June 2004

DISCUSSION PAPER

Preliminary Views on Accounting Standards for Small and Medium-sized Entities

Comments to be submitted by 24 September 2004

International
Accounting Standards
Board®

Preliminary Views on Accounting Standards for Small and Medium-sized Entities

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Published for comment by the International Accounting Standards Board

Comments to be received by 24 September 2004

This Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* is published by the International Accounting Standards Board (IASB) for comment only. The Discussion Paper includes preliminary views of the Board that may be modified in the light of the comments received before being issued in the form of one or more proposed Standards for SMEs. Comments on the issues and questions raised in the Discussion Paper should be submitted in writing so as to be received by **24 September 2004**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post.

Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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PRELIMINARY VIEWS ON ACCOUNTING STANDARDS FOR SMALL AND MEDIUM-SIZED ENTITIES

DISCUSSION PAPER

Summary of the issues, preliminary views and questions

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

Preliminary view 1.1 – Full IFRSs are suitable for all entities. The objective of financial statements as set out in the IASB *Framework* is appropriate for SMEs as well as for entities required to follow full IFRSs. Therefore, full IFRSs should be regarded as suitable for all entities. ('Full IFRSs' are Standards and Interpretations adopted by the IASB. They comprise International Financial Reporting Standards, International Accounting Standards and Interpretations originated by the International Financial Reporting Interpretations Committee or the former Standing Interpretations Committee.)

Preliminary view 1.2 – The Board will develop standards for SMEs. The Board will develop a set of financial reporting standards that is suitable only for those entities that do not have public accountability ('IASB Standards for SMEs'). Those standards would not be intended for use by publicly accountable entities, including those whose securities have been listed for trading in a public securities market, even if national law or regulation were to permit this. Public accountability is discussed in issue 3 and preliminary views 3.1-3.6.

Preliminary view 1.3 – Disclose the basis of presentation. If an entity follows IASB Standards for SMEs, the basis of presentation note and the auditor's report should make that clear.

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

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

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?

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

Preliminary view 2 – Objectives of IASB Standards for SMEs. Financial reporting standards for SMEs should:

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

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

(c) be built on the same conceptual framework as IFRSs;

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

(e) allow easy transition to full IFRSs for those SMEs that become publicly accountable or choose to switch to full IFRSs.

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?

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

Preliminary view 3.1 – No size test. The Board should describe the characteristics of the entities for which IASB Standards for SMEs are intended. Those characteristics should not prescribe quantitative 'size tests'. National jurisdictions should determine whether all entities that meet those characteristics, or only some, should be required or permitted to use IASB Standards for SMEs.

Preliminary view 3.2 – Public accountability principle. Public accountability is the overriding characteristic that distinguishes SMEs from other entities. Full IFRSs, and not IASB Standards for SMEs, are appropriate for an entity that has public accountability. An entity has public accountability if:

(a) there is a high degree of outside interest in the entity from non-management investors or other stakeholders, and those stakeholders depend primarily on external financial reporting as their only means of obtaining financial information about the entity; or

(b) the entity has an essential public service responsibility because of the nature of its operations.

Preliminary view 3.3 – Presumptive indicators of public accountability. A business entity would be regarded as having public accountability, and therefore should follow full IFRSs, if it meets any of the following criteria:

(a) it has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;

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(b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;

(c) it is a public utility or similar entity that provides an essential public service; or

(d) it is economically significant in its home country on the basis of criteria such as total assets, total income, number of employees, degree of market dominance, and nature and extent of external borrowings.

Preliminary view 3.4 – Required assent of all owners. An entity that does not satisfy any of the presumptive indicators of public accountability would nevertheless be regarded as having public accountability unless it has informed all of its owners, including those not otherwise entitled to vote, that it intends to prepare its financial statements on the basis of IASB Standards for SMEs rather than on the basis of IFRSs, and none of those owners objects to using IASB Standards for SMEs.

Preliminary view 3.5 – Scope: all entities that do not have public accountability. The Board intends to include all entities that do not have public accountability as potential adopters of IASB Standards for SMEs.

Preliminary view 3.6 – Subsidiaries, joint ventures and associates. 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 the parent, venturer or investor, it should comply with full IFRSs, not IASB Standards for SMEs, in its separate financial statements.

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?

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?

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?

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?

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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?

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?

Preliminary view 4 – Mandatory fallback to IFRSs. If IASB Standards for SMEs do not address a particular accounting recognition or measurement issue that is addressed in an IFRS, the entity would be required to look to that IFRS to resolve that particular issue only. The entity would continue to use IASB Standards for SMEs for the remainder of its financial reporting. Each IASB Standard for SMEs should explicitly mention the required fallback to IFRSs.

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?

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?

Preliminary view 5 – Optional reversion to an IFRS. If an IASB Standard for SMEs provides an exemption or simplification from a recognition or measurement requirement in the related IFRS, an entity that uses IASB Standards for SMEs would not be prohibited from applying the related IFRS in its entirety, while otherwise continuing to use IASB Standards for SMEs. Optional reversion would not be permitted for only some, but not for all, principles in the related IFRS.

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?

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

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(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?

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?

Preliminary view 6 – IFRSs are the starting point for developing SME standards. Development of IASB Standards for SMEs should start by extracting the fundamental concepts from the IASB *Framework* and the principles and related mandatory guidance from IFRSs (including Interpretations).

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?

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?

Preliminary view 7.1 – Justification for modifications. Any modifications to the concepts or principles in IFRSs must be based on the identified needs of users of SME financial statements or cost-benefit analyses.

Preliminary view 7.2 – Likelihood of disclosure and presentation modifications. It is likely that disclosure and presentation modifications will be justified on the basis of user needs and cost-benefit analyses. The disclosure modifications could increase or decrease the level of disclosure relative to full IFRSs.

Preliminary view 7.3 – Rebuttable presumption of no recognition and measurement modifications. There would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles in IFRSs. Such modifications can be justified only on the basis of user needs or cost-benefit analyses.

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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?

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?

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?

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

Preliminary view 8.1 – Separate volume. IASB Standards for SMEs should be published in a separate printed volume. The Board may also use other means of publication, such as Web publishing.

Preliminary view 8.2 – Organised by IAS/IFRS (and Interpretation) number. IASB Standards for SMEs should:

(a) follow the IAS/IFRS (and Interpretation) numbering system – ie SME-IAS 1, SME-IAS 2 etc and SME-IFRS 1, SME-IFRS 2 etc; and

(b) not be reorganised by topic, such as integrated in a balance sheet-income statement line item sequence like the UK *Financial Reporting Standard for Smaller Entities (FRSSE)*.

Preliminary view 8.3 – Foreword material in each Standard. Each IASB Standard for SMEs should include a statement of its objective and a summary.

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.

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.

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?

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?

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PRELIMINARY VIEWS ON ACCOUNTING STANDARDS FOR SMALL AND MEDIUM-SIZED ENTITIES

DISCUSSION PAPER

Introduction and invitation to comment

IN1 In most countries, many or even all entities have a statutory (ie legal) obligation to prepare financial statements that conform to a required set of accounting principles that are generally accepted in that country (national GAAP). Those statutory financial statements are normally filed with a government agency and thus are available to creditors, suppliers, employees, government and others. The great majority of those entities are small or medium-sized entities (SMEs)—no matter how one might define 'small' or 'medium-sized'.

IN2 In developing International Financial Reporting Standards (IFRSs), the International Accounting Standards Board (IASB) has not indicated that its standards are designed or intended only or primarily for entities whose securities are listed for trading in public capital markets. In this the IASB has followed the practice of its predecessor, the International Accounting Standards Committee. However, at least in those developed countries in which IFRSs are used either by regulation or at the option of the entity, the primary adopters are entities whose securities are publicly traded.

IN3 In some smaller or emerging economy countries, IFRSs are used as national GAAP for all or many unlisted entities. Thus, SMEs are required to follow all of the requirements of IFRSs. Not all of those SMEs have cited difficulties in applying IFRSs. However, there are many cases in which particular standards are departed from (sometimes with and sometimes without disclosure), and IFRSs are applied without rigorous enforcement or quality control. Also, SMEs often cite difficulties or excessive costs in applying IFRSs.

IN4 Some commentators argue that identical standards ought to be applicable to all financial statements that purport to give a fair presentation. Others advocate simplified or different standards for small or non-public entities, reasoning that some IFRSs are unnecessarily demanding for non-public entities, and some of the resulting information is not relevant for or used by the users of financial statements of SMEs. Those who hold the latter view

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have called for exemptions and modifications of IFRSs for small or non-public entities or, alternatively, for two separate sets of accounting standards, with one specific to small or non-public entities.

IN5 In its transition report of December 2000 to the newly formed IASB, the outgoing International Accounting Standards Committee said: "A demand exists for a special version of International Accounting Standards for Small Enterprises". In their 2002 annual report, the Trustees of the IASC Foundation wrote: "The Trustees also support efforts by the IASB to examine issues particular to emerging economies and to small and medium-sized enterprises."

IN6 The Board has begun a project to develop accounting standards suitable for SMEs. At public meetings of the Board during the second half of 2003 and early 2004, the Board developed some preliminary and tentative views about the basic approach that it will follow in developing IASB accounting standards for SMEs. It has also tested that approach by applying it to several existing IFRSs.

IN7 The Board has set up an advisory panel whose members provide views and comments on specific issues that are presented to them. Also, because a number of the Board's preliminary views on standards for SMEs require an assessment of the needs of users of financial statements of SMEs, the project staff have organised an informal user advisory group to provide assistance in this area.

IN8 The purpose of this Discussion Paper is to invite comments on the Board's preliminary views on its basic approach to the project on accounting standards for SMEs and on any other aspect of the project on which a respondent wishes to comment. The Board's views are tentative and are presented here to aid respondents in providing their comments.

IN9 The issues and the Board's preliminary views are set out in the following format:

(a) issue;

(b) alternative solutions to that issue, and arguments for and against each;

(c) the Board's preliminary views and reasoning; and

(d) specific question(s) to which the Board is seeking responses.

IN10 For convenience, the issues are numbered. Questions to which the Board would particularly welcome responses are highlighted in ***bold italic*** typeface.

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IN11 A summary of the issues, preliminary views, and questions is presented on pages 4-9. Those views and questions are also noted throughout this Discussion Paper issue by issue.

IN12 This Discussion Paper examines issues relating to accounting standards for small and medium-sized entities, identifies the Board's preliminary and tentative views on those issues, and raises questions about them. The Board invites comments on any aspect of this Discussion Paper and would particularly welcome answers to the questions posed in the Discussion Paper. Comments are most helpful if they indicate the specific paragraph(s) or question(s) to which they relate, contain a clear rationale and, when applicable, provide a suggestion for an alternative approach.

IN13 Comments should be submitted in writing and sent so as to be received no later than **24 September 2004**.

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Whether the International Accounting Standards Board should develop Standards for SMEs

The issue

1 **Issue 1. Should the Board develop special financial reporting standards for SMEs?** This is the most fundamental question in the project.

Alternatives considered

2 The principal alternatives considered by the Board in addressing that issue are:

(a) The Board should not develop special financial reporting standards for SMEs. Full IFRSs should be regarded as suitable for all entities including SMEs. 'Full IFRSs' are the Standards and Interpretations adopted by the Board and comprise International Financial Reporting Standards (IFRSs), International Accounting Standards (IASs) and Interpretations originated by the International Financial Reporting Interpretations Committee or the former Standing Interpretations Committee.

(b) The Board should develop special financial reporting standards for SMEs ('IASB Standards for SMEs'). The IASB should indicate the types of entities for which it believes those standards are suitable. National jurisdictions should determine whether all such entities as defined by the Board, or only some, should be required or permitted to use the IASB Standards for SMEs.

3 Alternative (b) does not mean that an SME could use *only* the special reporting standards for SMEs and would be prohibited from using full IFRSs. The special standards for SMEs would be a choice available to an SME, but not to entities that do not meet the IASB's definition of an SME (discussed in issue 3). Full IFRSs would be another choice available to SMEs. The basis of presentation note and the auditor's report would clearly state which standards were being followed.

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Preliminary views

4 The IASB's preliminary views about issue 1 are:

Preliminary view 1.1 – Full IFRSs are suitable for all entities. The objective of financial statements as set out in the IASB *Framework for the Preparation and Presentation of Financial Statements* is appropriate for SMEs as well as for entities required to follow full IFRSs. Therefore, full IFRSs should be regarded as suitable for all entities.

Preliminary view 1.2 – The Board will develop standards for SMEs. The Board will develop a set of financial reporting standards that is suitable only for those entities that do not have public accountability 'IASB Standards for SMEs'. Such standards would not be intended for use by publicly accountable entities, including those whose securities have been listed for trading in a public securities market, even if national law or regulation were to permit this. Public accountability is discussed in issue 3 and preliminary views 3.1-3.6.

Preliminary view 1.3 – Disclose the basis of presentation. If an entity follows IASB Standards for SMEs, the basis of presentation note and the auditor's report should make that clear.

5 The Board reached the preliminary view that full IFRSs should be regarded as suitable for all entities because it concluded that the objectives of general purpose financial statements are fundamentally the same for all entities. Paragraph 12 of the IASB *Framework* states:

> The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

Therefore, standards for general purpose financial statements of entities with public accountability would result in financial statements that meet the needs of all users of financial statements.

6 At the same time, the Board noted that users of financial statements of SMEs may have less interest in some information in general purpose financial statements than users of financial statements of entities whose securities are listed for trading in public securities markets or that otherwise have public accountability. For example, users of financial statements of SMEs may have greater interest in short-term cash flows, liquidity, balance sheet strength and interest coverage, and in the historical trends of earnings and interest coverage, than they do in information that is intended to assist in making forecasts of an entity's long-term cash flows, earnings and value. On the other hand, users of financial statements of SMEs may need some information that is not ordinarily presented in the financial

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statements of listed and larger entities. For example, as an alternative to the public capital markets, SMEs often obtain capital from shareholders, directors and suppliers, and shareholders and directors often pledge personal assets so that the SME can obtain bank financing. Consequently, there may be need for expanded related party disclosure requirements for SMEs. Such differences suggest that a separate set of financial reporting standards suitable for SMEs may be appropriate. Such standards may also be justified on the basis of cost-benefit considerations with respect to application of full IFRSs by SMEs. The extent of the differences between full IFRSs and IASB Standards for SMEs will be determined on the basis of user needs and cost-benefit analyses. In practice, the benefits of applying accounting standards differ across reporting entities, depending primarily on the nature, number and information needs of their financial statement users. The related costs may not differ significantly. Therefore, the Board believes that the cost-benefit trade-off should be assessed in relation to the number and information needs of the users of an entity's financial statements.

7 The two preceding paragraphs highlight the fundamental dilemma facing the Board in deciding whether to develop standards for SMEs. On the one hand, it believes that the same concepts of financial reporting are appropriate for all entities regardless of size—particularly the concepts for recognising assets, liabilities, income and expenses. That suggests that a single set of accounting standards should be suitable for all entities, although that would not rule out a limited number of disclosure differences based on user needs and cost-benefit considerations. On the other hand, the Board acknowledges that differences in the types and needs of users of SME financial statements, as well as limitations in, and the cost of, the accounting expertise available to SMEs, suggest that a separate set of standards for SMEs may be appropriate—with constraints such as linkage back to the IASB *Framework*, consistent definitions of elements of financial statements, and focus on the needs of users of financial statements of SMEs.

8 Developing a set of standards for SMEs is consistent with the IASB's mission. The principal objective of the IASB, as set out in its Constitution and in the *Preface to International Financial Reporting Standards*, is "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions". "Single set" means that all entities in similar circumstances globally should

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follow the same standards. The circumstances of SMEs can be different from those of larger, publicly accountable entities in a number of ways, including:

(a) who the users of the entity's financial statements are, and what are their information needs;

(b) how the financial statements are used;

(c) the depth and breadth of accounting expertise available to the entity; and

(d) their ability to bear the costs of following the same standards as the larger, publicly accountable entities.

9 Existing IFRSs include several differences for entities whose securities are not publicly traded. For example:

(a) IAS 14 *Segment Reporting* requires disclosure of segment information only by entities whose equity or debt securities are publicly traded.

(b) IAS 27 *Consolidated and Separate Financial Statements* exempts some parent companies from preparing consolidated financial statements if their debt or equity instruments are not traded in a public market. Similar exemptions are in IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures.*

(c) IAS 33 *Earnings per Share* requires presentation of earnings per share data only by entities whose ordinary shares or potential ordinary shares are publicly traded.

10 The Board considered whether GAAP for SMEs would best be developed by others—either globally, country by country, or perhaps at the regional level—while the IASB focuses its efforts primarily on GAAP for entities that participate in public capital markets. However, it concluded that its mission as set out in its Constitution is not restricted to standards for entities that participate in public capital markets. Focusing only on these entities is likely to result in standards or practices for other entities (including SMEs) that are not consistent with the IASB's *Framework* or Standards, may not address the needs of external users of financial statements, may lack comparability across national boundaries or within a country, and may not allow for an easy transition to full IFRSs for entities that wish to enter the public capital markets.

11 National standard-setters throughout the world strongly support an IASB initiative. In September 2003, the IASB hosted a meeting of 40 of the world's national accounting standard-setters. In preparation for that

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meeting the Board surveyed them about standards for SMEs. With near unanimity, the 30 standard-setters that responded said that the IASB should develop global standards for SMEs.

12 Requiring disclosure of the basis of preparation, including an indication that the entity has followed IASB Standards for SMEs, follows from the requirement in paragraph 8(e) of IAS 1 *Presentation of Financial Statements* (as revised in 2003) for disclosure of a summary of significant accounting policies and the requirement in paragraph 108 regarding the content of such a summary. International Standard on Auditing 700 *The Auditor's Report on Financial Statements* requires that "the opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements." Furthermore, IAS 1 paragraph 14 states that "financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs." If, instead of complying with IFRSs, an entity complies with IASB Standards for SMEs, that fact should be disclosed.

13 In preliminary view 1.2, the Board tentatively concluded that IASB Standards for SMEs would not be intended for use by entities whose securities have been listed for trading in a public securities market, even if national law or regulation were to permit this. The Board recognises that ultimately decisions on which entities use IASB Standards rest with national regulatory authorities and standard-setters. However, a clear definition of the class of entity for which IASB Standards for SMEs are intended is essential so that (a) the Board can decide on the standards that are appropriate for that class of entity and (b) national regulatory authorities, standard-setters, and reporting entities and their auditors will be informed of the intended scope of applicability of IASB Standards for SMEs.

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Questions for respondents

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

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

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?

Objectives of IASB Standards for SMEs

The issue

14 **Issue 2. What should be the objectives of a set of financial reporting standards for SMEs?**

Alternatives considered

15 This is not an issue for which specific alternatives can be identified. Comments are invited on the objectives agreed to by the Board as set out in preliminary view 2.

Preliminary views

16 **Preliminary view 2. Objectives of IASB Standards for SMEs.** Financial reporting standards for SMEs should:

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

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

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

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

(e) allow easy transition to full IFRSs for those SMEs that become publicly accountable or choose to switch to full IFRSs.

17 Objective (a) is consistent with the overall objective of the IASB as set out in its Constitution and in the *Preface*. Objectives (b) and (d) are based on the two primary reasons for undertaking the SME project—to reduce the burden on financial statement preparers and to meet the needs of financial statement users. Objectives (c) and (e) reflect the Board's intention that IASB Standards for SMEs should be a modified version of full IFRSs rather than a body of standards developed independently of full IFRSs.

18 Some have suggested that an objective of financial reporting standards for SMEs should be to provide information that the management of an SME needs to carry out its planning, decision-making and control responsibilities (ie management information). Unquestionably, management is interested in and uses the information contained in the financial statements an entity provides to outsiders. In fact, for SMEs, owner-managers are often the primary users of the SME's financial statements. At the same time, management has access to additional information (financial and non-financial) that helps it in managing the entity, and it has the ability to determine the form and content of such additional information to meet its own needs. The IASB's objectives, however, are to develop standards for the information in general purpose financial statements and other financial reporting to help investors, creditors and others who provide resources to the entity make economic decisions—decisions such as whether to provide goods or services on credit or to lend or invest and at what price. Standards for management information are not an objective of the IASB generally or with respect to SMEs.

19 Tax authorities are also often important external users of the financial statements of an SME. Tax authorities generally have the power to demand whatever information they need to meet their statutory tax assessment and collection obligations. Tax authorities often look to financial statements as the starting point for determining taxable income, and some governments have policies to minimise the adjustments to accounting profit and loss for the purpose of determining taxable income. Nonetheless, IASB Standards are not intended to meet the needs of tax authorities.

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Questions for respondents

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?

Definition of SME

The issue

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

Alternatives considered

21 Issue 3 is aimed at specifying the entities that the Board regards as the potential adopters of its financial reporting standards for SMEs. The Board recognises that ultimately decisions on which entities use IASB Standards rest with national regulatory authorities and standard-setters. However, a clear definition of the class of entity for which IASB Standards for SMEs are intended is essential so that (a) the Board can decide on the standards that are appropriate for that class of entity, (b) the Board can inform national regulatory authorities and standard-setters of its intended scope of applicability of IASB Standards for SMEs and (c) reporting entities will know whether they meet the IASB's 'eligibility requirements' for use of the IASB Standards for SMEs.

22 In considering which entities should be eligible to use IASB Standards for SMEs, the Board has tentatively concluded that any entity that has filed, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market (a 'listed entity') should use full IFRSs, not IASB Standards for SMEs. Listed entities have chosen to enter the public capital markets. Consequently, there is a high degree of outside interest in listed entities from non-management investors, potential investors and other stakeholders. Moreover, those stakeholders depend primarily on external financial reporting as their only means of obtaining financial information about the entity. Full IFRSs provide financial information intended to meet the needs of the users of financial statements of listed entities.

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23 Consequently, the Board's deliberations on the definition of an SME focused on whether full IFRSs should also be regarded as essential for some unlisted entities and, if so, what the characteristics of those unlisted entities are. The Board considered three alternatives:

(a) IASB Standards for SMEs should be suitable for all unlisted entities (any entity that is not a listed entity as defined above). In other words, all unlisted entities would be regarded as SMEs.

(b) IASB Standards for SMEs should be suitable for those unlisted entities that are below a quantified size threshold. Unlisted entities above the size threshold would be required to follow full IFRSs and, therefore, would not be regarded as SMEs.

(c) There are some unlisted entities that by their nature, rather than by their size, have a public reporting obligation that is equivalent to that of a listed entity. The Board should define the characteristics of those entities. Those entities would be required to follow full IFRSs and, therefore, would not be regarded as SMEs. Unlisted entities that do not meet the defined characteristics would be regarded as SMEs.

24 Alternatives (b) and (c) are not mutually exclusive. SMEs can be defined in terms of both characteristics and size.

25 The Board also examined a separate but related question: whether IASB Standards for SMEs should be intended only for some but not all SMEs—for instance, only for 'relatively large' SMEs and not for 'very small' ones (or vice versa). However, pursuing this approach would require the Board to specify size criteria that would apply globally and for a period of years, and this is very difficult if not impossible.

Preliminary views

26 **Preliminary view 3.1 – No size test.** The Board should describe the characteristics of the entities for which IASB Standards for SMEs are intended. Those characteristics should not prescribe quantitative 'size tests'. National jurisdictions should determine whether all entities that meet those characteristics, or only some, should be required or permitted to use IASB Standards for SMEs.

27 The Board has tentatively concluded that because its Standards are used in more than 100 countries around the world, it is not feasible to develop a quantified size test that would be applicable and long-lasting in all of those countries. This is consistent with the Board's general principles-based approach to standard-setting.

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28 **Preliminary view 3.2 – Public accountability principle.** Public accountability is the overriding characteristic that distinguishes SMEs from other entities. Full IFRSs, and not IASB Standards for SMEs, are appropriate for an entity that has public accountability. An entity has public accountability if:

(a) there is a high degree of outside interest in the entity from non-management investors or other stakeholders, and those stakeholders depend primarily on external financial reporting as their means of obtaining financial information about the entity; or

(b) the entity has an essential public service responsibility because of the nature of its operations.

29 The Board has tentatively concluded that these principles provide a framework for assessing the trade-off between the costs of preparing full IFRS financial statements and the benefits of those statements to their users. The common thread in the two principles is the existence of a substantial group of persons outside the entity (ie persons other than owner-managers) who have a direct financial interest in or claim against the entity or who are dependent on the entity to provide essential public services. These persons have a legitimate need for financial information about the entity but lack the power to demand the information for themselves. Financial statements and other financial reports based on full IFRSs are intended to meet those needs.

30 By having filed its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, an entity automatically becomes publicly accountable. However, an entity does not become publicly accountable simply because, in its home jurisdiction, it is required to submit its financial statements to a central registry maintained by a government agency and open to public inspection. Rather, the principles of public accountability set out in preliminary view 3.2 look to the needs of the users of financial statements to assess public accountability. More detailed discussion of user needs is presented with issue 7 later in this Discussion Paper.

31 **Preliminary view 3.3 – Presumptive indicators of public accountability.** A business entity would be regarded as having public accountability, and therefore should follow full IFRSs, if it meets any of the following criteria:

(a) it has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;

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(b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;

(c) it is a public utility or similar entity that provides an essential public service; or

(d) it is economically significant in its home country on the basis of criteria such as total assets, total income, number of employees, degree of market dominance, and nature and extent of external borrowings.

32 The Board has tentatively concluded that in each of indicators (a)-(d) above one or both of the principles of public accountability in preliminary view 3.2 are satisfied:

(a) Public securities markets, by their nature, bring together non-management investors who must consider whether to provide capital, and at what price, and entities that seek capital. Although those public investors often provide longer-term risk capital, they do not have the power to demand the financial information they might want for investment decision making. An entity's choice to enter a public capital market makes it publicly accountable—and it must provide the outside investors with financial information.

(b) Similarly, banks, insurance companies, securities broker/dealers, pension funds, mutual funds and investment bankers stand ready to hold and manage financial resources entrusted to them by a broad group of clients, customers or members who are not involved in the management of the entities. Because such an entity acts in a public fiduciary capacity, it becomes publicly accountable.

(c) Public utilities—electric, gas, telephone, water and similar entities—provide services that are recognised as basic necessities of society, and they provide those services in markets in which few, if any, competitors also provide those services. The nature of the services combined with the nature of the market in which they are provided makes the entities that provide them publicly accountable. Government agencies that regulate entities that hold assets in a fiduciary capacity or that provide essential public services have the power to obtain whatever financial information they feel they need as regulators. The IASB's role is different—it is to establish standards for general purpose external financial reporting by those same entities to those whose assets they hold and those who rely on the essential services.

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(d) An entity that is economically significant in its home country is publicly accountable to the community in which it operates. The external stakeholders in this case do not necessarily have an investor or creditor relationship with the entity. However, they do have a financial interest because their jobs, their businesses and the local economy may depend directly on the entity's financial performance and financial stability. Guidance on the specific criteria for assessing economic significance in an individual national jurisdiction would be left to the regulatory authorities or standard-setters in that jurisdiction—consistently with the principles in IASB Standards for SMEs.

33 **Preliminary view 3.4 – Required assent of all owners.** An entity that does not satisfy any of the presumptive indicators of public accountability would nevertheless be regarded as having public accountability unless it has informed all of its owners, including those not otherwise entitled to vote, that it intends to prepare its financial statements on the basis of IASB Standards for SMEs rather than on the basis of IFRSs, and none of those owners objects to using IASB Standards for SMEs.

34 An entity's owners are key users of its financial statements. In developing IASB Standards for SMEs, the Board will base modifications of IFRSs on the needs of users of the financial statements and a cost-benefit analysis. Preliminary view 3.2 notes that persons other than owner-managers are outside the entity and may lack the power to demand the information they need. This group may include non-managing or minority owners as well as creditors or other stakeholders. Therefore, the Board has tentatively concluded that the objection of even one owner of an entity to the use of IASB Standards for SMEs is sufficient evidence of the need for that entity to prepare its financial statements on the basis of full IFRSs. Those who do not agree with preliminary view 3.4 argue that the principle in preliminary view 3.2 combined with the indicators in preliminary view 3.3 will appropriately identify entities with public accountability. In their judgement, preliminary view 3.4 is not needed, because a request, or even a non-response, by one shareholder does not make an entity publicly accountable.

35 **Preliminary view 3.5 – Scope: all entities that do not have public accountability.** The Board intends to include all entities that do not have public accountability as potential adopters of IASB Standards for SMEs.

36 The Board sees no basis to focus only on the relatively larger non-publicly accountable entities and to state that IASB Standards for SMEs may not be suitable for very small entities. In the Board's judgement, that is inconsistent with its conclusion in preliminary view 1.1 that full IFRSs are

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suitable for all entities. If full IFRSs are not unsuitable for very small entities, then surely IASB Standards for SMEs are not unsuitable. Whether to require or permit very small entities to use IASB Standards for SMEs is a matter for each national jurisdiction to decide. The Board determines which entities are eligible to use IASB Standards for SMEs. Then each national jurisdiction must decide whether to permit or require IASB Standards for SMEs to be adopted by all, some or for that matter none, of the entities that, based on the IASB's definition of an SME, are eligible to use those standards.

37 Some believe that the Board should develop standards for SMEs that are aimed only at the relatively smaller entities, rather than all sizes of non-publicly accountable entities. Those who advocate this approach point out that non-publicly accountable entities can include some of the largest private business entities in the world, and also millions of tiny entities. In their judgement, the same financial reporting standards are not suitable for all non-publicly accountable entities because of differences in user needs as well as cost burdens. They encourage the Board to focus its standards for SMEs on small entities. However, criterion (d) in preliminary view 3.3—that an entity is regarded as publicly accountable, and therefore not an SME, if it is economically significant in its home country—will exclude most large unlisted entities from the target user group for IASB Standards for SMEs.

38 **Preliminary view 3.6 – Subsidiaries, joint ventures and associates.** 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 the parent, venturer or investor, it should comply with full IFRSs, not IASB Standards for SMEs, in its separate financial statements.

39 The Board has tentatively concluded that IASB Standards for SMEs are not intended as a means of avoiding the reporting of financial information that has already been produced for other purposes and, therefore, is readily available. If a subsidiary, joint venture or associate is held by an entity with public accountability, it will often provide to the parent, venturer or investor financial statements that comply with full IFRSs. If that is the case, it would be more costly to prepare a second set of financial statements that comply with IASB Standards for SMEs.

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Questions for respondents

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?

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?

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?

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?

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?

Mandatory fallback

The issue

40 **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?**

Alternatives considered

41 The Board considered two alternatives:

(a) The entity would be required to look to the appropriate IFRS to resolve that particular issue only, while continuing to look to IASB Standards for SMEs for the remainder of its financial reporting.

(b) The entity would use its judgement to develop and apply an accounting policy in a manner similar to that required by IAS 8, ie the policy results in information that is:

(i) consistent with the IASB *Framework*;

(ii) consistent with other IASB Standards for SMEs;

(iii) relevant to the economic decision-making needs of users; and

(iv) reliable, in that the financial statements:

(A) represent faithfully the financial position, financial performance and cash flows of the entity;

(B) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

(C) are neutral, ie free from bias;

(D) are prudent; and

(E) are complete in all material respects.

In exercising that judgement, the entity would look to full IASs/IFRSs and Interpretations as sources of guidance.

42 The first approach (IFRSs as the mandatory fallback) is essentially the approach adopted in Canada, which treats its SME standards as “differential reporting options”. If an SME does not elect a particular option, then the relevant non-SME Canadian accounting standard applies.

43 The second approach (IFRSs as guidance for exercising judgement) is the approach adopted, for example, in the United Kingdom’s *Financial Reporting Standard for Smaller Entities (FRSSE)*:

> Reporting entities that apply the FRSSE are exempt from complying with other accounting standards (Statements of Standard Accounting Practice and Financial Reporting Standards) and Urgent Issues Task Force (UITF) Abstracts, unless preparing consolidated financial statements, in which case certain other accounting standards apply....

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> Financial statements will generally be prepared using accepted practice and, accordingly, for transactions or events not dealt with in the FRSSE, smaller entities should have regard to other accounting standards and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice. [FRSSE, page 1]

44 Those who support the mandatory fallback approach argue that it is more likely to lead to consistent treatment by SMEs and, therefore, greater comparability. That approach is also consistent with the hierarchy in IAS 8. It is also more likely than the second approach to result in an SME following accounting policies that are consistent with the IASB *Framework*.

45 Those who support the second approach—management judgement with IFRSs as a source of guidance—argue that a mandatory fallback would have the effect of requiring virtually full IFRSs for SMEs, and the objective of reducing the financial reporting burden on SMEs would not be achieved. They contend that it would increase the volume of standards for SMEs because the SME would be subject to two sets of standards.

Preliminary views

46 **Preliminary view 4 – Mandatory fallback to IFRSs.** If IASB Standards for SMEs do not address a particular accounting recognition or measurement issue that is addressed in an IFRS, the entity would be required to look to that IFRS to resolve that particular issue only. The entity would continue to use IASB Standards for SMEs for the remainder of its financial reporting. Each IASB Standard for SMEs should explicitly mention the required fallback to IFRSs.

47 The Board favours this approach for the reasons of comparability and consistency with the hierarchy and the IASB *Framework* as mentioned in paragraph 44 above.

48 The following examples illustrate the approach the Board favours. The Board emphasises that all of the examples in this Discussion Paper are hypothetical examples and are not proposals:

Example 4A

The SME version of IAS 19 *Employee Benefits* might not address accounting for defined benefit plans because SMEs are much more likely to participate in defined contribution, multi-employer, state or insured plans. This would make the SME version of IAS 19 more relevant to SMEs than the full version. However, if an SME were to enter into a defined benefit plan, it would be required to look to the full version of IAS 19 for guidance.

Example 4B

The SME version of IAS 39 *Financial Instruments: Recognition and Measurement* does not address hedge accounting because it is not generally relevant to an SME. However, if an SME were to enter into a hedging transaction and wished to follow the practice of hedge accounting, it would be required to comply with the hedge accounting requirements of IAS 39.

Questions for respondents

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?

Optional reversion to an IFRS by an entity using IASB Standards for SMEs

The issue

49 **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?**

50 This issue could arise in at least four situations:

(a) A disclosure is either eliminated or simplified in the IASB Standard for SMEs. An SME wishes to make the disclosure required by the IFRS, while otherwise continuing to use IASB Standards for SMEs.

Example 5A

IAS 16 *Property, Plant and Equipment* requires disclosure of a reconciliation of the carrying amount of each class of property, plant and equipment at the beginning and end of the period, showing changes classified into eight categories. Hypothetically, the related IASB Standard for SMEs might require an SME to present the reconciliation for all of its property, plant and equipment in the aggregate, rather than by class, or might require fewer than eight categories within the reconciliation, or might not require the reconciliation.

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(b) A measurement standard in an IFRS is simplified in the IASB Standard for SMEs. An SME wishes to make the measurement using the standard in the IFRS, while otherwise continuing to use IASB Standards for SMEs.

Example 5B

A hypothetical example of this could be that the SME standard based on IAS 19 *Employee Benefits* allows an SME to measure the present value of its defined benefit obligations using the same actuarial method as is used for funding purposes, if that method is a generally accepted actuarial method, instead of requiring the Projected Unit Credit Method as required by IAS 19.

Another example is the following:

Example 5C

The SME version of IAS 39 *Financial Instruments: Recognition and Measurement* might permit an SME to amortise discount or premium arising on issuance of debt using the straight-line method. If an SME wanted to use the effective interest method, it would follow the guidance in the full IAS 39.

(c) An IASB Standard for SMEs provides an explicit exemption for SMEs from a recognition or measurement principle in an IFRS. An SME wishes to follow the recognition or measurement principle in the IFRS, while otherwise continuing to use IASB Standards for SMEs.

Example 5D

The SME version of IAS 17 *Leases* might permit an SME to treat all leases as operating leases, but with expanded disclosures of lease commitments (perhaps a year-by-year commitment schedule) required in the notes. An SME could choose to follow the full IAS 17 approach—accounting for finance leases as such—but then the added note disclosures in the SME version of IAS 17 would not be required.

(d) An IFRS gives an entity a choice between two recognition or measurement options. The related IASB Standard for SMEs includes only one of those choices but does not prohibit the other.

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An SME wishes to use the option in the IFRS that is not included in the IASB Standard for SMEs, while otherwise continuing to use IASB Standards for SMEs.

Example 5E
IAS 23 *Borrowing Costs* allows, but does not require, borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised as part of the cost of that asset. Hypothetically, an IASB Standard for SMEs on borrowing costs might state that all borrowing costs are recognised as expense when incurred.

Alternatives considered

51 The alternatives considered were:

(a) The IASB Standards for SMEs should be regarded as optional simplifications of IFRSs. Therefore, an SME should be permitted to revert to the IFRS on a principle-by-principle basis, while otherwise continuing to use IASB Standards for SMEs.

(b) The IASB Standards for SMEs should be regarded as optional simplifications of IFRSs. However, the recognition and measurement principles in an individual IFRS are so interrelated that they should be regarded as an integrated package. Therefore, an SME should be permitted to revert to the full IFRS in its entirety, on a standard-by-standard basis but not principle by principle, while otherwise continuing to use IASB Standards for SMEs.

(c) An entity should be required to choose only either the complete set of IFRSs or the complete set of IASB Standards for SMEs.

Preliminary views

52 **Preliminary view 5 – Optional reversion to an IFRS.** If an IASB Standard for SMEs provides an exemption or simplification from a recognition or measurement requirement in the related IFRS, an entity that uses IASB Standards for SMEs would not be prohibited from applying the related IFRS in its entirety, while otherwise continuing to use IASB Standards for SMEs. Optional reversion would not be permitted for only some, but not all, principles in the related IFRS.

53 If an entity that is eligible to use IASB Standards for SMEs elects or is required to revert to one or more IFRSs while continuing to use IASB Standards for SMEs for the remainder of its financial reporting, its financial

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statements would be described as conforming to IASB Standards for SMEs. Its financial statements could not be described as conforming to International Financial Reporting Standards if the entity uses one or more of the exemptions or simplifications for SMEs. As IAS 1 paragraph 14 states, "financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs."

54 In preliminary view 1.1, the Board tentatively concluded that full IFRSs should be regarded as suitable for all entities because it concluded that the objectives of general purpose financial statements are fundamentally the same for all entities. Therefore, standards for general purpose financial statements of entities with public accountability would result in financial statements that meet the needs of all users of financial statements. Preliminary view 5 follows from preliminary view 1.1.

55 As a practical matter, this is an issue only with respect to possible recognition or measurement differences. IFRSs rarely prohibit an entity from making a disclosure. The only justification for prohibiting an SME from making a disclosure that is required of an entity that complies with full IFRSs would be a conclusion that the IFRS disclosure is misleading in an SME context but not in the context of a publicly accountable entity. The Board cannot envisage such a situation. The net effect of preliminary view 5 is that any recognition or measurement differences that the Board might adopt for SMEs would be in the nature of options for SMEs on a standard-by-standard basis.

56 Some would prohibit an SME from following a treatment in an IFRS that differs from the treatment in the related IASB Standard for SMEs for reasons of inter-entity comparability. They contend that the financial statements of such an SME will not be comparable either with those of other SMEs or with those of entities that follow full IFRSs. The Board acknowledges the potential for reduced inter-entity comparability but believes that it is more than offset by the benefits of entities following full IFRSs.

57 In preliminary view 5, the Board has tentatively concluded that if an SME that otherwise is using IASB Standards for SMEs elects to revert to the recognition and measurement requirements in an IFRS, it must follow all of the requirements of that IFRS. In other words, reversion to the IFRS must be on a standard-by-standard basis. The entity would not be permitted to adopt some recognition and measurement principles in the IFRS selectively while using other recognition and measurement principles in the related IASB Standard for SMEs. The recognition and measurement principles in each IFRS are interrelated and are adopted by the Board as a package, and they should be applied as such.

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58 In some cases, bankers or other users of an SME's financial statements may request or insist that the SME follow a particular IFRS. Preliminary view 5 is intended to prevent such a requirement from forcing an SME to use full IFRSs. It is for this reason that the Board rejected the alternative of requiring an entity to choose only either the complete set of IFRSs or the complete set of IASB Standards for SMEs.

59 Some support a middle ground between reverting to an IFRS in its entirety and allowing an entity to revert on a principle-by-principle basis. They question whether an entity's decision to use a treatment in an IFRS should trigger a requirement to use those recognition and measurement standards in the IFRS that are not interrelated with the one that the entity wishes to use. They cite, as an example, an entity wishing to amortise premium or discount using the effective interest method in IAS 39 *Financial Instruments: Recognition and Measurement*, if the principle in the IASB Standard for SMEs were to be straight-line. Under preliminary view 5, using the effective interest method would require the entity to use all of IAS 39. Therefore, even if the SME version of IAS 39 were to include, for example, some simplifications relating to hedge accounting, those simplifications would not be available to the SME using the effective interest method. The Board is open to considering a middle ground between allowing reversion to an IFRS only in its entirety and allowing reversion on an unrestricted principle-by-principle basis, and question 5b invites comments.

Questions for respondents

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?

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);

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(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?

Starting point for developing IASB Standards for SMEs

The issue

60 **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?**

Alternatives considered

61 The alternatives considered were:

(a) IASB Standards for SMEs should be developed by starting with full IFRSs and modifying them as appropriate.

(b) IASB Standards for SMEs should be developed as a separate body of standards independent of full IFRSs.

Preliminary views

62 **Preliminary view 6 – IFRSs are the starting point for developing SME standards.** Development of IASB Standards for SMEs should start by extracting the fundamental concepts from the IASB *Framework* and the principles and related mandatory guidance from IFRSs (including Interpretations).

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63 Because the needs of users of financial statements of SMEs are similar in most ways to the needs of users of financial statements of publicly accountable entities, the Board concluded that IFRSs are the logical starting point for developing a set of IASB Standards for SMEs. The differences between alternatives (a) and (b) are a matter of degree, because even in following alternative (b) due regard would have to be given to existing IFRSs. Otherwise, the resulting standards would not meet the objectives of building on the same conceptual framework, meeting user needs and allowing easy transition to full IFRSs. Approach (b) is likely to result in more differences in wording and structure of IASB Standards for SMEs than approach (a), possibly making transition to full IFRSs more difficult.

Questions for respondents

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?

Appropriate bases for modifying concepts and principles for SMEs

The issue

64 **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?**

Alternatives considered

65 In preliminary view 6, the Board tentatively concluded that the starting point for developing IASB Standards for SMEs should be the *Framework* and IFRSs. The nature of any modifications of the *Framework* and IFRSs must be guided by the objectives of the IASB's standards for SMEs that the Board has tentatively concluded in preliminary view 2, namely (a) to meet the needs of users of SME financial statements and (b) to reduce the financial reporting burden on SMEs that wish to use global standards. Assessing user needs and assessing costs and benefits are necessary

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considerations for all standards developed by the IASB. Thus issue 6 does not involve 'alternative' solutions but, rather, consideration of how to balance the trade-offs inherent in meeting user needs and reducing the burden on preparers.

Preliminary views

66 **Preliminary view 7.1 – Justification for modifications.** Any modifications to the concepts or principles in IFRSs must be based on the identified needs of users of SME financial statements or cost-benefit analyses.

67 **Preliminary view 7.2 – Likelihood of disclosure and presentation modifications.** It is likely that disclosure and presentation modifications will be justified on the basis of user needs and cost-benefit analyses. The disclosure modifications could increase or decrease the level of disclosure relative to full IFRSs.

68 **Preliminary view 7.3 – Rebuttable presumption of no recognition and measurement modifications.** There would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles in IFRSs. Such modifications can be justified only on the basis of user needs or cost-benefit analyses.

69 Financial statements of listed entities and most other entities with public accountability are widely circulated and, therefore, available to an unlimited number and wide variety of users. Current and prospective investors and creditors are the primary audiences for financial reporting by most of those entities. Those investors and creditors are dependent on financial statements to make economic decisions. They form a heterogeneous class of users, including individuals, investment advisers and analysts, pension funds, insurers, trust companies, banks and mutual funds. Within those different groups, individual investors may have different objectives: for example, some may emphasise a steady, continuing return whereas others may be less risk-averse. This large group of users of the financial statements of a publicly accountable entity, whose membership is unlimited and whose needs vary, is likely to benefit from access to a wide range of detailed financial information in financial statements.

70 Most unlisted entities (namely, those that are not publicly accountable for other reasons) have a narrower range of financial statement users than listed entities. The existing owners of an unlisted entity constitute one of the main user groups of its financial statements. However, the existing owners are commonly also officers of the entity or participants in its operations and, therefore, usually have access to information that is not

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included even in financial statements that comply with full IFRSs. Although listed company investors primarily use financial statements for valuation purposes to make 'buy/sell/hold' decisions, that is not as true for owners of unlisted entities, because selling may not be a realistic option or may occur only infrequently. A non-managing owner of an unlisted entity typically uses the financial statements to assess management, with a view to influencing how the entity will be managed in the future, and may also have access to information beyond that contained in the financial statements. When an interest in an unlisted entity is acquired or sold, a limited number of outsiders, the potential investors, use the financial statements. However, in those circumstances, the outsiders' limited access to information is usually increased by agreement as part of the due diligence process. In some circumstances, providers of risk capital (such as venture capitalists or merchant bankers) are also involved. They, too, normally gain access to additional information by agreement and often become members of the board of directors.

71 In most circumstances, the primary external users of the financial statements of unlisted entities are lenders and trade creditors. The most crucial financial information for creditors is how much cash will be available for payment of debt. The cash-generating ability of the entity and short-term liquidity are of prime importance to short-term creditors. Long-term creditors are also interested in the cash-generating ability of the entity, although their time horizon is longer. To assess the longer-term cash-generating ability of an entity, they pay more attention to earnings than do short-term creditors, generally by focusing on interest coverage and on earnings before income taxes, depreciation and amortisation figures. Banks and other lenders often have the power to obtain information additional to that provided in the financial statements (for example, information on owners' personal assets, business plans and budgets, and details of specific assets to be provided as security). Like banks, the major suppliers of an entity may be able to exercise their economic power to demand additional information.

72 The main groups of users of the financial statements of most SMEs are likely to be owners who have access to internal information and outsiders who have the power to demand additional information. Nonetheless, some suppliers and bank lenders do not have the power to demand additional financial information, for instance, because their competitors do not make such demands.

73 Although banks and suppliers may need somewhat different information about SMEs than the external users of financial statements need about listed and other entities with public accountability, 'different' does not always equate to 'less' information. An example was noted earlier in

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paragraph 6 that users of financial statements of SMEs may need expanded information about related party relationships and transactions, because SMEs often obtain capital from shareholders, directors and suppliers, and shareholders and directors often pledge personal assets so that the SME can obtain bank financing.

74 In an SME context, outside users of financial statements often use simplified methodologies of analysis. They look to short-term cash flows, liquidity, balance sheet strength, interest coverage and historical trends of such items rather than trying to make forecasts of an entity's long-term cash flows and earning power. The information needs of this group of users are, therefore, different from the needs of users of financial statements of publicly accountable entities.

75 The Board will rely on those differences in the needs and expectations of users of financial statements of SMEs in developing any modifications of IFRSs that it would propose for IASB Standards for SMEs.

76 In deciding which modifications to make, the Board will also be guided by the costs and other burdens that particular requirements in IFRSs impose on SMEs. For example, there would be minimal benefit—but possibly a substantial cost—for an SME to provide information that users of its financial statements do not use. In that regard, some contend that once an item has been accounted for in accordance with the recognition and measurement standards in an IFRS, the additional cost of disclosure is usually not significant. Therefore, in their view, to achieve a significant reduction in the burden for preparers of financial statements of SMEs it will be necessary to 'relax' some recognition and measurement requirements in IFRSs. Others support a relatively sizeable number of differences for such SMEs—in recognition and measurement standards as well as in disclosure and presentation standards. The Board's preliminary view is that users of financial statements that bear the title of 'International Financial Reporting Standards for SMEs' need and expect a level of financial reporting that is based on full IFRSs and includes only a relatively limited number of modifications to full IFRSs.

77 Some disclosures in IFRSs are intended primarily to meet the needs of users of financial statements of entities with public accountability. This is the basis for restricting the applicability of IAS 14 *Segment Reporting* and IAS 33 *Earnings per Share* to entities whose securities are listed for trading in public securities markets.

78 Some disclosures in IFRSs are intended primarily to assist users of financial statements in making forecasts of the future. As noted earlier, users of financial statements of SMEs—particularly those outside the entity who do

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not have the power to demand information—often do not make such kinds of forecasts. In such cases, those disclosures in IFRSs may lack relevance in an SME context.

79 The Board notes that most national financial reporting systems provide reduced and simplified presentations and disclosures for SMEs.

(a) Examples of presentation differences identified in the Board's survey of existing national requirements include condensation of financial statements, omission of one or more financial statements (for instance, the statement of comprehensive income), exemption from preparing consolidated financial statements, and exemption from providing some supplemental reconciliations or schedules.

(b) Areas in which jurisdictions have provided for disclosure exemptions and simplifications include management remuneration, fair values of assets and liabilities, provisions and contingencies, impairments, income taxes, depreciation, discontinued operations, inventory and cost of sales, asset disposals, business combinations and pensions and other employee benefits.

These examples illustrate current practices around the world. Not all of them may be consistent with the principles underlying the Board's preliminary views as set out in this Discussion Paper.

80 The Board believes that a review of the disclosure requirements in IFRSs is warranted to assess their appropriateness for SMEs. Such a review, in the Board's judgement, is likely to result in proposals for disclosure exemptions or perhaps simplifications for SMEs. At the same time, because such a review would be based on the needs of users of SME financial statements, the Board recognises that some proposals for additional disclosures uniquely appropriate for SMEs may be justified, especially if recognition or measurement differences are considered.

81 The Board has tentatively concluded (preliminary view 2) that IASB Standards for SMEs will be based on the same conceptual framework as full IFRSs. The *Framework* defines the basic elements of financial statements: assets, liabilities, equity, income and expenses. Because income and expenses are defined in terms of changes in assets and liabilities, and equity is defined as the difference between assets and liabilities, it is really the definitions and recognition principles for assets and liabilities that are most critical. Assets and liabilities are defined in terms of the economic benefits they will cause to flow to or from the entity. And the principles for recognising assets and liabilities are expressed in terms of (a) the probability of and (b) the ability to measure reliably the flows of economic benefits to or from the entity.

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82 The economic benefits inherent in assets do not depend on who owns them, and outflows of economic benefits inherent in liabilities do not depend on who owes them. Yet, recognition principles in IASB Standards for SMEs different from recognition principles in IFRSs would mean, in substance, different definitions of assets and liabilities (and related income and expenses) for SMEs. What is an asset for one entity would not be an asset for a different entity. The Board finds such a result troublesome and illogical. For that reason, preliminary view 7.3 creates a rebuttable presumption of no recognition differences.

83 The principles in the *Framework* for recognising assets and liabilities include an ability to make reliable measurements of cost or value (for assets) or settlement amount (for liabilities). Because of both the nature of the business environment of some SMEs and constraints on their resources, when measuring some assets and liabilities (and related income and expenses) the cost to obtain the same degree of measurement reliability as would be required of an entity applying full IFRSs might not be justified in some circumstances for an SME. Although preliminary view 7.3 establishes a rebuttable presumption of no recognition or measurement differences, the presumption might be more easily rebutted in the case of measurement principles than in the case of recognition principles. The Board particularly invites comments on measurement reliability concerns of SMEs, as well as on other aspects of preliminary views 7.2 and 7.3.

84 Some national financial reporting systems provide recognition and measurement differences for SMEs. In most cases, the differences relate to matters of:

(a) measurement simplification rather than recognition—for example, measurement of some assets at cost rather than at fair value, simplified amortisation calculations and simplified calculations of employee benefit obligations; and

(b) substitution of some note specific disclosures for balance sheet recognition—for example in the areas of income taxes and leases.

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Questions for respondents

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?***

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?***

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?***

Format for publishing IASB Standards for SMEs

The issue

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

Alternatives considered

86 Alternatives considered with respect to the nature of the document setting out the IASB Standards for SMEs:

(a) IASB Standards for SMEs should be published in a separate printed volume.

(b) IASB Standards for SMEs should be included in separate sections of each individual IFRS (including Interpretations).

(c) Both.

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87 Alternatives considered with respect to organising the IASB Standards for SMEs:

(a) IASB Standards for SMEs should be organised by topic.

(b) IASB Standards for SMEs should be numbered following the IAS/IFRS numbering system.

Preliminary views

88 **Preliminary view 8.1 – Separate volume.** IASB Standards for SMEs should be published in a separate printed volume. The Board may also use other means of publication, such as Web publishing.

89 **Preliminary view 8.2 – Organised by IAS/IFRS (and Interpretation) number.** IASB Standards for SMEs should:

(a) follow the IAS/IFRS (and Interpretation) numbering system—ie SME-IAS 1, SME-IAS 2 etc and SE-IFRS 1, SME-IFRS 2 etc; and

(b) not be reorganised by topic, such as integrated in a balance sheet - income statement line item sequence like the UK *Financial Reporting Standard for Smaller Entities (FRSSE)*.

90 Although the Board has not adopted a timetable for issuing such a separate printed volume, its tentative views about the steps that it will take are generally as follows:

(a) Initially, the Board will issue a single exposure draft of the 'SME versions' of all existing IFRSs (including IASs and Interpretations), rather than separate exposure drafts of individual IASB Standards for SMEs.

(b) Initially, the Board will adopt a final combined volume of the 'SME versions' of all IFRSs (including IASs and Interpretations) at one time, with a single effective date.

(c) Thereafter, once the initial set of IASB Standards for SMEs is in place, concurrently with each exposure draft of an IFRS and each draft Interpretation, and most likely as part of those documents, the Board will propose the related IASB Standard or Interpretation for SMEs. The effective dates of the new or revised IASB Standards for SMEs would probably be the same as the effective date of the new or revised IFRSs (including Interpretations).

(d) The timing of publication of the exposure draft and initial combined volume of IASB Standards for SMEs is currently under review and will depend on, among other things, the responses to this

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Discussion Paper and decisions regarding possible field testing by SMEs of the Board's proposed standards for SMEs.

91 **Preliminary view 8.3 – Foreword material in each Standard.** Each IASB Standard for SMEs should include a statement of its objective and a summary.

92 Regarding the nature of the document in which the IASB Standards for SMEs would be published, the Board saw merit in both approaches—separate volume and separate sections in each individual IFRS (including Interpretations). The principal advantages of the separate volume are:

(a) ease of use for those seeking to understand and apply SME standards. Even if IFRSs are a mandatory fallback, most of the material in IFRSs would not normally have application for an SME.

(b) in a separate volume, the SME standards can be drafted in a simplified language without the details that are needed in IFRSs.

93 The advantages of including the IASB Standards for SMEs in separate sections of each IFRS (including Interpretations) include:

(a) the modification or exemptions are highlighted.

(b) if there is a mandatory fallback to IFRSs, this puts the SME standard and the fallback standard in one place.

(c) it would reduce the likelihood that, in drafting IASB Standards for SMEs, an unintended difference will arise between an IFRS and the related IASB Standard for SMEs.

(d) this approach would more readily permit individual national jurisdictions to 'opt out' of a particular simplification or SME standard in their jurisdiction. Earlier in this Discussion Paper, Question 5 asked whether an SME should be permitted to choose, standard by standard or principle by principle, from the SME standards and from IFRSs. The Board has not yet discussed or reached a preliminary view on whether it would encourage or discourage a national jurisdiction from 'opting out' of a particular simplification or SME standard in its jurisdiction—or remain neutral on the question. But 'opting out' is one argument put forward by those who would integrate IASB Standards for SMEs directly within each IFRS (including Interpretations).

(e) including standards for SMEs in separate sections of each full IFRS (including Interpretations) would eliminate the need for a separate statement of objective, summary and definitions for the IASB Standards for SMEs.

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94 As with the nature of the document in which IASB Standards for SMEs would be published, the Board saw merit both in numbering the SME standards similarly to IFRSs (primarily the ability of a user to link back to the full standard to seek further guidance on an accounting question) and in topical reorganisation (the IASB SME standards would be more like a reference manual, which is likely to be the way persons using those standards would use them). Indexing could minimise the benefits of one of those approaches over the other. Providing the IASB Standards for SMEs in electronic form could also minimise the benefits of one approach over the other.

Questions for respondents

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.

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.

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?

Other matters

95 This Discussion Paper presents the issues that were considered by the Board in its preliminary deliberations on accounting standards for SMEs. The Board invites comments not only on those issues but also on any other aspects of the project on which specific questions have not been posed.

Questions for respondents

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?

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