

## **Technical report**

### **Draft SME accounting standard**

The IASB published its draft *IFRS for SMEs* in February. This is the culmination of nearly five years of often painful work, as members of the IASB persuaded themselves first that they were the appropriate body to undertake such a task and then to allow simplifications to be made. The exposure draft is open for comment until 1 October 2007 and so the earliest it is likely that the final standard will be in force is 2009.

The question of the IASB preparing a standard for SMEs was reviewed by the Board as early as 2002. The predecessor body, the IASC, had already done some preliminary work and constituted a working group on the subject, but its work had been abandoned.

However, the IASB was lobbied by a number of international bodies about the need for accounting guidance for SMEs. The World Bank was keen on this, as was the European Commission. The United Nations expert group on international standards of accounting and reporting had produced their own guidance but then passed the baton to the IASB to provide alternative guidance.

Some members of the IASB were doubtful that the IASB's mandate extended to SMEs, and others questioned the appropriateness of asking a body dedicated to providing accounting standards for stock exchange listed companies to look at the different environment of small company reporting.

However, the mood of the times is internationalisation, and national jurisdictions wanted a lead from the IASB, whether appropriate or not. The Trustees of the IASC Foundation amended their constitution to make explicit that the mandate did extend to SMEs and this project took shape.

#### **Size issue**

One of the biggest problems in working out a standard for SMEs is deciding exactly what kind of company is the target of the guidance. In a developing economy, a company with 250 employees may be amongst the largest indigenous businesses, and even 50 employees would put the enterprise in a prominent position.

Whereas in the European Union there are many privately owned companies that might have between 500 and 1,000 employees. Which kind of SME is the focus of the standard? The IASB debated this subject many times, and eventually fixed on a notional target of a company with 50 employees.

Whether the IFRS for SMEs is applicable in a particular country will be the decision of individual national jurisdictions, and they will also decide what size and nature of company may use them. The IASB has tried to limit the degree of national freedom on this issue by making a cut between publicly accountable entities and non-publicly accountable entities. Publicly accountable entities may not claim to follow IFRS when conforming to the SME standard, irrespective of what any particular jurisdiction allows.

The draft proposes that the SME standard should be usable only by non-publicly accountable entities. These are defined as:

- not filing financial statements with any regulator for the purpose of issuing any class of instruments for sale to the public
- not holding assets in a fiduciary capacity for a broad group of outsiders

The draft says a company has public accountability if it is accountable to external resource providers who do not have the power to demand reports tailored to their information needs. In earlier drafts, public accountability included also the notion of being economically significant within the jurisdiction in which it operates.

Views have been expressed during the evolution of the project that the draft does not focus on small enough companies. The UN guidance in fact envisaged a three tier structure of reporting to take in the smallest entities.

In Australia the standard-setter has reserved the possibility of opening up a third tier if it finds that the requirements of the IASB's SME standard are too onerous for small companies. The German standard-setter is preparing a questionnaire for SMEs on the usefulness of the proposal.

### **Measurement and disclosure**

One of the most hotly contested issues for an SME standard is the question of whether the measurement and recognition rules for larger companies may be modified in any way for SMEs. Usually there is little dispute about the possibility of derogations on disclosure. For example the EU Fourth Company Law Directive proposes a three tier approach to accounting requirements where disclosures are modified according to size, although measurement is the same.

Some people take the view that SMEs have much less complicated transactions and it is appropriate to use simplified measurement rules. However, many take the opposite view. The problems that the IASB experienced in the 1990s with companies failing to comply fully with IAS have not encouraged the IASB to be flexible in this area. The IASB staff participant in the UN's project insisted that measurement could not be modified, and the UN recommendations worked within that.

As far as the IASB project is concerned, some members tried to establish that as a principle for this project. However, over time they were persuaded to allow some simplification.

It is a matter of conjecture whether SMEs have sophisticated financial instruments, but a major breakthrough achieved for the proposed standard is a simplification of IAS 39. The four categories of financial instrument in the main standard are reduced to two, and de-recognition is based on a simple principle of continuing involvement. Hedge accounting is simplified by limiting the types of hedge that can be accounted for.

Another concession is impairment testing for goodwill. Opinion is divided as to the question of whether SMEs are typically engaged in takeover activity, but supposing that they are, the draft allows that goodwill impairment is done on an indicator basis. There is no requirement to conduct an annual impairment test.

IAS 19 on employee benefits is also modified. While, again, it is not clear whether SMEs frequently have such plans, defined benefit plans are addressed with a

principled approach rather than the detailed rules of IAS 19. The corridor approach which allows deferral of gains and losses is not available to SMEs. There is some argument that on both pensions and financial instruments the step towards simpler standards also reflects the direction the Board feels the main standard should move.

### **Selection of issues**

In providing shorter rules for SMEs, the IASB has had to make choices about what sort of transactions are typically encountered by privately held companies with 50 employees. In most cases it has simply omitted standards that address transactions that are unlikely to be encountered by the SME.

Examples of such omissions include lessor accounting (lessors are usually large financial institutions), segment reporting and insurance. At the same time, the draft standard also refers businesses to the main IFRS if their circumstances require this. Examples are interim reporting and extractive industries.

Nonetheless the standard is intended to be stand-alone for the vast majority of small businesses. It includes a section on the selection of accounting policies, and specifies that the order in which the SME should look for guidance if the transaction is not included is

- by analogy to other transactions in the SME standard
- by reference to the Framework principles included in the SME standard
- only if that fails should the SME look to full IFRS
- the pronouncements of other standard-setters with a similar framework.

This hierarchy was hard won in debate in the IASB. Some members would have had SMEs revert immediately to full IFRS if their transaction was not covered by the SME version. The proposed hierarchy allows the entity to use the Framework first, and thereby allows that the entity could find an accounting solution that complied with the Framework but was not in conformity with a solution that existed in the full IFRS.

The 2006 bound volume of IFRS runs to 2,400 pages, while the draft SME standard is a mere 255 pages. This has been achieved in part by omitting transactions that are unlikely to be encountered.

The choice of which transactions to include has been influenced by responses to the IASB's 2004 discussion paper. However, a key question on the exposure draft is the extent to which the transactions selected are a good match with SME needs. The UN guidance, for example, did not address pensions, group accounts or sophisticated financial instruments, all of which are included in the IASB draft.

### **Organisation of the standard**

Although the SME standard was originally conceived as being organised to reflect the main standards from which it was drawn, this has changed so that now it is drawn up by topic, with relevant material drawn from different standards, and a derivation table included as an appendix to link back to the original standards. In addition an attempt has been made not just to reproduce the language of the original but to provide a plain English version.

To emphasise the intended self-contained nature of the project, the proposed standard starts with a conceptual framework. When entities are seeking an accounting policy, they can therefore refer to the framework supplied within the main document.

However, implementation guidance is supplied in a separate book which runs to a further 81 pages. This includes illustrative financial statements and a disclosure checklist. There is also an analysis of disclosure split by reference to each of the 38 sections in the main standard.

Introducing the standard, IASB chairman Sir David Tweedie said: 'Our goal has been to produce a standard for use by smaller and unlisted companies that offers the comparability of full IFRS while reducing the burden on the preparing company. When completed the SME standard will make the accounting requirements more accessible to smaller preparers in both developed and emerging markets. With this publication, we are now actively seeking the views of companies, banks, the audit profession, and other interested parties as part of a broad consultation to see if we've taken out too much or not enough or if we've got it about right.'

The project has been led since early on in its development by Dr Paul Pacter, who has been seconded from Deloitte in Hong Kong. Dr Pacter has in the past served on the staff of the FASB and the IASC. He was the principal staff member involved in the drafting of IAS 39. He has achieved a great deal in addressing early hostility from some IASB members to any simplifications and producing a cohesive, rational document.

Peter Walton  
1 March 2007