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24 September 2004

Mr Paul Pacter  
Director of Standards for SMEs  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

[CommentLetters@iasb.org](mailto:CommentLetters@iasb.org)

Dear Mr Pacter

**IASB Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities***

Pitcher Partners is large middle-tier Australian accounting firm with a strong reputation for providing professional services to privately owned and middle market businesses. Our comments on this discussion paper are based on our extensive experience and expertise in relation to financial reporting issues arising in privately owned business.

Pitcher Partners has a continuing interest in promoting quality financial reporting for non-listed entities. We have concerns that standards setters are primarily concerned with standards appropriate for financial information presented to stakeholders in capital markets and as a consequence, the usefulness of information being provided under current accounting standards for non-listed entities has declined over the past five to ten years. This is clearly demonstrated by the fact that the statutory general purpose financial report currently has minimal relevance for owner-operators in making their business decisions.

At the current time, Australian requirements call for many of these non-listed entities to provide disclosure in their financial reports at 30 June 2004, as to how they are preparing for the impact of adopting IFRSs. Therefore, our responses to the IASB Discussion Paper also represent the issues arising through implementing current international standards.

If there are any matters arising from this submission which you would like to discuss further, please contact our National Technical Director, Dianne Azoor Hughes ([dhughes@pitcher.com.au](mailto:dhughes@pitcher.com.au)).

**Confusion regarding use of the term “SME”**

An overriding concern is that although the discussion paper title refers to "SMEs", the context and discussion clearly relates to any *non-listed entity*. We believe that "SME" is one of the most misused terms in financial reporting circles across the globe, and as a consequence the accountability relationships that need to be identified and addressed become camouflaged by questions of size.

**Support for *non-listed entity* classification**

We strongly support a distinction between businesses that operate in the public domain (ie. those businesses which offer their securities to the public) and those that rely on private investment. We believe that distinguishing businesses by size misses the point when considering accountability relationships which the provision of financial information is intended to satisfy.

Further discussion of this issue is provided as an attachment to this submission, and we urge the IASB to give this matter urgent attention.

**Our responses to questions asked in the Discussion Paper are provided below.**

**Q1a:** We do not believe that full IFRS should be considered suitable for all entities for the following reasons:

- Many IFRSs require a high level of technical expertise to enable understanding of the requirements, appropriate application and appreciation of consequence of the reported outcome.
- These skill levels are rarely present in non-listed entities. Although a non-listed entity could purchase those skills, the resulting outcome has limited meaning to the users of the financial information.
- A simple example would be the accounting treatment of redeemable preference shares, which might have both an equity and debt component. However, to make this allocation often causes confusion and misunderstanding between a closed group of private investors. When redeemable preference shares are included wholly in equity, these stakeholders can readily understand that a portion of contributed equity is comprised of shares that will be “bought back” at a specified date, at a specified amount. In contrast, stakeholders in capital markets may require more specific analysis of debt and equity to address a risk profile for individual investment portfolios.

**Q1b:** We agree that the Board should develop a separate set of financial reporting standards suitable for non-listed entities.

- The major problem with applying IFRSs to non-listed entities arises due to the *volume* of information in the IFRS rather than difficulties in applying the technical requirements.
- Typically IFRSs address a broad range of financial reporting issues, including more complex transactions. However, in our experience, a majority of non-listed entities (of all sizes) are not involved in complex transactions, which are often primarily designed to secure certain reporting outcomes.

- Typically, there is a high level of transparency in the financial reports of non-listed entities across all sizes of non-listed entities. This outcome makes sense when we appreciate that non-listed entities are accountable to a closed group of investors, who ordinarily have far more access to financial information in their private investment, in comparison to investors in capital markets.
- A separate set of financial reporting standards that focussed on basic principles rather than simple transactions would alleviate much of the difficulty that non-listed entities are experiencing in their implementation of IFRS.
- A simple example would be in relation to IAS 39 and recognition of hedges. Our clients may use say, five forward rate foreign exchange contracts to hedge their foreign exchange risk anticipated during a twelve-month period. To ascertain the appropriate accounting treatment for this relatively simple hedging strategy, they need to consider more than 100 pages of information to confirm that they have not overlooked something in error.

**Q1c:** We agree that IASB standards for non-listed entities should not be used by any entity that offers their securities to the public where those securities are listed on a securities exchange.

- Investors in global capital markets need to be assured of a level playing field when considering financial information. In our opinion, this factor is the primary reason for the promulgation of international financial reporting standards.

**Q2:** We concur with the objectives of IASB Standards for SMEs, which are also appropriate for all non-listed entities.

**Q3a:** The IASB should recognise the financial accountability relationships as the primary factor for determining the nature and extent of financial information to be provided.

- As the concept of corporate social responsibility has evolved, we have observed an increasing tendency for standard setters to attempt to address social responsibilities through the provision of financial information, prepared from an investment perspective.
- This situation is costly with limited benefits for all concerned. Employees typically have limited understanding or appreciation of the detailed financial information provided in the notes to the financial statements, yet are identified as key stakeholders requiring the provision of detailed financial information.
- For example, an entity with a large number of employees has responsibility to ensure that occupational health and safety issues are addressed, that employees have access to continuing training and education and to ensure there is adequate provision made for employee benefits. Only the last point is addressed in the financial statements.

**Q3b:** We strongly believe that the IASB should develop standards that would be suitable for ALL entities that do not have public accountability.

- Issues of size, rather than ownership, have already confused recognition of accountability relationships and the determination of the needs of users of financial reports for privately owned business (refer to our attachment to this submission).

**Q3d:** We are not against the suggestion that an entity should be required to use full IFRS if one or more of the owners of shares object to the entity preparing its financial statements on the basis of IASB Standards for SMEs. However, we consider that this issue is not relevant to the IASB preparation of accounting standards, but should be addressed within the regulatory regimes of national jurisdictions.

**Q3e:** We do not agree that a subsidiary, joint venture or associate of an entity with public accountability should be required to prepare financial information in accordance with IFRS.

- An entity with public accountability would prepare consolidated financial information and therefore would need to include financial information for group entities. However, provided that financial information can be made available to enable consolidation in accordance with IFRS, the preparation of separate financial reports for subsidiaries, joint venture or associates in full compliance with all the disclosures required by IFRS may have limited cost-benefit.

**Q4:** We agree that if the IASB Standard for SMEs do not address a particular accounting recognition or measurement issue, the appropriate IFRS should be used to as the authoritative reference.

**Q5a:** We do not support an “all-or-nothing” approach to adopting IASB Standards for SMEs.

- We consider that a non-listed entity should be able to apply IASB standards for SMEs, together with selective adoption of individual IFRSs if desired, to address that entity’s stakeholders’ need for further financial information.
- However, we would not support an option that allowed “switching” between two sets of standards. We suggest that if a non-listed entity using IASB Standards for SMEs adopted an IFRS, then a reversion to the SME equivalent standard would not be permitted, unless certain exceptional circumstances had arisen (eg. discontinuing operations, down-sizing, or change of ownership).
- Gradual adoption of full IFRS would also reduce the educational and reporting burden for an entity that was considering moving from private ownership to a public offering of securities in the future.

**Q5b(a):** We consider that ideally an entity should adopt an IFRS in its entirety, however this may not be practical.

- Take the example of an entity with both redeemable preference shares and forward rate foreign exchange contracts. While the stakeholders may wish to recognise the financial impact of entering into the forward rate foreign exchange contracts, they may not find it useful to apportion their redeemable preference shares between debt and equity. This desired outcome might require the partial adoption of an IFRS.

**Q5b(c):** A middle ground between standard-by-standard and principle-by-principle approach might be a preferred outcome. However, this introduces a new dimension into the judgment required to identify the extent of “related” principles. We are not able to articulate appropriate criteria at this stage of our deliberations, as this proposal needs more careful in-depth consideration.

**Q6:** We agree that the fundamental concepts from the Framework and principles from the IFRSs should be used as a starting point and then be modified as appropriate.

**Q7a:** We concur with the view that modifications for SMEs/non-listed entities must be on the basis of the identified needs of users, taking into account cost-benefit analysis.

**Q7b:** We concur with the view that disclosure and presentation modifications should be justified on the basis of user needs and cost-benefit analysis.

- The appropriate level of disclosure beyond key financial information should be directly related to the needs of financial stakeholders. In our experience, there is considerable time and cost expended in preparing lengthy disclosure notes, which may not be used or understood.

**Q7c:** While we concur with a general principal that there should be a rebuttable presumption of no recognition and measurement modifications, we are aware that many of the more complex measurement models (such as measurement of options for share-based payments) do not provide reliable measurement estimates for non-listed entities. Therefore we do not consider that this presumption will produce a practical or reliable outcome.

- Where a standard requires measurement by reference to a valuation model, such that the quality of the estimate depends on the availability of data, it is unlikely to produce reliable or meaningful estimates for many non-listed entities, depending on the size and nature of that entity.

**Q8a:** As previously indicated, the sheer volume of information provided in each IFRS is a major stumbling block for many non-listed entities that do not engage in complex transactions. We recommend a separate printed volume, and electronic versions to promote useability.

**Q8b:** We recommend that the IASB Standards for SMEs should follow the same number sequence as the equivalent IFRS.

- As businesses continue to evolve it becomes more difficult to lay down topical boundaries. However, an indexing system to direct users by topic to different accounting standards would be useful.

**Q8c:** We consider that the IASB Standard for SMEs should contain similar objectives, summaries and glossaries as for the equivalent IFRS. Any differences should arise from the different perspectives due to different accountability relationships. Therefore, an objective may be satisfied in a different way by considering the context for its application, but still be based on the same principle.

**Q9:** We strongly urge the Board to reconsider its use of the term “SME” in developing alternative standards to IFRS, due to the wide variation in understanding of the types of entity being considered. Please refer to the attachment to this letter for examples of the divergence arising in just one jurisdiction.

- The provision of financial reporting information by privately owned entities is just one aspect of that entity’s corporate governance responsibilities.

- The corporate governance responsibilities of privately owned entities have yet to be examined in context.
- The development of reporting requirements to address social responsibilities of all types of entities needs to be addressed as a separate issue, and not in terms of investor-based financial information. Social responsibilities will not be satisfied through the provision of the type of financial reporting information appropriate for making investment decisions and a clear distinction needs to be identified.

Pitcher Partners is currently undertaking research to ascertain the usefulness of financial information produced by non-listed entities in response to their statutory reporting obligations in Australia. If you would like a copy of our research findings when they become available, please contact Dianne.

Yours sincerely

**TERRY BENFOLD**

Partner

**S.DIANNE AZOOR HUGHES**

National Technical Director

Cc: Mr Warren McGregor, IASB  
Mr Kevin Stevenson, IASB  
Mr David Boymal, Australian Accounting Standards Board



**ATTACHMENT: Misuse and Misunderstanding Arising from References to “Small and Medium-Sized Entities (SMEs)”**

While we concur with the general thrust of the IASB Discussion Paper, we consider that the use of the term "SME" to describe the project, is not meaningful for financial reporting purposes. There is no single generally accepted definition of “SME” within Australia and when that same term is applied in a global context the broad variations in understanding/semantics are dispersed even further.

For example, there are at least two regulatory definitions of "SME" within Australia. SMEs may be used to refer to those entities that are not considered "large" as defined by section 45A(3) of the Corporations Act 2001. Entities that are “large” for application of the financial reporting provisions under the Australian Corporations Act 2001 must satisfy at least two of the following criteria:

- the consolidated gross operating revenue for the financial year of the company and the entities it controls (if any) is A\$10 million or more;
- the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is \$5 million or more;
- the company and the entities it controls (if any) have 50 or more employees at the end of the financial year.

In contrast, the Australian Bureau of Statistics and the Department of Industry classify SMEs as those entities with less than 20 employees.

Applications for industry grants and economic assistance often apply different criteria to define an SME dependent on the views of the funding organisation. For example, an organisation Intelligent Manufacturing Systems, delivered a letter to encourage *Australian industry, particularly small to medium enterprises (SMEs)*, to participate in IMS Projects, indicating that financial assistance may be provided to qualified applicants. (refer [http://www.au.ims.org/participation/pdf/Funding\\_SME.pdf](http://www.au.ims.org/participation/pdf/Funding_SME.pdf)). For the purpose of that funding offer, the criteria applied was:

“SMEs are defined in accordance with current Commonwealth Government definition, nominally: companies incorporated in Australia employing fewer than 200 persons and which together with related and parent entities have an aggregate annual revenue of less than \$A250 million.”

Therefore as cross-border transactions continue to increase in a global economy, a wide divergence in the understanding of terms will arise depending on the size and experience of each economy.

The application of US definitions of SMEs, based on size criteria, is clearly not appropriate in Australia. However, criteria based on operating and ownership characteristics are more likely to be relevant. Consider this extract from the US Small Business Administration government web site (found at [www.sba.gov/size](http://www.sba.gov/size)):

“The Small Business Act states that a small business concern is "one that is independently owned and operated and which is not dominant in its field of operation." The law also states that in determining what constitutes a small business, the definition will vary from industry to industry to reflect industry differences accurately... ..SBA has also established a table of size standards, matched to North American Industry Classification System (NAICS) industries.”

The table of size standards (found at <http://www.sba.gov/size/sizetable2002.pdf>) then explains small businesses by a wide range of average annual receipts or number of employees, depending on the industry classification.

Clearly the meaning attributed to “SME” is very much in the hands of the user.

In substance the IASB Discussion Paper considers "Accounting standards for non-listed entities". We believe that the IASB should consider ownership characteristics as the distinguishing feature between those entities that should adopt IFRS in full, and those that might be eligible for reduced reporting obligations, and leave individual jurisdictions to determine reporting thresholds relevant to size.

Ultimately, it is the investor group need for information that underlies the financial accountability relationships and hence the nature and extent of information provided.

- Investors may comprise a “fluid group” in capital markets. This means that investors in listed entities are not individually able to command the compilation of specific financial information but depend on general purpose financial reports as their primary source of financial information.
- In contrast, investors in privately funded enterprises are a closed group, usually with restrictions on transfers of equity. The level of communication between equity holders and managers is often more frequent, and certainly more feasible. Access to financial information can be requested and made available.
- Owner-managers are typically those that are perceived as operating “SMEs” but the size of these entities can vary from very small to very large in any jurisdiction, and regardless of the local thresholds adopted. *Small* and *large* will always be relative terms.

“Larger” entities in these second two categories seem to cause the most problem for standard setters and national regulators. Recognising that large corporations have a social responsibility, regulators have attempted to satisfy social accountability with financial information produced from the perspective of investors needs for information. This has resulted in a clear mismatch of accountability relationships and consequences.

This outcome is further compounded by the fact that a high level of financial reporting technical expertise is required to be able to understand the financial information provided using IFRS. As acknowledged when the IASB was reconstituted, the primary driver for international financial reporting standards was comparability and consistency in the information provided to global capital markets.

We believe that the IASB should take a lead roll in establishing the distinction between differing accountability relationships as:

- Those entities who offer their securities to the public;
- Not-for-profit entities that operate in the public interest (public sector entities and charitable concerns); and
- Privately-owned entities or non-listed entities.

By clearly articulating the relationship, as a prerequisite to discussion, the ability to determine the nature and extent of accountability, including the application of standards is considerably assisted.