Accounting Standards Board
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Memo

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To: International Accounting Standards Board

From: Canadian Accounting Standards Board Staff

Date: September 16, 2004

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

The following comprises the response of Canadian Accounting Standards Board staff (AcSB staff) to the IASB's June 2004 Discussion Paper: Preliminary Views on Accounting Standards for Small and Medium-sized Entities ('Discussion Paper'). This response incorporates the views of the Accounting Standards Board's Differential Reporting Advisory Committee [1] ('DRAC').

Canada has had a differential reporting regime in place since 2002. DRAC recommends differential reporting options to the Accounting Standards Board (AcSB) using a decision model based on estimated costs versus benefits. DRAC advises the AcSB and the Emerging Issues Committee on actual or potential problems that existing and proposed accounting standards cause for non-publicly accountable enterprises.

We currently have limited feedback on the extent to which differential reporting is being used. Some say it is hardly used at all, because there are not enough concessions, others say it is very helpful and is becoming widely used.

Both staff and DRAC believe that the IASB SME project is important and congratulate the IASB on addressing the difficulties SMEs face in applying IFRSs.

[1] DRAC is composed of 10 volunteer members representing a cross-section of auditors, preparers and users of financial statements of non-publicly accountable enterprises. DRAC meets periodically to discuss new and existing accounting standards in the context of differential reporting. DRAC aims to review all exposure drafts before they are issued, as well as exposure draft responses that raise differential reporting issues.

Our responses to the questions in the Discussion Paper follow. We would be pleased to elaborate on these points in more detail if you so require. If so, please contact Paul Cherry, AcSB Chair at +1 416 204 3456 (e-mail paul.cherry@cica.ca), Peter Martin, Director, Accounting Standards at +1 416 204 3276 (e-mail peter.martin@cica.ca), Ian Hague, Principal, Accounting Standards at +1 416 204 3270 (e-mail ian.hague@cica.ca) or Greg Edwards, Principal, Accounting Standards at + 1 416 204 3462 (e-mail greg.edwards@cica.ca) .

RESPONSES TO QUESTIONS

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

We agree that full IFRSs should be considered suitable for all entities, with modifications available to SMEs for specific IFRSs based on cost/benefit.

We believe that SME modifications should not generally be viewed as deviations from the conceptual framework. Rather they should reflect instances where the cost/benefit constraint merits different specific accounting or reporting requirements. This belief is consistent with Canadian Handbook Section 1300, Differential Reporting, and the options available under Section 1300.

Notwithstanding our belief that SME modifications should not generally be viewed as deviations from the conceptual framework, we note that there may be limited instances when the cost/benefit analysis might cause one to conclude that changes are necessary to the conceptual framework. For example, the Canadian experience is that the presentation of debt vs. equity is a major issue for entities qualifying for differential reporting. This issue is one of fundamental definitions of liabilities and equity, which may call for changes to the conceptual framework for SME standards.

Some members of DRAC prefer a model whereby standards suitable for all entities are developed and additional requirements are developed for entities with public accountability.

Other members of DRAC believe that there may be an appetite for a formalized 'other comprehensive basis of accounting' (e.g. a modified cash basis), if GAAP (including differential reporting) does not satisfy the needs of small entities. In establishing Section 1300, Differential Reporting, the AcSB considered and rejected a non-GAAP approach, as Canadian enterprises are required under legislation to prepare financial statements in accordance with GAAP. Non-GAAP solutions also undermine the comparability of financial statements and are generally believed to result in lower quality information.

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

We agree that the IASB should address the financial reporting needs of SMEs because the needs of SME financial statement users are different, it may be more difficult for SMEs and their independent accountants to comply with complex requirements, and there is a different cost/benefit for SME financial statement users. However, we do not agree that a separate set of standards is necessary to address the needs of SMEs.

We believe that the IASB should consider the approach followed in implementing and maintaining Section 1300, Differential Reporting. This approach would involve applying a cost/benefit decision model to existing IFRSs, to determine instances where exceptions to full IFRSs are required.

We note the IASB's preliminary view with respect to disclosure of the basis of preparation, indicating that the entity has followed IASB Standards for SMEs. We believe this disclosure is important, as users of the financial statements need to understand the accounting policies used by the entity and that these policies are different from those followed by publicly accountable entities. When differential reporting is used in Canada, an entity discloses in its summary of accounting policies the fact that its financial statements have been prepared in accordance with differential reporting requirements.

We note that many feel that disclosure of the use of differential reporting has contributed to a view of Differential Reporting as 'dirty GAAP'. We recommend that the IASB stress the high quality of both SME standards and full IFRS, but that the SME standards have a greater suitability for SMEs. What is important is that the process to develop standards suitable for SMEs is appropriate and that this process is not "second class," or inferior, to the process for full IFRS.

We also note the preliminary view regarding disclosure of the use of SME GAAP in the auditor's report and question whether audit reporting matters are within the IASB's mandate. We note that this requirement is consistent with Canadian standards. In implementing differential reporting the Canadian Auditing and Assurance Standards Board insisted on disclosing the use of differential reporting in the auditor's report.

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?

We agree that IASB Standards for SMEs should not be used by publicly listed entities. Public companies should apply full IFRSs. Differential reporting in Canada is not available to publicly accountable enterprises.

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?

We agree that the individual objectives for SME standards as set out in preliminary view 2 are appropriate. However, we note that some of the objectives may be conflicting, possibly resulting in inconsistent decisions regarding individual IFRSs and the need for departure from full IFRSs. For example, allowing ease of transition may conflict with the objective of reducing the financial reporting burden on SMEs. Would a potential difference be rejected if significant costs were required to revert to full IFRSs? Presumably, most SMEs would follow SME GAAP as it will ease the financial reporting burden to them. If this were the case, 'ease of transition' would most likely only be a factor if an SME becomes publicly accountable. It is likely that the number of SMEs that become public, relative to the total number of SMEs is small. Under this reasoning, the 'ease of transition' objective could be considered a secondary objective. Optional application of SME standards may also reduce the importance of the 'ease of transition' objective.

Conflict between multiple objectives may be addressed by assigning weights to certain 'second order' objectives, or perhaps a framework for assigning relative significance of objectives for particular cost/benefit analyses.

In Canada, Differential Reporting uses the same conceptual framework as full Canadian GAAP, but allows delineations from the framework when the cost/benefit decision model indicates a potential need for a differential reporting option.

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?

We believe that, rather than describing the characteristics of the <u>entities</u> for which the IASB intends the standards, the IASB should describe the characteristics of the <u>users</u> for which it intends the standards. This view is consistent with the public versus non-publicly accountable enterprise distinction. In differential reporting, the focus is on the needs of users; the size of the entity does not matter.

We do not believe that characteristics should prescribe quantitative size tests. This is not an appropriate focus and, in any case, is likely to be very difficult to implement internationally.

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?

We agree that the IASB should develop standards that would be suitable for all entities that do not have public accountability. Non-publicly accountable entities have a much narrower range of financial statement users, and those users often have the ability to access information in addition to the financial statements. Users of non-publicly accountable entity financial statements receive different benefits from financial statements than the users of public company financial statements. Due to the fewer number of financial statement users, the cost per user of financial reporting may be excessive.

We note that in implementing and maintaining differential reporting in Canada many have expressed the view that incorporation of a size test would better allow addressing instances where the financial reporting burden falls disproportionately on small entities. Under a public versus non-public distinction, large private companies (which may be economically significant) qualify to use differential reporting. In considering possible differential reporting options those that could significantly reduce the financial reporting burden for small entities are sometimes not pursued, since some large private companies may have user groups that may find the information in that particular circumstance useful. The IASB should acknowledge that the SME category would include a range of sizes of entities, which may make it difficult to apply cost benefit criteria.

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?

We are concerned that the presumptive indicators in preliminary view 3.3 may be too broad. The term 'economically significant' is not defined; in application this term could have various meanings. Would an economically significant entity be forced to follow full IFRSs, even though the users of the financial statements would find SME standards more useful? What is "economically significant" to a small economy might be very different from what is "economically significant" to a much larger economy. The discussion paper notes that defining 'economically significant' will be left to individual jurisdiction authorities. We suggest that this indicator of public accountability should be removed and separately considered by jurisdictions in determining applicability of SME standards.

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 objects to the entity's preparing its financial statements on the basis of IASB Standards for SMEs? If not, why not?

We agree that unanimous consent from owners should be an eligibility requirement for application of IASB Standards for SMEs. This requirement is consistent with Section 1300, Differential Reporting. Some have criticized the differential reporting unanimous consent requirement, noting that Canadian law provides minority rights protection. Critics suggest that majority consent should be sufficient to apply differential reporting. DRAC maintains that unanimous consent constitutes pro-active minority rights protection and that majority approval is not sufficient.

We note that Question 3d discusses owners in the context of shareholders, which would not capture partnerships or trusts. We recommend the IASB define the term 'owners' in the SME standards.

We note the following suggestions and questions regarding the practicality of the proposed unanimous consent requirements:

- The IASB SME unanimous consent requirement seems to be a negative confirmation, whereas the Canadian approach requires a positive confirmation. With a negative confirmation, there might be many reasons why a shareholder may not object to SME standards, for example, the shareholder does not understand the issue and potential impacts on the information they will receive, they are away for the response period, or they did not receive the mailing. We believe that a positive confirmation provides a better indication of shareholder consent and suggest that the IASB require positive confirmation of unanimous consent.
- Does the IASB intend the unanimous consent to be an annual requirement? The differential reporting unanimous consent requirement is not required on an annual basis. After initial adoption, unanimous consent must be reaffirmed only if there is a change amongst owners or a change in the differential reporting options selected. This was done to ease the administrative burden of differential reporting.
- What is the standard of proof to ensure that the entity has done its best to notify all owners? Will there be an opportunity for owners who are not sophisticated in accounting matters to become informed about the differences the IASB SME Standards will produce from full IFRSs?
- Is the consent for the SME standards as a whole or individually?

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?

We agree that entities should not apply standards for SMEs to avoid the reporting of financial information that has been produced for other purposes and therefore is readily available. However, subsidiaries often prepare information for consolidation purposes using a materiality level appropriate for the consolidated financial statements, which may not be appropriate for its own reporting. In these circumstances, we believe that the entity should be able to apply standards for SMEs.

We believe that this is more appropriate to express this requirement in terms of whether the information has been prepared, rather than the nature of the entity. In this regard, the CICA Handbook, paragraph 1300.11, states that a qualifying entity that is a subsidiary, joint-venture or equity-accounted investee of a publicly accountable enterprise does not use a differential reporting option to omit information required of a non-qualifying enterprise when that qualifying entity prepares such information to meet the needs of the parent, venturer or investor.

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?

We agree that there should be mandatory fallback to full IFRSs, but note that fallback would only be workable if the conceptual frameworks between full IFRSs and SME standards are the same. We believe that the alternative outlined in paragraph 41(b) is not feasible, as most SMEs would not have the technical expertise to determine what the related principles of the IFRS are and develop appropriate accounting based on these principles.

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?

The 'all or nothing' approach has the following implications:

a. Some companies do not benefit from SME reporting as some stakeholders do not agree with a specific SME standard.
b. Some stakeholders agree to SME reporting, as on balance, they see the benefit—but they would prefer not to use one or more individual SME standards.
c. It hinders those SMEs that would like to phase into full IFRS reporting on a gradual basis.

We believe that an SME should be permitted to revert to an IFRS on a case-by-case basis. This 'mix-and-match' approach is fundamental to Differential Reporting in Canada, as it allows cost/benefit to be addressed by individual entities and recognizes that individual non-publicly accountable entities have varying needs for financial reporting. For example, one of the Differential Reporting options allows an entity to follow the cash basis of accounting for income taxes. An entity's owners might believe that recording future income taxes results in relevant information, and would therefore not select this option. This same entity might believe that differential reporting options providing relief from disclosure of fair value information are essential to relieving the burden of financial reporting, and would be free to adopt differential reporting options that are useful.

Critics of the selective application approach note that inter-company comparability is potentially lost. We understand that comparisons amongst non-publicly accountable entities are relatively infrequent. Occasionally, lending officers compare the financial statements of different non-publicly accountable enterprises. However, in most cases, differential reporting in practice gives lending officers the information they need, as differential reporting options are established largely based on their information needs.

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)

(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.

We do not agree with alternative (a), for the reasons expressed in the response to Question 5a. In addition, we do not believe that this alternative is operational unless each IFRS has clearly defined bounds that cover all aspects of the relevant accounting. For example, financial instruments standards are, presently, contained primarily in two IASs (32 and 39). A standard-by-standard approach would allow an entity to consider disclosure and presentation separately from recognition and measurement, purely as a result of the structure of the underlying standards.

If alternative (c) were to be adopted, we agree that it would be necessary to establish clear criteria for defining "related" principles.

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?

We do not agree that extraction of the fundamental concepts from the framework is necessary in developing SME standards. Extracting fundamental concepts runs the risk of using different words to say the same thing, and may have limited value since a SME would be required to refer to full IFRSs when SME standards do not provide guidance.

We believe that the IASB should consider the approach followed in implementing and maintaining Canadian Handbook Section 1300. This approach would involve applying a cost/benefit model to existing IFRSs, to determine where exceptions to the general requirements are required.

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 analyze the costs and benefits of IFRSs in an SME context?

We agree that the basis for modifications from full IFRSs should be based on the needs of users or cost/benefit analysis. We note that analyzing cost/benefit is a subjective exercise and for purposes of obtaining consistent modifications for SMEs we urge the IASB to develop a cost/benefit decision model similar to that outlined in the basis for conclusions to Section 1300 of the CICA Handbook which states:.

> 65 Comparing the costs and benefits of an accounting standard, or of a requirement within a standard, is a complex task. Despite several efforts to rationalize the approach, it remains a judgmental process as acknowledged in FINANCIAL STATEMENT CONCEPTS, paragraph 1000.16, and equivalent material published by other standard setters.
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> 66 To ensure maximum consistency in decisions, the Differential Reporting Advisory Committee and the AcSB applied the evaluation process described below in reviewing various potential differential reporting options. The benefits to the users were assessed in relation to three of the four fundamental qualitative characteristics of financial information set out in FINANCIAL STATEMENT CONCEPTS, Section 1000: understandability, relevance, and reliability. Comparability was not used as a criterion because it fundamentally conflicts with providing accounting alternatives. However, as previously discussed, GAAP already allows for alternative treatments in a number of circumstances. When a conflict arises between the characteristics of relevance, reliability, comparability and understandability, a trade-off needs to be found that enables the objective of financial statements, i.e., decision usefulness, to be met. The assessment of benefits was made in relation to the two identified groups of users of the financial statements of non-publicly accountable enterprises: the non-managing owners and the creditors.
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> 67 The costs of complying with individual accounting requirements were broken down into the following categories: preparation costs, communication costs (when appropriate), specialized expertise costs and related audit or review costs. Costs and users' benefits were weighted on a three-point scale (low, moderate, high). The following situations were agreed upon as indicating a potential need for a differential reporting option:
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> - Low benefits and low, moderate or high costs of compliance call for a differential treatment.
> - Moderate benefits and moderate or high costs of compliance call for a differential treatment.
> - High benefits and high costs of compliance at most lead to a simplified treatment producing not significantly different results.
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> 68 The Differential Reporting Advisory Committee and the AcSB will apply the same evaluation process to consider differential reporting issues as new accounting standards are developed, so that such issues may be considered in a timely and consistent manner.

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?

We agree that the disclosure and presentation modifications could increase or decrease the current level of disclosure for SMEs, depending on the needs of SME financial statement users and cost/benefit analysis of particular IFRSs.

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?

We believe that recognition and measurement differences should not be precluded. We believe that each IFRS should undergo a SME cost/benefit analysis. If recognition and measurement differences are necessary to make GAAP viable for SMEs, then the IASB should adopt these differences. It might be the case that recognition and measurement differences require satisfying a higher cost/benefit threshold. Specific objectives set out in preliminary view 2 might require different weighting for recognition and measurement differences as compared to disclosure differences. For example, the 'ease of transition' objective might be given a low weighting for disclosure and presentation differences and a high weighting for recognition and measurement differences.

There are many who believe that without recognition and measurement differences any 'differential reporting' regime has limited usefulness. This may be especially true as accounting standards are continuing to move toward 'fair value' as a basis for measurement. We believe that, in certain cases (e.g. private equity), 'fair value' for SMEs might not always result in reliable information within the cost/benefit constraint. The benefits of 'fair value' may also be different for SMEs because the users are mainly lenders who aren't interested in current values. DRAC usually challenges accounting standards that require fair value (for recognition, measurement or disclosure) when fair value is not readily observable or determinable without incurring significant costs.

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.

We do not agree that a separate set of financial reporting standards published in a separate volume or extraction of fundamental concepts in IFRSs is necessary to accomplish the goals of SME standards. We believe that extracting fundamental concepts and housing them in a separate location runs the risk of using different words to say the same thing, and may have limited value since a SME would still be required to refer to full IFRSs when SME standards do not provide guidance.

In Preliminary View 1.1, the Discussion Paper notes that full IFRSs are suitable for all entities. Under this view, we believe that a limited number of exceptions to full IFRSs would accomplish the goals of SME standards, without requiring a separate set of financial reporting standards.

The Discussion Paper preliminary views regarding mandatory fallback and optional reversion to full IFRS supports not publishing SME standards in a separate volume. Placing the differences/exceptions available to SMEs in the respective standards would allow the differences to be more readily apparent, allows consistent language, and would reduce the amount of cross-referencing.

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.

As expressed in the response to Question 8a, we do not agree with publishing a separate volume for SME standards. Assuming the IASB adopts a separate volume of SME standards, we agree that these standards should be organized by related IAS/IFRS number. This would allow for quick reference between full and SME standards.

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?

As expressed in the response to Question 8a, we do not agree with publishing a separate volume for SME standards. Assuming the IASB adopts a separate volume of SME standards, we agree that each SME standard should include a statement of its objective, a summary and key terms. This information would help readers better understand the purpose and intent of each standard.

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?

Standards overload is particularly acute for many SMEs and their accountants. The speed with which new or revised standards are being adopted for SMEs does not have to be the same as for public companies. There could be delayed implementation for SMEs, in order to benefit from lessons learned from implementation by public companies.