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For the attention of Paul Pacter, Director of Standards for SMEs

Our ref: NNS/MPC

Dear Sirs

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

We write to offer our comments on your Discussion Paper: "Preliminary views on accounting standards for small and medium-sized entities".

Our detailed responses to the questions raised in the Discussion Paper are set out in the Appendix to this letter. Our general comments on the project are set out below.

Despite the comment in IN2 of the Discussion Paper that the IASB has not indicated that its standards are designed or intended only or primarily for entities whose securities are listed for trading in public capital markets, in practice the needs of the users of such financial statements (as contrasted in paragraph 6 of the Discussion Paper with the needs of users of the financial statements of SMEs) have often been used to justify the standards which have been developed.

This has two main consequences for SMEs attempting to follow IFRSs:

a) firstly, as recognised in paragraph 6 of the Discussion Paper, the cost of preparing SME financial statements on the required bases may outweigh the benefits; and
b) secondly, SMEs will often not have available the information required to prepare financial statements on the required bases.

Although these factors may often operate together (the cost of obtaining the relevant information may simply be prohibitive) the second point does not only arise from the first. For example, SMEs will have particular difficulties with:

a) fair value methods, because it is more likely that the assets involved will not belong to a homogenous population of assets which are regularly traded (this will also apply to any requirement to value their own, unlisted, shares); and

b) discounting and impairment calculations, because SMEs are less likely to maintain sufficiently detailed projections of future cash flows.

In developing the IFRSs attention has been paid to cost benefit considerations, but in general we believe that the balance has been considered only in the context of larger listed companies. In our view, the result of SMEs applying IFRSs will not only be that the cost of compliance is out of balance with the likely benefits, but also that the reliability of the financial statements will be compromised. On this basis IFRSs are not the most appropriate accounting standards for SMEs to use.

We therefore welcome the commencement of a project (to which we believe the IASB should give priority) to consider how a set of international standards which are more appropriate to the needs of SMEs might be developed. From a UK perspective we particularly welcome the fact that this project does not appear to be starting from the same assumptions as the UK FRSSE.

One problem with the UK FRSSE is that it is often difficult to determine where its simplifications are intended to actually simplify the applicable requirements and where it is only their expression which is simplified. Another increasing problem, which will particularly apply in the context of IFRSs, is that while the UK FRSSE does offer some disclosure exemptions, it retains the principle that its measurement requirements should be substantially the same as those of the full standards. As discussed above, we believe that there is a need for international standards for SMEs to include some simplifications of the applicable measurement rules.

We believe that it is possible to simplify the measurement rules applying to SMEs while maintaining the same measurement objectives. SME financial statements would still give broadly equivalent results (and comply with the same conceptual framework), although these results <u>would</u> differ in detail from those prepared under IFRSs. Without attempting at this stage to give a full analysis of the differences which might arise, an initial indication of the main differences might be:

a) <u>Fair value</u>. SMEs are less likely to hold assets whose values fluctuate significantly. (In our response to question 4 we suggest that the SME standards might impose different conditions in those comparatively rare cases where particular types of assets or liability are held, for example different rules might apply if derivatives are held. For all other assets and liabilities:
   i) changes in the value of assets held for the relatively short-term would be reflected on disposal, thus the cumulative effect of such changes in value will be the same whether or not they are revalued at any particular accounting date;
   ii) the number of assets held over the longer term will be comparatively few and information about the date of the last valuation (including cases where the last valuation is based on cost) will give any user of the financial statements who has an interest in such information, sufficient

indication of the underlying value of these assets. The UK ASB were concerned to prevent irregular revaluation of assets, but it is not clear that there is any reason to think that an outdated valuation, whose date is disclosed, gives less useful information than either cost or an older value as at the date of the introduction of a particular accounting standard.

b) Discounting. Again SMEs are unlikely to have assets or liabilities for which discounting is likely to have any real impact on the view given by their financial statements. All such amounts reverse over time.

c) Impairment. It will be important that SMEs consider and reflect impairment. In the particular case of goodwill, the use of amortisation should be allowed as an optional treatment in place of an annual impairment review. For all assets where there is an indication of impairment, a more straightforward basis for calculating the recoverable amount should be devised. We do not believe that prescriptive rules for carrying out impairment tests improve the reliability of the measurement of impairment in cases where the underlying information on which such measurements are based are not prepared and reviewed regularly. We accept that the lack of reliable information will probably have the effect that a more prudent view would have to be taken.

In conclusion, we believe that there is a need for the development of a set of separate international accounting standards for SMEs. These should aim to simplify the requirements applying to these entities and should also make it possible for SMEs to fully comply with the requirements (which should be clearly differentiated from those deriving from IFRSs) rather than just doing the best they can to comply with the IFRS requirements.

Yours faithfully

M. P. Comeau
Senior Technical Manager

APPENDIX

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

We agree that all entities should have the option to apply full IFRSs. Some of the requirements of the full IFRSs are, as the Discussion Paper recognises, comparatively more difficult for smaller entities to apply. This is not only a matter of the costs involved. In some cases insufficient information will be available to enable smaller entities to fully comply with the requirements. Where this arises, applying the full IFRSs may give less reliable information than if simpler accounting requirements applied and to this extent full IFRSs may not be considered the most suitable standards for SMEs. The entity itself is best placed to assess where this may be the case and accordingly all entities should retain the option to follow full IFRSs.

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 strongly support the development of a separate set of standards for SMEs. These should be integrated with the full IFRS, but allow for a simpler approach to be applied to measurement issues and a reduction in the level of disclosure. It will be important to balance the need to integrate the SME standards with IFRSs, with the need for simplification, and we believe that it will be important to accept from the outset that (as discussed in more detail in the covering letter and below), in order to achieve the necessary simplifications, following the standards for SMEs will result in some differences in the results presented. Notwithstanding these differences we believe that financial statements following either set of standards can reasonably be said to give a true and fair view so long as the basis on which they have been prepared is adequately disclosed as set out in preliminary view 1.3.

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?

Yes, we agree with both points made.

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 broadly agree with these objectives, but the difficulties of the project are likely to arise where there is conflict between the requirements of b) and d) of preliminary view 2 on the one hand and c) and e) on the other. At the limit it could be argued that ease of transition between the two sets of standards would rule out any real differences between the systems. Such arguments should be resisted as they would lead to the imposition of accounting requirements on SMEs which they cannot realistically be expected to follow. We accept that all five of the points listed in preliminary view 2 should be retained as objectives but suggest that from the outset it is agreed that meeting the needs of the users of SME financial statements and simplifying the requirements applying to them will in some cases make transition between the two sets of standards more complex and that there may be areas where the conceptual framework should be applied in a different way. (We believe that the different approach to SMEs that we are suggesting is consistent with the IASB “Framework”, but that the approach will reflect a different balance between the various relevant factors identified in that document.)

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?

Yes, we strongly support preliminary view 3.1 that the use of the SME standards should not be based on a size test. The difficulties in arriving at an appropriate size test referred to in paragraphs 25 and 27 are not the main reason for this conclusion. The main reason that separate standards are required is that some of the reasoning used to justify the requirements of the full IFRSs is based on the particular information needs of the shareholders of listed companies. It follows that it is the distinction between these entities and others that should determine the standards which apply.

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

Yes, we agree that no distinction should be made between the requirements of relatively larger or relatively smaller entities. We note that the UK ASB in its Press Release announcing the publication of the Discussion Paper expresses a concern that in practice this may mean that "If smaller entities are to enjoy a substantially reduced burden, this could imply the need for a 'three tier' system of accounting standards". We hope, and believe, that this is neither the IASB's intention, nor the likely result of this project. We believe that in practice significant simplification of the requirements of the full IFRSs would be in the interests of most unlisted companies. In cases where this does not apply, such companies should (per question 1(a)) have the option of applying the full IFRSs.

We do, however, believe that in devising standards for SMEs the IASB should have in mind the practicalities of applying them to the smallest of entities.

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 agree that it may be appropriate for a wider group of "publicly accountable" entities to be required to follow the full IFRSs, in that for some of these there will be stakeholders whose information needs are analogous to those of shareholders. However, care will be needed to avoid using too wide a definition of "public accountability". For example, although charities are not discussed in the paper, it can be argued the charities are publicly accountable, but that the information needs of donors and the public at large are different from those of the stakeholders of listed companies. It would not be a suitable use of charitable funds to incur the cost of preparing information which was not needed. It would be better for the IASB to require full IFRS is to the applied only to entities whose securities are listed for trading on public capital markets and to leave it to the relevant national legislators to determine which additional publicly accountable entities should apply them.

Question 3d. Do you agree that an entity should be required to use full IFRSs if one or more of the owners of its shares object to the entity's preparing its financial statements on the basis of IASB Standards for SMEs. If not, why not?

In principle the owners of a substantial proportion of the shares could be given the option to require full IFRS financial statements, but we believe that the standards for SMEs will in practice be more appropriate for the majority of SMEs and that the default position should be that they are used. There should not be a requirement as suggested in preliminary view 3.4, to obtain positive consent from all owners to use the SME standards.

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?

No. We agree that, for the reasons set out in paragraph 39 of the discussion paper, full IFRS financial statements would often be prepared for subsidiaries, joint ventures and associates. However there will often be situations where the difference between financial statements prepared under full IFRSs and the standards for SMEs may (at least in some areas) be regarded as immaterial in the context of the entity with public accountability. Where this occurs there will be no reason to apply the full requirements of IFRSs to the smaller entity's individual financial statements. The publicly accountable entity will need to ensure that the judgements made here are reasonable and that adjustments are made at the consolidation level where this is necessary, but the choice of the basis on which the financial statements of the smaller entities are prepared may reasonably be left to that company's board.

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 would favour the "mandatory fallback" approach to that adopted by the UK FRSSE. We have always thought that the basis on which the UK FRSSE is drafted is flawed in this regard. It is difficult to determine in what circumstances a preparer who "had regard to" the full accounting standards in a material area would decide on a different accounting treatment to that which they require.

However, we would favour an approach which differs from both of the options presented. This issue would not arise if the approach to SMEs was to give exemptions and alternative treatments within the full standards. This would be our favoured approach.

If separate SME standards are to be prepared, the problem would also not arise if such standards set out as simply as possible the circumstances in which the requirements of full standard should be referred to and followed.

One purpose of preparing separate standards for SMEs (as noted in paragraph 17 of the Discussion Paper) is to reduce the financial reporting burden for all SMEs that wish to use global standards. The means of achieving this should be through a combination of simplifications and exemptions. Most of the existing standards could potentially apply to SMEs unless there is a decision as part of this project to exempt them from these requirements. There are a number of areas where an exemption for SMEs from the requirement to follow a particular standard might depend on the particular transactions and balances it has. For example (this example is only to illustrate the point, the merits of this particular proposal would need to be discussed in more detail in a later phase of this project) it might be decided that SMEs could be fully exempted from some, or all, of the requirements of IAS 32 (and the potential successors to these requirements in ED7) and IAS 39 unless they hold derivative financial instruments (or possibly one of a wider group of financial instruments). It might then further be decided that where such financial instruments are held by SMEs some simpler requirements should be applied.

Where there are parts of an IFRS which are seldom expected to be relevant to SMEs, these should be excluded from any separate SME standards, but there should be a clear statement within the standard for SMEs setting out the circumstances, if any, in which they do apply so that the preparer of the financial statements need not automatically refer to the full standard.

The IASB standards for SMEs would then comprise:

a) extracts from the full IFRSs (where the same requirements apply the same wording should be used);
b) simplified requirements which replace the detailed requirements of the full IFRSs; and
c) cross references to the full IFRS which clearly specify the circumstances in which the full IFRS should be referred to, and the sections which are relevant in these circumstances.

It would be useful to develop a table of concordance stating for each main paragraph in an IFRS:

a) the paragraph within the equivalent standard for SMEs which replicates it, indicating whether or not modifications have been made;
b) the paragraph(s) within the equivalent standard for SMEs which replaces it with a simplified requirement;
c) the cross-reference that sets out the circumstances in which the paragraph should be applied to SMEs; or
d) a clear statement that the paragraph does not apply to SMEs (<u>not</u> just that the SME standards have "no reference" to the point).

On this basis there need not be any accounting or measurement issues which are covered in the full IFRSs which are not addressed at some level in the IASB standards for SMEs and question 4 would not arise.

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?

On balance we support permitting entities to follow individual IFRSs while in general following the SME versions. We have some concern that "reverting to an IFRS" is not the best way to describe this approach and do not support the suggestion (for example in paragraph 56 of the discussion paper) that the full IFRS approach will always be better. The challenge of this project is to devise standards for SMEs which are appropriate to their needs, and which will therefore be the appropriate standards to be used by these entities. As noted earlier, it will be important that the basis of the preparation of the financial statements is made clear. Where a mixed approach is adopted the statement discussed in preliminary view 1.3 should include reference to the IFRSs followed in the place of the SME versions.

We have some concerns over the issues of comparability discussed in paragraph 56 of the discussion paper, and suggest that mixing the requirements should be discouraged rather than encouraged, but there may be particular cases where an SME has particular reasons for adopting one or other particular IFRS while otherwise following the SME standards. This should be rare and such reasons should, where they arise, be disclosed.

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?

The important issue is the disclosure of the basis on which the financial statements are prepared. Option (a) would make the basis adopted easier to describe, while option (b) would maintain the greatest comparability with other entities using the SME standards. We would suggest that the presumption should be that the SME standards are followed in full and that where there are good reasons to depart from them the extent of the departure should be judged in the context of these reasons, with a clear disclosure of the policy adopted and the extent of the departure from the SME standards (i.e. option (b) should be allowed, but only in exceptional circumstances).

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?***

Yes. We agree that the starting point for the development of IASB standards for SMEs should be the existing body of IFRSs. The reason for this is that, notwithstanding the differences between the requirements of the users of (broadly) listed and unlisted financial statements, the users, preparers and auditors of both types of financial statements will all be helped if the requirements of the two sets of standards are as similar as possible and that differences can be readily identified. Where the same requirements apply, the same wording should be used (if it is possible to simplify the wording of a given requirement for the purpose of the SME standards the same simplification should be applied to the equivalent IFRS).

Nonetheless it is important that this conclusion should not lead to a presumption that the IFRS requirements should not be changed. The impact of each requirement on SMEs should be considered. Wherever the costs of adopting a particular requirement, or set of requirements, exceed the related benefits in the context of SMEs or where SMEs cannot be assumed to have available the required information, the SME standard should either include a simplified requirement or an exemption from that requirement.

We are concerned that in order to minimise differences between the two sets of standards in areas where SMEs will find compliance with the requirements difficult there could be a tendency to conclude that SMEs should comply "as best they can" (this appears to be the approach of the UK FRSSE). It will be preferable for SMEs to work to a different standard where full compliance can be straightforwardly achieved.

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?

We agree that modification should be made on the basis of the needs of users or on the basis of a cost/benefit analysis. However, as noted above, we believe that a third principle should be that a particular measurement basis can be more reliably applied by SMEs. The balance between cost and benefit will be informed by the consultation process.

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 there may be some areas where additional requirements may be appropriate for SMEs, but the expectation would be that there will be a greater number of full IFRS disclosures which are not regarded as necessary.

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 this to be the most important issue to resolve. We agree that the initial presumption should be that recognition and measurement principles will not be modified without good reason (such as those identified in the answer to 7a) but we believe that the <u>expectation</u> should be that some modifications should be made, at least to the measurement principles. We accept the analysis set out in paragraphs 81 to 84 of the discussion paper and the implication that the IASB would particularly oppose modification to the recognition principles, but we believe that a final conclusion on this depends on a detailed analysis of the requirements of each IFRS. We would suggest that while modification to recognition principles are not expected, the possibility is not ruled out at this stage.

For example, there may be areas where the effect of applying particular recognition rules would be unlikely to have a material effect on the financial statements of SMEs but where a realistic judgement on materiality could only be made after a considerable amount of effort. In such cases it might be reasonable to exempt SMEs from the relevant requirement.

On this basis the “rebuttable presumption” formulation as applied to the recognition principles is reasonable. Its application to measurement principles is also accepted if this means that unnecessary differences will be avoided, but we believe that it should be accepted that some differences in measurement principles will have to be made and that in proceeding with this project genuine consideration should be given in particular cases to whether either presumption can reasonably be rebutted. The areas where measurement principles may need to differ include those affected by the issues mentioned in paragraph 83 of the Discussion Paper concerning measurement reliability. We suggest that SMEs will more often have difficulty in establishing a fair value for their assets than listed companies and that the detailed projections required to apply discounting to assets and liabilities, or to calculate impairments, may often not be maintained by SMEs. Where they are maintained, they will often not have the necessary level of reliability. SME standards should not assume that reliance can be placed on such detailed calculations and will need to establish alternative methods of reaching the same accounting objective.

Question 8a. Do you agree that IASB Standards for SMEs should be published in a separate printed volume? If you favour including them in separate sections of each IFRS (including Interpretations) or some other approach, please explain why.

We believe that the IASB standards for SMEs should be set out in separate sections in each IFRS. If, while accepting that there will be some differences, the intention is that the presumption should be that the requirements of both standards should be the same, the best approach would be to have such requirements as apply to all entities set out once with separate text used only where differences arise. Setting out identical requirements separately should be avoided as far as possible, although in some cases it may ease the exposition to allow some duplication of the requirements (this already happens in existing IFRSs where similar requirements are applied in different situations).

In principle the main part of the standard should distinguish:

a) requirements applicable to all entities;
b) requirements applicable to SMEs only; and
c) requirements applicable to publicly accountable entities only.

The introductory material, basis of conclusions, definitions and implementation guidance would be common to both sets of standards (although they would refer where appropriate to the differences). It may be that some standards should have wider scope restrictions (a narrower scope) for SMEs. Drafting issues will need to be considered in detail, but it will probably aid the exposition of requirements to group the material by subject and it may be that the level at which the analysis of the requirements between the headings set out above may vary from subject to subject. Nonetheless the requirement to state which standards are being followed will mean a clear distinction between the different requirements will have to be maintained.

Overall we believe that the advantages of this approach are as listed in paragraph 93 of the discussion paper, and that these outweigh the advantages of the alternative approach suggested in paragraph 92. We give particular weight to the point in 93 (c) that there are dangers that differences in the drafting of requirements which are not intended to be different could give rise to unintentional differences in practice and we believe that this danger outweighs the potential advantage of drafting the requirements in a simplified language suggested by paragraph 92 (b). If, however, this point is not accepted, a possible approach might be for a clear correspondence between the different wordings to be established and for there to be a clear statement that the simplification is not intended to change the requirements and that the more complex wording should be referred to in case of doubt.

The approach that we have suggested does not preclude the separate publication of a volume which extracts the provisions which are most commonly relevant to SMEs, such a volume need not contain all the requirements which could, in theory, apply to SMEs, but could include cross-references as suggested in the answer to question 4 above which set out the circumstances in which reference to the full IFRS is required. The publication of such a volume could achieve the advantages listed in paragraph 92 (a) of the Discussion Paper while avoiding the dangers of unintended divergence between the IFRSs and the standards for SMEs.

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.

This would happen automatically if the approach set out above were followed. But if the decision was taken to issue a separate sequence of standards, we agree that these should be organised with reference to the related IAS/IFRS numbering system to clarify the similarities and differences between the requirements, and to consolidate the updating process along the lines suggested in paragraph 90 (c).

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?

Again this question does not arise if the approach suggested in answer to question 8 a) is adopted. If separate standards are prepared, these materials will be needed but should as far as possible be the same as those used in the full standards with an indication of where differences arise.

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?

We believe that it is not practical to require SMEs to make extensive use of a fair values or measurement techniques which rely on detailed projections such as discounting in their financial statements. We believe that SME international standards should be based more firmly on historical cost data, although this would be modified in some areas - there would be no logic in requiring a strict historical cost approach in all areas. If this means that there has to be a difference between the bases on which SME financial statements and listed company financial statements are prepared this will be an acceptable cost of ensuring that SMEs are able to prepare reliable financial statements at reasonable cost.

There may also be an argument that, even for listed companies, fair values (if more informative) are less reliable than the modified historical cost values which we suggest SMEs can more realistically apply. It may be that, just as cash flow information is regarded as a useful addition to accruals-based accounting, it will be useful to the users of listed company financial statements to separately disclose the effect of the more judgement-based measurement techniques on their financial statements. The columnar approach which was considered in the original phases of the "comprehensive income" project could be adapted so that both the balance sheet and that the performance statement present a reconciliation between the more reliable modified historical cost figures and those derived using full IFRS. This would mean that the modified historical cost figures could be compared for all companies and SMEs would simply be given an exemption from preparing the additional market-based information. In listed company financial statements this would focus the reader's attention on the areas where the greatest judgement has been applied. Acceptance of this final suggestion is not, however, an essential part of our case that the requirements applying to SMEs must be simplified.