent shareholder of a very small entity could dictate that an entity should publish their financial reports under full IFRS and we would question what would be gained from this option when it is likely that the SME version is relevant to their users' needs.

- The existence of one non-assenting shareholder does not in our view create public accountability as defined in the principle, nor is it consistent with the other presumptive indicators. These refer, for example, to ‘high degree of interest’ and ‘broad group of outsiders’ and in the use of the word ‘public’ in the first place.

The requirement for the consent of all owners seems a debatable matter at the least. Whether a single shareholder has the right to burden a company with the higher costs of full IFRS seems another question best left by IASB to national jurisdictions, and also one which does not in any way affect the *setting* of the standards which is IASB’s role.

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?

SME Standards should be available to all qualifying entities for the purpose of preparing their own separate financial statements including any regulations imposed by the national jurisdiction. Public accountability is a quality to be judged in relation to the reporting entity, unaffected by the status of an entity investing in it.

This again seems a matter which does not affect in any way the *setting* of the standards by IASB.

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?

We support the approach set out in Paragraph 41(b) as compared to that in 41(a). This approach seems closer to the process the Board would have adopted in developing an SME version of any ‘missing’ standard. The differential reporting option approach in 41(a) would be appropriate if that is how the whole system of SME standards had been developed – that is the full IFRS is appropriate for all entities without any modification unless noted otherwise. It seems more likely, however, that the reason that an IFRS or IFRIC would be missing from the list of those covered by an SME standard is that the subject is relevant to very few SMEs. This would not make the recognition and measurement treatment necessarily appropriate.

If the approach in 41(a) is adopted then there will tend to be pressure for an SME version of each IFRS developed even if the probability of practical application is very remote. This will increase the length and complexity of the SME set of standards.

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?

An SME should be permitted to revert to an IFRS if the treatment in the SME version of the IFRS differs from the treatment in the IFRS.

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?

An SME should be 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). Our reasons for this are

- SME standards should not need to cover all the matters addressed by full standards and so a particular SME may find some aspect of a full standard helpful in their particular situation

- The boundary of coverage of any one IFRS within the system is to some extent arbitrary and so a standard-by-standard approach would not be appropriate. For example the treatment of construction contracts or government grants could have been in the revenue standard, but as a function of the history of the work programme of the IASC ended up as separate standards.

As noted in the discussion paper the issue is only of importance in relation to recognition and measurement differences. In preliminary view 7.3 the extent of these are likely to be limited. If there were any significant incompatibilities created by those few differences, then the SME standards could address those.

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?

We agree. If the IASB are to be the authority in the setting of standards for SMEs it is appropriate that fundamental concepts in the Framework are the source for the SME version and that the IFRSs are the basis for modification if relevant to SMEs. However, it is important to ensure that IFRSs are applied to take account of the characteristics of 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?

Any modifications for SMEs to the concepts and principles in full IFRSs must first be on the basis of identified needs of the users of financial reports produced for SMEs – we agree generally with the observations on this in paragraph 6 of the Discussion Paper. This then should be followed by a cost benefit test.

The problem is that the costs are relatively easy to identify because in the main they are tangible but the benefits are problematic to identify and they tend to be intangible. The benefits need to identified and valued from research into user needs. Whilst the cost needs to be established mainly through research in consultation with the preparers who are of course in the main practicing accountants. What the users of SME accounts desire is credible financial reports which are reliable and that they can use confidently in their planning, control and decision making. This does not, necessarily, mean that they have to understand the concepts underpinning the reported position and performance of the entity.

This modification process will need to be carried out on a coherent and objective basis. An adaptation of the IASB's Framework for SMEs will be important to assist in this. Cost benefit and different user needs have already been identified. There could also be differences in understandability (see our answer to Q2 above).

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?

Meeting user needs and ensuring that the benefits exceed the costs of SME financial reports should result from disclosure, presentation modification and amendments to measurement and recognition aspects from the full IFRS. If amendments are not made to measurement and recognition aspects from the full IFRS it is likely that the overall size of and complexity of a IFRS for SMEs will only marginally be reduced vis-à-vis the full IFRS.

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?

We disagree. On the basis of user needs and the cost/benefit question it is inevitable that recognition and measurement principles will have to be modified. Therefore there should be no presumption.

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.

We agree that the IASB Standards for SMEs should be published in a separate printed volume.

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.

IASB Standards for SMEs should be in topical sequence with a cross reference to the relevant full IFRS. Also there should be a reference to IFRS's that the SME version has not addressed. A topical sequence is more logical and would be easier to use and understand. The order in which IAS/IFRS have developed is purely a function of the agenda of the old IASC and now of the IASB.

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?

No. Given our preference for a single volume topically arranged set of standards, there would probably no reason for separate objectives, summaries and glossaries for each topic.

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