David Cairns
International Financial Reporting

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Mr Paul Pacter
Director of Standards for SMEs
International Accounting Standards Board
30 Cannon Street
London
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Dear Paul

Accounting Standards for Small and Medium-sized Entities

I support the proposal to develop simplified IFRS for small and medium-sized entities (SMEs) because compliance with current IFRS is too burdensome for such entities. As explained below the project is a response to demand from national bodies. The main issues for the IASB are, therefore, to decide whether to meet that demand and, if so, to decide how it should simplify IFRS.

I understand the other pressures on the IASB's resources but I am concerned about the slow progress on this project. There seems to confusion about the purpose and nature of the project and a lack of understanding of the market demand for the project. This confusion and lack of understanding should be resolved before the Board undertakes further work. This letter includes other suggestions for moving forward.

The IASB should also use the project advisory group in resolving the confusion about the purpose of, nature of and demand for the project. The project advisory group, of which I am a member, has met only once, in April 2003. Its near unanimous views at that meeting were not reported to the Board. In recent months, its activities have been limited to commenting on drafts of SME versions of IFRS.

The Discussion Paper fails to address several major issues. It confuses the roles of the IASB and national bodies. It does list 8 issues, 19 preliminary views and 19 questions (many of which are multiple questions) but few of these focus on the important matters.

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The Way Forward

I suggest the IASB begins from two indisputable assumptions:

- Any entity *may* issue full IFRS financial statements.

- National bodies determine which entities *must* issue full IFRS financial statements and which entities *must* or *may* issue other financial statements.

The acceptance of these assumptions leads to one question. Should the IASB provide accounting standards for those entities which are not required by national bodies to issue full IFRS financial statements?

The IASB should answer 'no' with respect to entities which are required to publish financial statements which comply with national tax rules or other national regulatory requirements (including national standards that are not based on IFRS.

The IASB could answer 'yes' with respect to entities which are required or allowed to publish financial statements which comply with simplified IFRS.

The Demand for Simplified IFRS

The demand for simplified IFRS comes from at least three sources:

- listed entities in countries which do not have the expertise to apply full IFRS;
- mid-cap and small-cap listed entities in any country; and
- small and medium-sized unlisted entities in any country.

The development of simplified IFRS by the IASB for entities in the first two sources would undermine the work of the IASB and run counter to the efforts in many countries and the European Union to require the use of IFRS in the (consolidated) financial statements of listed companies. Therefore, the IASB should not meet these demands of such entities. The IASB should, however, ensure that IFRS address the events and circumstances that arise in the financial statements of such entities (this is not the same as allowing these entities to account for the same event and circumstances differently). It should also encourage the appropriate education, proper enforcement and proper auditing.

It is in the IASB's interests to meet the demand for simplified IFRS for small and medium-sized entities.

Simplified IFRS for SMEs

The demand for simplified IFRS for SMEs has arisen primarily in countries which already use IFRS as national standards but which believe that current IFRS are too burdensome for SMEs. They favour the development and use of simplified IFRS that would meet the needs of users of the financial statements of SMEs, allows an easy transition to full IFRS for those entities that grow or seek public capital, facilitate education and training of accountants and facilitate the preparation and audit of the financial statements of SMEs.

The demand for simplified IFRS for SMEs is likely to grow as more countries require the use of IFRS by some entities. It will grow, in particular, in those countries that:

- require all (or many) business entities to publish financial statements; and
- want those financial statements to be prepared in accordance with requirements which are compatible with IFRS.

If the IASB decides not to meet the demand for simplified IFRS for SMEs, several things could happen:

- national or regional bodies could develop their own or 'regional' simplified IFRS for SMEs;
- national bodies may continue to allow or require SMEs to comply with old IAS; or
- another body (for example, the United Nations, IFAC, the European Commission or the World Bank) could develop simplified IFRS for SMEs or even a competing set of SME Standards.

It is highly desirable that the IASB meet the demand for simplified IFRS for SMEs. In reaching that decision, it may help the IASB to acknowledge that:

- the users of SME financial statements probably place less reliance on the financial statements that do the users of listed and large company financial statements (this should have been explored fully before publishing the Discussion Paper); and
- no major, developed economy (including those with IASB partner standard setters) *requires* SMEs to comply with accounting requirements that are equivalent to current IFRS.

How should the IASB define SMEs?

The IASB needs to define SMEs in order to:

- restrict the application of the simplified IFRS for SMEs; and
- influence the simplification of IFRS.

Restricting the Application of Simplified IFRS

The Discussion Paper proposes a public accountability test that is a long-winded, tortuous set of rules. The IASB should learn from IAS 14 *Segment Reporting* in which an equally tortuous and long-winded set of rules for the definition of segments is interpreted and applied in significantly different ways and has little practical effect on what segments are reported. A similar fate awaits the proposed rule in the Discussion Paper.

The Discussion Paper also confuses the responsibilities of the IASB and national bodies responsible for determining the application of accounting standards. The IASB should discuss the (likely) attitudes of such national bodies to the use of the simplified IFRS (it should have done this before publishing the Discussion Paper). It should seek an agreement with national bodies which allow the IASB to adopt a simpler rule.

As explained above, the use of simplified IFRS by listed companies would undermine the work of the IASB and run counter to the efforts being made in many countries and the European Union to adopt IFRS. Therefore, listed companies should not be permitted to use simplified IFRS for SMEs.

The use of simplified IFRS by banks, insurance entities and similar financial institutions would also probably undermine the work of the IASB. Furthermore, many national bodies have already identified these entities as among those that should comply fully with IFRS. Furthermore, those parts of IFRS that are likely to be of most relevance to banks, insurance entities and similar financial institutions would be omitted in any realistic attempt to simplify IFRS. Therefore, banks, insurance entities and similar financial institutions should not be permitted to use simplified IFRS for SMEs.

The simpler rule that the IASB should seek to agree with national bodies should be based on these two conclusions. Much of the rest of the detail in the IASB's proposed rules is a matter for national bodies.

Influencing the Simplification of IFRS

If SMEs are defined as any business entity other than listed entities, banks, insurance entities and similar financial institutions, there is no need to develop simplified versions of IAS 14, IAS 26, IAS 30, IAS 33, IAS 34 and IFRS 4. There may also be no need for significant parts of IAS 32 and IAS 39 and little need for much of IFRS 2. This is a good start but it is insufficient.

Further progress depends in part on the needs of users of SME financial statements. It also requires the IASB to consider the relationship between the size of an entity and the complexity of its transactions. The higher the size threshold, the more likely that some SMEs will undertake complex transactions and the greater the need for Standards that deal with those transactions. The lower the threshold, the less likely that SMEs will undertake complex transactions and the easier the simplification of IFRS.

While it may be impossible for the IASB to set an absolute size test, the IASB should adopt a working benchmark so that the Board and its constituency have a common understanding of the focus of the project. The best benchmark is the definition of either a small company or a medium sized company in the EU Fourth Directive. These definitions are familiar to Europeans and should not cause problems in other emerging economies. Furthermore, they are probably what all the countries that are asking for simplified IFRS for SMEs have in mind.

The Board may favour a much higher threshold and may even want to exclude from its deliberations financial reporting by SMEs that are small enough to fit within the Fourth Directive definitions. This may preclude any simplifications of IFRS because it is likely that these larger SMEs will undertake all the types of transactions, including complex transactions, envisaged by full IFRS.

Two examples can illustrate this point. The principle in IAS 36 *Impairment of Assets* that an asset should not be carried in excess of its recoverable amount should be well understood by all accountants. Nevertheless, IAS 36 is a long and difficult Standard. Applying IAS 36 is, however, straightforward for ‘benchmark’ SMEs because recoverable amount is usually fair value less costs to sell and any value in use calculations are simple. Therefore, it is easy to simplify IAS 36 for ‘benchmark’ SMEs. It would be more difficult to simplify IAS 36 for larger entities that have complex cash generating units.

The principles in IAS 39 *Financial Instruments: Recognition and Measurement* are difficult but ‘benchmark’ SMEs tend to do simple things. They usually receive cash for their receivables. They may discount or factor receivables but they do not undertake more complex transfers or sales. They usually settle their payables for cash. They use derivatives only to hedge foreign currency risks in outstanding receivables/payables or commitments to acquire plant and equipment. Therefore it is easy to simplify IAS 39 for ‘benchmark’ SMEs. It is more difficult to simplify IAS 39 for larger entities that enter into more complex transactions.

These examples also illustrate why simplified IFRS should be included in a stand-alone IFRS. Finding the simple answers in the 2300 pages of current IFRS is difficult, often almost impossible with the result that some people may be deterred from looking. A stand-alone IFRS for SMEs will make it easier for those who prepare, audit and use the financial statements of ‘benchmark’ SMEs.

What principles should govern the simplification approach?

The simplified IFRS should:

- improve financial reporting by SMEs;
- meet the needs of users of SME financial statements;
- allow easy transition to full IFRS for SMEs that grow or wish to raise capital on public markets; and
- provide an easy link to tax reporting when IFRS and tax reporting are compatible.

The simplification of IFRS should:

- retain the key principles of IFRS;
- focus on the application of IFRS to events and transactions that affect SMEs;
- choose the simpler alternatives in IFRS;
- allow the use of simplified methods to achieve compliance with IFRS principles even when those methods are not permitted by IFRS; and
- reduce disclosure and presentation requirements based on the needs of users of SME financial statements.

An entity that uses the simplified IFRS should disclose that it complies with those standards. It should *not* disclose that its financial statements comply with IFRS nor that its accounting policies are based on IFRS.

Discussion Paper Questions

Answers to the questions in the Discussion Paper are included on page 7 to 11. These answers should be read in the context of the comments in this covering letter. A single answer is given for related questions.

Yours sincerely

David Cairns

DISCUSSION PAPER QUESTIONS

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

Yes but the question misses the point. It is not a matter of whether full IFRS are 'suitable' but whether they are too 'burdensome' for some entities. See covering letter.

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. There is a market need and the IASB should meet that need. See covering letter.

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?

Broadly, yes. However, the users of SME financial statements probably place less reliance on the financial statements that do the users of listed and large company financial statements (this should have been addressed in the Discussion Paper). Indeed, the fact that all major developed economies allow SMEs to publish financial statements which do not comply with IFRS or equivalent requirements suggests that they accept, and the market accepts, that the needs of some of the users of those financial statements are more restricted (or can be met in other ways) than those envisaged in the *Framework for the Preparation and Presentation of Financial Statements*.

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?

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?

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?

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?

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?

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?

The public accountability test in questions 1c, 3a, 3b, 3c, 3d and 3e is a long-winded, tortuous set of rules. Furthermore, the proposals confuse the responsibilities of the IASB and national bodies responsible for determining the application of accounting standards. See covering letter for proposals on a more practical approach.

The proposed rule in 3e could have silly consequences. Suppose, for example, a German listed company that publishes IFRS consolidated financial statements has subsidiaries in France, the United Kingdom and the USA and requires all those subsidiaries to submit IFRS financial statements for consolidation purposes. Suppose also that subsidiaries meet the definition of an SME (apart from the 3e issue) and that the UK has adopted the IASB's SME standards but that France and the USA have not. The proposal in the Discussion Paper would *require* the UK subsidiary to publish full IFRS financial statements (even if UK law allows it to use UK GAAP) but would have no effect on the French or US subsidiaries. What is the point of the IASB's rule?

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?

No. The entity should apply the SME version of the hierarchy in paragraph 10 in IAS 8.

Question 5a. Should an SME be permitted to revert to an IFRS if the treatment in the SME version of the IFRS differs from the treatment in the IFRS, or should an SME be required to choose only either the complete set of IFRSs or the complete set of SME standards with no optional reversion to individual IFRSs? Why?

Question 5b. If an SME is permitted to revert to an IFRS, should it be:

(a) required to revert to the IFRS in its entirety (a standard-by-standard approach);
(b) permitted to revert to individual principles in the IFRS without restriction while continuing to follow the remainder of the SME version of the IFRS (a principle-by-principle approach); or
(c) required to revert to all of the principles in the IFRS that are related to the treatment in the SME version of that IFRS while continuing to follow the remainder of the SME version of the IFRS (a middle ground between a standard-by-standard and principle-by-principle approach)?

Please explain your reasoning and, if you favour (c), what criteria do you propose for defining 'related' principles?

An SME should be permitted to revert to any aspect of an IFRS which is consistent or does not conflict with the simplified IFRS for SMEs. It should not be permitted to revert to an IFRS which is inconsistent or conflicts with the simplified IFRS for SMEs.

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?

The 'extraction' of concepts, principles and guidance is an administrative matter.

What is important and what is missing from the Discussion Paper is that the simplification process should be based on a set of principles. Since the publication of the Discussion Paper, the IASB has considered drafts of several SME standards and the absence of principles has hampered the Board's discussions and delayed the process. See covering letter for more detailed proposals.

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?

Yes. See covering letter for more detailed proposals.

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?

Yes to both parts of the question (but the second part is so obvious that it is redundant). See covering letter for more detailed proposals.

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?

No. The modifications should be based on principles. See covering letter for more detailed proposals.

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.

The simplified IFRS for SMEs (whether printed or electronic and whether or not they are included in the same volume as other IFRS) should be a stand-alone document to which an entity can refer without, necessarily, having to refer to the other Standards. See covering letter for more detailed proposals.

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.

No. The simplified IFRS for SMEs should includes references to the other IFRS.

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?

The simplified IFRS for SMEs should have a single objective and glossary of key terms. There is probably no need for a summary.

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?

The Board should promise that it will never again publish a Discussion Paper (or other documents) with 8 issues, 19 preliminary views and 19 questions which do not address the key issues in the project.