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GAAP FOR SMALL AND MEDIUM SIZED ENTITIES

INTRODUCTION

1. I hereby provide a submission on the Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*. I present my submission as follows:
 - Some background on myself and my qualifications for making a submission.
 - Some general views on the accounting problems arising in the SME context.
 - Commentary in regard to the specific questions posed in the Discussion Paper.

BACKGROUND

2. I am a general practitioner in New Zealand, having trained in the United Kingdom.
3. I have provided advice to a range of African and New Zealand public sector entities with public accountability. In particular I was the author of the New Zealand Ministry of Education's model financial statements distributed to 2,300 schools to aid them in the preparation of financial reports to comply with the New Zealand Public Finance Act 1989. This Act imposes an generally accepted accounting practice (GAAP) requirement on all New Zealand schools. Many of these, but not all, were of such a size that they were able to apply the New Zealand version of differential reporting, entitled the *Framework for Differential Reporting*.
4. I have for a number of years provided credit control advice to the New Zealand Customs Service (Customs). Customs is a grantor of credit due to its deferred duty scheme. It is reliant upon financial reports prepared in accordance with GAAP for assessment of credit risk. In addition, I have, as a Court appointed liquidator at the petition of Customs, taken a number of successful actions involving failure to keep accounting records and in regard to the New Zealand solvency test. I shall refer to these cases in my general commentary.

GENERAL COMMENTARY

Introduction

5. The Discussion Paper suggests that the most fundamental issue is whether or not the Board should develop Standards for SMEs. Within this question there lies inherent a precursor question even more fundamental. That is, what is an SME? I should say at the outset that I think it self-evident that the Board needs to turn its mind to the formulation of a GAAP for SMEs. However, I think the form, or possibly, forms of that GAAP will vary depending upon what is encompassed with the scope of the term SME.



6. Based on the New Zealand experience I see there being four distinct classes of SME:
 - Not-for-profit entities (NFPs).
 - Incorporated for-profit entities (entities registered as companies).
 - Unincorporated for-profit entities.
 - Fiduciary entities.
7. Before I analyse the reporting requirements of these entities, I note that the Board has introduced a subtle but significant variation in its terminology. It refers to the sector neutral terminology 'entity' rather than to the profit orientated term 'enterprise'. Presumably this represents an expansion of the scope of the Board's responsibilities away from commercial entities to include all potential reporting entities (see IASB Framework para 8).
8. In the event the Board is expanding its scope (as I would argue it must do), it will need to expand the potential users of financial reports. For example, within the list of users donors to and beneficiaries of NFPs do not appear (IASB Framework para 9). Such people have a specialised information needs.
9. Each of these types of entity I identify has a requirement for an accounting, almost certainly annual and sometimes more frequently.

NFPs

10. I am an advocate of a GAAP for NFPs (see my article in New Zealand's *Chartered Accountants Journal* page 36 May 2004 Volume 83 Issue 4). There is a school of thought in New Zealand that would have it that GAAP is too onerous for small to medium sized entities. I think this is misguided. As noted above, all schools in New Zealand comply with a form of GAAP. Some of these schools are minute. The smallest have less than 10 pupils yet they have no difficulty complying.
11. The problem in the NFP context is that the financial measures of position and performance do not necessarily convey to the interested audience the effectiveness or otherwise of the conduct of an entity's affairs. This is so for two reasons.
12. First, a surplus in an entity may be indicative of a failure rather than a success. For example, in the school context the majority of its grants and donations (received) are intended to be applied for the benefit of the current pupilage. In the event some of these funds are not spent, the school can be considered to have failed. By way of contrast, some grants are provided for the purpose of long term maintenance. In the event a school is in deficit it may mean that it will fail in the long term. Balance and context is everything. Nothing in the Board's canon has the subtlety to convey this balance.
13. Second, in the NFP context it is often the case that resources not amenable to financial quantification are as important as those that can be quantified. Again the Board's GAAP is ill-equipped to deal with non-financial resources.

Companies

14. Companies incorporated in New Zealand may be seen to be of four sorts:
 - Companies deemed to be issuers of public securities.
 - Companies owned by non-residents.
 - Companies that are closely held but in which there is a separation between shareholders and directors
 - Companies that are so closely held that there is no distinction between the directors and the shareholders.
15. The first of these are subject to full GAAP (currently NZ financial reporting standards but soon to be the Board's standards) and they should be.

16. Companies of the second class have a public disclosure obligation, but are entitled to apply the *Framework for Differential Reporting* and usually do. Some of the companies are subsidiaries of large overseas companies and are frequently very substantial in their own right. Quite what the rationale is for forcing overseas owned companies into public disclosure when their domestic counterparts avoid it, is unclear. However, at some future date this anomaly will be eliminated and either all companies will disclose (as in the UK) or none will other than issuers.
17. The majority of New Zealand companies are owned and operated by a small group of people, frequently husband and wife. There are a few closely held companies which have a less narrowly based shareholding. Clearly, there is a need for some sort of related party disclosure provisions in such cases though the New Zealand Companies Act 1993 makes more than adequate provision for this. Aside from, perhaps, disclosures emanating out of IAS 10 and IAS 37, there is no need for the plethora of disclosure applicable to full GAAP. The current disclosure requirements of New Zealand GAAP are similar to but slightly less onerous than those to be introduced with the Board's Standards. Yet even now there is an incipient revolt amongst general practitioners as their services are rendered uncompetitive by the punctiliousness of unnecessary disclosure.
18. There is, therefore, a disparate need for financial reporting information amongst New Zealand companies. There are, however, common requirements.
19. The New Zealand Companies Act makes specific reference to financial reports prepared in accordance with GAAP. GAAP in New Zealand comprises a set of approved Standards. These are similar to IAS Standards with one or two notable exceptions, being IAS 19 and 39. In addition, where there is no approved Standards, accounting policies which have 'authoritative support' are applicable. Authoritative support comprises Standards from other (Anglo-Saxon) jurisdictions (including the Board meaning, for instance, IAS 19 or IAS 39) and the New Zealand version of the conceptual framework.
20. The two points where specific reference is made to financial reports prepared for GAAP are:
 - In regard to the main form of creditor protection, being a solvency test based mechanism.
 - In the general record keeping requirement, also part of the creditor protection measures. In this case the ability to determine financial position is paramount.
21. New Zealand has therefore based its creditor protection upon the promise of a GAAP that is able to shed light upon the balance sheet solvency or otherwise of a company. As Standard setting has progressed this goal is closer to being achieved. Imperative to this are the measurement principles applied in Standards such as IAS 36, IAS 37, IAS 38 and IAS 39. Irrespective of the size of the Companies concerned, all these measurement principles are now or will become central to creditor protection under the New Zealand Companies Act. (See also commentary on the myth of complexity below).
22. I have litigated both provisions (*Re Cellar House* in regard to record keeping) and (*Re Samarang* in regard to the solvency test). The Samarang case has only just concluded so I do not know the result as yet. In both cases the main point at issue was the point at which a liability to Customs duty should be recognised. For this purpose I was reliant upon the definition of the liability element from the New Zealand version of the conceptual framework.
23. In the Cellar House case the Judge seemed to reluctantly accept that the principles inherent in the definition of liabilities should govern the measurement and recognition of liabilities. It remains to be seen whether or not this idea becomes even more firmly embedded as a result of the Samarang case. In any event I think it dangerous that determination of solvency should be left to the whims of lawyers.

24. It is imperative that the basic principles of accounting measurement and recognition are made an inherent part of any GAAP regime for SMEs, at least so far as companies are concerned. In this regard the UK FRSSE is superior to the New Zealand equivalent as it enshrines these principles within the body of material that which binds SMEs (see FRSSE para 2.1).

Unincorporated entities

25. Leaving aside entities such as those that offer participatory securities, these accounting entities almost invariably have a special purpose financial reporting requirement (IASB Framework para 6). The main priority of such entities is to compute profits for tax purposes. Despite what the IASB Framework would suggest, the paraphernalia of the complete set of IASB's financial reporting standards would be inappropriate to such entities. The primary reporting requirement is to produce an income statement as closely aligned with taxation requirements as is possible. As alternative accounting measurement bases supplant historic cost, GAAP of one sort or another is less and less able to satisfy this requirement.
26. It is doubtful that the owner of an unincorporated business would wish to have prepared a Statement of Cash Flows in accordance with IAS 7. There may be some merit in such a statement being prepared for the business's banker, but then the banker has got cash flow information albeit not in the IAS 7 format. Similar sentiments can be expressed about many of the disclosure requirements arising out of IAS 2 and IAS 16, two Standards that will frequently apply to small, unincorporated business.
27. Far more important to such entities is the definition of the entity itself. For instance, an unincorporated entity does not, conventionally configured, represent all of the assets at the disposal of a creditor. The IASB canon does not seem to assist in this regard.

Fiduciary entities

28. This represents the most disparate class of entity. The term encompasses simple testamentary estates (so-called 'fixed interest trusts') through *inter-vivos* trusts created with or without a commercial motive to fiduciary responsibilities in regard to insolvent estates (liquidation, administration, receivership etc.).
29. In the case of simple estates, there is a requirement for a trustee to report to a frequently highly unsophisticated audience. The AICPA has provided the only guidance in this area that I am aware of. Chapter 16 of its series on *Guide to Compilation and Review Engagements* provides guidance on preparation of fiduciary reports. The guidance emphasises that reports should be simple so as to be intelligible to their audience and, at least as importantly, proportional to the resources of the fund. This can be taken to mean that the plethora of disclosures required by the Board's Standards would not be appropriate.
30. The AICPA guideline emphasises the need to account for fiduciary assets. For this purpose some sort of financial performance reporting is necessary. However, the AICPA guidance discourages the recognition of trust liabilities. The rationale eludes me. Suffice to say though, this guidance would be at variance with the Board's Framework (para 12 ff).
31. One form of fiduciary accounting I carry out is in regard to liquidated estates of companies. I always prepare financial reports in accordance with NZ GAAP (as I am obliged to do by the NZ *Explanatory Foreword to General Purpose Financial Reporting*). However, I find this difficult. For whilst financial position is important, financial performance is not because the entities with which I deal do not trade. More important is the process of realisation. That might tend to suggest that IAS 7 is an important component of the reporting. That is not so as the format of the Statement of Cash Flows is configured for an continuing operation and not the realisation of a moribund entity's estate.
32. For a variety of reasons the basic assumptions and general requirements of the Board's GAAP (modified by a differential philosophy or not) do not suit fiduciary accounting requirements.

Recommendation

33. I recommend that the Board:

- Ensure that the nature of entities falling within the scope of the proposed SME GAAP be made clear.
- Recognise that for some accounting entities, particularly those arising in the principles of GAAP (whether modified for a differential reporting requirement or not) are not appropriate to their circumstances.
- Consider formulating variations of entity specific GAAP to suit these entities.
- Recognise that the measurement bases applied in the formulation of many of the 'difficult' standards are necessary to support modern creditor protection regimes in corporate law, irrespective of whether or not the companies concerned are closely held or otherwise.

The myth of complexity in Standards

34. There is an increasingly prevalent myth that needs to be challenged, particularly in the formulation of a GAAP for SMEs. The myth is that accounting standards are too complex for all but the largest entities. In my view it is circumstances which are complex and accounting standards are established to reflect complexity. Cause is confused with effect. Avoidance is easy – don't engage in economic complexity unless it is necessary. When such complexity is necessary, accept that the price to be paid is complex accounting measurement.
35. Take, for example, a forward foreign exchange contract. An importer or exporter may need to enter into such transactions. Because it is relatively difficult to account for transactions of this character should not be a reason that they are ignored in the accounting process. Irrespective of whether or not an accounting standard prescribes recognition at fair value, it should be incumbent on the manager of a business to be aware of liabilities to protect the creditor or an asset to ensure credit risk is managed.
36. I can think of two specific examples where it may be argued that accounting standard complexity is unwarranted. However, I will put the alternative case.
37. In New Zealand there is consternation about implementation of IAS 41 in the primary sector. It is partially the advent of this Standard that has caused consternation amongst the general practitioner community. It is said that fair value measurement is too difficult, especially for smaller agricultural producers.
38. I do not accept that safeguards are not already built into IAS 41. Paragraph 30 makes it abundantly clear that where market values are not readily ascertainable, historic cost is an acceptable alternative. In the cases where it is not possible to avoid fair value, at the point of harvest (paragraph 32), it is a simple matter to configure the accounting cycle so that balance date occurs sufficiently after harvest time to enable produce to be sold and therefore readily valued.
39. I recently spent some time in the Kingdom of Lesotho. The labour code in that country imposes a form of deferred benefit for employees upon the employer. In such a case IAS 19 would be imposed across the economy and would be unavoidable. This may appear problematic as the accounting expertise would not be available to deal with IAS 19's measurement basis. Standard setters should not, however, be concerned about such impacts. Employees in Lesotho depend upon this benefit for retirement. Whether or not an accounting standard exists, the employer should ensure that adequate resources are available to meet the obligation. This could only be achieved in the event the liability's value was known.

Recommendation

40. I recommend that the Board:

- Do not adulterate measurement principles for SMEs so as to accommodate entities supposed lacking accounting expertise.

Differential Reporting: the New Zealand experience

41. New Zealand introduced a differential reporting version of GAAP in 1993. It was originally designed to relieve the small and / or closely held entity of disclosure burden, yet retain the basic measurement bases applicable to 'full GAAP' entities (a 'top down' approach). It has been problematic for three reasons:
 - The regime was altered early in its life to provide measurement concessions.
 - The regime entails the application of size criteria which are difficult to implement.
 - The relief from disclosure did not go far enough.
42. The New Zealand differential regime when introduced gave exemptions from measurement requirements. These were few in number but created anomaly. The most important concession was to allow tax to be accounted on a payables basis. This makes some sort of sense as the calculation of deferred tax is complex and the result elusive to the inexpert. However, a serious and unresolved legal issue arose.
43. The New Zealand accounting regime (in both its legal and professional forms) makes provision for the addition of information where application of GAAP does not give a true and fair view. Consequently, in theory at least, a company, say, could avail itself of the concession to avoid accounting for deferred tax in its Statement of Financial Position but then be required to identify this application of GAAP failed to identify a deferred tax liability. It would then be forced to compute the liability and add the information thereby negating the concession.
44. The second problem relates to the application of size criteria. Size criteria will generally be a combination of total revenues and asset values. In New Zealand a problem arises in regard to revenue as the notion of gains (being disposal proceeds less book value) is not an acknowledged concept in the New Zealand version of the conceptual framework. It therefore follows that it is unclear whether the net or gross figure needs to be taken into account when applying the revenue criterion. This problem ought not to be quite as severe in regard to the IASB's Framework as gains are acknowledged. However, it is noted that the word 'normally' qualifies the definition of gains, meaning there is room for doubt.
45. A further issue arises in respect to an income based size criterion when commissions are considered. It is not clear whether a travel agent's revenue is the gross sale or merely the percentage of the sale price they ultimately retain. Clearly in both cases the determination of revenue can make a significant difference to an entity's differential status. It is essential that in any differential reporting regime guidance is given as to how to apply size criteria.
46. The final problem with the New Zealand differential reporting regime is that the disclosure concessions became fewer and fewer as time went on. It is my view that the incipient revolt against GAAP is attributable to the failure to make disclosure relief effective. I do not believe the origin of this problem lies within the 'top down' approach. I think that the problem lay within the size of the New Zealand standard setting apparatus and its difficulty in serving all potential masters. In other words, there is nothing inherently wrong in the 'top down' approach. It simply needs the will and the wherewithal to implement.
47. The advantage of the 'top down' approach is that it facilitates the easy transition from 'small GAAP' to 'full GAAP' because, by and large, the measurement bases will be the same. All that will differ will be disclosure.

Recommendation

48. I recommend that the Board:

- Avoid as much as possible giving concessions to SMEs in respect to measurement either completely or partially.
- Even if it does not intend to set size criteria, establishes the basis upon which size criteria are applied.
- Accept that differential reporting regimes should provide disclosure relief only and that a 'top down' approach facilitates such an implementation.

Specific commentary**Introduction**

49. I provide the answers to specific questions as follows.

Question 1a

50. I do not think that IFRS are suitable for all SMEs. My reasons for so saying are set out in paragraphs 25 to 32. These reasons relate to the nature of certain SMEs. I also believe that vast array of disclosure requirements are inappropriate for many closely held companies, but that all such companies should be subject to the measurement bases applicable in the IFRSs.

Question 1b

51. Subject to the conditions I have outlined above I answer yes.

Question 1c

52. It would stand to reason that publicly listed entities should not use a differential reporting regime. However that is a matter for each national jurisdiction. The answer to the second question would depend on how any such SME regime was configured. If it were to state that only those entities meeting a set of criteria can apply the regime were able to comply with the regime, then any entity not complying would, be definition, not comply.

Question 2

53. As noted above the various objectives may be in conflict with one another. For example, the needs of users of financial reports for fiduciary accounting purposes may conflict with elements of the conceptual framework.

Question 3a

54. I agree that precise values for size criteria must be left to individual jurisdictions. However, it is imperative the Board prepare a framework for how size criteria are to be implemented.

Question 3b

55. For the reasons given above, I do not think it possible for the Board to formulate a GAAP for all potential SMEs. In the first instance it should concentrate on formulating a regime that is applicable to commercial enterprises subject to a legally binding accounting regime such as the New Zealand Companies Act and its equivalent in other jurisdictions.

Question 3c

56. Yes.

Question 3d

57. I think it would be more appropriate if a minority owner were able to force the application of certain elements of 'full GAAP'. For example, in the event there is relief from related party disclosure, there should be a requirement that the availability of such concession should depend upon the unanimous consent of all owners.

Question 3e

58. Yes.

Question 4

59. Yes. Having said that it is hoped that, for the reasons given in paragraphs 14 to 24 that there is no measurement distinction between 'small GAAP' and 'full GAAP'.

Question 5a

60. For the reasons given, the question ought not to arise. There should be no distinction between different classes of GAAP in terms of measurement and recognition. If there is, then the option to use what presumably will be a more accurate measurement basis should be available to the SME if it so wishes.

Question 5b

61. Notwithstanding that there should be no measurement concessions, in the event an SME opts to apply a measurement basis that it could otherwise be exempt from it should then be compelled to apply the complete standard. The risk is that if the SME can be selective about applicable principles, it might, for instance, choose to apply a fair value measure to its currency derivatives because they are in gain but not its interest derivatives because they are in loss. A standard-by-standard approach prevents a legally sanctioned form of 'cherry picking'.

Question 6

62. Yes – it is imperative that the Board begin by defining a set of principles for reporting for SMEs.

Question 7a

63. I have suggested in my general commentary above that designing for all potential accounting entities in the context of the IASB's Framework may not be appropriate in all cases (see particularly paragraphs 28 to 32). As noted, I think the Board should consider formulating different GAAP regimes for different classes of entities. In terms of fiduciary accounting I suggest that the AICPA's guidelines may provide a useful start point.

Question 7b

64. I can't see any other basis other than cost benefit and user needs for formulating an SME regime. I would hope that, aside for key issues such as related parties, disclosure requirements are drastically reduced from 'full GAAP' and even from the current disclosure regime applicable to differential reporting entities here in New Zealand. If the SME regime does not achieve this goal it will be a failure.

Question 7c

65. I see no need whatsoever for varying measurement and recognition principles.

Question 8a

66. I would have thought the format of presentation would automatically predispose the regime to one of the existing models, for instance, being that applicable in the UK in the event there was a separate volume. As I see a differential reporting regime being a truncated version of the full GAAP from which it is derived, I do not believe it should be kept in a separate volume.

Question 8b

67. Yes.

Question 8c

68. Yes.

Question 9

69. See the general commentary I have provided above

Yours faithfully

Robert B Walker