SME REPORTING AND IFRS

Interview with Paul Pacter

PAUL PACTER HOLDS TWO CONCURRENT POSITIONS:

- Director of Standards for Small and Medium-Sized Entities (SMEs) at the International Accounting Standards Board in London, and

- Director in the Global IFRS Office of Deloitte Touche Tohmatsu in Hong Kong.

The goal of his IASB work is to develop accounting standards that reduce the financial reporting burden on SMEs. His responsibilities at Deloitte include responding to client technical questions, writing an IAS newsletter called IASPlus, and managing the website www.iasplus.com. He worked for the IASB's predecessor in London from 1996-2000, managing projects on financial instruments, interim financial reporting, segment reporting, discontinuing operations, extractive industries, agriculture, and electronic financial reporting. He also developed IASB's web site. Previously, Paul worked for the U.S. Financial Accounting Standards Board for 16 years, and, for seven years, was Commissioner of Finance of the City of Stamford, Connecticut. Paul was Vice Chairman of the Advisory Council to the U.S. Governmental Accounting Standards Board (1984 to 1989) and a member of GASB's pensions task force and FASB's consolidation task force. He has published over 100 professional monographs and articles. He received his Ph.D. from Michigan State University and is a CPA. He has taught in several MBA programmes for working business managers.

Jonathan Dingli caught up with Paul to find out more about his involvement in IASB and on the SME reporting project currently being undertaken. The views expressed in this interview are Paul's personal views and not necessarily those of the IASB.

SME reporting working group

Can you give us a brief overview of the IASB organisational structure, how are decisions taken and standards approved and how does the SME reporting working group fit in the whole picture?

The IASB is an independent private sector body broadly funded by the accounting profession and companies around the world.

The IASB is a board of 14 members (12 full-time and 2 part-time). Its role is to deliberate accounting issues and reach decisions based primarily on the needs of users of the financial statements of business entities. Decisions are published as International Financial Reporting Standards, or IFRSs. The Board meets monthly for about a week. Staff of about 50. Annual budget of about US$20 million.

The IASB operates under a parent foundation with 22 trustees from all over the world. Trustees' role is oversight, fundraising and strategy. No involvement in standard setting.

The structure also includes a 40-member Standards Advisory Council which meets three times a year. Members are from a broad range of backgrounds and interest groups.

The IASB and its predecessor, the International Accounting Standards Committee (IASC), have been setting global accounting standards since 1973. Today those standards are used in over 90 countries around the world. IASB and IASC never said the standards were intended only for listed companies, but they have been designed to meet the reporting needs of listed and other large companies. Which means they are comprehensive and complex, and require many disclosures. Few countries require IFRSs for small or unlisted companies (small and medium-sized entities, or SMEs). Instead, SMEs generally use simpler national accounting standards. For many reasons, including cross-border lending and product sales and credit ratings, there is a strong demand for global simplified accounting standards for SMEs.

We have recently seen a change in the name of the target reporting entity from NPAE (Non Publicly Accountable Entity) to SME. Does this change of name imply a change in the Board's direction?

SME is a term that is widely understood around the world. The problem with it is that "small" and "medium sized" suggest quantified criteria (for example, all companies with revenues or assets below X dollars). However, what is small in one country can be large in another. Each jurisdiction should set its own quantified criteria for small and medium-sized. So the Board, at first, thought "Non-publicly accountable entity" or NPAE might be a more universal term. However, NPAE is not well understood. Also, it sounds negative – that the company is not accountable. And the IASB's constitution specifically refers to SMEs, not NPAEs. So the Board decided to go back to SME and to define very precisely how it is using that term (but without quantified criteria).

Can you give us a brief outline of what we should expect to find in the accounting standards for small entities? Or, if it makes it easier to answer, what IASs/IFRSs will not be covered and on which a fallback to the full standard will be necessary?

Full IFRSs are published in a single bound volume annually. This year's book is around 2,400 pages. It includes over 40 detailed standards and around two dozen interpretations. It includes a great deal of mandatory application guidance, non-mandatory implementation guidance, and background reasoning. It requires over 3,000 different disclosures in financial statements. While all of this is intended to meet the reporting needs of most large and listed companies, some of it is not relevant to the average SME. And, in some cases, the resulting information is not useful to those who use SME financial statements. And some parts that may be relevant are simply beyond the ability of most SMEs to use on a cost-benefit basis. The IASB is working on standards that are suitable for SMEs.

The IASB has appointed a working group of around 35 SME experts to advise the Board on what is relevant. They have set, as a goal, an SME standard of about 200 pages – roughly 10% of the full standards. A lot of what would be eliminated would be detailed guidance on non-SME-relevant matters. Some standards would be simplified. Those simplifications could be an easier measurement methodology – for example, amortise certain costs on a straight-line basis

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From left to right: the Executive Committee (Hilary Galea-Lauri, Simon Flynn, Raphael Aloisio, Mario Galea), Paul Pacter, Bernard Scicluna, Jonathan Dingli

instead of the conceptually purer effective interest method used by banks. Some simplifications might be that an SME would not recognise at all certain items that a large company would recognise – in which case extra disclosure might be added. For example, the IASB standard on leases requires that the lessee put on its balance sheet some assets leased under long-term leases, and the related lease obligation. Complex calculations are needed to determine which ones do go on the balance sheet, and at what amounts. Plus there is complex amortisation in each subsequent reporting period. For an SME, a possible simpler approach might be to put extra information about your lease commitments in the notes to the financial statements, rather than putting the assets and obligations on the balance sheet.

I should emphasise that the IASB Board has not yet begun to deliberate the specific standards. That will begin early in 2006.

In case of fallback, will an accountant be expected to apply the IASs/IFRSs in full? Could this in practice result in burdensome compliance?

If we are successful in getting the IASB standards down from 2,400 pages to 200 pages, or even 300 or 400, obviously there will be a lot of material eliminated – generally because it is not thought to be relevant to most SMEs. The "fallback" question arises when an SME encounters one of the transactions for which the guidance was eliminated in the SME standards. Is the SME required then to follow the full IFRS? If so, many would say that the SMEs are really being held to both the SME standards and the full standards – a more onerous requirement than even for listed companies, who only have to know the big book. On the other hand, it is hard to imagine that the SME should simply ignore the full standards in which the IASB has clearly expressed a view on the issue. At the moment, the Board is leaning toward requiring a mandatory fallback to full IFRSs for all matters that have been omitted in the SME standards. A middle ground might be to require a fallback only for specific items that would be identified in the SME standards.

There has been in the past a declared reluctance by the IASB to relax recognition and measurement criteria for small entities and that only disclosure and presentation will be addressed by the SME accounting standard. What were the factors that led to the removal of this approach?

Most SMEs and their auditors say that the real difficulties in applying full IFRSs lie in the recognition and measurement rules – more and more of which, lately, are moving away from historical cost measurements and toward measures of fair market values or discounted present values, sometimes with quantified probability assessments. This is true, for example, in such areas as financial instruments, agriculture, investment property, and some intangible assets and property, plant, and equipment. And some of the new standards require recognition of assets and liabilities that are difficult to identify and measure, such as intangibles, contingent assets and liabilities, and contractual commitments such as derivatives and firm commitments to acquire financial instruments. And some new standards require recognition and measurement of assets and liabilities that some users of SME financial statements say they do not find useful – for example, comprehensive recognition of all deferred income taxes. Remember that users of SME financial statements are primarily interested in short-term cash flows – if I sell to this company or lend to this company will they be able to pay me? For listed companies, in contrast, equity investors, bondholders, and financial analysts generally have a longer time horizon and, so, different information needs.

Will micro entities, which form a substantial part of the local entity population, be covered under these SME accounting standards?

As a private sector body, the IASB has no power to tell any company to use its standards – listed companies or SMEs. Each national jurisdiction must decide which companies must prepare financial statements and which accounting standards to follow. The IASB already has a set of standards that many jurisdictions (including all of Europe) have adopted for all listed companies and that some jurisdictions (including Malta) have extended also to SMEs.

Each jurisdiction will have to decide which companies should be required, permitted, or possibly prohibited from using the IASB's SME standards. So your question about micro entities should be addressed to the government for reply. I do believe that the IASB's standards for SMEs are likely to be suitable for micros, however. Please bear in mind, though, that these standards are aimed at general purpose financial reporting to outside resource providers – not to providing information for owner-managers to run the business or for tax authorities.

At what stage are these accounting standards at present? By when should we be seeing an exposure draft issued by the IASB?

Our goal is an exposure draft by 30 June 2006. In January 2006, the Board will be considering the first draft of a major section of the standards.

Will these be put forward to be endorsed by the European Commission, as is the case with IASs and IFRSs?

The European Commission has indicated that it strongly supports the IASB SME project. Right now, including the three EEA

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countries, they have 28 sets of SME GAAP despite a large and growing percentage of cross-border buying and selling, lending, and investing at the SME level. The EC has four representatives on the IASB SME Working Group. It is likely that the Commission will consider some sort of "endorsement" when the standards are ready.

When reviewing the Wong Report, which was commissioned by IFAC to study the challenges and successes in adopting and implementing international standards (IFRSs and ISAs), one finds that some concerns were expressed on the relevance and appropriateness of the international standards to SMEs. Namely most of these concerns related to:

- *Length and complexity of international standards;*
- *Cost of compliance with IFRSs versus benefits obtained;*
- *Perceived focus on large-entity issues; and*
- *Lack of sufficient SME representation on international standard-setting board.*

Will the accounting standard for SMEs take into consideration, and possibly resolve, some or all of these concerns?

Definitely. All four of those points are the very reasons why the IASB is taking on the SME project.

IFRS

IFRSs are sometimes criticised as being more Balance Sheet oriented rather than Profit and Loss oriented. What is your view on this?

Personally, I do not understand this comment. Profit and loss for a period is the difference between revenues and expenses. The IASB's conceptual framework defines revenues and expenses in terms of changes in assets and liabilities. So the balance sheet (assets and liabilities) and profit and loss (revenues minus expenses) go hand in hand. I think that most people who state this criticism would say that "revenues are recognised when the earning process is complete, and expenses are matched against those revenues." The problem with this view is that completion of the earning process is very subjective, often resulting in deferring things on the balance sheet that do not meet the definition of asset or liability.

For example, a new customer of a broadband service provider must pay a non-refundable up-front set-up charge and then a monthly fee. When is the "earning process" complete for the up-front set-up charge? When the service is first installed? At the end of the initial contractual period (say one or two years)? Later? If the fee is non-refundable, does the broadband company have a liability once connection is completed?

As another example, consider a company that owns many retail stores. It chooses to self-insure for fire losses rather than purchase insurance. They say that "we price this into our product sales price, and even if there is no fire this year, in measuring profits we want to deduct some expense for future fires that eventually will occur". That is, we want to spread the fire loss a little bit each year, rather than hit earnings when the event happens. The problem is that recognising the expense also results in recognising a liability on the balance sheet for future payments for future fire losses. This liability does not meet the test of a liability under the IASB's conceptual framework – which defines a liability as a present obligation arising from an event that already took place. If we want to book obligations

for future payments for future events, where do we stop? A company that purchases fire insurance transfers risk to the insurance company, and so its annual insurance premiums are an annual expense reflecting the cost of risk transfer. However, a company that chooses to self-insure has retained risk, and thus is in a more volatile circumstance that the company that buys insurance. Shouldn't the financial statements of the two companies reflect their different risk situations?

Also, there has been some criticism on the lack of SME constituents on the IAS decision-making Board and on the IASB not researching much on users' needs when drafting standards. How fair, in your opinion, is such criticism?

At least one IASB Board member was, for many years, the senior partner of a small auditing firm whose clients were almost exclusively SMEs. Others have also had SME experience. The 35-member IASB Working Group comprises almost entirely people with SME experience, including a number of lenders to SMEs and venture capitalists. We have made many efforts to assess user needs by inviting public comment in a Discussion Paper (June 2004); a public questionnaire on SME recognition and measurement simplifications (April 2005); and public round-tables with the Board (October 2005). More assessment of user needs is planned.

To what extent, in your opinion, may one trade-off in favour of relevance through fair value accounting at the expense of reliability through historical cost accounting, or vice-versa?

Recently, the CFA Institute, which represents investment professionals who regularly use financial statements, published its vision of financial reporting in which it says: "Fair value

information is the only information relevant for financial decision making." Fair values often are reliable, as well. Quoted stock and bond prices, commodity prices, foreign exchange prices in public markets are very reliable. Other price quotations for land, buildings, machinery, equipment, etc, are also often reliable. On the other hand, historical costs may give an unwarranted illusion of reliability. For example, in agriculture, the historical cost of a baby calf is measured by allocating acquisition and breeding costs generation after generation. We get it down to the penny, but is it reliable? How about the depreciated historical cost of a building or machine. There are many methods of depreciation, all of which give very precise numbers. But can we say they are reliable? And, in any event, are costs relevant? Is the amount you paid for an office building relevant to investors or lenders if the building is sitting half-empty with little prospect of finding a tenant? Is the cost of a derivative financial instrument – which is usually zero – relevant one month later when the index or price to which the derivative is linked has moved significantly up or down? Would you sell me your house for what you paid for it, if the real estate market is booming?

Of course, relevance is relative to the users of financial statements. Users of financial statements of SMEs will likely find information about short-term cash flows more relevant than information useful in forecasting long-term performance. The issue here is not a trade-off of relevance and reliability but, rather, a trade-off of less relevant for more relevant information.

You are responsible for the Deloitte IAS Plus newsletter and website. Although you are a member of IASB staff, and a standard developer, keeping abreast of all developments and advising clients accordingly would still certainly be a demanding task. What does this involve?

The website www.iasplus.com is a labour of love. I put at least an hour or two into it daily, seven days a week. It involves searching every day many websites (IASB, EFRAG, EC, FASB, FEE, FEI, IOSCO, CESR, PCAOB, SEC, and a couple of dozen more). It involves subscribing to a number of news tracking services. It involves good friends at various organisations who constantly remember to send me important news. www.iasplus.com has grown to be the number one source of information about international financial reporting on the web – nearly 30,000 visitors a week. The newsletter involves compiling the news from the website quarterly, plus special editions each time the IASB publishes a new standard or interpretation.

I should also put in a plug for Deloitte's IFRS e-learning. We have spent hundreds of thousands of US dollars developing an outstanding programme of on-line IFRS training for the 120,000 employees of Deloitte worldwide. And we decided to make it available without charge in the public interest to everyone. Well over 300,000 modules have already been downloaded from www.iasplus.com, and that does not include Deloitte internal usage.

Following extensive changes to a number of IASs and a new IFRS as a result of the improvements project, the IASB has declared a 'stable platform' for the coming two or three years. Few months down the line we have seen the new 'Technical Corrections' concept introduced. This leads me to ask, how stable will this platform be?

The stable platform was designed for the "big bang" adoption of IFRSs in 2005. The goal was to make very few changes in 2004 and 2005, so companies could gear up for the switch from their national GAAP. I think that, by and large, the IASB kept its promise. Few pronouncements were issued in 2005 and none of those is mandatory for 2005. Also, only a few things issued in 2004 are required for 2005. Stable platform doesn't mean, however, that IASB has essentially finished the job with few changes ahead. There are still areas not addressed – such as industry issues. Existing standards have accounting policy options that need to be reconsidered. There remain older standards that need to be modernised or clarified. There is a commitment to convergence with US GAAP, which is a two-way street. Some implementation guidance may be needed. And, of course, the world changes. New kinds of instruments, contracts, and transactions may require new accounting standards.

By the way, the IASB has now decided to abandon its Technical Corrections programme, which in any event would not have unstabilised the stable platform. These were to be very minor wording changes for clarification purposes.

In an accounting world where the only constant factor is change, what or where do you envisage accounting to be in 10 years' time?

I have no better crystal ball than anyone else. But I do know what's on the IASB's active and research agendas, and to some extent what's the buzz among accounting standard setters. I would envisage:

1. Greater use of fair values for financial statement measurements, particularly as measurement methodologies

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improve. I think it is likely that all financial instruments for which reliable fair value measurements can be obtained will be measured at fair value, with value changes in profit and loss. This will eliminate the need for most hedge accounting. Greater use of fair values for non-financial assets is also likely.

2. Performance reporting without reliance on the traditional notions of realisation and matching. This means more components of income based on changes in values while assets are held and while liabilities are outstanding.

3. A redesigned income statement that reflects all revenues, expenses, gains, and losses, with appropriate subtotals and segregations of different types of performance results (such as value changes), and with no P&L items reported directly in equity.

4. Expansion of the traditional boundaries of financial statements to include other aspects of a company's programme for reporting financial information. IASB has already published a discussion paper on the management commentary. There are issues around the world with companies touting "non-GAAP earnings" figures and downplaying reported profit or loss.

5. Elimination of some of the accounting policy choices that currently exist in IFRSs for a given type of transaction.

6. Moving more off-balance-sheet items onto the balance sheet. This would include such areas as pensions, leases, special-purpose entities, and possibly commitments.

7. Fewer opportunities for earnings management.

8. Recognition of more non-traditional assets such as trade names, customer base, employee skills, research outcomes, and the like.

9. Better definition of what exactly is the accounting entity. These days, companies increasingly operate through joint ventures, associates, affiliates, and outsourcing partners.

10. Less reliance on "management intentions" as the driver of accounting recognition and measurement. "We intend to hold this investment for the long term, so fair value need not be reported" is not likely to be given a lot of credence. Today's intentions may not be tomorrow's, and they're not very auditable anyway.

11. In Europe, pan-European regulation of securities markets, rather than national regulation. This means pan-European enforcement of IFRSs.

12. In the USA, elimination of the requirement to reconcile to US GAAP for foreign SEC registrants using IFRSs.

13. Possibly: Broadening of IASB's scope to include financial reporting by not-for-profit entities and governments.