



European Federation of Accountants and Auditors for SMEs

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CONSULTATION RESPONSE

ACCOUNTING STANDARDS FOR SMALL AND MEDIUM SIZED ENTITIES.

A discussion paper from IASB

Comments from EFAA

Brussels, September 2004

EFAA is the European umbrella organisation for accountancy bodies whose individual members provide services to small and medium-sized enterprises (SME's).

The aim of EFAA is to serve the interests of the SME accountants and their clients by:

- Ensuring the needs of the SME sector are effectively represented
- Influencing legislation and regulation to reflect SME concerns
- Building contacts with the European Commission and relevant institutions
- Co-operating with other European representative organisations
- Monitoring the work of EU institutions
- Participating in the technical work of EU committees

Membership of EFAA is open to those national organisations whose members are authorised to conduct statutory audits, providing an education that meets the requirements of the Eighth Directive (auditing) or a similar level of education within accounting.

General observations:

The European Federation of Accountants and Auditors for SMEs (EFAA) welcomes this opportunity to respond to the IASB discussion Paper.

EFAA's core business is aimed at servicing Small and Medium sized Entities (SMEs) and their prime advisors, the Small and Medium sized accounting Practices (SMPs).

Within EFAA a considerable amount of SME knowledge is present due to our individual members daily work with and for SME.

Our response to the IASB discussion paper is based on that knowledge, and produced in close direct co-operation with members.

EFAA also wishes to use this opportunity to offer any help that might be needed in the future development of this project.

EFAA very much appreciates the initiative taken by IASB with this project, although we appreciate that getting this project right in such a diverse constituency as the SME constituency is at global level, is a very demanding challenge. However, EFAA very much want to see IASB as *the* global accounting standard setter, including standards for SMEs.

In this context, we are concerned that IASB should get too involved in defining users of the SME standards. We find that a reasonable first step is to make the standards available, clearly indicating for whom they are meant, and then leave it up to national or regional legislators to decide on the precise use of standards within the indication of for whom these standards are made.

There is also a clear demand for an understanding of the SME environment, and it is our assessment that the SME environment is very much different from the environment for which IASB has been setting standards for hitherto. One such difference can be seen in our response to question 2. *"....in the SME environment, stakeholders do not need to fully understand the tools(the standards), but the standards must be build in a way which allows the stakeholders to understand the outcome(the accounts)"*

Developing standards for SMEs is, as mentioned above, a challenge. It should be brought in mind that it is not only a question of "simpler" standards, although we in this context see a need for changes from full IFRS not only in disclosure, but also, if relevant, in the recognition and measurement areas. It is additionally a question of getting it right in order for SMEs and SMPs to benefit from such standards.

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

No, we disagree.

We do appreciate that the full version of IFRSs *could in theory* be considered suitable for all entities, but since full IFRS is primarily designed for users in the capital markets, it is evident that most of the standards contains requirements that are irrelevant to SMEs, and even some standards are themselves irrelevant to SMEs. Evidence suggests that users of SME financial reports are very different¹.

However, we do agree that ideally one set of standards would be the right solution.

This, however calls for a restructuring of existing standards:

The often mentioned “think small first” approach is often mistaken for an argument for giving priority to SME matters.

Our conception is different: “Think small first” means in our conception that i.e. when standards are produced, outset should be taken from basic requirements applying to all entities (starting from bottom). On the top of that, additional requirements could be added in a “building block” structure, based on the need for more sophisticated and complex requirements, i.e. for larger and/or listed entities.

Such a system has recently been introduced in an EU member country with a considerable success.

It ought to be considered if this is not the right point in time to change the structure of accounting standards accordingly.

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

Yes, we agree that the Board – if not taking onboard the “building block” philosophy mentioned just above - should develop a separate set of financial reporting standards suitable for SMEs.

We have also noted that the majority of the questions to follow would not apply if a bottom up approach was applied.

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.

We find that IASB Standards for SMEs should not be used by public interest entities² because they would not be relevant and could not fully meet the needs of most stakeholders in such entities. See also the comments to question 3c.

¹ Jarvis, R. 1996, Users and Uses of Unlisted Companies' Financial Statements: A literature Review, ICAEW.

² As defined in the EU recommendation on Auditor Independence. (16/5 2002, 2002/590/EC)

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:

On *high quality*, we agree, provided it is measured at the level of SMEs.

On *understandable*, we appreciate the intention, and for preparers, we agree.

However, when it comes to other stakeholders, the professional knowledge within the SME environment differs substantially, and therefore what is understandable to some is not understandable to others.

What they all 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.

In short, in the SME environment, stakeholders do not need to fully understand the tools(the standards), but the standards must be build in a way which allows the stakeholders to understand the outcome(the accounts).

On *enforceable*, we do agree that ideally standards should be even easily enforceable.

However, it is unlikely that these standards will be equally easy enforceable in all jurisdictions. The cost of enforcement could in “worst case” scenarios exceed the benefits. No doubt that ideally entities would want to comply with the standards because they make the financial reports credible in the eyes of their users. It is however, much more likely that other drivers would be much more useful for implementation than enforcement. Software produced for preparing financial reports that comply with IASB’s Standards for SMEs could be an effective enforcement agent because to deviate from the software approach could be too burdensome.

- b) Focus on meeting the needs of users of SME financial statements

We agree with this objective.

- c) Be based on the same conceptual framework as IFRSs

We tend not to agree: The IFRS’s Framework is too oriented to large listed companies and needs to be amended to include references to fit SMEs and the users of their financial reports.

- d) Reduce the financial reporting burden on SMEs that want to use global standards

We agree with this objective.

- e) Allow easy transition to full IFRS’s for those SMEs that become publicly accountable or choose to switch to full IFRS

We disagree with the concept of ‘public accountability’ and it’s lack of definition. In principle we agree with the concept allowing easy transition

for SMEs to full IFRS if needed. (see reply to question 1.c and it's footnote).

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 agree that the Board should describe the characteristics of the entities for which it intends the standards.

We also agree that Board in setting standards for SMEs should use qualitative criteria in defining SMEs rather than a quantitative size test. You are of course familiar with the definition used in the IFAC IAASB Practise Statement on The Special Considerations in The(IAPS 1005). The definition there is to our mind a very useful and practical qualitative definition, which might form a useful basis for the IASB IFRS for SMEs definition.

Finally, we do not disagree that some form of quantitative measurements should be introduced. However, we think that quantitative measurement should be decided upon at national or regional level, not by IASB.

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?

In our view the IASB should try to address the needs of all SMEs. To do that sensibly it must accept that it cannot set standards to deal with every possible eventuality and that there will be a trade-off between the length/complexity of the standards on the one hand and their coverage on the other.

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 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 at global level.

We have experienced, during the work in the EU Committee on Auditing, how much ground for misinterpretation there was only in EU on this issue during the process of finalising the EU recommendation.

Naturally, from an EU point of view, we would prefer an already known definition: Public / non-public interest entity³. The reason why we suggest the EU definition is because it already exists, it is widely known and accepted and understood in an important and large constituency, and by using this definition the global constituency will be freed from working with yet another definition.

³ ³ As defined in the EU recommendation on Auditor Independence. (16/5 2002, 2002/590/EC)

Another solution, which is even more clear-cut and easy to relate to is listed/non-listed entities. Such definition would at the same time and to a large extent also make a natural cut between the investor-driven (large) entities and other entities.

We could also agree to such a definition.

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?

We disagree.

It is doubtful if owner-managers or other shareholders of SMEs would fully understand the distinction between the two standards. The evidence suggests that they are likely to rely on their external accountant for making accounting choices of this nature. Further, an independent shareholder of a very small entity could then dictate that an entity should publish their financial reports under full IFRS. Such requirement would be very costly and probably irrelevant, and should therefore – if at all – be decided by some sort of majority. We would also question the enforceability of such a provision.

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 do agree that there seems to some logic in 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 .

However, we would leave it up to the parent to decide on this.

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.

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?

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) 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?

An SME should be permitted to revert to individual principles (b) 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. Disclosure on how standards have been used should apply.

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 agree. If the IASB are to be the 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.

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?

Any modifications for SMEs to the concepts and principles in Full IFRSs must first be on the basis of identified needs of the users of financial reports produced for SMEs. This then should 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 the cost needs to be established mainly through research in consultation with the preparers who are of course in the main practicing accountants.

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?

Meeting user 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 a IFRS for SMEs will only marginally be reduced compared to the full IFRS.

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 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? If you favour including them in separate sections of each IFRS (including Interpretations) or some other approach, please explain why.

We agree that the IASB Standards for SMEs should be published in a separate printed volume.

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.

We would prefer 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 IFRS's 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 IFRSs are not relevant to 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.
