Institute of
Chartered Accountants
of New Zealand

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Dear Paul

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

The Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand (the Institute) is pleased to submit its comments on Discussion Paper Preliminary Views on Accounting Standards for Small and Medium-sized Entities

The FRSB supports the initiative of the International Accounting Standards Board (IASB) in addressing financial reporting by small and medium-sized entities (SMEs). We believe it is important that financial reporting concerns of SMEs are addressed at an international level and in a manner consistent with IFRSs – something which would not necessarily be the case if the IASB proceeds with the current approach of developing two sets of financial reporting standards.

However, the FRSB has some fundamental concerns regarding the project and is strongly opposed to the approach proposed in the Discussion Paper. These concerns are discussed below.

Title of the Project

We have a concern about the title of the project. Our view is that the title may be misleading as we believe that the project is more akin to differential reporting (directed to unlisted entities that are required to prepare general purpose financial reports) which permits reporting entities, other than issuers, which meet specified criteria to apply certain financial reporting standards on a differential or partial basis rather than accounting by SMEs.

We note that entities which are small or medium-sized are often not required to prepare general purpose financial statements. Such entities do, however, prepare financial statements for special purposes, to support such things as the determination of the amount of income tax payable to revenue authorities or to support a loan application for bank funding. Our understanding is that the financial statements prepared for these tasks and activities are not the subject of this project.

Our response to the questions is, accordingly, based on our interpretation of the project. So, reference to SMEs throughout the remainder of this submission, means entities which prepare general purpose financial statements and which may qualify to use the IASB Standards for SMEs.

Importance of the Project for New Zealand

Irrespective of the title of this project, it is a very important one for New Zealand and the timing of it is crucial because the decision to adopt IFRSs in New Zealand applies to all reporting entities. Although all reporting entities are required to apply New Zealand equivalents to IFRSs for annual accounting periods beginning on or after 1 January 2007, entities have an option to adopt early for annual accounting periods beginning on or after 1 January 2005. The requirement for all reporting entities to adopt IFRSs is different to adoption in the European Union (which applies only to listed entities) and Australia (which does not currently have a differential reporting framework). Some reporting entities which currently report under the New Zealand *Framework for Differential Reporting* will be required to adopt IFRSs from 2005 as they are subsidiaries of Australian or European parent entities.

In developing New Zealand equivalents to IFRSs to date, the FRSB has not yet considered differential reporting exemptions. The two reasons for this are firstly, the very short time-frame within which the initial suite of New Zealand standards have been developed and, secondly, the FRSB has been participating in the SME project with the IASB through representation on the Advisory Panel. The ideal position for us would be to adopt the IASB Standards for SMEs as the ongoing New Zealand differential reporting standards. This would allow reporting entities qualifying for the exemptions to assert compliance with the IASB SME framework. Furthermore, development of a separate framework in New Zealand would duplicate effort and likely make it more difficult for reporting entities moving from compliance with IASB Standards for SMEs to compliance with full IFRSs.

It is imperative for us to have a differential reporting framework in place for reporting entities to apply for annual accounting periods commencing on or after 1 January 2005.

An example of a significant issue we are currently dealing with in New Zealand is the application of the New Zealand equivalent to IAS 41 *Agriculture*. Agriculture, as you will be fully aware, is a major sector of the New Zealand economy and the requirement to measure biological assets and agricultural produce at fair value will impose significant costs on SMEs. Representatives from different sectors in the agricultural industry have consistently identified the measurement of biological assets at fair value, particularly bearer assets, as an area where the increased costs of compliance for entities is likely to exceed any benefits to the users of those financial statements. The FRSB will need to respond positively to these concerns and wants to work collaboratively with the IASB. This explains why the FRSB wrote a letter to Sir David Tweedie in July 2004 offering to work collaboratively with the IASB on the development of IASB Standards for SMEs. A copy of the letter is attached to this submission.

One Framework for All Entities

The IASB *Framework for the Preparation and Presentation of Financial Statements* (IASB *Framework*):

- sets out the concepts that underlie the preparation of financial statements for external users (paragraph 1);
- is concerned with general purpose financial statements, which are prepared and presented at least annually and are directed toward the common information needs of a wide range of users (paragraph 6);
- applies to reporting entities (entities for which there are users who rely on the financial statements as their major source of financial information about the entity) (paragraph 8); and
- states that 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 (paragraph 12).

The Discussion Paper refers to the "needs of users of SME financial statements" but does not identify whether the users of SME financial statements would be different to the users of financial statements prepared in compliance with full IFRSs, nor does it identify how the needs of the users would differ. The FRSB considers that the users of both sets of financial statements would be similar, in which case there would be no substantial difference in their needs and general purpose financial statements would be prepared to meet these information needs. In these circumstances, the IASB *Framework* should apply to the financial statements prepared by SMEs because they are general purpose financial statements.

The IASB *Framework* has been developed to provide the guidelines from where the principles for recognition, measurement and disclosure of items included in general purpose financial statements can be determined. It is, therefore, fundamental that both full IFRSs and IASB Standards for SMEs are developed within the same framework. This means that the definitions of and recognition criteria for the financial elements (assets, liabilities, equity, income and expenses) must be the same, which means that only disclosures and, possibly, measurement should be considered for differential treatment based on cost:benefit and, possibly, user needs where these are identified as being different.

Furthermore, the IASB *Framework* discusses the qualitative characteristics of financial statements that make the information provided in financial statements useful to users. These characteristics will be relevant to all general purpose financial statements, although the balance or trade-off between them for SME financial statements may be different to that of financial statements prepared in compliance with full IFRSs.

The application of one framework to underpin both sets of financial statements also enables an entity to transition more easily from IASB Standards for SMEs to compliance with full IFRSs.

Development of Standards for SMEs

If, as discussed above, SME financial statements are general purpose then it must be decided what criteria are to be used to determine the available exemptions. The obvious criteria to be used are cost:benefit and user needs. However, because the proposed criterion for qualifying for SME standards is not being publicly accountable (a criterion that will capture a wide variety of entities), the potential users of SME financial statements are likely to be very similar to, if not the same as, users of financial statements prepared in accordance with full IFRSs. If the users are essentially the same then the primary criterion for determining SME exemptions must be cost:benefit.

The IASB *Framework*, paragraph 44, acknowledges that (i) the evaluation of benefits and costs is substantially a judgemental process, (ii) that the benefits derived from information should exceed the costs of providing it, (iii) that the costs do not necessarily fall on those users who enjoy the benefits, (iv) that benefits may also be enjoyed by users other than those for whom the information is prepared and (v) that standard setters should be aware of the cost:benefit constraint and should not impose additional compliance costs onto entities when developing financial reporting standards.

The definitions of and recognition criteria for the elements of financial statements will be the same because they are based on a common framework, therefore the only exemptions for SMEs should be related to disclosure and, possibly, measurement. The FRSB notes that according to Preliminary View 2, financial reporting standards for SMEs should "(d) reduce the financial reporting burden on SMEs that want to use global standards". Some measurement exemptions would help to achieve this objective, for example, permitting an SME to use historical cost when the full IFRS requires fair value, permitting the use of 'tax values' as a surrogate of fair value for agricultural produce and biological assets where such values are not unreasonable representations of fair value or permitting the use of tax depreciation rates where such rates are based on the consumption of the economic benefits embodied in an asset (and are, therefore, similar to the rates of depreciation for accounting purposes).

The second annual survey of business compliance costs conducted by Business New Zealand in conjunction with KPMG (published August 2004) indicated that, consistent with the results of the 2003 survey, small entities have much higher compliance costs per employee compared to larger entities. Consultations with New Zealand constituents regarding the adoption of IAS 41 *Agriculture* has indicated that the requirement to measure biological assets and agricultural produce at fair value is likely to result in disproportionately increased compliance costs in relation to the benefits obtained by the users of those financial statements. Furthermore, increased compliance costs will result in increased cost of capital for smaller entities. Standard setters, therefore, have a responsibility to consider the increased compliance costs which may be imposed on entities which are required to prepare financial statements in compliance with a set of financial reporting standards, whether full IFRSs or IASB Standards for SMEs.

The FRSB recommends, therefore, that the IASB develop an appropriate cost:benefit framework which can be used for the identification of disclosure and, possibly, measurement exemptions for SMEs.

Definition of SME and Application of Standards

The FRSB believes that it would be more appropriate for local jurisdictions to define which entities could be categorised as SMEs. This would enable local jurisdictions to reflect the culture and degree of economic development of an entity's place of business when considering the cost:benefit analysis to determine which reporting regime is most useful to the end users of the financial statements in that jurisdiction.

Although we agree that IASB Standards for SMEs should not be used by publicly listed entities, we do not believe that the IASB has any authority to override national laws on this issue. The IASB has stated that it will not prescribe quantitative size tests because such tests should be determined by national jurisdictions. Similarly, it is for national jurisdictions to determine which entities are required to prepare general purpose financial reports and the basis on which those financial reports are to be prepared. Furthermore, we would anticipate that virtually every stock exchange or national securities commission would require the financial statements of listed entities to comply with full IFRSs and believe that those regulators are the appropriate bodies to make such judgements and regulations.

Format of Standards for SMEs

Another serious concern of the FRSB regarding the proposed approach to the project is the publication of a separate set of IASB Standards for SMEs. The FRSB requests that the IASB consider the New Zealand *Framework for Differential Reporting* as an alternative approach for identifying financial reporting exemptions. The New Zealand *Framework for Differential Reporting* (i) explains the rationale behind differential reporting, (ii) identifies the three assumptions on which the pronouncement was developed, (iii) explains the surrogates used for the benefit:cost criterion, (iv) explains the broad assumptions on which the surrogates are based and (v) sets out the criteria which qualify entities for differential reporting exemptions. In addition, each New Zealand financial reporting standard identifies the differential reporting exemptions available for qualifying entities, with disclosure exemptions indicated by the use of an asterisk next to the relevant disclosure. The New Zealand *Framework for Differential Reporting* is discussed after this covering letter and before the detailed submission. A copy of the document is also attached to this submission for your information.

The Canadian Institute of Chartered Accountants (CICA) issued a standard on Differential Reporting, General Section 1300 *Differential Reporting*, which is effective for fiscal years beginning on or after 1 January 2002. The Canadian approach is similar to the New Zealand approach, that is, the promulgation of a document which identifies the reporting entities which qualify for differential reporting and the exemptions available to those entities. The exemptions are also identified in the individual standards.

An important feature of the approach adopted in New Zealand and Canada is that there is only one set of standards. Differential exemptions are identified within each standard and are summarised in the *Framework for Differential Reporting* itself

(General Accounting Section 1300 *Differential Reporting* in Canada). The advantages of this approach are that (i) only one set of standards is required to be published, (ii) the same concepts, principles and guidance are available to all reporting entities using the standards, (iii) when an amendment is made to a financial reporting standard there is no risk that the amendment is not carried through to the 'smaller' standard, and (iv) transitioning from differential reporting to full GAAP is relatively simple.

The FRSB notes that the emphasis in the Discussion Paper is on disclosure exemptions for SMEs and that very rarely are there likely to be recognition or measurement exemptions. We consider that disclosure exemptions support the use of an asterisk or other symbol next to a disclosure that an SME is not required to comply with. This will be a more efficient use of resources and less prone to error as only one set of standards will be required.

Our detailed comments on the specific questions are attached. If you have any queries, or require clarification of any matters in the submission, please contact me or Vanessa Sealy-Fisher (vanessa.sealy-fisher@icanz.co.nz)

Yours sincerely

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The New Zealand *Framework for Differential Reporting*

The *Framework for Differential Reporting* has been part of the New Zealand financial reporting framework for the past 10 years. When the document was exposed for comment 70 submissions were received, most of which indicated strong support for the proposals. Approximately 90-95% of reporting entities in New Zealand are eligible to take advantage of the differential reporting exemptions.

The purpose of differential reporting in New Zealand is to allow reporting entities, other than issuers, which meet specified criteria to apply certain financial reporting standards on a differential or partial basis. These 'qualifying entities' are exempted partly or fully from specific financial reporting standards. The *Framework for Differential Reporting* only applies to entities which are required to prepare general purpose financial reports, that is, reports that are intended to provide information to meet the needs of external users who are unable to require or contract for the preparation of special purpose reports to meet their specific information needs.

The primary objective of the *Framework for Differential Reporting* is to address the costs of compliance faced by reporting entities when preparing financial reports. It was developed on the basis of the following three assumptions:

- Compliance with financial reporting standards creates costs (usually for the reporting entity) and benefits (usually for the users of the financial reports);
- Compliance should be required only when the benefits of compliance exceed the costs; and
- Financial reporting standards will be more accepted if they apply only where benefits are generally perceived to exceed costs.

To measure the costs and benefits of financial reporting is a difficult process so the *Framework for Differential Reporting* uses surrogates based on broad assumptions:

- Public accountability – more benefits are derived from general purpose financial reports of entities with an increased public accountability because these reports are likely to have more users. (An entity has public accountability in New Zealand if (i) at any time during the current or the preceding reporting period the entity was an issuer as defined in the Financial Reporting Act 1993 (including listed entities, registered banks, certain insurers and unit trusts) or (ii) the entity has the coercive power to tax, rate or levy to obtain public funds (that is, public sector entities such as the Crown and Local Authorities).)
- Separation between owners and governing body of an entity – generally not as great a level of accountability arises when all the owners of an entity are also members of its governing body.
- Size – in general, the larger the entity the more extensive the group of users benefiting from the information provided in the entity's financial report, and the greater the benefit likely to be derived.

The FRSB acknowledges that such surrogates are not the only ones, and may not necessarily be the most appropriate, which can be used but they have provided a framework for identifying financial reporting exemptions.

The *Framework for Differential Reporting* sets out the criteria which qualify entities for differential reporting exemptions. These are that the entity does not have public accountability and:

- At the end of the reporting period, all of its owners are members of the entity's governing body; or
- The entity is not large.

The *Framework for Differential Reporting* includes an appendix which lists (i) the differential reporting exemptions in each New Zealand financial reporting standard (FRS) and (ii) the FRSs which contain no exemptions, which must therefore be complied with in full. Furthermore, each New Zealand FRS includes, in the Application section, the differential reporting exemptions available in that Standard together with a statement that entities adopting the exemptions are not required to disclose the information denoted with an asterisk in the Standard. A reporting entity is required to disclose the basis on which it qualifies for differential reporting exemptions and which of the exemptions it has taken advantage of.

Response to Specific 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.)

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

FRSB response

The FRSB agrees with this preliminary view but considers that the IASB should specify that full IFRSs are suitable for all reporting entities as it is reporting entities that are required to prepare general purpose financial reports. The FRSB does not agree that full IFRSs should be considered suitable for all entities, as many small entities will have no obligation to prepare general purpose financial statements for external users and should, therefore, not be required to comply with IASB standards.

Paragraph 8 of the *IASB Framework* states that "A reporting entity is an entity for which there are users who rely on the financial statements as their major source of financial information about the entity." Such entities would prepare general purpose financial statements (referred to in paragraph 6 of the *IASB Framework*) to meet the information needs of a wide range of users.

In New Zealand, a reporting entity is defined in the Financial Reporting Act 1993 as (i) an issuer, or (ii) a company, other than an exempt company, or (iii) a person that is required by any Act, other than this Act, to comply with this Act as if it were a reporting entity. Part (iii) of the definition captures many entities that may not otherwise be required to prepare general purpose financial statements because many statutes governing entities other than companies refer to the Financial Reporting Act 1993 for financial reporting requirements. The Financial Reporting Act 1993 also requires the financial statements of a reporting entity to comply with generally accepted accounting practice (defined in section 3), which includes compliance with applicable financial reporting standards.

There are also many small entities which have no reporting obligations and we would not wish such entities to be inadvertently captured by IFRSs, or even IASB Standards for SMEs, as this would impose undue compliance costs on such entities. The FRSB, therefore, recommends that the wording in preliminary view 1.1 should be amended to read "Full IFRSs are suitable for all reporting entities as identified in paragraph 8 of the IASB *Framework*."

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.

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

FRSB response

The FRSB agrees that the IASB should develop financial reporting standards suitable for SMEs but does not agree that it should be a separate set of standards.

If the IASB considers that full IFRSs are suitable for all entities (Preliminary view 1), full IFRSs should be the basis for IASB Standards for SMEs. If, as is proposed, the IASB extracts basic principles and mandatory guidance from full IFRSs as a basis for IASB Standards for SMEs then some of the basic principles and mandatory guidance will be taken out of their current context, which could result in a different interpretation being placed on the content of the SME standard. Furthermore, there is no explanation in the Discussion Paper regarding a framework or criteria to be used for determining the appropriate content to be extracted from the full IFRSs. Such an approach could result in inconsistencies arising among the IASB Standards for SMEs and between full IFRSs and IASB Standards for SMEs.

We reiterate the advantages of publishing only one set of standards, which are (i) the same concepts, principles and guidance are available to all entities using the standards, (ii) when an amendment is made to a financial reporting standard there is no risk that the amendment is not carried through to the 'smaller' standard, (iii) transitioning from differential reporting to full GAAP is relatively simple and (iv) publication of one set of standards is a more efficient use of resources.

Furthermore, SMEs will not want to incur the additional cost of purchasing two sets of standards, which is what will be required when an accounting recognition or measurement issue is not dealt with in the IASB Standards for SMEs and the entity needs to refer to full IFRSs. (Refer to Issue 4 and Preliminary view 4)

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 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?

FRSB response

The FRSB agrees with this preliminary view that if an entity follows IASB Standards for SMEs, the basis of presentation note and the auditor's report should make that clear. The basis on which financial statements are prepared is important information for users of the financial statements.

Although we agree that IASB Standards for SMEs should not be used by publicly listed entities, we do not believe that the IASB has any authority to override national laws on this issue. The IASB has stated that it will not prescribe quantitative size tests because such tests should be determined by national jurisdictions. Similarly, it is for national jurisdictions to determine which entities are required to prepare general purpose financial reports and the basis on which those financial reports are to be prepared.

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?

FRSB response

The FRSB agrees with the objectives of IASB Standards for SMEs as set out in preliminary view 2 above.

The Discussion Paper proposes that the criterion used to distinguish those entities that are able to use IASB Standards for SMEs should be "public accountability". Such a criterion would mean that a very wide range of entities would not qualify to use the IASB Standards for SMEs. Consequently, the range of potential users of SME financial statements is likely to be as great, or almost as great, as for full IFRS financial statements. The Discussion Paper makes several references to "the needs of users of SME financial statements" but there is no explanation of how the needs of such users differ from the needs of users of financial statements prepared on the basis of full IFRSs, if in fact the users do have different needs. If the IASB considers that the needs of the users of SME financial statements are different to the needs of users of financial statements prepared on the basis of full IFRSs, the IASB needs to identify and articulate these differences.

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

Preliminary view 3.1 – No size test. The Board should describe the characteristics of the entities for which the 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.

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?

FRSB response

The FRSB agrees with this preliminary view. National jurisdictions should have responsibility for determining any size test in order that the quantitative criteria used are appropriate to that jurisdiction. This responsibility also enables national jurisdictions to make changes to the size criteria as and when appropriate.

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 3.5 – 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.

Question 3b. Do you agree that the Board should develop standards that would be suitable for <u>all</u> entities that do not have public accountability and should not focus only on some entities that do not have public accountability, such as only the relatively larger ones or only the relatively smaller ones? If not, why not?

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 one 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;

(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 based on criteria such as total assets, total income, number of employees, degree of market dominance, and nature and extent of external borrowings.

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?

FRSB response

The FRSB agrees that the IASB should develop standards that would be suitable for all reporting entities that do not have public accountability (Question 3b) but has some fundamental concerns regarding the principles and presumptive indicators of public accountability and their application in New Zealand (Question 3c), particularly as this will result in more New Zealand entities being required to comply with full IFRSs. We note that principle (b) of public accountability and presumptive indicator (c) are almost identical in wording and query why the criteria is included as a principle for and as a presumptive indicator of public accountability.

The decision to adopt IFRSs in New Zealand applies to all reporting entities for annual accounting periods commencing on or after 1 January 2007, with an option for entities to early adopt for annual accounting periods commencing on or after 1 January 2005. Reporting entities include issuers, companies other than exempt companies (defined in the Financial Reporting Act 1993) and persons required by any Act, other than the Financial Reporting Act 1993, to comply with the Financial Reporting Act 1993 as if it were a reporting entity. The definition captures indirectly many public benefit entities (public sector and not-for-profit entities) because several statutes in New Zealand include a reference to the reporting requirements of the Financial Reporting Act 1993. This is different to adoption in the European Union, which only applies to listed entities, and to adoption in Australia, which does not have a differential reporting framework.

Ideally we would wish to adopt the IASB Standards for SMEs in New Zealand as our differential framework for New Zealand equivalents to IFRSs as this would (i) allow entities qualifying for the exemptions to assert compliance with an IASB SME framework, (ii) ensure that there is consistent and comparable reporting among entities and (iii) enable entities to transition more easily from IASB Standards for SMEs to compliance with full IFRSs.

The New Zealand *Framework for Differential Reporting* uses three broad assumptions as surrogates for the benefit:cost criterion, which is used to identify differential reporting exemptions. The three assumptions are:

(a) More benefits are derived from the general purpose financial reports of entities with public accountability because the reports of such entities are likely to have more users (public accountability).

(b) There is generally no accountability requirement when all of the owners of an entity are also members of the governing body. Where the owners and governing body of an entity are different, an accountability requirement arises which increases the value of the entity's general purpose financial reports and greater benefit is likely to be derived (separation of owners and governing body).

(c) In general, the larger an entity, the more extensive the group of users benefiting from the information provided in its general purpose financial reports, and the greater the benefit likely to be derived (size).

An entity qualifies for differential reporting when it has no public accountability and at balance date, all of its owners are members of the entity's governing body or the entity is not large in terms of the size criteria identified in the *Framework for Differential Reporting.* However, if a parent or ultimate controlling entity has the coercive power to tax, rate or levy to obtain public funds, a controlled entity can use only the size criteria to qualify for differential reporting. This requirement prevents large public sector entities from applying differential reporting on the basis of no separation between owners and the governing body.

Application of the IASB principles and presumptive indicators of public accountability will capture many New Zealand reporting entities which currently qualify for differential reporting in New Zealand, with a resulting increase in compliance costs for such entities.

IASB public accountability

An entity has public accountability when:

(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.

New Zealand public accountability

An entity has public accountability for the purposes of this Framework if:

(a) at any time during the current or the preceding reporting period, the entity (whether in the public or private sector) was an issuer as defined in the Financial Reporting Act 1993 (listed entities, insurers and unit trusts); or

(b) the entity has the coercive power to tax, rate or levy to obtain public funds (that is, public sector entities such as the Crown and Local Authorities).

The New Zealand definition is similar to principle (a) and presumptive indicators (a) and (b) of public accountability. The FRSB, therefore, agrees with this principle and these presumptive indicators as they are consistent with the current position in New Zealand.

However, principle (b) of the IASB concept of public accountability (and presumptive indicator (c)) will be problematic in New Zealand because of the application of IFRSs to public sector entities. Schools will have public accountability as they have an essential public service responsibility because of the nature of operations and will be required to prepare financial statements in compliance with full IFRSs. These entities currently qualify for differential reporting in New Zealand based on no public accountability (no coercive power to tax, rate or levy to obtain public funds) and their size. The FRSB believes that the examples of entities having an essential public service responsibility (electric, gas, telephone, water) identified in the Discussion Paper would often fall within the definition of reporting entities in jurisdictions which have such a concept and would therefore have public accountability under principle (a). Furthermore, such entities would have public accountability under presumptive indicator (d) (if it is retained) as they are usually economically significant in their home country.

Application of New Zealand equivalents to IFRSs to all reporting entities will result in many entities currently reporting under the *Framework for Differential Reporting* who early adopt New Zealand equivalents to IFRSs being captured, for example, closely-held entities and subsidiaries which currently qualify for differential reporting on the grounds of no public accountability and no separation of ownership from the governing body of the entity (such an entity could have public accountability under the IASB definition as a result of the entity being large according to the size criteria). Many subsidiary companies which qualify for differential reporting have an overseas parent entity (European or Australian) and these subsidiary companies will be required to adopt New Zealand equivalents to IFRSs early from 2005. The loss of differential reporting exemptions will result in additional costs for these entities with little or no additional benefits.

Regarding presumptive indicator (d), the FRSB acknowledges that the size of an entity can and does have an impact on the community. However, whether size alone is an appropriate indicator of public accountability, and hence a criterion for an entity to prepare general purpose financial statements that comply with full IFRSs, is debatable. While it can be argued that an economically significant entity has an impact on its community, particularly if the entity ceases or reduces its level of trading, this is not necessarily a reason for an entity to be compelled to prepare financial statements in compliance with full IFRSs. Much of the information sought by stakeholders may be non-financial and may be available through media other than financial statements, for example in-house publications that are available to employees and press articles.

As mentioned previously, the FRSB believes that the determination of which entities should be required to prepare general purpose financial statements should be undertaken by local jurisdictions in order that the local environment can be considered. Furthermore, the FRSB believes that presumptive indicator (d) should be given further consideration before it is accepted as an indicator of public accountability.

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.

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?

FRSB response

The FRSB does not agree with this preliminary view. The FRSB considers that such an option potentially gives too much power to any one dissident owner and would prefer that owners holding a minimum percentage of shares (for example, 5%, or such percentage as is determined appropriate by national jurisdictions) have the ability to require the entity to comply with full IFRSs. However, the FRSB acknowledges that in some circumstances the outcome would be the same irrespective of whether one owner or owners with a minimum shareholding require the entity to prepare its financial statements on the basis of full IFRSs because one owner could own the required minimum shareholding.

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 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?

FRSB response

The FRSB does not agree that a subsidiary, joint venture or associate of an entity with public accountability should be required to prepare its own financial statements in accordance with full IFRSs. The subsidiary, joint venture or associate of an entity with public accountability does not necessarily itself have public accountability. The Discussion Paper specifically states that IASB Standards for SMEs are for application by entities which do not have public accountability. A subsidiary, joint venture or associate of a parent entity with public accountability should, therefore, be able to apply the IASB Standards for SMEs in the preparation of its own financial statements if it does not itself have public accountability.

As mentioned earlier, many subsidiaries in New Zealand qualify for differential reporting and the requirement for such entities to prepare financial statements in compliance with full IFRSs would impose additional costs on these entities with little or no corresponding benefit.

Furthermore, the parent entity, venturer or investor does not necessarily obtain the information required for the consolidated financial statements from the financial statements of the subsidiary, joint venture or associate. The relevant information is more often obtained from a schedule supplied by the parent entity, venturer or investor and completed by the subsidiary, joint venture or associate. We consider that requiring such subsidiaries, joint ventures or associates to complete their own financial statements in accordance with full IFRSs is imposing an unnecessary cost on such entities.

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?

FRSB response

As outlined earlier, the FRSB does not consider that there should be recognition exemptions in IASB Standards for SMEs.

The FRSB does agree that the entity should be required to look to the appropriate IFRS to resolve a particular measurement issue if it is not addressed in the IASB Standard for SMEs but notes that if the measurement exemptions are indicated within IFRSs, as recommended by the FRSB, the question of an IASB Standard for SMEs not addressing a particular accounting measurement issue will not arise. Furthermore, an SME will be required to purchase an additional set of standards if it is required to look to the appropriate IFRS to resolve an issue not addressed in the IASB Standards for SMEs.

The FRSB has a concern that an IASB Standard for SMEs not addressing a particular accounting measurement issue for an SME may be indicative of a wider problem with the project, for example, not having an appropriate framework for determining which requirements should be subject to an exemption. The omission of an issue is highly probable if no appropriate frameworks (identifying the needs of users of SME financial statements and/or cost-benefit analysis) are developed for identifying the financial reporting exemptions.

A further matter to be considered is disclosure of the basis on which the financial statements have been prepared as the financial statements will be in compliance with (mainly) IASB Standards for SMEs except for the issue accounted for in accordance with the appropriate full IFRS. We consider that entities should be required to specifically disclose when they have reverted to an IFRS for resolution of an issue and the treatment applied under the IFRS.

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

(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.

FRSB response

The FRSB agrees that an entity should be permitted to revert to individual IFRSs (Question 5a) where the measurement in an IASB Standard for SMEs differs from that in the IFRSs and that in such circumstances the entity should be required to revert to the IFRS in its entirety (Question 5b option (a)). We consider that, based on the application of one framework to all general purpose financial statements, the recognition criteria for financial elements will always be identical, therefore an entity should not be able to choose from a selection of recognition principles. We also consider that there should rarely be a choice of measurement bases. What is important is that (i) the IASB clearly identifies the exemptions and, where appropriate, any related disclosures, (ii) the identification of such exemptions is based on an appropriate framework, (iii) the exemptions are clearly identified within each standard and (iv) entities are required to disclose the exemptions that they take advantage of.

For example, one of the differential reporting exemptions available in New Zealand relates to Property, Plant and Equipment. In respect of items of property, plant and equipment accounted for under the historical cost method, the entity may adopt the rates of depreciation applicable for income tax purposes. The income tax rates of depreciation in New Zealand are determined based on the consumption of the economic benefits embodied in an asset and are, therefore, closely aligned to the accounting treatment. The rates are constantly monitored and reviewed by Inland Revenue and amended when necessary. For this reason there is often very little difference between the amount of depreciation calculated for income tax purposes and the amount of depreciation reported in the financial statements in the financial statements of SMEs. If an entity elects to adopt this exemption, it (i) is also exempted from the requirement to review the useful lives of the assets and the depreciation method used, (ii) is required to expense all borrowing costs incurred, (iii) is exempted from the related disclosures and disclosures that are not applicable because of the exemption adopted, but (iv) must subject the assets to the normal impairment testing. However, if an entity elects not to adopt the exemption, it is required to comply with all the requirements of the standard.

The application of income tax depreciation rates by SMEs further reduces the cost of preparing financial statements because of the consequential effects of no deferred tax being calculated on the depreciated assets.

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?

FRSB response

The FRSB does not agree with the approach being proposed by the IASB. We believe, as discussed earlier, that there should be a common framework for all general purpose financial statements, which means that there is no necessity to extract the fundamental concepts from the IASB *Framework*. We also believe that all exemptions should be separately identified within the relevant IFRS, which would mean that the concepts, principles and mandatory guidance in IFRSs are automatically relevant for and available to SMEs.

National jurisdictions that have elected to adopt IFRSs are unable to make changes to the wording of the international standards, particularly if they wish to ensure that entities are able to assert that their financial statements comply with IFRSs. One of the reasons for not changing the standards is to ensure that the requirements are not inadvertently changed, which could result in inconsistencies and incompatibilities between standards. The IASB is now proposing to 'extract the fundamental concepts (which should be identical for all reporting entities) from the IASB *Framework* and the principles and related mandatory guidance from IFRSs'. Extracting this information could result in meanings being changed because the extracts have been taken out of their original context. This would, then, result in inconsistencies between full IFRSs and the IASB Standards for SMEs.

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.

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?

FRSB response

The FRSB agrees that any modifications to the concepts or principles in IFRSs must be based on the identified needs of users of SME financial statements (when the IASB has appropriately identified such needs) or cost-benefit analyses. We consider that important aspects of this project are the identification of the needs of users of SME financial statements where these are different from the needs of users of financial statements based on full IFRSs and the establishment of criteria which can be applied when identifying reporting exemptions under cost-benefit analyses.

Although the IASB Discussion Paper refers to the needs of users of SME financial statements, there is no consideration or discussion of how or where these needs differ from the users of financial statements prepared in compliance with full IFRSs. As discussed earlier, the FRSB is not convinced that the needs of users of SME financial statements are necessarily different from the needs of users of financial statements prepared in compliance with full IFRSs. Likewise, there is no mention in the IASB Discussion Paper of any criteria which can be used for a cost-benefit analysis.

Differential reporting was introduced in New Zealand because there was acceptance that the benefits and costs of compliance with financial reporting standards differ among reporting entities. The New Zealand *Framework for Differential Reporting* has been developed on the basis of the following assumptions:

(a) compliance with financial reporting standards creates costs (usually for the reporting entity) and benefits (usually for the users of the financial reports);
(b) compliance should be required only when the benefits of compliance exceed the costs; and
(c) financial reporting standards will be more accepted if they apply only where benefits are generally agreed to exceed costs.

The benefit:cost criterion is met when the benefits of financial reporting requirements outweigh the costs imposed. All costs of compliance should be considered when applying the benefit:cost criterion to financial reporting requirements. The benefits are more difficult to determine and measure and may be derived by the entity itself, by those to whom the entity is accountable or by those who have some other interest in the entity. The benefits are considered to increase with (i) the number and diversity of users, (ii) their information needs and (iii) the qualitative characteristics of the information, such as reliability, relevance and timeliness.

To measure the costs and benefits of financial reporting requirements is difficult therefore the New Zealand *Framework for Differential Reporting* uses surrogates based on the following broad assumptions:

(a) More benefits are derived from the general purpose financial reports of entities with public accountability because the reports of such entities are likely to have more users.
(b) There is generally no accountability requirement when all of the owners of an entity are also members of its governing body. However, where the owners and the governing body of an entity are different, an accountability requirement arises. In this case, the value of the entity's general purpose financial reports to users may be expected to increase, and greater benefit is likely to be derived.

(c) In general, the larger the entity, the more extensive the group of users benefiting from the information provided in its general purpose financial reports, and the greater the benefit likely to be derived.

Using these three broad assumptions, the surrogates for the benefit:cost criterion for a reporting entity are:
(a) public accountability;
(b) separation of owners and governing body of an entity; and
(c) size.

An entity qualifies for differential reporting exemptions when the entity does not have public accountability and:
(i) at balance date, all of its owners are members of the entity's governing body; or
(ii) the entity is not large (in terms of the size criteria identified).

Approximately 90-95% of reporting entities in New Zealand qualify for differential reporting under the New Zealand *Framework for Differential Reporting*.

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.

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?

FRSB response

Provided that the IASB is able to differentiate the user needs of SME financial statements, the FRSB agrees with this preliminary view as it ties in with objectives (b) and (d) identified in preliminary view 2 dealing with the objectives of IASB Standards for SMEs.

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.

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?

FRSB response

As discussed earlier, the FRSB does not agree that there should be any recognition exemptions on the grounds that there should be one framework relevant to all general purpose financial statements.

However, the FRSB agrees that measurement exemptions should only be justified on the basis of cost-benefit analyses, consistent with objective (d) identified in preliminary view 2 dealing with the objectives of IASB Standards for SMEs.

An example of a measurement modification under the New Zealand *Framework for Differential Reporting* is for investment properties. The required "full GAAP" measurement basis is at valuation. However, entities that qualify for differential reporting may choose to use historical cost. We intend retaining these requirements under the New Zealand equivalents to IFRSs. Currently IAS 40 permits both measurement bases for all entities. Once the IASB establishes separate standards for SMEs, it is possible that the IASB would require valuation for entities that have public accountability (full IFRSs), but would continue to allow the choice under the IASB Standard for SMEs. In this way, the IASB would be able to reduce available options and increase the overall quality of full IFRSs, but acknowledge the cost:benefit argument for requiring valuation by SMEs.

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.

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 Interpretation) or some other approach, please explain why.

FRSB response

The FRSB does not agree that IASB Standards for SMEs should be published in a separate printed volume because of the advantages of publishing one set of standards, which are (i) the same concepts, principles and guidance are available to all entities using the standards, (ii) when an amendment is made to a financial reporting standard there is no risk that the amendment is not carried through to the 'smaller' standard, (iii) transitioning from differential reporting to full GAAP is relatively simple and (iv) publication of one set of standards is a more efficient use of resources.

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).

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.

FRSB response

The FRSB reiterates its disagreement to the publishing of a separate set of IASB Standards for SMEs because of the risks of inconsistencies among standards, amendments not being carried through to the 'smaller' standards, the costs to SMEs of possibly needing to purchase two sets of standards and the inefficient use of resources to publish two sets of standards. However, if the IASB continues with its proposed approach and publishes a separate set of standards, the FRSB agrees that these standards should be organised by IAS/IFRS number.

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 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?

FRSB response

The FRSB does not agree that a separate set of IASB Standards for SMEs should be published. We consider that the publication of a separate set of standards, including a statement of objectives, a summary and a glossary of key terms is an inefficient use of resources and an unnecessary duplication of material. The IASB has an existing glossary of terms which should be appropriate for all reporting entities so we do not see the purpose of including a glossary of key terms in each IASB Standard for SMEs. Likewise, IFRSs and IASs include an objective which should be the same for SMEs, particularly if the exemptions are likely to be disclosures. A separate set of standard will therefore result in the duplication of material that is currently available.

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?

No.