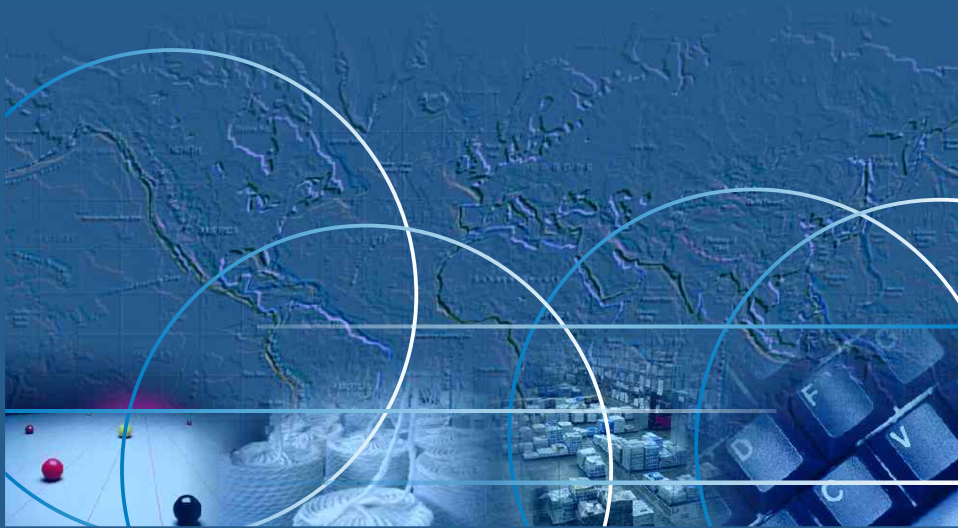
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# ACCOUNTING AND FINANCIAL REPORTING GUIDELINES FOR SMALL AND MEDIUM-SIZED ENTERPRISES (SMEGA)

## LEVEL 2 GUIDANCE



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## *Preface*

At its 17th session in July 2000, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) identified a number of obstacles that small and medium-sized enterprises (SMEs) were facing in applying accounting standards that had been issued by various standard-setting bodies, both national and international. It was agreed that a project should be undertaken to identify possible approaches that would meet the accounting and financial reporting needs of such enterprises.

ISAR has supported the International Accounting Standards Board (IASB) as the international standard setter of reference for accounting and reporting standards. The International Accounting Standards (IAS) issued by the IASB, however, have been created largely with the financial reporting needs of listed companies in mind. Consequently, it has often been difficult to apply them to SMEs, particularly those in developing countries and countries with economies in transition. For many businesses in these countries, professional help may also be disproportionately expensive.

To meet the financial reporting needs of SMEs, ISAR is proposing that a three-tiered structure be adopted, as follows:

*Level 1.* This level would apply to listed enterprises whose securities are publicly traded and those in which there is significant public interest. These enterprises should be required to apply the accounting and financial reporting standards (IAS and International Financial Reporting Standards, or IFRS) issued by the IASB.

*Level 2.* This level would apply to significant business enterprises that do not issue public securities and in which there is no significant public interest. ISAR has developed a single set of requirements derived from the IAS issued by the IASB, but embodying only requirements for the most regularly encountered transactions. This level would still have the option to follow the full set of IAS and IFRS issued by the IASB.

*Level 3.* This level would apply to the smallest entities, which are often owner-managed and have few employees. The approach proposed is a simple accruals-based accounting, based on that set out in IAS, but closely linked to cash transactions. A derogation would, however, be permitted within this level for businesses to use cash accounting for a limited time when first establishing their accounting systems.

Exactly how the boundaries between the three levels should be specified is a matter that cannot be dealt with adequately without knowledge of the specific economy in which an enterprise operates. ISAR recommends that there be a system with at least three levels, but how these levels are defined must be determined by each member State that chooses to apply this approach, taking into account the prevailing economic, legal and social circumstances, particularly the member State’s enterprise structure.

However, for some member States an indication of ISAR's thinking with regard to some of the terminology used in defining the three levels may be useful. One example is the concept of significant public interest. While enterprises in which there is significant public interest exist in all member States, the criteria and thresholds for identifying them vary. In general, ISAR considers that the impact of an entity on employment or the generation of significant economic activity in the country implies a public interest. One possible criterion for assessing public interest could therefore be the number of employees that an enterprise has. Some member States might, for example, wish to designate the top 10 per cent of enterprises (ranked by number of employees) that employ the largest number of workers in their economies as enterprises in which there is significant public interest.

The proposed guidance (SMEGA) that ISAR has developed for Level 2 enterprises is set out in the material that follows.

The Level 2 guidance is intended to be available to member States to use in its present form, but they can also adapt it to suit their specific national circumstances. For example, Guideline 3 contains a benchmark treatment for property, plant and equipment (depreciated historical cost) and an allowed alternative (revalued amount). Member States can choose to eliminate one of these options in using the SMEGA.

The guidance for Level 2 is intended, on the one hand, to be user friendly, understandable and focused only on the most frequently encountered transactions, but, on the other hand, to be derived from IAS/IFRS and facilitate the development of enterprises from Level 2 to Level 1. It is based on the view that, to be useful and cost effective, the SMEGA should be as short as possible and concentrate on measurement approaches that are feasible within the available infrastructure but enable users to make informed decisions. In developing the guidance, judgements are needed to balance the need for brevity and usability with the need to be comprehensive and to provide sufficient explanation.

ISAR realizes that there are no objective criteria for determining which standards should fall within the SMEGA and which do not, and that, consequently, it is largely a matter of judgement which standards are included and which excluded. For instance, IAS 11, Construction Contracts, has been excluded. While it might be considered an industry-specific standard, and therefore of limited general application, it includes a fundamental revenue recognition principle that applies to all entities having unfinished contracts at the accounting date. However, as is discussed above, the main criterion applied in identifying the standards to be included in the SMEGA was whether most small enterprises would be likely to have the particular kind of operation or transaction addressed by an individual standard. Accordingly, IAS 11 was excluded from the SMEGA. However, compliance with IAS 11 would be required if an enterprise had to record revenue earned on partially completed construction contracts.

In accordance with Guideline 12 of the SMEGA, an enterprise that complied with the SMEGA would indicate in its accounting policy note that its accounts had been drawn up in accordance with the SMEGA (and not the full IAS/IFRS). If the enterprise also had to refer to an element of full IAS/IFRS, it would still retain the reference to the SMEGA in its policy note.

ISAR is aware that the IASB has an "active research project" on the application of IAS to SMEs and in emerging economies. At this stage, it is not clear what the outcome of this project will be and if and when any definitive guidance will be produced. ISAR supports the IASB's work in this area and has requested that it be given priority. ISAR will keep the SMEGA under review in light of developments in the IASB's project.

The SMEGA's guidance for Level 2 is based on the IAS applicable in 2002. ISAR recognizes that the IASB's work to improve its existing standards and develop new ones may mean that in the future changes are needed to the SMEGA. For this reason, as well as to take into account any feedback from practical application, the SMEGA will need to be reviewed from time to time.

## CONTENTS



***Note:*** Certain terms in the SMEGA have been italicized, and definitions of these terms can be found in Annex 1. When the same term appears with and without italics, the un-italicized term may have a different meaning from that given in the definition.

# Introduction

## Scope

1. These accounting and reporting guidelines for small and medium-sized enterprises (SMEGA) are intended for the preparation of general-purpose financial statements for SMEs in developed and developing countries as well as in economies in transition. Such statements would be prepared at least annually and are intended to meet the information needs of a wide range of users.

## Users

2. Users of financial statements generally include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and, in some jurisdictions, the public. For SMEs, the most significant users are likely to be investors/owners and creditors, who may have the power to obtain information additional to that contained in the financial statements. Management is also interested in the information contained in the financial statements, even though it has access to additional management and financial information.

## Objectives

3. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to users of such information in making economic decisions. Financial statements show the results of management's stewardship of and accountability for the resources entrusted to it.

## Underlying assumptions

4. Financial statements are prepared on the accrual basis of accounting. They are normally prepared on the assumption that an enterprise is a going concern that will continue to operate for at least the foreseeable future.

## Qualitative characteristics

5. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal characteristics are:

(a) Understandability: It is essential that information provided in financial statements be readily understandable by users.

(b) Relevance: To be useful, information must be relevant to the decision-making needs of users. The relevance of information is affected by its nature and materiality.

(c) Reliability: Information is reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it is said to represent. In assessing reliability, substance over form, prudence, neutrality and completeness are