

## Investor Perspectives

### **Paul Pacter: Capital providers need good small business reporting, too**



Good financial reporting makes investing and lending more efficient. Historically, financial reporting standards were developed by each country individually. Sometimes they were set by government, in other cases by the accounting profession, and, in still other cases, by an independent board. National standards made sense when companies raised money in, and investors looked for investment opportunities in, only their home country.

But a huge change occurred in the 35 years from 1975 to 2010—the globalisation of the world’s capital markets. Now, investors seek investment opportunities all over the world. And companies look for capital at the lowest price anywhere. Almost daily we read about cross-border mergers.

In globalised capital markets, accounting differences make financial reports less understandable and complicate comparisons that investors and creditors want to make—hindering the efficient allocation of capital. This is true equally for both equity capital and debt capital, and also for both large companies and small ones.

High quality global financial reporting standards—carefully applied and rigorously enforced—benefit capital providers by:

- presenting financial information that is understandable, both within the same country and across borders
- providing financial information that is directly relevant to the decisions that capital providers have to make
- enhancing comparability within a jurisdiction and across borders.



Global standards also benefit companies that seek capital by:

- reducing compliance costs
- removing the penalties that capital providers impose when they do not understand a company's financial figures or do not have confidence in them (sometimes called 'information risk').

Global standards also improve consistency in audit quality and facilitate education and training and software development.

In 1973, the accounting standard setters in nine countries acknowledged the need for global accounting standards by jointly creating the International Accounting Standards Committee (IASC). The IASC was a part-time body that produced a series of International Accounting Standards (IASs 1 to 41). However, by 2000, there were only a limited number of voluntary adoptions of IASs by listed companies, and very few adoptions by unlisted companies.

In 2001, the IASC was reorganised in the form of a full-time International Accounting Standards Board (IASB). To date, the IASB has produced the first nine in its series of International Financial Reporting Standards and has also improved virtually every one of the IASs that it inherited. By late 2010, IFRSs had been adopted as a requirement for listed companies in over 120 countries. Europe was the catalyst for global adoptions of IFRSs—making the use of IFRSs mandatory in the consolidated financial statements of listed companies from 2005 onwards. Once Europe made the decision, dozens of other countries followed. And many other countries that did not adopt IFRSs directly instead converged their national standards with IFRSs.

This growing use of IFRSs around the world (directly or via national convergence) occurred at the same time as IFRSs themselves were greatly expanded, made more rigorous and more detailed, and (by addressing tough issues) made more complex. Not surprisingly, small companies began expressing concerns that these complex and detailed standards were beyond their needs and capabilities—and the resulting financial statements, while suitable for investors in listed companies, were not aimed at the kinds of credit decisions that most users of the financial statements of small companies have to make. And, the little companies said, the volume of required disclosures is burdensome and amounts to 'overkill'.

Consequently, in late 2003 the IASB began a project to develop a separate, simplified IFRS for Small and Medium-sized Entities (IFRS for SMEs). Six years later, that standard was issued in July 2009.

The IFRS for SMEs is tailored for small companies that are not publicly accountable. That is, it focuses on the needs of lenders, creditors, and other users for information about cash flows, liquidity, and solvency. And it takes into account the capabilities of SMEs to prepare financial information and the costs to them of doing so.

The IFRS for SMEs is much smaller than full IFRSs—only 230 pages as compared to over 3,000 pages for the complete set of full IFRSs. It is organised by topic. And compared with full IFRSs, and with many national requirements, the IFRS for SMEs is less complex in a number of ways. Topics that are not relevant to SMEs have been omitted, and many principles for recognising and measuring assets, liabilities, income and expenses in full IFRSs are simplified. Two examples of simplifications are amortisation of goodwill and accounting for investments in associates and joint ventures at cost.

Moreover, where full IFRSs allow accounting policy choices, the IFRS for SMEs allows only the easier option. For example, in the IFRS for SMEs, there is no option to revalue property, equipment or intangibles (though values can be disclosed), and there is no ‘corridor approach’ for actuarial gains and losses. SMEs would use a cost-depreciation model for investment property and agricultural assets unless fair value is readily available without undue cost or effort.

While there are significantly fewer disclosures required (roughly 300 versus 3,000), the required disclosures are tailored to the needs of lenders, creditors, and rating agencies. To further reduce the burden for SMEs, revisions to the IFRS for SMEs will be limited to once every three years.

Why would lenders and creditors want smaller companies to adopt the IFRS for SMEs? Lenders worry ‘if I lend to this company, will they be able to pay the interest and principal when due?’ And creditors worry ‘if I sell goods or services to this company on credit, will they be able to pay the invoice when I send it?’ Financial statements that conform to the IFRS for SMEs provide information that is useful in assessing shorter-term cash flows, liquidity, and solvency. Many national GAAPs for small companies today do not require even a cash flow statement. And often, under national

SME GAAPs, relatively short-term obligations are off the balance sheet entirely—for example by measuring derivatives at cost (which is nil) or by not recognising them at all, and by ignoring deferred tax, employee benefit, and warranty obligations. Assets are overstated when SMEs fail to recognise impairments of both financial and non-financial assets on a timely basis. And often related party disclosures are minimal under national SME GAAPs. Capital providers want transparency. They know how to assess and balance both good news and bad news. What they abhor (and impose a price for) is uncertainty.

Comparability of financial information is just as important to investors, lenders, and other creditors as the quality of information. A global financial reporting standard for SMEs will improve comparability with other companies in an SME's jurisdiction and across borders. At the same time, it can reduce the burden for entities in jurisdictions where full IFRSs or full national GAAP are now required.

To enhance the quality of implementation of the IFRS for SMEs, the IASB is providing support that includes training materials, workshops, Q&As, and a monthly newsletter. By late 2010, over 70 jurisdictions all over the world either have adopted the IFRS for SMEs or have publicly proposed or indicated a plan to adopt it in the next three years. In my judgement, the IFRS for SMEs will result in better quality reporting, tailored for the capabilities of small companies, tailored for the needs of lenders and creditors, and understandable across borders. An SME's ability to obtain the capital it needs improves if capital providers understand and have confidence in its financial figures. Ultimately, the economy in which the SME operates will also improve as a result.

Please tell us what you think.

**Paul Pacter** is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.