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**CL 47**

Comments to IFAC discussion paper June 2004

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

### **Introduction**

As Association of Certified Accountants in Finland and as a full member of IFAC and whose members audit mainly the small and medium sized enterprises in Finland, we give our opinion on your discussion paper referred to above concerning accounting standards for SMEs. The contents of our comments are organised according to your questions concerning the approach to the issue. In our response to your final question we also discuss the content aspects.

In this connection we will also state that we will be willing to actively follow and comment your future work regarding this issue.

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

In principle yes, but in practice the full IFRS is too complicated for SMEs. The full version of IFRS is primarily designed for users in the capital markets and thus many of the standards are irrelevant to SMEs. The evidence suggests that the users of SME financial reports are very different.

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

In principle, the rules should be of the same origin for all enterprises. However, the Board should develop a separate set of financial reporting standards suitable for SMEs by giving focus to the most material contents of full IFRS and by eliminating needless alternatives and details, especially needless notes.

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**Question 1 c. Do you agree that IASB Standards for SMEs should not be used by publicly listed entities...**

We agree that IASB Standards for SMEs should not be adequate for publicly listed entities regarding consolidated financial statements and possibly the financial statements of parent companies because they may not meet the needs of the users of listed entities.

**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?**

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

We would question two issues.

The reference to 'understandable': Presumably understandable refers to both users and preparers. In the case of preparers we would agree with the concept. In the main for SMEs the preparers are likely to be professional accountants. However, in case of users of financial reports of SMEs it is very unlikely that they will have a reasonable understanding of accounting concepts. What they desire is credible financial reports, which are reliable, and that they can use confidently in their planning, control and decision-making. This does not, necessarily, mean that they have to understand the concepts underpinning the reported position and performance of the entity.

The reference to enforceable: It is unlikely that these standards, in all jurisdictions, will be enforceable. The cost of enforcement is likely to exceed any benefits. Entities would ideally want to comply with the standards because they make financial reports credible in the eyes of their users. It could, however, be the case that software produced for preparing financial reports that comply with IASB Standards for SMEs will be an effective enforcement agent because to deviate from the software approach could be too burdensome. The principle of 'no constraint no hindrance' should be adhered to.

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

We agree to this objective.

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

In principle yes. However, the IFRSs' Framework as such is too oriented only to large listed companies and needs to be amended to include references to fit SMEs and the users of their financial reports.

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

We agree to this objective.

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

We disagree with the concept of 'public accountability'. But in principle we agree with the concept of easy transition for SMEs to full IFRS if and when they become listed.

**Question 3a. Do you agree that the Board should describe the characteristics of the entities for which it intends the standards...**

We agree that Board in setting standards for SMEs should use qualitative criteria in defining SMEs rather than a quantitative size test. However, the standards should allow quantitative size tests to be implemented through local legislation if needed. The SME rules should be available for all not using full IFRS.

**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

**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...**

We disagree that the concepts of public accountability and non-public accountability would provide a workable definition. Generally, the concept is too complex and open to misinterpretation. More specifically:

The IASB's Framework states that IFRSs should be driven by user needs. But it is not clear how the concept of neither public accountability nor non-public accountability fits with user needs. If an SME were to be classified as publicly accountable, they would be subject to the same standards as listed entities. That is, their users' needs would be seen to be compatible with the needs of users in the capital markets.

The fact that SMEs will be described as non-publicly accountable implies that their contribution (collectively) to the economy and their responsibility in society is less than that of listed entities.

To capture the prime user needs of listed players in capital markets and the users of SME financial reports, the most appropriate differentiation in setting standards would be between listed and unlisted. The main constituents of unlisted entities are SMEs and the standard should therefore reflect their needs. It would then be up to national

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legislation to decide what reporting standard regime large unlisted entities should adopt.

Our proposal is to use only the limit listed / unlisted and that the unlisted units are allowed to choose between full IFRS and IFRS for SMEs by disclosing the choice in the notes.

**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... IASB Standards for SMEs...**

We disagree that an entity should be required to use full IFRSs if one or more of the owners of its shareholders object to the entity's preparing its financial statements on the basis of IASB for SMEs. Firstly, it is doubtful if owner-managers or other shareholders of SMEs would understand the distinction between the two standards. The evidence suggests that they are likely to rely on their accountant for making accounting choices of this nature. Secondly, an independent shareholder of a very small entity could dictate that an entity should publish their financial reports under full IFRS and we would question what would be gained from this option when it is likely that the SME version is relevant.

Regarding non-listed entities, the choice between full IFRS and IFRS for SMEs should be done at the board level if not done by the majority of owners.

**Question 3e. Do you agree that if a subsidiary, joint venture or associate of an entity... prepares financial information in accordance with full IFRS to meet the requirements of its parent... the entity should comply with full IFRSs, and not IASB Standards for SMEs...**

We disagree. Only the financial statements of the listed parent companies and the correspondent consolidated financial statements are meant for corresponding public use. The financial statements of subsidiaries etc. are typically meant only for few recipients. Therefore it should be allowed for subsidiaries etc. to make their own choice between full IFRS and IFRS for SMEs by disclosing their choice. If choosing IFRS for SMEs in their own financial statements, the subsidiaries etc. can supply their parent units internally the needed supplementing information for the parent's full IFRS.

**Question 4. Do you agree that if IASB Standards for SMEs do not address a particular accounting recognition... the entity should be required to look the appropriate IFRS...**

We agree when the issue has material role. Here also the principle 'comply or explain' should be adhered to.

**Question 5a. Should an SME be permitted to revert to an IFRS if the treatment in SME version of the IFRS differs from the treatment in the IFRS...**

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An SME should be permitted to revert to an IFRS if the treatment in the SME version of the IFRS differs from the treatment in the IFRS.

**Question 5b. If an SME is permitted to revert to an IFRS, should it be... a standard-by-standard approach... a principle-by-principle approach or... a middle ground between...**

An SME should be 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). By giving SMEs this option they can ensure that in general they are adopting standards that are relevant to SMEs. Also, in general, the features of full IFRS cannot be worse choice than the corresponding features in IFRS for SMEs. Here the principle 'comply or explain' is essential: when applying IFRS for SMEs, any deviation from IAS for SMEs shall be disclosed in notes.

**Question 6. Do you agree that development of IASB for SMEs should start by extracting the fundamental concepts... and then making modifications...**

We agree. If the IASB is to be authority in the setting of standards for SMEs it is appropriate that fundamental concepts in the Framework are the source for the SME version and that the IFRSs are the basis for modification if relevant to SMEs. However, it is important to ensure that IFRSs are applied to take account of the characteristics of SMEs. Extracting is desirable but modifications avoidable.

**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... or cost benefit analyses?**

Any modifications for SMEs to the concepts and principles in Full IFRSs must first be on the basis of identified needs of users of financial reports produced for SMEs. This should then be followed by a cost benefit test. The problem is that the costs are relatively easy to identify because in the main they are tangible but the benefits are problematic to identify and they tend to be intangible. The benefits need to be identified and valued from research into user needs. Whilst mainly the cost needs to be established through research in consultation with the preparers who are of course mainly practising accountants.

**Question 7b. Do you agree that it is likely that disclosure and presentation modifications... justified... could increase or decrease the current level of disclosure for SMEs? ...**

Meeting users' needs and ensuring that the benefits exceed the costs of SME financial reports should result from disclosure, presentation modification and amendments to measurement and recognition aspects from the full IFRS. If amendments are not made to measurement and recognition aspects from the full

IFRS it is likely that the overall size of and complexity of an IFRS for SMEs will only marginally be reduced vis-à-vis the full IFRS.

**Question 7c. Do you agree that, in developing standards for SMEs, the Board should presume that no modification would be made... though that presumption could overcome on the basis of user needs and a cost benefit analysis? ...**

We disagree. On the basis of user needs and the cost/benefit question it is inevitable that recognition and measurement principles will have to be modified. Therefore there should be no presumption.

**Question 8a. Do you agree that IASB Standards for SMEs should be published in a separate printed volume... in separate sections of each IFRS... or some other approach...**

We agree that the IASB Standards for SMEs should be published in a separate printed volume, but they should also be included as separate sections etc. into the corresponding full IFRS standards.

**Question 8b. Do you agree that IASB Standards for SMEs should be organised by IAS/IFRS number rather than in topical sequence? ...**

IASB Standards for SMEs should be in topical sequence with a cross reference to the relevant full IFRS. Also there should be a reference to IFRSs that the SME version has not addressed. If the SME version followed the IASB/IFRS number it would not be sequential as some of the IFRS are not relevant to SMEs. When selecting the sequence, focus should be put on easy ways to parallel use of both full IFRS and IFRS for SMEs.

**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?**

We agree.

**Question 9: Are there any other matters to how... to develop standards for SME ...**

The IFRSs for SMEs shall be built on the basis of full IFRS Standards in force, by adjusting them for SMEs. If any new rules are needed, they shall be included also into the set of full IFRS Standards.

When preparing adjustments, focus should be put on costs. The IFRS standards for SMEs shall not materially increase workload and costs.

The full IFRS includes immense quantities of notes, which may be relevant for listed entities, but not at all for SMEs. In a typical SME entity there exists only few material needs for notes.

At least cumbersome and costly supplementing studies shall be avoided. This concerns not only notes but also the whole contents of the financial statements. Examples of this kind of avoidable contents are: asset value adjustments deviating from cost values and calculatory taxes other than based on the corresponding realised results. All information shall be produced for real needs of the users of the financial statements, not only for interest. Typical SMEs don't necessarily have own resources to gather or produce cumbersome information.

Examples of IAS Standards generally not at all applicable or useful for SMEs are: IAS 14 (segmentation); IAS 22 (consortiums); IAS 26 (pension benefits); IAS 29 (hyper inflation); IAS 33 (result per share); IAS 34 (interim reports).

Examples of also for SMEs highly useful IAS Standards are: IAS 11 (long time projects); IAS 16 (material long term assets); IAS 18 (earnings); IAS 24 (closely related parties); IAS 37 (provisions, conditional assets and conditional liabilities).

In general, the use of IFRS for SMEs shall be as flexible as convenient. Excluding the group 'listed entities', all decisions of standards to be applied shall be done freely within each entity, generally on the board level and according to the principle 'no constraint no hindrance'. This means voluntarily, according to the needs of each entity.

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