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QUESTIONNAIRE ON POSSIBLE RECOGNITION AND MEASUREMENT MODIFICATIONS FOR SMALL AND MEDIUM-SIZED ENTITIES (SMEs)

Introduction

This submission is presented in two parts:

- General remarks aimed at some of the conceptual matters which arise in considering an accounting regime for SMEs.
- Specific commentary on the questions posed in the questionnaire.

General comments

I wish to make three general comments as follows:

- My interest in the SME financial reporting regime.
- The nature of entities to be included in the scope of the term SME.
- The principles to be adopted in formulating measurement and recognition criteria.

I have two inter-related reasons for an interest in the SME financial reporting regime. First, I advise the New Zealand Customs Service (Customs), a grantor of credit in respect to imposts arising on importation, in regard to entities to which credit may be given. Second, I undertake liquidation assignments frequently at the petition of Customs.

In the first capacity, the need for a clearly articulated financial reporting framework to apply to private business is self-evident. In the second capacity the need is not quite so apparent. However, as a liquidator one of the main weapons in my armoury in the pursuit of delinquent directors is to hold them accountable for failure to maintain proper records. A proper financial reporting regime is a *sine qua non* of the workability of such statutory provisions. The need for a proper financial reporting regime is also implicit in the statutory prohibitions, common to British based company law jurisdictions, to avoid reckless trading and entering commitments a company cannot meet.

This brings me to my second point. I am concerned that paragraph 1 of your cover letter seems to limit the scope of any SME regime to entities with an overt requirement to report externally. In New Zealand companies, when not issuers or overseas owned, are not obliged to publicly disclose their financial information. This does not mean, however, that creditors are not reliant upon a properly constituted financial reporting regime.

Directors in New Zealand assume responsibility for protecting the interests of creditors in a quasi-fiduciary capacity. A regime providing an SME form of generally accepted accounting practice (GAAP) is essential to fulfill this purpose. Care must therefore be taken to ensure that entities which, at first sight, do not appear to fall into general purpose financial reporting category in fact do have an equivalent need for a financial reporting code. In other words, company law statutes since their very origin in Victorian Britain have pre-supposed the existence of an accounting regime which enables directors to establish the amount they can safely distribute amongst other things. This requirement must be accommodated.

In New Zealand the GAAP regime necessary to give effect to company statutory assumptions is one based on solvency. As the IASB approach is one based on fair value, it is well suited to the needs of the New Zealand company governance regime. Therefore, any attempt to dilute the measurement and recognition rules such as might render the financial reporting regime inappropriate to the determination of solvency should be resisted.

I think that the principles which need to be adopted in the preparation of an SME financial reporting regime must begin with this proposition. Fair value accounting is necessary to determine solvency. It must remain essentially intact.

However, that imposes significant accounting burden in two senses. First, small enterprises cannot afford the accounting effort to fully apply fair value accounting. Second, most small enterprises perceive the main purpose of a formal accounting process is to deliver a basis for assessing tax. Tax accounting differs significantly from fair value accounting, certainly in New Zealand and, I suspect, elsewhere.

The solution to this is to think laterally. There is no inconsistency necessarily in accounting for, say, tax purposes and for solvency determination. The trick may be in the mode of presentation. A piece of plant, for instance may have a certain tax written down value but a difficult to determine real value, which may be considerably lower. Provided the entity does not present its tax WDV as the fair value of the plant then no harm is done.

For example, Table 1 sets out a mode of presentation which may be considered.

Table 1 Mode of presentation: Balance Sheet

	Conventional $	Modified $
Current assets		
Cash	10,000	10,000
Receivables	50,000	50,000
	60,000	60,000
Non-current assets		
Property plant & equipment	100,000	-
Total assets	160,000	60,000
Current liabilities		
Payables	30,000	30,000
Taxes	2,500	2,500
	32,500	32,500
Non current liabilities		
Loan	25,000	25,000
Equity		
Paid up capital & retained earnings	102,500	102,500
Property plant & equipment		(100,000)
	102,500	2,500
Total equity & liabilities	160,000	60,000

If the directors of the above entity wish to avoid the difficulties of fair value accounting and to apply tax accounting to elements such as property, plant and equipment, then they should deduct them from equity so as to not imply a solvency position which may or may not be justified. In the event they wish to apply a conventional format, then they should not be allowed to avoid all of the measurement issues that entails.

In New Zealand the modified presentation would have significant consequences. No distribution could be made, for instance, beyond the amount stated as being the net equity position.

Specific comments

Question 1

I make the following comments in regard to question 1.

IAS 2 Inventories

It need first be noted that IAS 2 is virtually identical to the existing inventory standard in New Zealand. No exemption is given for measurement in the existing New Zealand

standards under the *Framework for Differential Reporting*. Indeed the income tax regime is substantially aligned with the relevant standard

Having said that, I am certain there is widespread non-compliance with the complex rules related to cost determination. Without very detailed job costing systems it is very difficult to allocate indirect costs (labour and overheads etc.). In my view a useful concession would be to require costing to apply only to direct cost of purchase of inventory. That approach would be suitable to my inclination to ensure assets are not overstated.

There are two flaws to this argument. First, there is always the risk that an entity can understate its assets values to the detriment of, say, minority shareholders. Second, understatement of inventory values can have the effect of decelerating income tax liability.

I do not see these as insurmountable problems. First, there should be no relaxation of the requirement to properly define accounting policy. That is sufficient to protect a person who may be the victim of understated assets. Second, the option to apply more comprehensive costing should be left available and at the discretion of the taxing authority.

IAS 11 Construction contracts

The New Zealand existing standard on construction allows differential entities the right to apply a completed construction contract method rather than a percentage of completions method.

To my mind this is a suitably conservative policy, bearing in mind the solvency imperative that I emphasise.

The same problems as arise under simplified costing rules relating to inventory arise and are amenable to the same solutions.

There should be no relaxation of the rule to require immediate write down when a loss is anticipated.

IAS 12 Income Taxes

The current New Zealand differential regime allows deferred tax accounting to be avoided in favour of the 'taxes payable' method. This is problematic. For example, a company owning a forest, in recognizing valuation changes, should be required to provide for the liability for future tax.

I think, on balance, if the sort of approach I suggest in my general comments is adopted then avoidance of deferred tax accounting should be permissible. However, there should be no concession if fair value accounting is adopted.

Certainly, there should be no obligation to recognize deferred tax assets from whatever source. In the event, of course, that an entity wishes to do so, the normal complex rules should apply.

IAS 27 and 31
As I believe the purpose of financial reporting for SMEs, at least in the company law context, is to determine solvency, I think that equity accounting should be used for all consolidation problems. Afterall this method is relatively easy and gives a valid net asset position without the need for a four column presentation.

IAS 36 Impairment of Assets
It is this standard that will present the most difficulty for the SME. Frankly, I believe the standard unworkable for all enterprises, of whatever size. It is to avoid the determination of impairment value when historic cost accounting is being otherwise applied, that I suggest the modified format in Table 1 above.

IAS 37 Provisions, Contingent Liabilities & Contingent Assets
I have no sympathy for concessions on measurement of complex liabilities of whatever nature.

In the event an SME engages in complex business, it must suffer the measurement consequences or run the risk of producing a materially misleading statement of financial position. For example, SMEs can give warranties. There is no reason that they should not account accordingly. Any simplified approach (e.g. the avoidance of discounting) will be tantamount to guesswork and therefore be useless.

What standard setters and government agencies must get used to doing is to emphasise that the complexities of standards such as IAS 37 can be avoided by not engaging in complex transactions in the first place. For instance, in the above case an SME can avoid IAS 37 by not giving warranties in the first place.

IAS 39 Forward exchange contracts (FECs)
FECs are commonly entered into by SMEs. Under no circumstances should there be any concessions in this regard. Again, it needs to be emphasized that in the event an SME enters into complex transactions, complex accounting will be needed accordingly.

In anticipation of what I might say in answer to question 2, I think that the rules on common derivatives such as FECs need to be abstracted from IAS 39 so that the overwhelmingly complexity of the standard does not detract from the message.

IAS 39 Fair value
I am not aware that SMEs enter into complex arrangements such as interest derivatives. The rules on obligatory fair value (with one or two exceptions) can therefore be avoided.

As most financial instruments held by SMEs will fall into the exempt classes specified by paragraph 46 of IAS 39, there should be no particular difficulty in applying an historic cost approach, subject to impairment. This is no different to what does (or should) prevail currently.

Again the secret will be in the way that the SME rules are presented. For example, the rules for common financial instruments should be removed from the generality of IAS 39. IAS 39 can then be given formal authoritative support in the event that an SME does, for instance, enter into an interest derivative or an investment the entity wishes to carry at fair value.

IAS 41 Agriculture
It is the consternation in regard to agriculture that has caused the New Zealand public practioner group, within the Institute of Chartered Accountants, to write intemperate letters to the IASB.

To be fair they have a point. IAS 41, like IAS 36, is probably unworkable for the same reasons. Another aspect of IAS 41 which galls primary sector accountants is that there are clearly defined regimes in tax law for the calculation of livestock values, for instance. Any attempt to impose other values will result in unnecessary complexity.

The solution will be to allow historic cost, perhaps as modified by the taxing authority. This may also present a case for applying the modified format I suggest in Table 1.

Question 2
I have essentially addressed this question above. I think it imperative that the rules relating to more common financial instruments be isolated from the generality of IAS 39 and reference made back in the event an entity enters into the more esoteric instruments.

The approach to agriculture needs to be completely rethought. There is sufficient prescription in the New Zealand jurisdiction to make IAS 41 unnecessary here.

I thank you for your attention. I am willing to participate in a forum to discuss the matters above.

Yours faithfully

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