29 October 2007

English only

Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA)

Level 3 Guidance:

Proposed revisions

Note by the UNCTAD secretariat

Executive summary

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) issued the publication *Accounting and Financial Reporting Guidelines for Small and Medium-Sized Enterprises (SMEGA) – Level 3 Guidance* after deliberations during its seventeenth and eighteenth sessions.

At its twenty-third session, ISAR requested the UNCTAD secretariat to reconvene a consultative group to, among other things, update the SMEGA Level 3 guidance. Accordingly, the UNCTAD secretariat reconvened a consultative group. During the inter-sessional period, the group conducted discussions on this topic, including during its meeting in Geneva in early July 2007. The UNCTAD secretariat has prepared this note containing proposed revisions for consideration by the twenty-fourth session of ISAR.

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Annex

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

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

LEVEL 3 GUIDANCE

UNITED NATIONS
New York and Geneva, 2003

NOTE

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Preface

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

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

The IASB recognizes that the IFRS are less suitable for meeting the needs of users, preparers and owners of unlisted entities. To address this deficiency, the IASB has issued the Exposure Draft IFRS for SMEs in February 2007. IFRS for SMEs has been developed from IFRS.

ISAR, however, also recognizes that it is likely that IFRS for SMEs will not be suitable for micro-entities that produce non–generalpurpose statements. Entities that are not required to prepare general purpose financial statements are those that need not place financial statements in the public domain. Another characteristic is that the non–general purpose financial statements are not designed to met the needs of a wide group of users.

To meet the needs of micro-entities ISAR has developed a single set of guidelines, Level 3, which meet the needs of micro-entities that produce non–general purpose financial statements. Level 3 Guidelines have been developed from a “bottom up” approach rather than being integrated into the “top down” approach which characterizes the proposed IFRS for SMEs. The “bottom up” approach starts from a grounded perspective of the consideration of the needs of users and preparers of financial statements of micro-entities.

Therefore, in order to meet the financial reporting needs of SMEs and micro-entities, ISAR is proposing that a three-tiered structure be adopted, as follows:

Level 1. This level would apply to listed enterprises whose securities are publicly traded and those in which there is significant public interest. These enterprises should be required to apply the accounting and financial reporting standards (IASs and IFRSs) issued by the IASB.

Level 2. This level would apply to significant business enterprises that do not issue public securities and in which there is no significant public interest.

Level 3. This level would apply to the smallest entities that are often owner-managed and have few employees. The approach proposed is a simple accruals-based accounting, based on that set out in international accounting standards, but closely linked to cash transactions. National regulators may permit a derogation for newly formed businesses or new entrants to the formal economy to use cash accounting for a limited time.

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

The SMEGA-Level 3 that ISAR has developed is set out in the material that follows.

Introduction

1. The SMEGA for Level 3 is designed for financial statements of small enterprises that are owner-managed and have no or few employees. Such enterprises should generally follow a simple accruals-based accounting system that is closely linked to cash transactions.[1]

Scope

2. Level 3 enterprises typically have difficulties in accessing bank and trade credit. They are likely to be one-person enterprises or businesses with few employees. The SMEGA for Level 3 is intended to meet the needs of users and preparers of financial statements for these enterprises.

Components of financial statements

3. A set of financial statements for Level 3 enterprises includes the following components:

(a) an income statement;
(b) a balance sheet; and
(c) explanatory notes.

Level 3 accounting framework

4. The two financial statements – the income statement and the balance sheet – are based on a simple accruals accounting approach similar to IAS 1. The guidance requirements are based on the historical cost and accruals measurement approach.

[1] National regulators may permit a derogation for newly formed businesses or new entrants to the formal economy to use cash accounting for a limited time.

5. Level 3 statements will normally be prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future (see paragraph 24).

The objectives of Level 3 financial statements

6. The objective of Level 3 financial statements is to provide information about the reporting enterprise's financial performance and financial position that will be useful to users in assessing the performance of the enterprise and the stewardship of the enterprise's management.

Users and their needs

7. The objective of financial statements is to help develop the business by providing useful information to users. Therefore, the statements are designed to reflect user needs. Evidence suggests that the principal users of financial statements of Level 3 enterprises are likely to be:

- (a) Management;
- (b) Lenders and other creditors;
- (c) Government;
- (d) Taxation authorities;
- (e) SME agencies; and
- (f) Credit agencies.

8. The following is a summary of the likely needs of these users:

Management:

- to confirm how well or badly the enterprise has performed during the year (including the levels of income, costs and revenues);

- for applying for external financing;
- for financial management purposes (e.g. deciding what portion of profits to retain); and/or
- as a tool for succession planning and management of wealth.

Lenders and other creditors:

- to assess risk in the credit decision; and
- to monitor the performance of enterprises that have been given credit.

Government: For macro- and microeconomic planning purposes

Tax authorities: For tax assessment purposes

SME agencies*:* To assess support requests from enterprises (e.g. grant applications, training requests, subsidized business services)

Credit agencies: To facilitate the assessment of the advancement of credit from a independent organization that keeps records of entities credit status.

Qualitative characteristics

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

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

(b) *Relevance:* To be useful, information must be relevant to the decision-making needs of users.

(c) *Reliability:* Information is considered to be reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it purports to represent.

(d) *Comparability:* Users must be able to compare the financial statements of an enterprise over time in order to identify trends in the enterprise's financial position and performance.

10. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Standard setters as well as the preparers and users of financial statements should be aware of this constraint.

11. In practice, trade-offs between qualitative characteristics are often necessary. Determining the relative importance of the characteristics in different cases is a matter of professional judgement.

Elements

12. *Asset*: An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

13. *Liability*: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

14. *Equity*: Equity is the residual interest in the assets of the enterprise after all its liabilities have been deducted.

15. *Income* encompasses both revenue and gains. It includes increases in economic benefits during the accounting period in the form of inflows or enhancements of assets as well as decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

16. *Expenses* encompass losses as well as those expenses that arise in the course of the ordinary activities of the enterprise. Expenses are decreases in economic benefits.

Recognition

17. An item that meets the definition of an element should be recognized if (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise, and (b) the item has a cost or value that can be measured with reliability.

Measurement

18. The measurement base most commonly adopted by enterprises in preparing their financial statements will be historical cost.

19. In many cases, it is unlikely that Level 3 enterprises will have the resources to prepare these statements, and therefore the assumption is that the statements will be prepared by an external agency.

Level 3 enterprises and financial management

20. For day-to-day management of the enterprise, owner-managers will tend to rely heavily on cash flow information. It is widely recognized that the managing of cash is critical to the

survival of a business and to managing relationships with banks and other providers of finance. It is recommended that owner-managers keep cash records that will be a source of prime entry for the financial statements. These records, whether produced manually or using a software package, will be an important component in the financial management of Level 3 enterprises.

I. Basic requirements

21. The following details the basic guidance for Level 3 enterprises. For material transactions or events not covered by this guidance, reference should be made to the appropriate requirements in the guidance for Level 2 enterprises.

22. The minimum set of primary financial statements includes the following components:

(a) A balance sheet;
(b) An income statement; and
(c) Explanatory notes.

23. Enterprises may wish to include other statements that are likely to enhance the overall transparency and quality of the enterprise's provision of information to users, for example a cash flow statement.

24. Financial statements should be prepared on a going-concern basis unless management either intends to liquidate the enterprise or cease trading, or has no realistic alternative but to do so.

25. An enterprise should prepare its financial statements using a simplified accruals basis of accounting.

26. The following information should be prominently displayed:

(a) the name of the reporting enterprise; and
(b) the balance sheet date and the period covered by the income statement.

27. Financial statements should be presented at least annually.

28. The enterprise should present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet.

29. An asset should be classified as a current asset when it:

(a) is expected to be realized in, or is held for sale or consumption in, the normal course of the enterprise's operating cycle; or

(b) is held primarily for trading purposes or for the short term and is expected to be realized within 12 months of the balance sheet date; or

(c) is cash on hand.

All other assets should be classified as non-current assets.

30. A liability should be classified as a current liability when it:

(a) is expected to be settled in the normal course of the enterprise's operating cycle; or

(b) is due to be settled within 12 months of the balance sheet date.

All other liabilities should be classified as non-current liabilities.

31. As a minimum, the face of the balance sheet should include line items that present the amounts in the formats in Annex 3.

32. Additional line items, headings and subtotals should, if relevant and material to the enterprise, be presented on the face of the balance sheet.

33. An enterprise should disclose the movement of owner's equity during the financial year.

34. The income statement should follow the structure and, as a minimum, use the headings shown in Annex 1.

35. An item of property, plant or equipment should initially be measured at its cost. The cost of an item of property, plant or equipment comprises its purchase price, including import duties and non-refundable purchase taxes, and any directly attributable costs of bringing the asset to working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.

36. The depreciable amount (cost less expected proceeds from disposal) of an item of property, plant or equipment should be allocated on a systematic basis over its useful life. Straight-line depreciation is the simplest method.

37. If an item of property, plant or equipment becomes impaired, in that it is unlikely to generate cash flows to absorb the depreciable amount of the item over its useful life, its carrying value should be reduced. Cash flows need not be determined by discounting and could come from either the disposal value of the asset or from its continuing use. Indicators of impairment would include a significant decline in market values or obsolescence.

38. Land normally has an unlimited life and, therefore, is not depreciated. Buildings have a limited life and, therefore, are depreciable assets.

39. The financial statements should disclose for each class of property, plant and equipment a reconciliation of the carrying amount at the beginning and end of the period showing:

- additions;
- disposals;
- depreciation; and
- other movements.

40. Lease payments, whether deriving from an operating or finance lease, and payments under hire purchase (HP) contracts should be recognized as an expense as they become payable. If the payments are material, the extent of lease obligations should be shown as a note.

41. The value of the lease should not be shown either as an asset or as a liability on the balance sheet. The same approach should be adopted for assets acquired under HP contracts. However, if the liability of the lease is material, this should be disclosed as a note to the financial statements.

42. Inventories should be measured at the lower of cost and net realizable value (the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale).

43. The cost of inventories should comprise all costs of purchase and other costs (such as for transport and manufacturing) incurred in bringing the inventories to their present location and condition.

44. The cost of inventories should be assigned by using specific identification of the individual costs of items whenever possible. The cost of other inventories should be assigned by

using the first-in, first-out (FIFO) or weighted average cost formulas.

45. Revenue should exclude taxes on goods and services but should include commissions receivable.

46. Revenue from the sale of goods should be recognized when the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods.

47. Revenue from the rendering of services should be recognized to the extent that the service has been provided.

48. Where there is uncertainty as to the receipt of payment for a trade debt, a reasonable provision should be made against trade receivables.

49. Any significant gains or losses should be separately disclosed.

II. Model financial statements

The financial statements

50. The two statements – the income statement and the balance sheet – are based on a simple accruals accounting approach similar to IAS 1.

The costs and benefits of the financial statements

51. The formats take into consideration the cost/benefit issues of Level 3 enterprises. In order to ensure that the statements are useful to owner-managers and other users of financial statements of typical Level 3 enterprises, the costs of preparing the statements need to be weighed against the benefits. For example, potential providers of external financing may well require the two financial statements in order to assess the risks involved in the proposed transaction.

Users and their needs

52. The objective of the proposed financial statements is to help owner-managers extract information that can be helpful in developing the business and also to help other users make decisions and monitor the progress of the entity. Therefore, the design of the statements is intended to reflect these users' needs.

Income statement: Annexes 1 and 2

Rationale

53. The structure of the income statement has been designed primarily to meet the needs of owner-managers. It is recognized that the income statement is used by owner-managers to see whether in their pricing they have correctly anticipated the level of costs and profit margins.

54. It is assumed that most enterprises at this level will price goods and services on a cost-plus basis. Thus, the "contribution" reflects the difference between the sales and those costs which the mark-up is calculated on, which are described in the statement as "direct costs".

55. Direct costs will vary from enterprise to enterprise. For example, Annex 2 illustrates an income statement for a typical retail business where the mark-up is likely to be made just on purchases. Other types of enterprises may have different definitions of direct costs.

56. The cost structures of enterprises at this level are likely to be very different from those of large businesses. The reason for this is that the majority of these enterprises' costs are likely to be direct. In contrast, the majority of the costs of large businesses are indirect (i.e. related to overheads).

57. The "tax" shown in the income statement relates to the estimated tax due for the year, which relates to the profit or loss for the same year. It therefore follows that the profit after tax and owners' drawings/dividends corresponds to the amount shown under the heading "increase/decrease in owners' capital" in the balance sheet in Annex 3.

58. The headings under "indirect costs" will reflect the materiality of the costs in relation to the total indirect costs and their importance with regard to disclosure for users in general. Therefore, there is likely to be some variation among different types of enterprises.

Balance sheet – Annex 3

59. The relevance of the headings will to a certain extent depend on the nature of the enterprise, but the main structure

and headings should be applicable for most enterprises at this level.

Cash flow statements

60. Historical cash flow statements have been excluded from the minimum set of financial statements at this level because there is little evidence suggesting that users at this level find such historical statements useful. It is, however, recognized that cash management on a daily basis is critical to the health and survival of enterprises at this level. No prescribed format has been suggested for the keeping of cash records because of variations that may be utilized by different enterprises. For example, some record-keeping systems are paper-based and individualized, whereas others use software packages that prescribe a standard format.

Annex 1

Model income statement format (example)

XYZ Ltd.
Income statement
for the year ended 31 December 20xx

Sales	
Direct operating costs	
Total direct operating costs	
Contribution	
Indirect costs	
Total indirect costs	
Profit before interest and other financing costs	
Less: Interest Other financing costs	
Profit after interest and other financing costs	
Less: Tax	
Profit after tax	
Owners’ drawings	
Increase/decrease in owners’ capital	

Annex 2

Model income statement (example)

XYZ Ltd.
Income Statement
for the year ended 31 December 20xx
(in US$)

Sales	325 000
Direct operating costs	
Opening inventories	30 100
Purchases	195 000
	225 100
Less:	
Closing inventories	32 500
Total direct operating costs	192 600
Contribution	132 400
Indirect costs	
Salaries	34 350
Depreciation	6 500
Lease rent	15 600
Motor vehicle expenses	6 500
Insurance	1 300
Telephone	1 700
Light and heat	1 150
Total indirect costs	67 100
Profit before interest and other financing costs	65 300
Less:	
Interest and other financing costs	1 300
Profit after interest and other financing costs	64 000
Less:	
Tax	8 400
Profit after tax	55 600
Owners’ drawings	45 000
Increase (decrease) in owners’ capital	10 600

Annex 3

Model balance sheet (example)

XYZ Ltd
Balance Sheet
as of 31 December 20X1
(in US$)

Assets			
Non-current Assets			
Property	170 000		
Less: Accumulated depreciation	40 000	130 000	
Equipment	85 000		
Less: Accumulated depreciation	25 000	60 000	
Total Non-current assets			190 000
Current Assets			
Materials		18 200	
Stock		34 000	
Trade receivables	28 500		
Less: Provisions	2 500	26 000	
Bank accounts		5 600	
Cash		1 200	
Total current assets			85 000
Total Assets			275 000 ======
Owners' Equity and Liabilities			
Owners' capital		132 900	
Earnings for the year	55 600		
Less: Drawings this year	45 000		
Increase in owners capital		10 600	
Owners' capital 31 December 20X1			143 500
Non-current liabilities			
Loans		105 500	
Current liabilities			
Bank	2 500		
Taxes payable	4 600		
Trade payables	18 900		
Total current liabilities		26 000	
Total liabilities			131 500
Total owners' equity and liabilities			275 000 ======