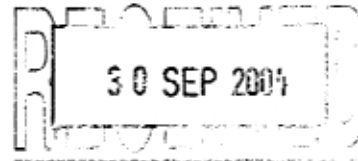


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**CL 109**

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24 September 2004



Dear Mr Pacter

**Preliminary views on accounting standards for small and medium-sized entities**

1. I am pleased to have the opportunity to comment on IASB's Discussion Paper "Preliminary views on accounting standards for small and medium-sized entities".
2. I set out below my overall comments on the Discussion Paper and then respond to the specific questions on which comments were invited.

**Overall comments**

3. I think that the IASB should develop standards that would be suitable for all entities that do not have public accountability. However, in describing the Discussion Paper "Preliminary Views on Accounting Standards for Small and Medium-sized Entities" a major perception problem has arisen because accounting standards suitable for all non-publicly accountable entities are not the same as standards suitable for SMEs. Whilst I agree that full IFRSs are suitable for SMEs, in practice almost all of these entities would prefer to use standards that are specifically designed for them. For example, compared to full IFRSs, standards suitable for SMEs would include guidance on only the most common types of transactions that SMEs have, using simplified measurement bases and having reduced disclosure requirements. Therefore they would be significantly shorter and simpler than full IFRS. The Discussion Paper gives the impression that the standards envisaged for SMEs will be suitable for all non-publicly accountable entities, which are not the same as standards for SMEs.
4. To overcome this perception problem, my suggestion is that larger non-publicly accountable entities have the same measurement and recognition rules as full IFRSs, with disclosure exemptions being incorporated into full IFRSs, e.g. an exemption for wholly-owned subsidiaries from preparing cash flow statements where its results are incorporated into consolidated financial

statements that are publicly available. Smaller non-publicly accountable entities (i.e. SMEs) would have a separate set of standards, based on full IFRSs, using mostly the same recognition rules but simplifying the measurement rules and having significantly reduced disclosures. These would be contained in a separate book. My suggestion is illustrated in the table below.

Type of entity	Publicly accountable?	Which IFRS to use?
Listed	Yes	Full IFRS
Unlisted large entity	No	Full IFRS with exemptions
Unlisted owner-managed entity	No	IASB Standards for SMEs

5. I believe that this suggestion would mean that SMEs would have accounting standards appropriate to the size and complexity of their business. Larger non-publicly accountable entities that are part of a group would have disclosure exemptions to decrease the burden of preparing individual financial statements that are usually prepared for regulatory purposes only.
6. My responses to the specific questions are predicated on the above view.

### Responses To Specific Questions

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

7. I agree. However, the emphasis should be on the phrase “should be considered suitable” and would result in a fair presentation of the accounts. I think that in practice many SMEs may not wish to use full IFRS and instead prefer IASB Standards for SMEs. My reasoning for this is that many SMEs may not:
  - have the type of complex transactions that some of the IFRSs cover i.e. much of the content of full IFRSs will be irrelevant;
  - have the expertise to prepare financial statements under full IFRSs;
  - wish to disclose the level of information required by full IFRSs because competitors may be able to gain an advantage from the information; and
  - obtain the benefits of financial statements prepared using full IFRSs as the users of SME financial statements may not understand the complexity of the full IFRSs.
8. Therefore, I think that in practice, most SMEs would prefer a separate set of standards that deal only with the types of transactions most commonly found in SMEs. This is because those standards will have the appropriate level of complexity and minimal disclosures. Obviously there will be a few SMEs that have transactions outwith the SME standards, but by having a fall back to full IFRS, these transactions would be covered. Separate standards for SMEs would also reduce the burden on preparers in that short and concise standards

would be more easily understandable and thus cheaper to prepare, whilst the benefit to users is that would be they still obtain understandable financial statements.

9. One other aspect regarding the objective of financial statements as written in the IASB Framework is that the financial statements are “useful to a wide range of users”. I think that most SMEs will not have a wide range of users e.g. a wholly-owned subsidiary could be said to have one user, its parent. A single-owner business that is managed by the owner could also be said to have one user, the owner. However, this does not alter my view that the objective of general-purpose financial statements is fundamentally the same for publicly accountable and non-publicly accountable entities. As many non-publicly accountable entities prepare financial statements for regulatory purposes only, e.g. entities that are part of a group, there isn’t the same need for the level of disclosure that full IFRSs require, because the owners can obtain the information they require.

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

10. I agree and these standards need to be issued as soon as possible. It is important for the IASB to be involved in standard-setting for this size of entity because the vast majority of entities and the majority of economic activity are carried out by non-publicly accountable entities.
11. An international set of standards suitable for SMEs would assist:
- in the convergence of financial reporting standards for SMEs in-line with the convergence of standards for publicly accountable entities;
  - those SMEs engaged in cross-border activity, by making their financial statements readily understandable for users based in different countries; and
  - countries where the development of financial reporting standards is in its infancy.
12. Although the IASC Foundation’s objectives do not currently include reference to SMEs, I hope that once the review of the Constitution is completed it includes a specific reference to SMEs, with recognition that the needs of their users are different from those of publicly accountable entities.

***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?***

13. I agree with both questions in 1(c). Regarding the second question, I would like to add that if an entity is using standards that are not applicable to it, i.e.

outwith the scope, then it seems self-evident that it could not be in compliance with IFRSs for SMEs.

***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?***

14. I agree. However, it is not clear whether the objectives set out in Preliminary View 2 are additional to the objective in the IASB framework, as tentatively agreed in Preliminary View 1.1. It is also not clear whether the stewardship of management, set out in paragraph 14 of the IASB Framework will also be included.
15. This could be made clearer by including an over-arching statement similar to the objective of financial statements as set out in the IASB Framework. Perhaps: “the objective of financial statements for SMEs is to provide financial information about an entity that is useful to users in making economic decisions. Financial statements also show the results of the stewardship management, or the accountability of management for the resources entrusted to it”. The five objectives in Preliminary View 2 could then appear below this statement.

***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?***

16. I agree. However, there needs to be further elaboration on this point because the focus of the Discussion Paper is on all non-publicly accountable entities, rather than SMEs. Therefore the proposed amendments to full IFRSs are minimal and relate mostly to disclosures. These types of amendments would seem to be more appropriate for subsidiaries, where there are one or few owners, which by virtue of their ownership can obtain the information they require. See my response to question 3b for further explanation.

***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?***

17. I agree. It is logical to start with all entities that are not publicly accountable and then develop a sub-set of that category of “small entities”. However, the IASB has referred to “SMEs” in the title of the Discussion Paper but then in paragraphs 25 and 36 explain that it focuses on all non-publicly accountable entities rather than the small end of the spectrum.
18. Preparers and users within the European Union have had a definition of small and medium-sized companies since the publication of the Fourth Directive in 1978. The Fourth Directive defines SMEs as entities that are not publicly

accountable (using similar criteria to those suggested in the Discussion Paper) and also meet certain size criteria. These criterion effectively put preparers and users' understanding of what an SME is into the Discussion Paper's "relatively smaller" or "very small" category rather than its "all entities that do not have public accountability" category. This has resulted in a major perception problem about the usefulness of the Discussion Paper's proposals.

19. The Fourth Directive currently define the size criteria as:

	<b>Small</b>	<b>Medium-sized</b>
Turnover	€7,300,000	€29,200,000
Balance sheet total (i.e. gross assets)	€3,650,000	€14,600,000
Number of employees	50	250

20. In the UK, the requirements of the Fourth Directive have been incorporated into the UK Companies Act 1985. It permits entities that meet the definition of small to have certain simplifications and exemptions from the full accounting requirements it contains. Small entities also have the option of applying a simplified accounting standard: the Financial Reporting Standard for Smaller Entities (FRSSE) and the option not to have an audit. The FRSSE simplifies some of the measurement requirements of the full UK accounting standards and significantly reduces the disclosure requirements. Therefore, in the UK (and most probably most of the European Union) the name of the Discussion Paper results in the perception that it will deal with the smaller entities in the non-publicly accountable spectrum rather than all non-publicly accountable entities.
21. I think that some of the perception problem regarding the usefulness of the Discussion Paper is partly linked to the size of an entity and whilst I think it is correct for the IASB to leave the setting of size criterion to individual jurisdictions, it needs to be clarified that standards for SMEs will address only the smaller non-publicly accountable entities. This could be done by including size criteria examples from individual jurisdictions. For example, suggesting that IASB Standards for SMEs will most probably be suitable for entities in the EU that qualify as small using the criterion in the Fourth Directive will help preparers and users in 25 countries to understand to which type of entities these standards will apply. Other examples using other jurisdictions would also help.
22. To go back to my comments in paragraph 17, I think it is logical to start with all entities that are not publicly accountable and then develop a sub-set of that category of "small entities". Therefore, my suggestion is that larger non-publicly accountable entities have the same measurement and recognition rules as full IFRSs, but have the option of reduced disclosures. Smaller non-publicly accountable entities (i.e. SMEs) should have a separate set of standards, based on full IFRSs using mostly the same recognition rules but simplifying the measurement rules and having significantly reduced disclosures. These would be contained in a separate book.
23. The suggestion for larger non-publicly accountable entities could be achieved by introducing disclosure exemptions into full IFRSs. I believe that these

exemptions are necessary to reduce the burden of preparing financial statements for subsidiaries. For example, UK GAAP contains over 13 exemptions from disclosure or preparation of information for entities within a group. Other exemptions are for non-publicly accountable entities generally. Introducing these types of exemptions would be an extension to the exemptions already contained in IFRSs regarding segment reporting, consolidated and separate financial statements, and earnings per share. It would also relieve national standard setters of the need to issue IFRSs in their jurisdiction with additional text for exemptions, as the full IFRSs will include the exemptions.

24. For the smaller non-publicly accountable entities (SMEs) my suggestion could be achieved by writing a separate set of standards for SMEs, as suggested in the Discussion Paper and based on full IFRSs. However, the standards would need to be radically reduced in complexity and content, using mostly the same recognition rules but simplifying the measurement rules and having significantly reduced disclosures. These would be contained in a separate book. As stated in paragraph 21, I agree that the size criteria should be left to individual jurisdictions but if the SME standard gave guidelines or examples of the size of entity it envisaged using the standards, preparers and users would have a much clearer idea of what types of entity could use the SME standard. An SME entity would still have the option to use full IFRSs, or full IFRSs with exemptions, if desired.
25. This suggestion can be illustrated, as follows.

Type of entity	Publicly accountable?	Which IFRS to use?
Listed	Yes	Full IFRS
Unlisted large entity	No	Full IFRS with exemptions
Unlisted owner-managed entity	No	IASB Standards for SMEs

26. Whilst I realise that some UK commentators do not see the need for three tiers of accounting standards, this is effectively what we have in the UK at the moment. Publicly accountable entities are required to use full UK accounting standards. Within these standards there are exemptions for eligible entities, which are effectively non-publicly accountable entities. These are usually for entities within a group, e.g. a cash flow statement is not required to be prepared for subsidiaries where "90% or more of the voting rights are controlled within the group, provided that consolidated financial statements in which those subsidiary undertakings are included are publicly available". The third tier is for small entities that meet the UK equivalent criteria of the EU's Fourth Directive where they have the option to use the FRSSE.

**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?**

27. I agree. I think that it is possible to have a workable definition of public accountability. However, additional guidance needs to be given on how the presumptive indicators of public accountability could be overridden where appropriate, otherwise they are not presumptions.

***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?***

28. I disagree. For example, this means that a shareholder with say one share of a total issued shares of 1,000 could demand that the entity use full IFRSs. This may be an unlikely scenario but I do not think that a shareholder with such a small-shareholding should be able to have that degree of power. However, if Preliminary View 3.4 were amended so that an entity could use of IASB Standards for SMEs unless shareholder/s with 10% or more of the shareholding dissented then I would agree that this was a reasonable view. This would be in-line with the requirement under the UK Companies Act whereby a shareholder with 10% or more of the shareholding has the right to require the entity in which they have a holding to have an audit.
29. I also disagree with the reasoning of Preliminary View 3.4. The required assent of all owners is not about public accountability but about minority shareholders getting a fair deal. An entity does not become publicly accountable because one owner objects to the entity preparing SME financial statements. It is a protection mechanism for minority owners.
30. Because the dissension of a shareholder is a protection mechanism for minority owners, I think that it should not be a requirement in the IASB Standard for SMEs. Rather, it should be a suggestion for individual jurisdictions to impose as they see fit.

***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?***

31. I disagree. However, the question can be interpreted in different ways, does "prepares financial information in accordance with full IFRSs" mean full IFRS financial statements are sent to the parent? Or does it mean that the information necessary to prepare the financial statements in accordance with full IFRSs has been provided? Either way, I would have thought that most subsidiaries prepare financial information for their parent in a format that is suitable for easy input into the consolidation process and think that this will be a different format from the subsidiary presenting a set of financial statements prepared under full IFRS.
32. However the question is interpreted, I think it is unlikely that groups will want to go to the effort of preparing their subsidiary financial statements with more



disclosures than absolutely necessary. Many groups will see the introduction of standards for non-publicly accountable entities as an ideal way to reduce the burden of preparing financial statements. Especially where the main use of these statements is to comply with statutory requirements rather than to inform users. A parent, by virtue of controlling the subsidiary should be able to obtain the information it requires without having to rely on the disclosures contained in full IFRSs.

33. The situation is slightly different for joint ventures or associates, simply by virtue of the nature of their relationship with their investors or venturers. However, I believe that public accountability should be judged in relation to the entity itself using the principle and presumptive indicators of public accountability as set out in the Discussion Paper. It should not be affected solely by the status of an entity or entities investing in it. Associates and joint ventures may not have much say in who their respective owners are and it is unfair to impose the requirements of full IFRS simply due to a change in ownership or change in status of an existing owner.

***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?***

34. I agree. However the wording of the question and the Preliminary View are unclear as to what “look to” means. Does this mean the requirements of the full IFRS must be complied with, or does it mean that the full IFRS are for guidance only? The examples 4A and 4B do not help clarify this point because 4A states “...look to the full version of IAS 19 for guidance” whilst 4B states “...required to comply with the hedge accounting requirements of IAS 39”. I assume that “look to” means comply with the requirements of the IFRS and my agreement is based upon this view.
35. I prefer the approach outlined in paragraph 41(a) whereby the entity would be required to use the appropriate IFRS to resolve that particular issue only, while continuing to use IASB Standards for SMEs for the remainder of its financial statements. Whilst I do not envisage this situation arising frequently, it is the simplest and least open to abuse of the two options outlined.

***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?***

36. I support the entity having the choice to use the complete set of full IFRS or the complete set of IASB Standards for SMEs. An entity using IASB Standards for SMEs should not be permitted to revert to individual full IFRS unless the presentation used in the SME standards either destroys the overall fair presentation of the financial statements or because that particular item is not covered in the SME standards. Being allowed the option to pick and mix



two different sets of standards would not help users understand the financial statements. It would also minimise entities “cherry-picking” specific IFRSs to achieve a desired result.

**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?*

- 37. Notwithstanding my response to question 5(a), if an entity is permitted to revert to full IFRS on an optional basis, I support approach (b) whereby an SME reverts to the relevant section of a standard. This would mean that the majority of the benefits of using SME standards are still retained for preparers.
- 38. Where an entity reverts to a section of a IFRS because the IASB Standard for SMEs does not cover that issue, I also support approach (b) whereby an SME is required to revert to the relevant standard on a principle-by-principle basis, for the same reasons given in paragraph 37.

**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?**

- 39. I agree.

**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?**

- 40. I agree. However, paragraph 76 of the Discussion Paper states that the Board’s Preliminary View is “that users of financial statements that bear the title of ‘International Financial Reporting Standards for SMEs’ need and expect a level of financial reporting that is based on full IFRSs and includes

only a relatively limited number of modifications to full IFRSs". I disagree with this view.

41. As stated in paragraph 18, the perception in the European Union where "SME" has been a understood term for a long time is that SMEs are the smallest of non-publicly accountable entities. In the UK these entities have a simplified accounting standard in the form of the "Financial Reporting Standard for Smaller Entities (FRSSE)". This is considerably shorter and simpler than full UK GAAP and has much reduced disclosure requirements. Many small entities in the UK have found the FRSSE appropriate to their needs. Therefore IASB Standards for SMEs, by focusing on the users of SME financial statements, should result in a short, concise and easily understandable set of requirements, both for preparers to use and users to read.

***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?***

42. I agree. However, I think that the overall levels of disclosure would decrease.

***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?***

43. I disagree. My response to question 3b states that I think that SMEs are at the smaller end of the spectrum of non-publicly accountable entities and this view is reinforced by the European Union's Fourth Directive having rules regarding both the public accountability and size of SMEs. If there is a presumption that the recognition and measurement principles in IFRSs require no modification for the smaller non-publicly accountable entities then there may be a tendency to overlook SME user needs. Therefore, I think there should be no automatic presumption and that there will be changes to recognition requirements and measurement rules, e.g. use of historical cost rather than fair values, and disclosures would be significantly reduced.

***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.***

44. I agree.

***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.***

45. I disagree. Because the IASB Standards for SMEs should be aimed at the smaller end of the spectrum of non-publicly accountable entities it would be more appropriate to use a topical sequence. Particularly as the current numbering sequence of IASs and IFRSs is based on the date of issue of the standard, rather than, say financial statement item order. However, it would be helpful to include a derivation table so that an overall view of the major exemptions could be obtained.

***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?***

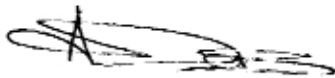
46. I agree. However, my response to question 8b was that a topical sequence should be used for the IASB Standard for SMEs. Therefore, for each topic there needs to be a statement of the objective for that topic as an objective will clarify why the specific requirements for that topic are needed. This may also help focus on exactly why the requirements are needed. My response to question 8a supports the production of a separate volume for IASB Standard for SMEs, therefore a single summary and a single glossary of key terms should be included in the volume.

***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?***

47. No.

Please contact me on the above number if you would like any further clarification of the views expressed above.

Yours sincerely



Annette Davis