

## **SME/SMP Strategy**

**Russell Guthrie, Director, Quality Assurance and  
Member Body Relations**

**Institute of Chartered Accountants of the Caribbean, St.**

**Kitts, June 30, 2007**

Good morning ladies and gentlemen, distinguished guests.

Before I begin may I offer my sincere thanks to the Institute of Chartered Accountants of the Caribbean for inviting me to present at your annual conference.

My main topic today will be Accounting Standards for SMEs. However as I there are a number of IFAC members and potential members here today, I will spend a little time at the end of my remarks to talk about the IFAC Member Body Compliance Program. This important program is moving into a new phase and I believe it is important for all you to understand the implications for each professional body.

In this presentation I will articulate the main issues as the IFAC SMP Committee sees them and outline its approach to dealing with them.

For the **first half** of my presentation I will outline what role IFAC and the SMP Committee are taking in the development of the IFRS for SMEs. I'll also present some of the SMP Committee's *preliminary* views on the ED. In the **second half** of my presentation I'll summarize the broader strategy and work program of the SMP Committee. At various points I'll suggest ways your organization can get involved.

On February 15 the IASB published for public comment the 254 page **Exposure Draft (ED)** of its *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs). At the same time the IASB also issued its Basis for Conclusions as well as Draft Implementation Guidance, comprising Illustrative Financial Statements and

Disclosure Checklist. The deadline for comments is October 1, 2007.

The stated **objective** of this project is to develop an IFRS to meet the needs of – and intended for use only by – SMEs.

### **But how has the IASB defined an SME?**

SMEs are **defined** as entities that (1) do *not* have public accountability and (2) publish general purpose financial statements for external users. Examples of such external users include owners who are not involved in managing the business, existing and potential creditors (such as lenders and vendors), customers, and credit rating agencies.

An entity has **public accountability** (and therefore should use full IFRSs) if:

- it has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; or

- it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment bank.

While the IASB has not specified a quantified size test, jurisdictions adopting the IFRS for SMEs may add one.

### **Why has the IASB developed a financial reporting standard for SMEs?**

The IASB gives a number of reasons:

First to provide a simplified, self-contained set of standards that are appropriate for smaller, non-listed companies while still based on full IFRSs, with modifications based on user needs and cost-benefit considerations. Second to remove choices for accounting treatment, eliminate topics that are not generally relevant to SMEs, and simplify recognition and measurement, thereby allowing it to shrink the volume of the standard by over 85% compared to full IFRSs. Third to

enable investors, lenders, and others to compare SMEs' financial performance, financial condition, and cash flows while, at the same time, reducing the burden of preparing SME financial statements. Fourth to provide emerging economies with an internationally recognized basis for financial reporting, helping to significantly raise standards in many countries whilst offering a clear upgrade path to full IFRS compliance. Fifth to ensure that the IFRS for SMEs results in general purpose financial statements on which an auditor can give an opinion as to fair presentation (or true and fair view) of financial position, performance, and cash flows. Sixth to redraft and simplify the language using plain English where possible so as to help SMEs prepare their financial reports. And finally, to develop a standard that will be suitable for, and easily applied by, even the smallest of SMEs – the so-called micro-entities with just a few employees.

A rigorous **due process** has been followed during the 3 years developing the ED. Starting in September 2003 the IASB surveyed world accounting standard-setters on the key issues. Then in June 2004 it published a Discussion Paper, *Preliminary Views on Accounting Standards for SMEs*. The responses formed the basis for the *Staff Questionnaire on Possible Recognition and Measurement Modifications for SMEs* issued in April 2005. Over 100, including IFAC, responded to each of these documents. In October 2005 respondents, including IFAC, had the opportunity to present to the IASB their views, in public round-table meetings, on possible recognition and measurement simplifications.

The project has also been discussed at over 30 public Board meetings and 6 Standards Advisory Council meetings.

Intent on getting input from various stakeholders a **Working Group** was formed. The Working Group comprises over 30 representatives of users and preparers drawn from all over

the world. The members provide views and comments on specific issues that are presented to them. The Working Group has met 3 times and provided written comments on an internal draft of the ED. The Working Group will meet again to consider comments on the ED and make recommendations to the IASB.

The ED was developed by extracting the **fundamental concepts** from the IASB *Framework for the Preparation and Presentation of Financial Statements* and the principles and related mandatory guidance from IFRSs with appropriate modifications in the light of needs of users of SME financial statements and cost-benefit considerations. While drafting the standard staff had in mind a typical SME with about 50 employees. In the interests of making the document stand-alone, there is no mandatory fallback to full IFRSs for topics not addressed in the standard.

**What are the modifications from full IFRS?**

The modifications are of 3 broad types:

**First**, IFRS topics not relevant to a typical SME are **omitted**, with cross-references to the IFRS if needed. These include:

- General price-level adjusted reporting in a hyperinflationary environment;
- Equity-settled share-based payment (the computational details are in IFRS 2 *Share-based Payment*);
- Determining fair value of agricultural assets (look to IAS 41 *Agriculture*, but the ED also proposes to reduce the use of fair value through profit or loss for agricultural SMEs);
- Extractive industries (look to IFRS 6 *Exploration for and Evaluation of Mineral Resources*);
- Interim reporting (look to IAS 34 *Interim Financial Reporting*);

- Lessor accounting finance leases (finance lessors are likely to be financial institutions who would be ineligible to use the IFRS for SMEs anyway);
- Recoverable amount of goodwill (SMEs would test goodwill for impairment much less frequently than under IAS 38 *Intangible Assets*, but if an SME is required to perform such a test it would look to the calculation guidance in IAS 38); and
- Earnings per share and segment reporting, which are not required for SMEs, and Insurance contracts (insurers would not be eligible to use the IFRS for SMEs).

**Second**, where full IFRSs provide an accounting policy choice, only the **simpler option** is in the IFRS for SMEs. An SME is permitted to use the other option by cross-reference to the relevant IFRS. These include:

- Cost-depreciation model for investment property (fair value through profit or loss is permitted by reference to IAS 40 *Investment Property*).
- Cost-amortization-impairment model for property, plant and equipment and intangibles (the revaluation model is allowed by references to IAS 16 *Property, Plant and Equipment* and IAS 38).
- Expense borrowing costs (capitalization allowed by reference to IAS 23 *Borrowing Costs*).
- Indirect method for reporting operating cash flows (the direct method is allowed by reference to IAS 7 *Cash Flow Statement*).
- One method for all grants (or an SME can use any of the alternatives in IAS 20 *Government Grants and Disclosure of Government Assistance*).

In adopting the IFRS for SMEs, an individual jurisdiction could decide not to allow the option that is cross-referenced to full IFRS.

**Third, recognition and measurement simplifications,**

including:

- Financial instruments:
  - There are 2 categories of financial assets rather than 4. This means there is no need to deal with all of the intent-driven held to maturity rules or related 'tainting', no need for an available for sale option, and many other simplifications.
  - There is a clear and simple principle for de-recognition - if the transferor has any significant continuing involvement, do not derecognize. The complex 'pass-through testing' and 'control retention testing' of IAS 39 *Financial Instruments: Recognition and Measurement* are avoided.

- Much simplified hedge accounting.
- Goodwill impairment - an indicator approach rather than mandatory annual impairment calculations.
- Expense all research and development cost (IAS 38 would require capitalization after commercial viability has been assessed).
- The cost method for associates and joint ventures (rather than the equity method or proportionate consolidation).
- Less fair value for agriculture - only used where 'readily determinable without undue cost or effort'.
- Defined benefit plans - a principle approach is used rather than the detailed calculation and deferral rules of IAS 19 *Employee Benefits*. The complex 'corridor approach' is omitted.
- Share-based payment – only the intrinsic value method.

- Finance leases - simplified measurement of lessee's rights and obligations.
- First-time adoption - less prior period data would have to be restated than under IFRS 1 *First-time Adoption of IFRSs*.

In order to ease the burden on preparers the IFRS for SMEs will be **updated**, if required, approximately once every two years via an 'omnibus' exposure draft. And it is **organized** topically, rather than in IAS/IFRS statement number sequence. It has 38 sections and a glossary.

**What then are the next steps?** The exposure period ends on October 1, 2007. The IASB plans to issue a final IFRS for SMEs in the second half of 2008. During the exposure period the IASB is conducting round-table meetings with SMEs and small firms of auditors to discuss the proposals. The IASB is also field-testing the proposed new standard. Barely 10 days ago it launched a field test kit which it hopes

will be widely used by IFAC member bodies, national standard setters and other interested parties to test the proposals on real life SMEs. The deadline for submission of findings to the IASB is October 31 of this year.

### **So what role is IFAC playing in the IASB's SME project?**

At its February meeting the IFAC Board indicated its strong support for this project and vowed to assist the IASB in various ways so as to secure an optimal outcome.

**First**, IFAC will respond to the ED. The response will take a global public interest perspective. The IFAC Board has asked the SMP Committee to lead the drafting. As it does it is consulting with relevant stakeholders including other IFAC committees and regional accountancy organizations.

**Second**, IFAC, chiefly through its SMP Committee, is encouraging participation in the debate and consultation by its member bodies and regional accountancy organizations. For example, it will help the IASB conduct its field tests. We

helped review the draft kit and, now that it is launched, we are promoting its widespread use. We are also encouraging stakeholders to respond to the ED and participate in IASB orchestrated roundtables. **Organizations represented here today should seriously consider participating.**

**Finally**, IFAC recognizes that often the users and preparers of SME financial statements do not get involved in the international standard-setting process for accounting, assurance and ethics. Hence IFAC, through its various communications vehicles and outreach efforts, is actively encouraging such groups to participate. **SMEs and SMPs present today should consider commenting on proposed standards like this one of the IASB.**

**Now let me focus on the SMP Committee's work in this area.** We have been closely following the project ever since it started back in 2003. We helped draft the IFAC responses to the aforementioned Discussion Paper and Staff

Questionnaire. And SMP Committee Staff had the opportunity to participate in the IASB public round-table meetings. In addition, two of our members sit on the IASB SME Working Group that offers guidance to the IASB.

We are looking for a globally applicable SME standard, consistently implemented. The guidance must ease the compliance burden on SMEs and ensure that the benefits from using SME financial reports exceed the costs of preparing, disseminating and using them. The release of the ED marks a significant milestone for the global accountancy profession. The project has come a long way in a short time.

On the basis of our *preliminary* review we have identified various issues that we feel need addressing when our member bodies and others respond to the ED. These include:

- **Scope** – we would prefer an unambiguous definition of those entities that should follow the standard. Principle-

based guidance on what size of entity it is suited may help. Some suggest small listed entities should be permitted to use the standard.

- **Users and user needs** – we suspect the IASB does not fully understand who are the primary users of SME financial statements let alone what their information needs are.
- **Cost-benefit** – we feel this deserves more emphasis within the ED so as to ensure a favorable cost-benefit outcome from using the standard. That is, the benefits from using the resulting financial statements prepared exceed the costs of preparing, disseminating, and using them.
- **Micro-entities** – we suspect the standard is geared more towards larger SMEs, despite the IASB stating that it was drafted with a typical 50 employee entity in mind. As a result the standard may be too complex for the smallest

entities. This has inspired us to undertake a research project that I will explain in a few moments.

- **Stand-alone** – the ED contains a number of cross references to the full IFRS, some for options and others for topics not addressed. This may detract from the object of the standard being self-contained. We would welcome elimination of these cross-references. Topics not addressed by the standard need not be referred to at all while options could be removed by only providing the simplest treatment.
- **Measurement basis** – there is much use of fair values. We would prefer the use of fair values restricted to a few cases and historic cost take precedence.
- **Recognition and measurement simplifications** – we see a case for further simplification in a number of areas including the impairment of non-financial assets, leases, share-based payment, deferred taxes, financial

instruments, discontinued operations and assets held for resale, and business combinations.

Aside from helping the IASB conduct field tests, the IFAC SMP Committee is also contributing to the research effort by way of its own project into micro-entity financial reporting research project. This project seeks to test the suitability of the ED to particularly small entities, so-called micro-entities.

**Micro-entities**, often defined as entities with less than 10 employees, are by far the most populous type of business entity. In many, if not most, countries in this region and others they account for a majority of GDP, employment, economic growth, and innovation. **Phase 1** of the project has culminated in the issue of an Information Paper in December 2006 entitled “Micro-Entity Financial Reporting: Perspectives of Preparers and Users”. It summarizes the research evidence on the needs of users and preparers of the financial reports of micro-entities. It is intended to inform the

debate and stimulate discussion. It highlights the disproportionate burden of new regulation on the smallest entities. It also reveals the lack of research specifically on micro-entity financial reporting. This has prompted us to embark on a second phase of research.

**Phase 2** will specifically investigate, by way of focus group interviews and surveys, whether the ED will satisfy the needs of users of micro-entity financial reports and whether it can be easily applied by preparers. We have already completed interviews in the UK, Kenya, Poland and Uruguay and work is nearly complete in Italy, Malaysia and India. These seven countries should give us a representative global sample. The research findings will be used in developing IFAC's response to the proposed IFRS for SMEs and will be summarized in an information paper to be released in late 2007.

We hope this research will help IFAC and the IASB better understand what micro-entities and their stakeholders are looking for from the IFRS for SMEs *and* identify what, if any, changes may be necessary if the standard is to be suitable for them.

**Now let me summarize the broader strategy and work program of the SMP Committee. I'll start by explaining what we consider the main issues for SME and SMP.**

We have identified 3 main issues facing SME/SMP.

**Firstly** there is the issue of the relevance of international standards of assurance, accounting and ethics to SME/SMP. Some believe these standards are written primarily for larger entities. The result may be over-regulation of SME/SMP. For example, in the sphere of **assurance** we have witnessed new auditing standards on risk, fraud, quality control and documentation. Some early evidence from those countries that have already adopted these standards suggests they

have improved audit quality. Unfortunately at the same time they have disproportionately increased the cost of conducting SME audits. This may undermine the viability of SME audits. This may be detrimental to the public interest.

**Secondly** there is the issue of the capacity of SMP/SME to efficiently implement and comply with these standards. Small practitioners and accountants working in SMEs lack specialist in-house resources and suffer from professional isolation. Often member bodies lack the funds to help.

**Thirdly** SMPs face acute problems – increasing competitive pressures, diminishing amount of staple regulatory work, and operational problems such as staff recruitment, succession planning, and effective networking.

**We have developed a strategy, and a supporting work plan, to tackle these issues.**

It is important to note that our plan is the result of extensive consultation with all relevant stakeholders. A key component

is our annual global IFAC SMP Forum and conference presentations like this. Such outreach activities help to: identify pertinent issues; inform the development of our plan; and provide a means of reporting back to our constituents on progress made. The last forum was held in Hong Kong in July 2006 where we hosted 135 representatives from 35 countries. The 2007 one will be held in Malta on October 30 – I hope that many of you will attend. Feedback received from this outreach activity is reflected in the *SMP Committee Strategic and Operational Plan for the years 2007-2010* which we are close to finalizing.

Our strategy takes a two-pronged approach to helping SME/SMP converge and comply with international standards of auditing, accounting and ethics *and* ensuring SMPs remain profitable and sustainable.

**First**, we are helping to shape the form and content of those standards, largely through direct input to the standard-setting process, so as to enhance their relevance to SME/SMP.

**Second**, we are providing practical support to SMPs, mainly through the provision of explanatory guides and web-based information resources, so as to raise their capacity to efficiently implement international standards *and* to be competitive, client-focused and profitable.

**Let me now illustrate how we are seeking to improve the relevance and cost effectiveness of international standards for SME/SMP.** This is being done by way of directly inputting to the standard-setting process from an SME/SMP perspective. We see the goal of international standard setters should be to develop succinct, relevant and understandable guidance. This guidance should ensure a favorable cost-benefit outcome for SMEs and SMPs. This essentially means that the costs of preparing, disseminating

and using financial statements should be proportionate to the benefits accruing to the users of those financial statements.

I've already mentioned how we are inputting to the IASB so let me focus on input to the IAASB and IESBA.

**First, input to the IAASB.** This is perhaps the most important element of our work program. We have articulated some broad policy positions to underpin this input. We believe an audit is an audit. We believe in having a single set of high quality auditing standards, consistently applied. We believe that these standards should permit the auditor a reasonable degree of flexibility to exercise their professional judgment in deciding how best to achieve the audit objective. Given that the vast majority of audits are *SME* audits, it is vital these standards are *equally* applicable across all audits - small, medium, and large. The challenge for those drafting is to think simple and straightforward. We believe this will

avoid disproportionate burdens on, and so safeguard the viability of, SME audits.

Our input to IAASB standard setting is made at all key stages of the development of a standard - from project proposal through to ED. We are constructively critical. We seek to support the IAASB's objective of setting standards for universal application in the public interest. Our input is largely in the form of comment letters but it also extends to SMPs serving on IAASB project task forces and the IAASB itself as well as high level lobbying through representation at the CAG. This input is effective *but* there is always more that can and needs to be done.

One project of considerable interest to us, and one we have been closely following, is the **Clarity** project. Some feel this will mark one of the most important changes to auditing standards for many years. It will improve the understandability of ISAs. It will make them easier to

translate. And it will clarify what the auditor is required to do and what is simply guidance. We do, however, share some concerns over the increase in the number of requirements. **It is crucial that organizations represented here today take a close look at the EDs of the redrafted ISAs and consider their impact on the SME audit.**

The SMP Committee is also inputting to the IAASB Strategic Review. In its response to a survey questionnaire the committee called for, amongst other things: a moratorium on changes to the body of standards; an increased focus on implementation assistance; and a cost-benefit analysis of all proposed future changes to the standards. An ED of the proposed IAASB Strategic and Operational Plan can be expected this October. **Organizations represented here today should consider responding to this ED and so help shape the IAASB's future agenda.**

We also note a global trend towards exempting SMEs from the audit requirement. We are concerned about the reliability of un-audited accounts. As a result we are assisting the IAASB investigate the whole issue of **alternative assurance services**. A likely outcome is the overhaul of its review standard.

**Our input is a considerable task – we track virtually every IAASB project. In 2006 the SMP Committee reviewed over 3000 pages of IAASB material and submitted over 30 comment letters. And we encourage organizations present today to respond when the proposed standards are eventually issued for public comment.**

Secondly, the SMP Committee is also keenly interested in the proposed changes to the Independence section of the *Code of Ethics*. We are inputting to its revision. We commented formally on the ED released in December last

year. While we expressed satisfaction with some of the proposals - for example, improved clarification – we also expressed serious reservations about some proposals. We noted that SMPs and their clients would be disproportionately adversely affected, especially by mandatory partner rotation for the audit of entities of significant public interest (ESPI) and by new restrictions on the provision of tax services. We are *not* convinced these proposals meet the public interest test and question whether they are justifiable on cost-benefit grounds. We are encouraged to find that IESBA is closely considering our comments.

Just as with the IAASB the SMP Committee is also inputting to the IESBA Strategic Review. And just like its response to the IAASB survey questionnaire the committee's comments on the IESBA one called for, amongst other things: a moratorium on changes to the Code; an increased focus on

implementation assistance: and a cost-benefit analysis of all proposed future changes to the Code. An ED of the proposed IESBA Strategic and Operational Plan can be expected later this year. **Again I encourage you to get involved by responding to this ED and so help shape the agenda.**

**Thus far I have focused on our efforts to improve the relevance of international standards for SMP/SME. Now finally let me turn to those initiatives aimed at increasing the capacity of SMPs to efficiently comply with international standards as well as improve their competitiveness.**

These initiatives fall into two categories - the development of explanatory guides and web-based information resources.

**First explanatory guides.** In response to the high demand for guidance on how to use ISAs on SME audits we have commissioned the development of the ISA Guide. The guide

is primarily intended to help practitioners around the world understand, comply with, and apply ISAs in SME audits. It is a non-authoritative implementation guide, *not* a standard.

IFAC will assume full copyright in the ISA Guide and an electronic version will be distributed to all IFAC member bodies *free* of charge. Member bodies like yours will be able to use the content of the ISA Guide for their own local adaptations and as a basis for developing products derived from the guide, so called derivative products such as audit software, checklists, forms, and training materials.

A global advisory panel is currently reviewing a 250 page second draft of the guide. It includes an integrated case study throughout. We plan to issue it later this year. Updates will follow in 2009 and 2010.

The ISA Guide will *not* be the complete “black box” solution. But it will help auditors perform high quality, efficient and cost effective SME audits. In addition, IFAC is looking at

ways of facilitating and encouraging the market to develop and widely disseminate derivatives at affordable prices.

In the long run the SMP Committee has visions of developing a suite of explanatory guides offered freely to all IFAC member bodies. Of course realization of this vision will depend upon the availability of resources and support from constituents such as you.

On the immediate horizon is a **Quality Control Guide**. In October last year we issued a request for proposal for commissioning the development of a QC Guide. We are now analyzing the 9 proposals to determine the best solution. The QC Guide will assist SMPs in the consistent implementation of the firm level quality control standard, International Standard on Quality Control 1, thereby enhancing the quality of their assurance services to SMEs. Subject to finding a suitable solution we hope to publish the guide in mid-2008.

On the more distant horizon is a Practice Management Guide. This would seek to improve the operational efficiency of SMPs as well as make them more responsive to the needs of their clients. IESBA is also considering the development of an Ethics Guide to help SMPs comply with its *Code*. This guide would address implementation of the revised Section 290, perhaps with example scenarios.

**Second we are assisting SMPs and accountants working in SMEs via web-based information resources.**

IFAC has launched a new International Center for Small and Medium Practices on its website to provide SMPs with access to news, information and resources relevant to them. The website also includes information about the work program of the SMP Committee. In addition, IFAC is seeking input to determine the level of interest in an online [Community](#) to facilitate the exchange of knowledge and best practices among SMPs through its website. The International

Center for SMPs can be accessed at <http://www.ifac.org/SMP>. The resources section of this new website includes links to websites of relevance on business advice, accounting and audit etc. as well as IFACnet.

Let me share a few words about IFACnet. Launched last October IFACnet is an internet search engine tailored specifically for accountants. Located at [www.ifacnet.com](http://www.ifacnet.com) it provides *free* access to a wide range of materials and guidance developed by IFAC and participating member bodies. A number of member bodies websites hosting significant practice related content are now included making it a particularly useful resource for SMPs. And later this year we can expect the search engine to be extended to cover non-member body websites such as, those of accounting firms, regional accountancy organizations, the IASB, and so on. Its future development may include an online communications centre for professional accountants working

in SMPs and SMEs. This would facilitate networking as well as focused input to standard setting. **Perhaps member bodies present would like to participate, for example by allowing its website to be included in the search engine. Presently over 25 are included. Failing that you may wish to simply include a link on your website directing your members to the facility.**

Overall our work plan entails an allocation of resource as follows: 20% on collaboration and outreach; 40% on input to standard setting; and 40% on practical support. The plan is ambitious. But the demand and expectation on us to execute it, sooner rather than later, is compelling.

**Ladies and gentlemen, thanks for listening. I look forward to answering your questions and listening to your view and suggestions on our work program.**