



3 September 2007

The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs

The Proposed IFRS for SMEs

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to make a submission on the Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities.

The Institute support the overall objective of the draft IFRS for SME proposals. We support a more simplified recognition and measurement standard in addition to reduced disclosure for entities that are not publicly accountable.

With a view to harnessing feedback on the exposure draft from our members, we conducted a Forum in Melbourne in June, involving 24 senior figures from the profession, business, government and academia, to discuss the proposed IFRS for SMEs. The White Paper that is the result of those discussions is attached.

We do not believe that sufficient consideration has been given in the proposal to the needs or wants of the key stakeholders of SMEs – such as users, preparers and auditors – in order to determine the appropriateness of recognition, measurement and disclosures. In particular we do not consider appropriate the use of fair value as a measurement principle in areas such as agriculture, financial instruments and share-based payments. We consider that users of SME financial statements are interested in information regarding short term stewardship rather than for long term investment decision making, therefore consider the use of fair value as not relevant in this context.

We consider the name of the proposed standard is problematic given that its meaning is understood differently by different jurisdictions around the world. In our view, it is causing confusion as practitioners generally seem to view SMEs as small privately owned businesses, which need minimal reporting requirements as all the stakeholders can demand the information they need directly from the entity. “IFRS for Non-publicly Accountable Entities” might be a clearer description of the standard for users. Practitioners see the title “IFRS for SMEs” expect it to be a much more simplified form of accounting for use by micro entities with limited outside users.

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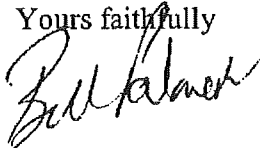
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Further we are concerned about the use of the public accountability criterion. As this criterion is currently defined, it is imprecise and as such open to a variety of interpretations. We consider the Board needs to explain further the term 'fiduciary capacity' since it could be envisaged that many service organizations hold assets to meet customer needs and therefore could operate in a 'fiduciary capacity' and we do not believe this was the intent of the IASB.

Our detailed comments and answers to the IASB's questions are attached.

We note that the Australian Accounting Standards Board (AASB) currently has its proposals for differential reporting out for public comment, which includes the application of IFRS for SMEs in Australia. We will be submitting a separate submission direct to the AASB in this regard. The outcome of the AASB's consultations may have an impact on the acceptance or otherwise of the IFRS for SME proposal in Australia.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Bill Palmer', written over the typed name.

Bill Palmer
General Manager Standards and Public Affairs

Cc: David Boymal

General Comments

As we noted in our covering letter, we are aware of considerable confusion among our constituents as to what is the exact role of the proposed IFRS for SMEs. The view that emerged from our Forum was that there was considerable confusion about the definition of a SME. It was thought that the term, as used by the IASB, is a misnomer because the entities of interest to the IASB are not that small.

Some of our members focus on the term SME and, coming from their understanding of an SME as a small business managed by its owners, more like the “micros” described in the IFRS for SMEs, they view the SME exposure draft as too complex. They would prefer to see something like the UK’s FRSSE or the Australian Institute’s Business Practice Guide (our own simplified financial reporting guidance for smaller entities which can be found at <http://www.charteredaccountants.com.au/A117157740>). Others accept that it is designed for an entity that is not publicly accountable (which is more elaborate than what we generally understand as an SME) and formulate their comments accordingly. Our view is that the ED as drafted is too complicated for small owner managed businesses, but may have a place as something for the larger but not publicly accountable entity and therefore our comments are phrased accordingly.

We have concerns about the use of the public accountability criterion and the definition of “publicly accountable” in the Glossary. Such a principles based definition may lead to significant differences in interpretation as has happened in Australia with our reporting entity concept. It is therefore vital that the definition should be clear and rigorous. The question arises as to how far public accountability should stretch. If one includes entities that hold assets in a fiduciary capacity, does that extend to the high street travel agent or insurance broker? Such businesses can be quite small but still hold assets in a fiduciary capacity on behalf of their clients. Similarly, would a trustee company that does nothing apart from acting as trustee for a family trust be publicly accountable?

Question 1 – Stand-alone document

In deciding on the content of the proposed IFRS for SMEs, the IASB focused on the types of transactions and other events and conditions typically encountered by SMEs with about 50 employees. For such entities, the proposed IFRS is intended to be a stand-alone document, with minimal cross-references to full IFRSs.

With the objective of a stand-alone document in mind, are there additional transactions, other events or conditions that should be covered in the proposed standard to make it more self-contained? Conversely, is there guidance in the draft standard that should be removed because it is unlikely to be relevant to typical SMEs with about 50 employees?

The Institute considers that the IFRS for SMEs should be a stand-alone document in the interests of ease of use. We are aware that some commentators are suggesting that the permitted options from full IFRS should be included to make the IFRS for SMEs a true stand-alone document. However, we support the IASB in the approach it has adopted, as the topics covered in the ED are those most likely to be chosen by the target user group.

Our only concern with the stand-alone approach is the implication of cross-references to full IFRS. Because IFRS themselves cross-refer, it is unclear where the cross-referencing will end once reference is made to the full standards. This should be clarified.

Question 2 – Recognition and measurement simplifications that the Board adopted

The draft IFRS for SMEs was developed by:

- (a) extracting the fundamental concepts from the IASB Framework and the principles and related mandatory guidance from full IFRSs (including Interpretations), and
- (b) considering the modifications that are appropriate in the light of users' needs and cost-benefit considerations.

Paragraphs BC70–BC93 of the Basis for Conclusions describe the simplifications of recognition and measurement principles contained in full IFRSs that have been made in the proposed IFRS for SMEs and explain the Board's reasoning.

Are there other recognition or measurement simplifications that the Board should consider? In responding, please indicate:

- (a) the specific transactions, other events or conditions that create a specific recognition or measurement problem for SMEs under IFRSs;
- (b) why it is a problem; and
- (c) how that problem might be solved.

The Institute are concerned that IFRS for SMEs still contains a significant amount of fair value measurement and would like to see much greater emphasis on historic cost on cost/benefit grounds, with cost or amortized cost always available to entities as an option. Historic cost information is easier to obtain for preparers and easier to verify for auditors. The users of SME accounts are reading them more from the perspective of stewardship than for the purposes of making investment decisions and the need for fair values is not as great as for publicly accountable entities.

In particular we suggest that amortized cost rather than fair value be the default option for financial instruments. Para 2.41 should therefore be amended so that fair value is not given preference over cost. Furthermore, in our view the circumstances in which hedge accounting is permitted in the ED are too limited. The circumstances in paragraph 11.31 should be expanded to include cross currency swaps and options as in our experience these are not uncommon in the SME environment.

We also suggest that amortized cost be permitted as an option for biological assets for those entities which do not manage their agricultural activity on a fair value basis. The use of cost here will remove the audit problems inherent in the proviso that fair value need only be used if it is readily determinable without undue cost or effort.

We also suggest that the IASB simplify its approach to share-based payments and require disclosure of the transaction only. We are aware of relatively small businesses giving shares to their employees by way of an incentive, and equity-based share based payment transactions are not uncommon when the private entity is a subsidiary of a foreign parent. For reasons of cost/benefit the reference to IFRS 2 does not represent a simplification as the cost to perform a valuation is high for this type of entity.

We also suggest that the IASB reconsider its stance on accounting for taxes – see Question 3 below.

Question 3 – Recognition and measurement simplifications that the Board considered but did not adopt

Paragraphs BC94–BC107 identify some recognition and measurement simplifications that the Board considered but decided not to adopt, for the reasons noted.

Should the Board reconsider any of those and, if so, why?

The Institute developed its own simplified reporting guidance for SMEs a few years ago, called the Business Practice Guide (see <http://www.charteredaccountants.com.au/A117157740>). In developing it, we prepared an exposure draft and called for feedback on our proposed simplifications. We have drawn on this feedback in formulating our answers to the Board's questions below. The two areas we feel the Board should reconsider are:

Deferred Taxes	<p>The Australian experience is that accounting for deferred taxes under IFRS is an area that even technically minded accountants find difficult. Non-technical users often do not understand the purpose of the exercise at all. We suggest that current tax be accounted for and deferred tax be disclosed by way of a commitment note. This was the approach adopted in the Institute's Best Practice Guide and supported by member feedback. The benefits of this method are its simplicity and understandability to users.</p> <p>We are aware that some jurisdictions do not perceive the accounting for deferred taxes as a problem, but we suspect that this may be because some jurisdictions have much simpler tax systems than Australia does. It may therefore be appropriate for the IASB to include an option to use a tax payable approach with disclosures.</p> <p>If the IASB are determined to keep the proposed approach in the final standard the Institute strongly recommend that it reflects IAS 12 and provides examples of how IAS 12 applies to private entities. We disagree with the current drafting which seems to pre-empt future changes to IAS 12 as a result of the ongoing convergence project.</p>
Cost model for agriculture.	We suggest that amortized cost be permitted as an option for biological assets, as discussed in Question 2.

Question 4 – Whether all accounting policy options in full IFRSs should be available to SMEs

The draft IFRS for SMEs proposes that accounting policy options available under full IFRSs should generally also be available to SMEs. As explained more fully in paragraphs BC108–BC115 of the Basis for Conclusions, the Board concluded that prohibiting SMEs from using an accounting policy option that is available to entities using full IFRSs could hinder comparability between SMEs and entities following full IFRSs. At the same time, the Board recognised that most SMEs are likely to prefer the simpler option in the proposed IFRS for SMEs. Therefore, the Board concluded that in six circumstances in which full IFRSs allow accounting policy options, the IFRS for SMEs should include only the simpler option, and the other (more complex) option(s) should be available to SMEs by cross-reference to the full IFRSs.

Do you agree with the Board's conclusions on which options are the most appropriate for SMEs? If not, which one(s) would you change, and why? Should any of these options that would be available to SMEs by cross-reference to the full IFRSs be eliminated from the draft IFRS for SMEs and, if so, why?

The Institute supports allowing reference back to all IFRS options where the entity determines that the IFRS for SMEs simplified option is not appropriate. It reasons that for the purpose of consolidation group companies, subsidiaries which are not publicly accountable may wish to make use of the simpler disclosure requirements in the IFRS for SMEs, but may need to ensure that measurement and recognition are done consistently across the whole group. Referral to full IFRS on a measurement issue should not necessitate adopting all the disclosure requirements from that IFRS.

We acknowledge that this approach may be to the detriment of consistency between entities, but in our view, adequate disclosure of accounting policies will enable users to understand the approach that has been adopted in each case.

Question 5 – Borrowing costs

IAS 23 Borrowing Costs currently allows entities to choose either the expense model or the capitalisation model to account for all of their borrowing costs. In May 2006 the IASB published an Exposure Draft proposing to amend IAS 23 to prohibit the expense model and to require the capitalisation model. Section 24 Borrowing Costs of the draft IFRS for SMEs proposes to allow SMEs to choose either the expense model or the capitalisation model.

Do you agree or disagree with the proposal to allow SMEs to choose either the expense model or the capitalisation model for borrowing costs, and why?

The Institute believes that the expensing of borrowing costs is an acceptable measurement simplification for SMEs and should be permitted as an option in spite of the reissue of IAS 23.

Question 6 – Topics not addressed in the proposed *IFRS for SMEs*

Some topics addressed in full IFRSs are omitted from the draft IFRS for SMEs because the Board believes that typical SMEs are not likely to encounter such transactions or conditions. These are discussed in paragraphs BC57–BC65 of the Basis for Conclusions. By a cross-reference, the draft standard requires SMEs that have such transactions to follow the relevant full IFRS.

Should any additional topics be omitted from the IFRS for SMEs and replaced by a cross-reference? If so, which ones and why?

Generally the Institute supports the selection of topics in the IFRS for SMEs as being the most likely topics to be applied by SMEs as defined.

Question 7 – General referral to full IFRSs

As noted in Question 1, the IFRS for SMEs is intended to be a stand-alone document for typical SMEs. It contains cross-references to particular full IFRSs in specific circumstances, including the accounting policy options referred to in Question 4 and the omitted topics referred to in Question 6. For other transactions, events or conditions not specifically addressed in the IFRS for SMEs, paragraphs 10.2–10.4 propose requirements for how the management of SMEs should decide on the appropriate accounting. Under those paragraphs, it is not mandatory for SMEs to look to full IFRSs for guidance.

Are the requirements in paragraphs 10.2–10.4, coupled with the explicit cross-references to particular IFRSs in specific circumstances, appropriate? Why or why not?

The Institute supports the IFRS for SMEs Proposal that a mandatory fall back to IFRS is not required as it is drafted as a stand-alone document with its own Framework. However, we would support the IASB recommending referral to full IFRS in the absence of other guidance within the IFRS for SMEs.

We draw the IASB's attention to the approach adopted in the UK's FRSE. An entity applying the FRSE is not required to apply any other accounting standards, but should have regard to them as a means of establishing current practice for transactions not dealt with in the FRSE. Wording similar to this could be used in paragraph 10.4, as the fall-back position in the hierarchy that starts in paragraph 10.3.

Question 8 – Adequacy of guidance

The draft IFRS for SMEs is accompanied by some implementation guidance, most notably a complete set of illustrative financial statements and a disclosure checklist. A sizeable amount of guidance that is in full IFRSs is not included. Accordingly, additional guidance especially tailored to the needs of SMEs applying the proposed IFRS may be required.

Are there specific areas for which SMEs are likely to need additional guidance? What are they, and why?

The Institute's preliminary thinking is that the Implementation Guidance prepared with the ED will be welcomed as users will not have to "reinvent the wheel". In our experience, proforma financial statements are very popular with our members.

We consider that there are certain areas within the Standard where the guidance currently contained in full IFRS would be extremely useful to an SME in adoption of the IFRS for SME proposals. These areas include:

- the examples on identification of intangible assets;
- guidance on determining what is impracticable in respect of retrospective application of accounting policies and restatements
- definition of terms in the SME proposal which are defined in full IFRS (for example, date of transition and derivatives)
- guidance on the accounting for hybrid instruments
- reverse acquisition guidance
- the use of the term 'probable' in the recognition of tax assets
- offsetting criteria in respect of tax balances
- guidance on the use of the undue cost and effort exemption in respect of comparative period deferred tax balances on transition to IFRS for SMEs
- transition guidance (see question 10 below)

Question 9 – Adequacy of disclosures

Each section of the draft IFRS for SMEs includes disclosure requirements. Those requirements are summarised in the disclosure checklist that is part of the draft implementation guidance Illustrative Financial Statements and Disclosure Checklist.

Are there disclosures that are not proposed that the Board should require for SMEs? If so, which ones and why? Conversely, do you believe that any of the proposed disclosures should not be required for SMEs? If so, which ones and why?

Those disclosures most relevant to SME users are those that relate to the evaluation of its future solvency, such as its debt and future commitments. Therefore we consider there is significant scope to reduce the disclosures (or at least make them non-mandatory) in the areas that do not relate to solvency and liquidity such as:

- the reconciliations of movements on asset and liability balances such as property, plant and equipment and provisions
- the disclosures regarding KMP remuneration are arguably excessive in an environment where the owners of the business are also those involved in its management

Question 10 – Transition guidance

Section 38 Transition to the IFRS for SMEs provides transition guidance for SMEs that move (a) from national GAAP to the IFRS for SMEs and (b) from full IFRSs to the IFRS for SMEs.

Do you believe that the guidance is adequate? If not, how can it be improved?

Transitional guidance within the IFRS needs to cover the transition between IFRS for SMEs and full IFRS in both directions as entities' circumstances may change. Furthermore, the guidance needs to differentiate between transition from local GAAP and transition from/to full IFRS.

Question 11 – Maintenance of the *IFRS for SMEs*

The Board expects to publish an omnibus exposure draft of proposed amendments to the IFRS for SMEs approximately every other year. In developing such exposure drafts, the Board expects to consider new and amended IFRSs that have been adopted in the previous two years as well as specific issues that have been brought to its attention regarding possible amendments to the IFRS for SMEs. On occasion, the Board may identify a matter for which amendment of the IFRS for SMEs may need to be considered earlier than in the normal two-year cycle.

Is this approach to maintaining the proposed IFRS for SMEs appropriate, or should it be modified? If so, how and why?

The Institute supports the proposal to update the IFRS for SMEs every two years where necessary. In our view there is no need to update it more frequently. SMEs by nature are not publicly accountable and therefore users' interests are unlikely to be prejudiced by the entity not using the most up-to-date accounting theory. Consideration will however have to be given to circumstances when a SME chooses to revert to full IFRS in respect of an area of its financial report. Will the SME have free choice of which version of IFRS to use when a version has been issued but is not yet applicable? If the SME chooses the older version, will it have to disclose the impact of any changes to that standard that have been issued but are not yet operative?

Furthermore, the IFRS for SMEs should not be used to try out potential changes to full IFRS. Any major changes to accounting should be implemented by ED of a full IFRS first and then reflected in the IFRS for SMEs if appropriate.



**The Institute of
Chartered Accountants
in Australia**

17 September 2007

The Chairman
Australian Accounting Standards Board
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Dear David

ITC 12 – Differential Reporting and the Proposed IFRS for SMEs

The Institute of Chartered Accountants in Australia (The Institute) welcomes the opportunity to make a submission on ITC 12 and to debate the future of differential reporting in Australia.

In its deliberations, we suggest that the AASB needs to take into account the work being done in this area by other bodies, such as the Treasury's discussion paper on unlisted public companies as these proposals interact with those of the AASB. We also recommend that no changes (if, at the end of the day, any are required) be made to the Australian differential reporting framework until the IASB has issued its final IFRS for SMEs. Our comments in this submission are based on the current draft of the IFRS for SMEs but if it were to change dramatically, our comments on how it should be used in Australia might also change.

As you will be aware from our submission to the IASB (and copied to the AASB), we generally support the proposed IFRS for SMEs. However we have significant concerns about the AASB's proposals for differential reporting in Australia and consequently how the IFRS for SMEs might be used here. The vast majority of our membership, from large firms and small and from business, supports the reporting entity concept and sees no reason for its removal.

The reporting entity concept has operated reasonably successfully for over a decade. We are aware that there have been interpretation issues surrounding the operation of the reporting entity concept in the context of Corporations Act entities, but in our view these can be readily addressed by giving explicit legal backing by way of an accounting standard to the views expressed in the ASIC Guide regarding recognition and measurement. There is no need to do away with the reporting entity concept altogether as the AASB proposes in ITC 12. The proposals in ITC 12 remove the flexibility of entities to prepare financial reports that suit the needs of users. These proposals impose a much more rigid financial reporting framework, which will be expensive for the community to implement and will require the production of more complex financial information for which there are no substantive users.

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The reporting entity concept forms a valuable conceptual backdrop to the Australian financial reporting environment and should not be discarded lightly. It also provides a framework for financial reporting that is not regulated by the Corporations Act, for example associations, trusts and small proprietary companies. While these types of entities are outside the scope of the Corporations Act, they may still be reporting entities. Much of what the AASB is proposing in terms of "public interest" bears a remarkable similarity to the content in SAC 1 *Definition of the Reporting Entity* and we suggest that the new approach should build on work the AASB and its predecessor Boards has already done.

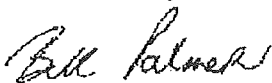
We disagree with the AASB's interpretation of the application paragraphs in the standards such that all reports lodged with the ASIC are deemed to be general purpose. As far as we are aware from ASIC's publications, this was never intended (see *Reporting Requirements for Non-reporting Entities – an ASIC Guide* and ASIC's original Media Release 92/106 issued when differential reporting first came in). The definition of general-purpose financial report per the AASB Glossary is "A financial report *intended* to meet the information needs common to users who are unable to command the preparation of reports so as to satisfy, specifically, all of their information needs". In the case of non-reporting entities, the reports are prepared to satisfy the information needs of specific users and lodgement is merely a matter of regulatory compliance. The intent of the preparers of a special purpose report is quite clear from reading the introduction to the statement of accounting policies, generally found in Note 1.

Our detailed comments follow. We also attach copies of:

- our white paper "Financial Reporting Standards for Small and Medium Entities: Stakeholder Insights", the findings in which come out of our Forum on Financial Reporting for SMEs held in June 2007;
- our submission on the Treasury discussion paper on unlisted public companies; and
- our submission to the IASB on the proposed IFRS for SMEs.

If you require any further information, please contact Kerry Hicks, Head of Reporting or myself.

Yours sincerely



Bill Palmer
General Manager Standards and Public Affairs

Specific Matters for Comment

(a) do you agree with changing the application focus of Australian Accounting Standards from 'reporting entity' to 'general purpose financial reports'?

The Institute disagrees with this proposal as it removes the flexibility of entities to prepare financial information that suits their users. We understand there have been interpretation issues surrounding the operation of the reporting entity concept. In our view these issues could be resolved by a statement within the AASB legally enforceable literature that Corporations Act entities need to comply with the recognition and measurement rules of the accounting standards or that the ability of a non-reporting entity to omit sections of an accounting standard extends to disclosure issues only. This approach could be achieved through the use of a separate accounting standard or by asterisked paragraphs, as used for differential reporting in New Zealand. This approach will still give users considerable flexibility as regards to disclosure.

Moving the focus to 'general purpose financial reports' merely moves the problem. There are numerous regulators outside the Corporations Act environment, which require the lodgment of financial information. A focus on 'general purpose financial reports' with commentary that lodgment on the public record means that a report will be general purpose could bring many small entities such as co-operatives and associations within the scope of general purpose financial reporting. At present, it is open to the members of such an organisation to decide the level of reporting that is appropriate to their needs. Furthermore, as we explained in our covering letter, this approach is at odds with ASIC's own pronouncements on the impact of lodgment on the public record.

Our members from larger practices and from business are particularly concerned about the impact these proposals would have on subsidiaries in large groups. Large groups need consistent accounting policies across the group (AASB 127 paragraph 28) and are therefore committed to following full IFRS, but need relief from the disclosure requirements of full IFRS. Adoption of IFRS for SMEs to obtain the disclosure concessions could result in inconsistent measurement in some areas of the financial report. We understand that similar issues exist in the public sector.

(b) if it is considered desirable to retain the reporting entity concept as the basis for differential reporting, what improvements could be made to remove related concerns(see paragraph BC6) and make it more effective?

The Institute disagrees with the AASB's reasoning in BC 6 supporting the removal of the reporting entity concept.

Firstly, the Institute considers that the issue of international comparability is not relevant to non-reporting entities. By nature, these entities have a restricted pool of users who have a say in the type of financial information they want. If the users want internationally comparable financial reports, they can request them.

Secondly, Australia is one of only a few countries that have adopted IFRS for all reporting entities. Other jurisdictions have de facto differential reporting by virtue of requiring IFRS for listed entities and local GAAP for non-listed entities. Even with the operation of the reporting entity concept, the entities for which international comparability is relevant are internationally comparable. Smaller entities in other countries do not have to be internationally comparable, so why require this of Australian entities?

We are already using a local equivalent of the concept of public accountability, as the IASB's definition of public accountability in the proposed IFRS for SMEs is not dissimilar from our "disclosing entity" as defined in the Corporations Act.

In the for-profit sector, with minimal legislative change, Australia could implement a differential system as follows (refer diagram in the Appendix):

1. Publicly accountable entities using full IFRS;
2. Non publicly accountable reporting entities, which can choose to use full IFRS or the IFRS for SMEs (the entity's choice, which should be disclosed);
3. Non-reporting Corporations Act entities, which can choose to use IFRS for SMEs or full IFRS recognition and measurement with reduced disclosure – the entity's choice, which should be disclosed; and
4. Non-reporting non-Corporations Act entities, which can choose the accounting policies and disclosures that, are applicable to the users, unless required to comply with particular standards under respective legislation.

(c) do you support the proposal to apply the IASB's definition of a publicly accountable entity to differentiate between for-profit entities that apply Australian equivalents to IFRSs and for-profit entities that apply an Australian equivalent to the IFRS for SMEs?

We support this proposal, but the concept of public accountability needs to be clarified, as we identified in our submission to the IASB on the Proposed IFRS for SMEs. We stated:

"We have concerns about the use of the public accountability criterion and the definition of "publicly accountable" in the Glossary. Such a principles based definition may lead to significant differences in interpretation as has happened in Australia with our reporting entity concept. It is therefore vital that the definition should be clear and rigorous. The question arises as to how far public accountability should stretch. If one includes entities that hold assets in a fiduciary capacity, does that extend to the high street travel agent or insurance broker? Such businesses can be quite small but still hold assets in a fiduciary capacity on behalf of their clients. Similarly, would a trustee company that does nothing apart from acting as trustee for a family trust be publicly accountable?"

We further direct the Board's attention to the Corporations Act defined term "disclosing entity". This term should be referred to in the definition of publicly accountable (at least

in an Australian context), to ensure that we do not have a situation where entities are subject to slightly different definitions.

(d) in respect of for-profit entities that do not satisfy the IASB's definition of a publicly accountable entity, but are viewed as being important from a public interest perspective because of their large size:

(i) do you agree that such entities should in the public interest apply Australian equivalents to IFRSs and that it is appropriate to use size thresholds to identify these entities?

(ii) do you agree with the proposed size thresholds? If you do not agree, what do you consider to be the appropriate thresholds, and why?

We do not see the need for size thresholds. The use of size thresholds would seem to suggest that the proposed IFRS for SMEs is in some way inadequate as an accounting standard. If an entity is not publicly accountable, IFRS for SMEs should be adequate for a privately held entity regardless of its size in dollar terms.

(e) since the IASB's ED of A Proposed IFRS for SMEs has been developed with only for profit entities in mind, do you agree it is appropriate to adopt the forthcoming IASB's IFRS for SMEs (after inclusion of Aus paragraphs similar to those included in Australian equivalents to IFRSs) in a differential reporting regime in respect of not-for-profit private sector entities and public sector entities?

The Institute disagrees with this proposal. The idea of the proposed IFRS for SMEs is to simplify the requirements. Adding numerous Aus paragraphs will make the standard harder for preparers of financial reports to use.

Feedback from our members tells us that they would like the AASB to draft a specific not-for-profit standard, using the IFRS for SMEs as a base, rather than just adding Aus paragraphs. This should be done in the context of a thorough review of not-for-profit reporting.

Furthermore, we understand that the needs of the users of not-for-profit reports are different. Users focus more on how well the entity has fulfilled its service objectives rather than its "bottom line". These different needs could be incorporated into a specific standard. We refer you to our 2007 Institute publication *Enhancing not-for-profit annual and financial reporting* for more information on the needs of users of not-for-profit financial reports.

- (f) in respect of not-for-profit private sector entities:
- (i) is there a need for differential reporting in the not-for-profit private sector? If yes, do you agree with using size thresholds to distinguish between not-for-profit private sector entities that should apply Australian equivalents to IFRSs and those that should apply an Australian equivalent to the IFRS for SMEs (which would include Aus paragraphs similar to those included in Australian equivalent to IFRSs)?
 - (ii) do you agree with the proposed size thresholds? If you do not agree, what do you consider to be the appropriate size thresholds and why?
 - (iii) not-for-profit entities that meet the thresholds of \$25m revenue and \$12.5m assets would prepare their general purpose financial reports in accordance with the Australian equivalents to IFRSs. In contrast, non-publicly accountable for-profit entities would only be required to apply the Australian equivalents to IFRSs when they meet the thresholds of \$500m revenue and \$250m assets. The AASB has justified this difference based on the higher degree of public interest in the activities of not-for-profit entities. Do you agree?
 - (iv) both private sector not-for-profit entities and public sector entities that meet the thresholds of \$25m revenue and \$12.5m assets would need to prepare their general purpose financial reports in accordance with the Australian equivalents to IFRSs. The AASB has justified the common size thresholds for both types of entities based on a view that there is an equivalent degree of public interest in the activities of these two types of entities. Do you agree?
 - (v) do you think a third tier of simpler reporting requirements should be added to cater for smaller not-for-profit private sector entities that prepare general purpose financial reports? If so, what should those simpler reporting requirements be and how would the category of entities applying those requirements be identified? How would your answer to this question differ if the forthcoming IFRS for SMEs has fewer disclosures than the ED of A Proposed IFRS for SMEs?

We identified there is a need for differential lodgement in the not-for-profit sector in our written submission to Treasury on this issue which has been attached to this submission. Further our submission identifies a governance process that could be adopted for entities that are not required to lodge financial statements if differential lodgement was introduced.

The participants in our SME Forum held in June 2007 (our white paper is attached) identified a potential need for separate paragraphs, or even separate standards, for the public sector and not-for-profit entities.

As we stated in (e) above, we suggest the AASB perform a comprehensive review of not-for-profit reporting in conjunction with the Treasury consultation on unlisted public companies.

(g) in respect of public sector entities:

- (i) is there a need for differential reporting in public sector? If yes, do you agree with differentiating based on size thresholds between public sector entities that should apply Australian equivalents to IFRSs and those that should apply an Australian equivalent to the IFRS for SMEs (which would include Aus paragraphs similar to those included in Australian equivalents to IFRSs)?**
- (ii) do you agree with the proposed size thresholds? If you do not agree, what do you consider to be the appropriate thresholds and why?**
- (iii) public sector entities that meet the thresholds of \$25m revenue and \$12.5m assets would prepare their general purpose financial reports in accordance with the Australian equivalents to IFRSs. In contrast, non-publicly accountable for-profit entities would only be required to apply the Australian equivalents to IFRSs when they meet the thresholds of \$500m revenue and \$250m assets. The AASB has justified this difference based on the higher degree of public interest in the activities of public sector entities. Do you agree?**
- (iv) both public sector entities and not-for-profit private sector entities that meet the thresholds of \$25m revenue and \$12.5m assets would prepare their general purpose financial reports in accordance with the Australian equivalents to IFRSs.**
- (v) The AASB has justified the common size thresholds for both types of entities based on a view that there is an equivalent degree of public interest in the activities of these two types of entities. Do you agree?**
- (vi) do you think another tier of simpler reporting requirements should be established to cater for smaller public sector entities? If so, what should those simpler reporting requirements be and how would the category of entities applying those requirements be identified?**

We understand that the public sector has similar issues with these proposals as large group entities in the private for-profit sector because of the different measurement rules in IFRS and proposed IFRS for SMEs. Public sector entities will eventually be consolidated into a whole-of-government report and so measurement needs to be consistent between entities, however smaller public sector entities would benefit from the ability to disclose less if they were considered a non-reporting entity.

In our view, the retention of the reporting entity concept would give entities the flexibility to prepare financial reports that suit their users' needs.

(h) do you think there are approaches, other than the proposed approach based on public interest and employing size thresholds, that would reasonably distinguish between entities that should apply the Australian equivalents to IFRSs and those that should apply an Australian equivalent to the IFRS for SMEs? If there are appropriate alternative approaches, please explain.

Refer to our responses above.

(i) do you agree that, consistent with the IASB's view of a general purpose financial report, under a revised Australian differential reporting regime:

- (i) all financial reports that are available on a public register, such as those prepared and lodged with the ASIC under the Corporations Act, should be regarded as general purpose financial reports; and**
- (ii) all financial reports that are made available to the public at large, such as those tabled in a Parliament, also should be regarded as general purpose financial reports?**

If you do not agree, explain why.

The Institute disagrees with this proposal for the reasons given in our covering letter. Furthermore, in our view, the phrase "made available to the public at large, such as those tabled in Parliament" is very open ended. This could include reports such as a Statement of Distribution of Funds prepared by a liquidator or trustee in bankruptcy. It would also include prospectus style documents that often contain pro-forma information, or information that has been adjusted to show financial trends and may no longer strictly be a general purpose financial report.

If, however, there is clear legislative backing for the practice of applying all measurement and recognition standards, many of the perceived interpretation issues associated with the reporting entity concept will disappear.

(j) Do you agree that, notwithstanding an entity having been exempted from filing a financial report with the ASIC, its financial report should be regarded as a general-purpose financial report if it is required by the Corporations Act to be prepared in accordance with Australian Accounting Standards?

The Institute disagrees with this statement. If the report is described as special purpose in Note 1, kept private and only circulated at the discretion of the entity's owners, it cannot satisfy the definition of a general-purpose financial report in the AASB Glossary.

(k) The Corporations Act includes three size thresholds respectively for revenue, assets and the number of employees to distinguish between small and large proprietary companies. The AASB's proposed size thresholds only include the monetary thresholds of revenue and assets. Do you think that, except for the case of for-profit entities that are not publicly accountable but are important from a public interest perspective, a further size threshold for the number of employees would be appropriate under the proposed differential reporting for not-for-profit private sector entities and public sector entities?

We do not support the introduction of size thresholds for differential reporting requirements.

- (l) Considering the AASB's tentative decision to base the second tier of reporting requirements on the IASBs pending IFRS for SMEs, do you consider that the IASB's ED of A Proposed IFRS for SMEs is appropriate for Australian circumstances? If not, explain how it could be improved, or what other options are more appropriate and why.**

The Institute supports the IFRS for SMEs as a standard. It is easier to use than the full suite of IFRS and would be a useful option for reporting entities that are not publicly accountable.

Our members tell us they would like the proposed IFRS for SMEs to be further simplified, particularly since it may be used for quite small not-for-profit and public sector entities.

For more detailed comments, refer to our attached submission on the IFRS for SME proposal.

- (m) Do you think adaptations, or additional guidance, are needed (in addition to Aus paragraphs that would be included consistent with Australian equivalents to IFRSs) for not-for-profit private sector entities and public sector entities if the IASB's IFRS for SMEs were adopted in Australia?**

Many of our members would like a specific not-for-profit standard based on the proposed IFRS for SMEs rather than the IFRS for SMEs with Aus paragraphs added. The addition of Aus paragraphs makes the standards harder to read and apply, particularly for the non-technical user.

- (n) Do you think Australia and New Zealand should seek to achieve harmonisation in their reporting requirements regarding SMEs?**

In view of the close economic relations between Australia and New Zealand, The Institute considers that harmonization with New Zealand is very important.

- (o) Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the preliminary views?**

The AASB should not finalise any outcome on unlisted public companies, until the outcome of the Treasury consultation on unlisted public companies is known.

Once IFRS for SMEs is finalised by the IASB we would expect the AASB to issue an Exposure Draft on the proposed differential reporting regime, which includes review of any significant changes to the IASB standard.

(p) do you think that the overall benefits that would arise from the proposals would exceed the overall costs? If you are an entity that prepares a general purpose financial report or would need to do so under the proposals, please advise us of any increased costs or any savings that would result from the proposals, and if possible, quantify them.

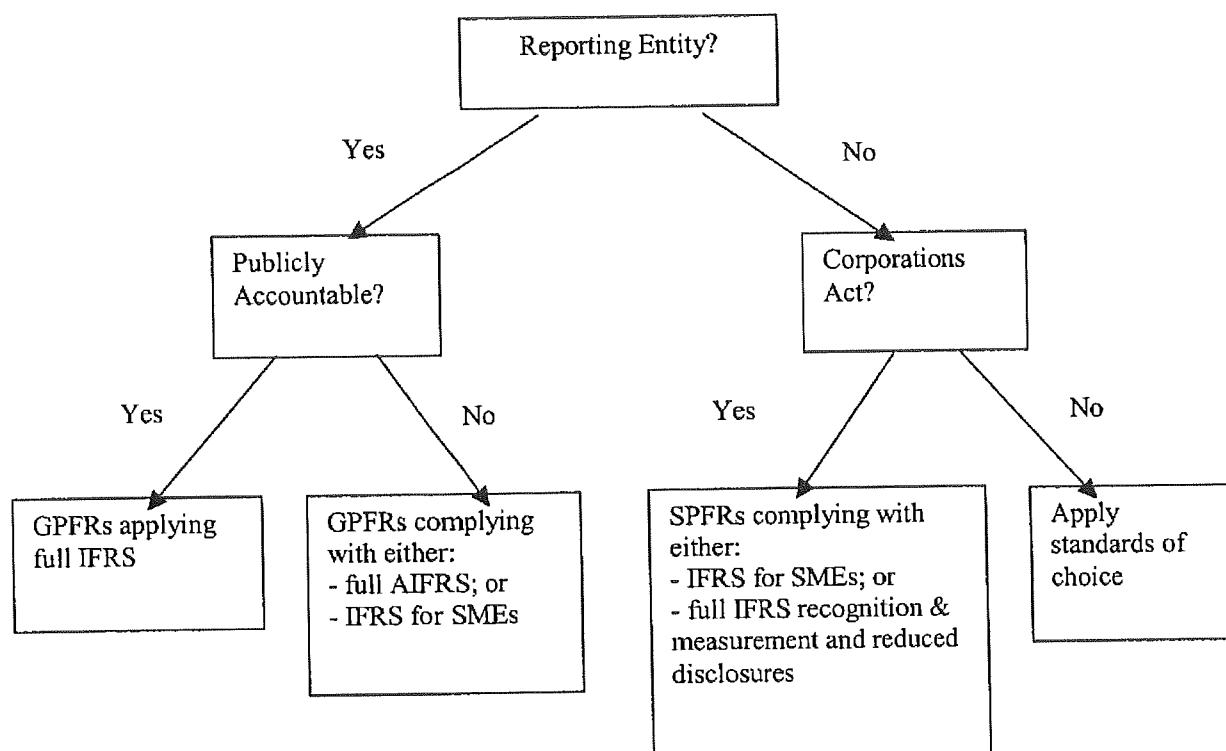
In the Institute's view, the costs to the community of implementing the proposals contained in ITC 12 will outweigh the benefits, as the proposals remove flexibility and impose arbitrary thresholds.

(q) Would the preliminary views be in the best interests of the Australian economy?

The Institute does not believe these proposals are in the best interests of the Australian economy for the reasons given above. They seem contrary to the government policy of cutting red tape.

We support the introduction of an IFRS for SME standard as part of an enhancement to the existing reporting entity framework. This would provide a choice to non-publicly accountable entities to adopt a standard with reduced disclosure recognition and some simpler recognition and measurement principles.

Appendix – Response to ITC 12 Proposal





The Institute of
Chartered Accountants
in Australia



24 August 2007

The General Manager
Corporations and Financial Services Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Email: UPCcomments@treasury.gov.au

Dear Sir/Madam,

Re: Financial Reporting by Unlisted Public Companies

CPA Australia, The Institute of Chartered Accountants in Australia and the National Institute of Accountants (the professional bodies) welcome the opportunity to make a submission on the Discussion Paper: Financial Reporting by Unlisted Public Companies. The joint submission does not address unlisted public companies limited by shares.

The professional bodies support some form of differential reporting for companies limited by guarantee that fall below a turnover-related threshold or size test. However, this support does not extend to eliminating all reporting requirements for these entities. The professional bodies believe these entities have both sufficient numbers of members and a general accountability to the community, such that an exemption for these entities from lodging any form of report is inappropriate.

There are varying views amongst the memberships of the three bodies on what the appropriate reporting mechanisms should be. We wish to draw your attention to three possibilities that have been the subject of discussion:

- Some commentators argue the work being done by the International Accounting Standards Board (IASB) in relation to the development of a standard known as 'IFRS for SMEs' provides a suitable level of reporting for companies limited by guarantee that fall below a threshold;
- A further alternative being considered by some commentators is the development of modified accounting that is simpler than the one proposed in 'IFRS for SMEs'. Commentators adopting this position appear to favour a cash basis method;
- Another suggestion is the development of a governance or accountability report that contains the fundamental information relevant to understanding a company limited by guarantee such as the names and positions of those charged with the governance of the entity, financial information in the form of key financial data or abbreviated financial statements and some mandatory notes such as expanded expenses and revenue disclosure and a related parties statement.

These proposals are set out in more detail in the separate submissions of the three accounting bodies.

We would ask Federal Treasury to give further consideration to each of the proposals in the separate submissions. We would consider it sufficient that the report prepared by a company limited by guarantee against the differential reporting regime be able to be audited by a member of the three recognised professional accounting bodies holding a practicing certificate.

While this joint letter states those views that are commonly held across the bodies it is important to acknowledge the fact all three bodies have conducted a range of consultations with members in preparation for drafting submissions to Federal Treasury. All three bodies have run either focus groups or discussion forums with members across the country and have sought members' feedback, which has led to a general consensus on the issues above. An online survey was conducted by the Institute of Chartered Accountants. That online survey data is provided in an appendix to their letter.

We note that the Australian Accounting Standards Board (AASB) currently has its proposals for differential reporting out for public comment. This may have an impact on the alternative reporting models for unlisted public companies stated above.


The professional accounting bodies thank Federal Treasury in advance for its consideration of the issues and we look forward to discussing the various aspects of our collective work in this topic area in the near future.

Please feel free to contact the Mark Shying (CPA Australia) on 03 9606 3903, Bill Palmer (Institute of Chartered Accountants in Australia) on 02 9290 5613 or Tom Ravlic (National Institute of Accountants) on 03 8665 3143 should you wish to discuss any issues further.

Yours sincerely



Geoff Rankin FCPA
Chief Executive Officer
CPA Australia Ltd



Graham Meyer
Chief Executive Officer
The Institute of Chartered
Accountants in Australia



Roger Cotton
Chief Executive Officer
National Institute of Accountants



**The Institute of
Chartered Accountants
in Australia**

The General Manager
Corporations and Financial Services Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

27 August 2007

Dear Sir

Re: Financial Reporting by Unlisted Public Companies

The Institute of Chartered Accountants in Australia welcomes the opportunity to make a submission on the Discussion Paper: Financial Reporting by Unlisted Public Companies.

The issue is complicated by the fact that these proposals interact with those of the AASB in ITC 12 with regard to the future of the reporting entity concept and the possible application of the proposed IFRS for SMEs in Australia. The reporting framework is consequently in a state of flux.

In our detailed response we suggest that companies limited by guarantee should continue to report to their members in some form, but that small ones (those that fall below certain thresholds) should not be required to lodge audited general purpose financial reports with the ASIC. However, we strongly recommend that some governance framework, administered by ASIC be set up to supervise these smaller unlisted public companies.

We conducted an online survey of our membership and received 48 responses. This is a high level of response to a financial reporting survey and indicates to us that there is a great deal of interest in these issues in the community. We attach a summary of the findings for your information.

Our detailed comments are attached.

Yours faithfully

Bill Palmer
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Unlisted Public Companies Discussion Paper

Companies Limited by Guarantee - Financial Reporting

- A. *Do you support the introduction of a differential reporting regime based on size for companies limited by guarantee? If so, what do you consider to be the appropriate criteria (both in terms of the indicators of size and the quantum of those indicators) for differentiating between those companies that are required to report and those companies that are exempt?*

We do support a differential reporting regime for companies limited by guarantee. In response to our survey, just over half of those who suggested thresholds suggested using the revised small/large proprietary company thresholds brought in by the Simpler Regulatory System legislation. Feedback from participants at our Financial Reporting for SMEs forum in June, however, leads us to believe that the community as a whole would not be comfortable with removing financial reporting and audit requirements from all companies limited by guarantee that fall below that level. In addition a significant minority of respondents to our survey suggested using a lower threshold, such as revenue of \$5m, \$2m or \$1m. Of the suggestions, \$5,000,000 was the most popular.

Our suggestion is therefore a compromise approach. Based on Table 1 of the discussion paper, we suggest that companies limited by guarantee above the \$25,000,000 revenue threshold apply full IFRS (per Table 1, this is the top 5% and is likely to include those that are publicly accountable) and those below apply a specific not-for-profit standard to be formulated by the AASB. Subject to the outcome of the ITC 12 consultation process, this might be based on the proposed IFRS for SMEs. We further suggest that companies limited by guarantee with below \$5,000,000 in revenue be exempted from the financial reporting and auditing requirements of the Corporations Act in a similar manner to small proprietary companies, but be subject to enhanced corporate governance requirements. From Table 1 in the discussion paper, we can see that such a cut-off point would exempt something like 75% of the companies limited by guarantee from the requirement to prepare audited general purpose reports. We have deliberately omitted an asset test here as we are aware that some not-for-profits for historical reasons own significant assets.

We are suggesting this lower threshold in view of the cost of preparing general purpose financial information compared with the benefit for members. While there is a significant level of public interest in these entities, members are primarily focused on whether the entity is fulfilling its stated objectives, whether that be charitable work, maintaining the golf course or whatever, rather than in its detailed finances. Apart from wanting comfort that the entity can continue to operate as a going concern, most of the financial information provided in a general purpose financial report is irrelevant to the membership. Such comfort can be derived by the imposition of a rigorous governance structure.

We assume that small unlisted public companies that are exempted from financial reporting and auditing obligations would be subject to the requirement in S 347A of the Corporations Act to pass a solvency resolution within 2 months of the review date of the company, in the same way as small proprietary companies are at present. In order to be able to make such a resolution, the directors need to have a reasonable governance structure in place. Small public companies that remain unaudited (ie, without a requisition by members) should be required to demonstrate an ongoing strong governance environment. Such a governance structure could include (as suggested by one of our members) various elements, not dissimilar to the attributes that ASIC looks for in granting audit relief to large proprietary companies, for example:

- Documented governance policies
- Directors trained in governance and accredited with some minimum qualification in governance (for example, Certificate IV in Small Business Management, a qualification widely available from TAFE – see <http://www.seeklearning.com.au/tafe/certificate-4-in-small-business-management.asp>)
- A strategic plan, action/business plan and risk register, all reviewed triennially
- Policies and procedures manuals
- Annual budgets and cash flow projections
- Annual accounts, which would not be general purpose, signed by the directors, prepared within 4 months of balance date and presented to AGM of members. Such accounts would comprise a detailed profit and loss account, a cash flow statement, a balance sheet, a statement of significant accounting policies, disclosure of significant commitments and related party disclosures.
- An Annual Return, including financial data (something like the old key financial data) and confirmation of the directors' solvency resolution, signed by the directors, to be lodged with ASIC
- The option of independent audit where 5% of members requisition a meeting to appoint an auditor

This structure would be supported by a triennial review of the governance and control environment by an independent reviewer (say a Registered Company Auditor or accredited member of a review panel). Should breaches be detected in items such as:

- Governance framework and control environment
- Triggering of a small/large test
- Propriety and timeliness of financial reporting to members
- Inappropriate accessing of benefits by directors or officers (pecuniary interest or conflicted directors etc)
- Late/no AGMs
- Late/no financial data or annual return or equivalent lodged with ASIC,

then that small public company should be subject to independent audit for a minimum 3 year period; the auditor would be appointed either by ASIC or by the members. Financial reports would be under, the appropriate reporting framework (perhaps the proposed IFRS for SME's, subject to the outcome of the ITC 12 consultation process) for that 3 year period.

We envisage ASIC would remain the regulator for these companies.

In our view, while the members of a company limited by guarantee may only seldom ask to see the financial report, they do at present derive some comfort from the fact that they know that one is prepared and audited. In our experience of running an auditing and financial reporting help line for the past fifteen years or so, fraud in licensed clubs (generally companies limited by guarantee) is not uncommon. Furthermore, the enquiry into the Penrith Panthers also suggested that the undisclosed accessing of benefits by directors and officers is an issue for members. Therefore it is absolutely vital that other mechanisms need to be put in place to ensure good governance if some entities are going to be relieved of the obligation to lodge audited financial reports.

- B. *Do you believe it is appropriate to differentiate between companies limited by guarantee by the nature of their operations rather than just size? If so, what nature of operations do you believe warrants greater transparency?*

74% of our respondents did not believe it is appropriate to differentiate between companies limited by guarantee by the nature of their operations rather than just size. Some constituents did, however, refer to the increased requirements for accountability where the entity has a liquor license or poker machines.

In our view, this kind of qualitative decision-making has led to confusion in the application of the reporting entity concept and in the decision as to whether an entity is in fact not-for-profit and eligible to use the not-for-profit concessions in the AASB standards. Not-for-profit reporting generally has a tight budget and the reporting regime should be kept simple to apply.

- C. *Do you consider that companies limited by guarantee that receive any money through grants should have financial reporting requirements? If so, can this obligation be satisfied by the company providing special purpose financial reports to the grantor rather than preparing general purpose financial reports under the Corporations Act?*

The acquittal of government grants is an issue that needs to be decided in consultation with the bodies generally granting the funds. While an acquittal report designed by the department concerned and signed off by the entity's auditor is more likely to provide relevant information to the grantor body than general-purpose financial reports, if every grantor body is asking for something slightly different, it makes compilation and audit or review of the report harder for the not-for-profits and for their advisers.

Users may find it helpful if the Department of Administration and Finance, together with its State counterparts, be delegated the task of preparing a standard form of grant acquittal report for government agencies and that they liaise with the Attorney General's Department and professional accounting bodies about the accounting and auditing requirements to obtain greater uniformity and simplicity.

With the introduction of thresholds, the acquittal report becomes even more important. For those companies falling below the chosen threshold, the acquittal report will be the only means the grantor has of assessing that the funds have been used appropriately.

- D. *If you support some companies limited by guarantee being exempted from financial reporting, what percentage of members should be required in order to require an exempt company limited by guarantee to prepare a financial report?*

Our survey revealed roughly equally strong support for the following percentage cut-off points: 5%, 10%, 25% and 75%. Our view is that 5% of members (in line with S 293 of the Corporations Act) or 100 members in number, whichever is lower, should be able to require a company limited by guarantee that falls below the lower threshold to prepare a financial report.

This requirement must, however, be supported by a strong commitment from the regulator to take an interest in the affairs of companies that fall below the threshold. Anecdotal evidence from our help line indicates that the provision in the Corporations Act enabling holders of 5% of a small proprietary company to demand financial reports can be ineffective where there is a falling out between shareholders. We have heard of instances where shareholders without the resources to pursue legal remedies are ignored by the majority owners when they request financial reports. When they complain to ASIC about the contravention of the Corporations Act, they receive no support. When a dispute between members arises, the majority or the individuals more concerned with day-to-day management may often be in a position to draw on company funds to pay legal expenses, whereas private individuals have to put in their own

money. Commencing legal action is very costly and private members can be effectively deprived of their rights if they cannot afford to pay to have them enforced.

- E. *If you support the retention of financial reporting requirements for all companies limited by guarantee, do you consider that there is scope to reduce the amount of financial information these companies are required to report? If so, what type of financial information do users need companies limited by guarantee to report (for example, related-party disclosures)?*

See our answer to A above.

To some extent, the answer to this question must depend on the outcome of the AASB's consultation on ITC 12. We suggest that companies limited by guarantee with revenue between \$5,000,000 and \$25,000,000 be able to use IFRS for SMEs (tailored for not-for-profits) if it is issued for use in Australia instead of full IFRS, should they wish. For the time being, under the current reporting framework, or if the proposals in ITC 12 do not gain acceptance, companies limited by guarantee that are non-reporting entities and fall between these two thresholds should be able to continue to prepare simplified accounts.

- F. *Do you consider that there is a need to harmonise the financial reporting requirements of companies limited by guarantee and incorporated associations to provide a consistent reporting framework for not-for-profit entities in Australia?*

We wholeheartedly agree with this proposition. Work done by our Not-for-profit Group in Victoria has demonstrated the wide variety of requirements that not-for-profits are subject to around Australia – see <http://www.charteredaccountants.com.au/files/documents/ICAA07-SSASubmission042707.pdf>. As time passes, Australia acts more and more as one single economy and a not-for-profit may have branches in every state. It would be of considerable assistance to our members and their clients if the requirements were harmonised.

We note the view recently expressed by David Gonski in "Company Director" August 2007 that a special not for profit corporate entity be established to replace companies limited by guarantee and associations, under powers referred to the Commonwealth by the States. This suggestion is, in our view, worthy of further investigation.

- G. *In order to assist in progressing this project, it would be useful to obtain an indication from companies limited by guarantee of the cost of preparing a directors' report and audited financial report as required by the Corporations Act.*

We are unable to provide this information, but are publicising the paper to our members who may be able to assist you. We have heard estimates ranging from \$7,500 to \$60,000.

Companies Limited by Guarantee - Auditing

- H. *If some companies limited by guarantee were to be exempt from financial reporting, do you consider there is value in these companies continuing to be subject to some level of non-statutory external assurance as a means of promoting good governance? If so, what should this assurance relate to and how do you think this regime should be introduced (for example, through best practice guidelines issued by the professional accounting bodies)?*

In our view, companies limited by guarantee that are required to prepare and lodge general-purpose financial reports should have them audited.

Those companies that fall below the threshold and are not required to lodge general-purpose financial reports should be subject to a governance regime similar to that used by ASIC in its

audit relief Class Order (see A above). Under that Class Order, large proprietary companies can be excused from having an audit if a suitably qualified accountant certifies that appropriate governance practices are in place.

In light of the shortage of registered company auditors in country areas, we suggest that the governance review described in A above should be able to be performed by a member of the accounting bodies with a practicing certificate.

In order to safeguard the public interest, regulation for those companies limited by guarantee that fall below the lower threshold should still be statutory.

- I. For those companies limited by guarantee that are required to prepare financial statements, do you consider that there is a need to change the current audit requirements? If so, which aspects of the current requirements need to be reformed?*

In our view, the current audit requirements are satisfactory for those companies limited by guarantee that are above our lower threshold and are therefore required to prepare financial statements.

Companies Limited by Guarantee - Other issues

- J. Do you support amending the Corporations Act so that companies limited by guarantee are specifically prohibited from distributing profits to members in the form of dividends?*

We were not aware that there was any demand for the legislation to be changed in this way, but we have no objection to such a change being made.

Unlisted Companies Limited by Shares

- K. Do you support the principle that all for-profit companies that have raised capital from the public should have statutory annual financial reporting obligations?*

We support this principle.

- L. Given a satisfactory mechanism to allow unlisted public companies limited by shares with a not-for-profit objective to convert to a company limited by guarantee is not available, would you support an equivalent differential reporting regime to that proposed for companies limited by guarantee to be established for unlisted public companies limited by shares with a not-for-profit focus? If so, do you support using the definition of not-for-profit entity in the accounting standards to determine whether a company has a not-for-profit focus?*

We question how many companies limited by shares with a not-for-profit objective there are and therefore how necessary this proposal is.

We also have reservations about this proposal as the definition of not-for-profit in the accounting standards is interpreted differently from practice to practice. However, if, as is proposed, the AASB drafts a more rigorous definition with supporting commentary, we would support this proposal.

M. In order to assist in progressing this project, it would be useful to obtain an indication from unlisted public companies limited by shares of the cost of preparing a directors' report and audited financial report as required by the Corporations Act and also the number of unlisted public companies limited by shares that have a not-for-profit objective.

We are unable to provide this information, but are publicising the paper to our members who may be able to assist you.

**The Institute of Chartered Accountants in Australia
Financial Reporting Standards for Small and
Medium Entities: Stakeholder insights**

August 2007



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**The Institute of
Chartered Accountants
in Australia**

The Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 54,000 of today's and tomorrow's business leaders, representing some 43,000 Chartered Accountants and 11,000 of Australia's best accounting graduates who are currently enrolled in our world-class post-graduate program.

Our members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 107 countries around the world.

We aim to lead the profession by delivering visionary thought leadership projects, setting the benchmark for the highest ethical, professional and educational standards, and enhancing and promoting the Chartered

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All information is current as at August 2007.

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First published August 2007

Published by: The Institute of Chartered Accountants in Australia
Address: 33 Erskine Street, Sydney, New South Wales, 2000

Financial Reporting for Small and Medium-sized Entities
First edition

Financial Reporting for Small and Medium-sized Entities
ISBN 978-1-921245-29-9

Foreword

Since the International Accounting Standards Board (IASB) introduced the International Financial Reporting Standards (IFRS), many Australian small and medium sized entities (SMEs) have been striving to adopt the standards for the reporting period beginning on or after 1 January 2005.

In February 2007, the IASB published a draft IFRS standard for SMEs with the aim of providing 'a simplified self-contained set of accounting principles that are appropriate for smaller, non-listed companies... (and) would allow investors for the first time to compare SME's financial performance across international boundaries on a like for like basis'.

Known as the IFRS-for-SMEs project, comments on the Exposure Draft (ED) are required, by 1 September 2007, to the Australian Accounting Standards Board (AASB) and by 1 October 2007 to the IASB.

With more than 95 per cent of companies in Australia being SMEs, the Institute provided 24 expert representatives from business, the accounting profession, regulatory and industry bodies and academia with the opportunity to express their views on the ED and other SME financial reporting issues. On Wednesday, 20 June 2007, the Institute hosted a forum on financial reporting for SMEs.

It is essential that the Institute lead the debate about financial reporting standards for SMEs. That is why the Institute developed a discussion paper *Financial Reporting for Small and Medium-sized Entities**. It is the reason why the Institute hosted the forum and it is why the Institute is using the outcomes of the forum in drafting its submissions to the IASB and other key standard setters.

By bringing together the expert panel at the Financial Reporting Standards for SMEs Forum, the Institute hopes to broaden the debate with a view to reaching a consensus. The Institute benefited from the broader perspective on issues raised by delegates and will use these to respond to the related AASB request for comment on a proposed differential reporting regime for Australia, ITC 12, (which includes the IASB's SME ED) and a recently released Treasury discussion paper on *Financial Reporting by Unlisted Public Companies*.

The Institute has published this White Paper so that interested parties can share those ideas.



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* Available in PDF form on the Institute's website.



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Executive summary

Small to medium-sized enterprises in Australia face a myriad of challenges including greater competition, a shortage of skilled labour, higher administrative burdens and faster technological changes. Changes to the existing differential reporting regime and the application of any new international financial reporting standard for SMEs could potentially mean even greater regulation and complexity.

The Institute has a vital interest in this issue and has engaged in a range of leadership activities to seek a consensus as to the most appropriate reporting framework for SMEs.

The 20 June forum brought together leading figures from business and the accounting profession, standard setters, regulators and academics, who together discussed a number of important issues and reached a number of important conclusions.

These conclusions are summarised below as well as being discussed in further depth in the body of this paper. The Institute is committed to further work on this issue and to keeping the accounting profession, regulators, standards setters and businesses up to date with its results.

Consensus views

Forum participants supported the concept of the IFRS for SMEs and a single book approach to the project. However, as the IASB has left it to each individual country to determine its application, there was considerable debate about how the IASB proposals should be applied in Australia and where the cut-offs for its use (both high and low) should fall.

Key issues arising out of the forum:

- > The importance of a clear definition of a SME and the delineation of which entities should prepare general purpose financial statements (GPFS)
- > The need for the consistent interpretation and application of the SME ED once it's introduced
- > The need for more discussion and debate on public policy and the issue of public accountability as a criterion for determining the level of complexity of financial reporting
- > The importance of seeking empirical evidence to identify the needs of users of SME accounts
- > The need for further consideration of specific disclosures for entities based on their size, nature of their business or industry
- > The need for more basic disclosures for subsidiaries preparing financial reports (based on the premise that they are not claiming class order relief and have a very limited circulation of users for the accounts)
- > The potential need for separate paragraphs, or even separate standards, for the public sector and not-for-profit (NFP) entities.

Financial Reporting Standards for SMEs Forum

The Institute would like to thank the delegates who attended the SME forum for their time and expertise.

Facilitator

Professor Nasser Spear, Professor of Accounting, Associate Dean, Faculty of Economic and Commerce Director – PhD Program Department of Accounting and Business Information Systems, Director – Master of Applied Commerce, Faculty of Economic and Commerce, University of Melbourne

Delegates

- > **David Boymal**, Chair, Australian Accounting Standards Board
- > **Charles Macek**, Chair, Financial Reporting Council
- > **Douglas Niven**, Deputy Chief Accountant, Australian Securities and Investments Commission
- > **Tom Ravlic**, Policy Advisor – Financial Advisor, Financial Reporting, National Institute of Accountants
- > **Mark Blair**, Senior Policy Advisor, Policy & Advocacy, Australian Institute of Company Directors
- > **Dianne Azoor Hughes**, Pitcher Partners
- > **Wayne Basford**, Partner, Audit & Assurance, BDO Kendalls
- > **Kevin Neville**, Managing Partner, Moore Stevens
- > **Allan Nash**, A H Nash & Co
- > **Michael Sucher**, Principal Accountant, BHP Billiton Limited
- > **Elaine Evans**, Department of Accounting & Finance, Macquarie University
- > **Anthony Braden**, Head of Group Accounting Policy – Group Finance, National Australia Bank
- > **Carlo Laruccia**, Group Manager – Planning & Reporting, Telstra Business & Government Finance
- > **Keith Reilly**, National Head of Professional Standards, Grant Thornton
- > **Denis Pratt**, Professional Standards Manager, CPA Australia
- > **Stephen Powell**, Accounting Policy Unit, Corporate Governance Division, Treasury
- > **Kimberley Smith**, NFP / NFP Taskforce
- > **Paul Shanley**, General Manager Finance – Operations, Aviva Australia Limited
- > **Victor Clarke**, Partner, PricewaterhouseCoopers
- > **Sasha Kitto**, Senior Manager, PricewaterhouseCoopers

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- > **Bill Palmer**, General Manager Standards & Public Affairs
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The SME forum – key insights

- > Definition of a SME
- > Definition of a reporting entity
- > Definition of publicly accountable
- > Appropriateness of a stand-alone document
- > What should be excluded or included in the SME exposure draft?
- > Treatment of subsidiaries
- > Appropriateness of a third-tier alternative framework
- > The public policy debate
- > Thresholds and size

The IASB's IFRS for SME project has created extensive debate among accountants, business owners, academics, regulators and industry bodies. Anecdotal evidence suggests that organisations already reporting under IFRS have found it difficult to adapt to the new reporting regime. Many of the Australian businesses currently striving to apply IFRS are relatively small and have limited time and money.

Furthermore, many SMEs are 'micro entities' and fall outside the regulatory net cast by general purpose financial reporting. However, they still need guidance as to what constitutes good reporting at their level. If they adopt the proposed SME standard, the prospect of increased, albeit simplified (in comparison to full IFRS) financial regulation is daunting.

The three-hour discussion at the Institute's SME reporting forum debated a number of key issues. As it would be impossible to summarise each individual argument, we have divided the discussion into key themes and outlined the core issues within each theme.

To encourage free and open debate, the forum was conducted under Chatham House rules where the confidentiality of each participant was respected.

The IASB has designed the proposed IFRS for SMEs for entities that prepare GPFS, but are not publicly accountable, ie a tier that sits below the public listed level. In a developing economy, the proposed IFRS for SMEs could even be used as that country's sole accounting standard.

Definition of a Small and Medium Entity (SME)

The IASB defines a SME as an entity, which does not have public accountability, but does produce financial information in the form of general-purpose financial statements (GPFS). This information is generally produced for external users such as banks who rely on the information for economic decision-making purposes.

The view that emerged from the forum was that there was considerable confusion about the definition of a SME. It was thought that the term, as used by the IASB, is a misnomer because the entities of interest to the IASB are not that small. The appropriateness of the current reporting entity concept was briefly debated in this context.

Delegates at the forum also suggested that the current definition of a SME does not adequately fit Not-For-Profit (NFP) organisations. Many NFPs regard themselves as publicly accountable. However application of the reporting entity concept and preparation of general purpose financial reporting statements (GPFRS) does not always result in information that meets the needs of users in this sector under the current regime.

Definition of a reporting entity

The SME Exposure Draft has re-opened the debate on the reporting entity concept. Key issues include whether the AASB has segregated the reporting population appropriately and if all entities that prepare general purpose financial reports should comply with either IFRS or IFRS for SMEs.

In the past, there have been issues regarding the consistency of the application of the reporting entity concept as it is currently used, but the concept of general purpose financial reporting, as promulgated in the Australian Accounting Standards Board's (AASB) Invitation to Comment ITC 12, is not without its difficulties.

A number of participants made the point that the standards governing which entities should be producing GPFS need to be revisited and more clearly explained. This is particularly relevant in the not-for-profit area and was an area of focus for the forum. The discussion was leading towards an acknowledgement that small not-for-profits should prepare some kind of abbreviated financial report, but it should still be on the public record and audited in the interests of accountability.



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Definition of publicly accountable

There was debate about exactly which entities should be described as publicly accountable. The IASB has chosen a 'big picture concept' of public accountability and left it up to individual countries' regulators such as the AASB and Australian Securities and Investment Commission to determine how to apply the SME standard in their own environment. This includes identifying which entities without public accountability should produce GPFS.

Delegates discussed the role an entity's fiduciary responsibilities play in deciding whether or not it has public accountability. While there was general agreement that a bank or insurance company is publicly accountable, the question was raised as to whether proprietary companies with fiduciary responsibilities such as trustee companies could be described as having public accountability.

Overall, delegates agreed that IFRS for SMEs made sense for those non-listed entities that are producing high quality financial reports and have some degree of public accountability.

Public accountability proved a particularly difficult concept in the public sector and not-for-profit contexts. The delegates acknowledged that there is a significant degree of public interest in these entities, but it was generally agreed that these entities should not be spending their funds, unnecessarily, on complex reporting.

It was noted particularly, that it made no sense for smaller entities such as incorporated cricket clubs to produce IFRS or even IFRS for SMEs.

Appropriateness of a stand-alone document

Most forum delegates believed that from an accountant's perspective, a totally separate accounting standard for SMEs was appropriate. A 250-page standard is more attractive than a 2,500-page standard, providing considerable benefits in terms of simplification, staff training and resource costs.

New Zealand's differential reporting system was raised as a successful model and its relevance to Australia was discussed. The New Zealand system uses the full set of IFRS accounting standards with asterisks marked against certain paragraphs to indicate that, if an entity is below a certain size, it does not need to comply with that particular paragraph. Some anecdotal feedback suggests that to date, many New Zealand users do not like this system and would prefer to use an IFRS for SMEs style 'small book'.

It was agreed at the forum that Australia needs a system that is easy to use, simple to keep up to date, relevant to Australia and cost effective.

While there was not extensive discussion on how the SME standard should be maintained, some delegates said that because IFRS for SMEs will be an international standard, then its maintenance and updating would be done by the IASB in the first instance and then updates would be adopted by the AASB.

What should be excluded or included in the IFRS for SME ED?

Each section of the IFRS for SMEs ED includes recognition, measurement and disclosure requirements. There was some discussion about whether the SME standard went far enough in terms of eliminating some of these requirements, particularly those that use fair value.

Some delegates also believed that the standard still contains a level of disclosure that is unnecessary and not relevant to users. It was suggested that the benefits of including certain disclosures were not enough to justify the complexity and difficulty involved in sourcing and preparing the required information.

It was noted that two areas where the disclosure requirements could be reduced, and would not damage the standard, include the defined benefit superannuation area and the incorporation of AASB 2 by cross reference.

Another point of discussion was the fair value measurement principles in the SME standard, which are likely to make it difficult for a number of entities to use and are potentially not relevant. Even if the fair value of an embedded derivative were included in the accounts, would the user actually understand what it means?

One suggestion was that all the disclosure requirements in the SME standard should be 'grey letter' guidance and the AASB should then prepare industry specific versions of the standard containing mandatory 'black letter' disclosure requirements. The need for a separate set of disclosures for NFP organisations was raised.

It was also suggested that the users of SME accounts be surveyed in order to identify which pieces of information were required to make a decision about a particular entity. This would provide greater clarification on which particular disclosures were most useful and relevant to users.



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Treatment of subsidiaries

It was generally agreed that the levels of disclosure in the Exposure Draft were just about right for larger and more sophisticated SMEs. However, there was also particular concern about how the SME exposure draft will affect organisations with complex group structures.

Although these entities often contain a number of subsidiaries that have to lodge accounts with the ASIC, their primary reporting focus is internal. The general consensus reached was that companies, which are part of large groups, are unlikely to make use of IFRS for SMEs because of the different measurement requirements. They are more likely to use the general purpose accounting framework for ease of consolidation.

Some delegates suggested that in most cases, it was not necessary for subsidiaries to prepare the information required under the additional disclosures. They thought there should be some sort of concession, which would involve more basic disclosures for subsidiaries preparing financial reports. This was based on the premise that the subsidiaries are not claiming class order relief and have a very limited number of users of the accounts. Others, however, argued that full reporting was the price an entity pays for not entering into deeds of cross guarantee under ASIC's Class Order CO 98/1418.

The forum debated whether all accounting policy options in IFRS should be available to SMEs. Delegates agreed that two sets of standards may hinder compatibility particularly in takeover situations.

Appropriateness of a third-tier alternative framework

The need for a third-tier alternative framework for entities, which are not required to produce general-purpose financial reports, was a key issue addressed at the forum. There were mixed opinions as to whether a set of accounting standards for third-tier entities was required. Some delegates agreed that there was a need for a set of standards at that level. However, they had concerns about the additional costs and resources associated with introducing a separate accounting system. Others believed that a third set of accounts wasn't necessary at all and recommended that any complex measurement requirements in the SME standard should just be adjusted so they can be applied to the micro entities.

The public policy debate

The public policy issues of which companies should report, what they should report and which body should make these decisions, was raised by delegates. One participant said, 'It's important to question whether in some cases a third set of standards for micro entities is warranted. Is the real issue a public policy issue? Should these entities be reporting in the first place?'

Delegates did agree that if entities have large amounts of creditors and external stakeholders, there was a need for some kind of regulatory protection in the form of a requirement to lodge accounts prepared in accordance with an IFRS for SME standard.

Thresholds and size

The forum agreed that the use of thresholds and size tests, while not perfect, seemed to be the only way to apply IFRS for SMEs. There was some discussion about whether public accountability is directly related to the size of an entity. Some delegates commented that there was more to public accountability than just being a listed company or deposit taker.

There was some debate about the appropriateness of the AASB's proposed size tests for NFPs. One delegate asked, 'How did the AASB justify that a public company or a private company had to meet a \$500 million (in consolidated gross operating revenue) or \$250 million (in consolidated assets) test and yet a NFP had to meet a \$25 million or \$12.5 million test?' The delegates debated whether the level of public interest in a NFP or government entity was actually lower than in a privately owned company.

Thresholds for NFP entities were discussed and the need for some kind of method of comparison between for profits and NFPs. One participant suggested that a compromise between a full set of accounts and a complete exemption might be one solution. He raised the question, 'Should it just be a one or two-page form that NFPs fill out with all the key pieces of financial information? For example, is this charity doing what it set out to do? How do the administration expenses compare to the expenses relating to the provision of services to the community?'

The forum discussed the need for some kind of standard for NFPs because they still need to be accountable to government bodies and financial supporters. The forum agreed that it was important that the public's interest continues to be served and that transparency is maintained.

One participant suggested that the preparation of a specific disclosure standard for NFPs was one way to reduce the complexity associated with the IFRS for SMEs standard.



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Next steps – creating an appropriate financial reporting system for SMEs

In general, delegates at the forum were supportive of the IFRS for SME standard and liked the stand-alone single book approach to the SME project. They unanimously agreed that there was a need for transparency and accountability in organisations in the next tier down from those companies operating in global capital markets with the following caveats:

- > There is not enough known about user needs for information outside the capital markets
- > While the SME ED may be appropriate for larger non-publicly accountable entities, it is too complex for the small businesses commonly described as SMEs.

Outcomes

The overall view that emerged from the forum is that the whole area of SME reporting is highly complex with different stakeholders having different understandings and expectations of what SME financial reporting should involve. The issue by the AASB of ITC 12 and the proposed IFRS for SMEs has reopened the reporting entity debate of who should prepare financial reports and what should they contain and the role of thresholds in these decisions.

General consensus on the following issues:

- > Definition of a SME – the use of the term IFRS for SMEs is a misnomer and contributes to confusion about what the introduction of this standard in Australia would achieve
- > Definition of publicly accountable – it is unclear from the SME ED just how far the notion of public accountability is expected to stretch in practice
- > Appropriateness of a stand-alone document – participants supported the IASB's choice to issue the IFRS for SMEs ED as a stand-alone document
- > What should be excluded or included in the SME exposure draft – participants expressed the view that the IFRS for SMEs is still too complicated, but time did not permit the group to delve into the detail
- > Treatment of subsidiaries – some concessions should be available for wholly owned subsidiary companies
- > Appropriateness of a third-tier alternative framework – there seems to be a need for a third tier of best practice guidance for entities that are outside the regulated financial reporting framework and further research needs to be done in this area.



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