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2002 Review

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In its continuing effort to improve the content of the Review, the secretariat has added a chapter containing articles written by prominent authors on development of accounting education in the Baltic countries, international accounting education and the proceedings of the new International Accounting Standards Board. UNCTAD would like to thank the authors – Professors Toomas Haldma, Vilam Paupa, Jonas Mackevicius, Mike Walsh and Peter Walton – for the articles they contributed.

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Preface

Within the international business world, 2001 and 2002 will be remembered largely for the magnitude and frequency of corporate collapses. Market capitalization of very large proportions was erased, and with it the lifetime savings of many investors, pensioners, employees and other stakeholders. Capital markets in the United States alone lost capitalization on the order of $8 trillion. These major corporate failures called into question the adequacy of financial and non-financial disclosure provided through corporate annual reports.

It is thus not surprising that the 19th session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), held in Geneva in September 2002, attracted a record number of participants – over 180 from about 52 Member States. It deliberated on two main issues: transparency and disclosure requirements on corporate governance, based on a comprehensive set of disclosure elements on corporate governance developed by UNCTAD; and the accounting needs of small and medium-sized enterprises (SMEs). The two topics could not have been discussed together at a better time.

Over the past decade, International Accounting Standards (IASs) and many national accounting and financial reporting standards have become increasingly complex. The SME sector has had to conform with accounting and reporting standards that were not originally designed for it. Recognizing this trend, the Group of Experts used previous sessions to identify the obstacles faced by SMEs in maintaining accounting records and generating meaningful financial reports and the ideal characteristics of an accounting and reporting system for SMEs. They developed a general approach to addressing SMEs' accounting needs, which broadly distinguishes among three groups of enterprises according to size and publicly traded stock and identifies an appropriate set of standards for each. The Group's 19th session endorsed draft guidelines on accounting and financial reporting for SMEs.

In cooperation with the University of Geneva, UNCTAD has been developing a distance-learning tool on environmental accounting and environmental performance indicators. The 19th session reviewed progress on this project, which has great potential for affordable and worldwide dissemination of the Group's work.

The session was also updated on follow-up work regarding the guideline on the requirements for the qualifications of professional accountants, including a model curriculum. Experts discussed an interim report on a survey on the awareness and use of the guideline and studied a report on the need for updating the ISAR model curriculum.

The Group of Experts continued its tradition of cooperation and coordination with other regional and international organizations, which briefed the Group on recent developments and which are increasingly asking for further opportunities to present it with their work.

In the light of the growing importance of this subject and of the quality of the debates held at this session, it seems reasonable to assert that the work of the Group has, and will continue to have, an impact on issues critical for the smooth functioning of our globalized economy and for the development of developing countries and economies in transition.

R. Ricupero

Rubens Ricupero
Secretary-General of UNCTAD
Geneva, July 2004

Executive Summary

This volume of the Review of International Accounting and Reporting Issues contains the proceedings of the nineteenth session of the Intergovernmental Working Group of Experts (ISAR), which took place in Geneva from 25 to 27 September 2002. The session dealt with two main agenda items – accounting for small and medium-sized enterprises and transparency and disclosure requirements for corporate governance.

At its tenth quadrennial conference, which took place in Bangkok in February 2000, member States requested UNCTAD to promote increased transparency and financial disclosure by encouraging the use of internationally recognized accounting, reporting and auditing standards and improved corporate governance. The Group of Experts conducted a preliminary consideration of corporate governance issues at its eighteenth session. The Group agreed to conduct further deliberations on the issue at its nineteenth session. A summary of the deliberations and the report discussed then on transparency and disclosure requirements for corporate governance are contained in the first chapter of this volume.

The Group of Experts has been deliberating on the accounting and financial reporting needs of small and medium-sized enterprises (SMEs) since its seventeenth session. At its nineteenth session, it discussed draft guidelines for level 2 and level 3 SMEs. A summary of the deliberations on this issue and the draft guidelines that the Group discussed are contained in the second chapter of this volume.

The last chapter of this volume consists of three articles contributed by prominent authors on accounting and financial reporting. The articles discuss developments in accounting education and training in the Baltic countries; international accounting education standards and trends in global accounting education; and the International Accounting Standards Board and its proceedings.

— Chapter I —

Transparency and disclosure requirements for corporate governance

Summary

For its consideration of this agenda item, ISAR had before it the following documentation:

"Transparency and disclosure requirements for corporate governance" (TD/B/COM.2/ISAR/15).

An UNCTAD resource person, introducing the item, recalled that at the tenth quadrennial conference (in Bangkok in February 2000), member States had requested UNCTAD to "promote increased transparency and financial disclosure by encouraging the use of internationally recognized accounting, reporting and auditing standards and improved corporate governance".

In concluding the eighteenth session and adopting the provisional agenda for the nineteenth session, ISAR proposed that it work on issues related to corporate governance in order to assist developing countries and countries with economies in transition in identifying and implementing best corporate governance practices. Through informal consultations conducted in a two-day workshop on 13 and 14 September 2001 and via e-mail and fax communications thereafter, it was agreed that the work be focused on disclosure requirements on corporate governance, with a view to developing guidelines.

The report was based on the deliberations of the ad hoc group of experts during their meeting held in April 2002 in Geneva, as well as on electronic communications that followed the meeting. The report covered both financial and non-financial disclosures on corporate governance.

In the discussions that followed a number of delegates expressed appreciation for the high quality of the report and emphasized the importance of ISAR's work on corporate governance disclosure, especially since the International Accounting Standards Board seemed to regard corporate governance disclosure as being beyond its mandate. It was noted that this work of ISAR was an important contribution to efforts to achieve the Millennium Development Goals[1] by conquering poverty and integrating developing countries and countries with economies in transition into the global economy.

Most of the questions raised by delegates related to the scope of application of the recommendations included in the report, the relationship between transparency and disclosure, details of some of the financial and non-financial disclosures, the location of disclosure on corporate governance in published reports to shareholders and other stakeholders, and further steps that ISAR should take in this area.

In particular, some delegates felt that there should be a separate corporate governance report in addition to the financial report. Other delegates, however, expressed concern that doing this could lead to repetition of information, especially in relation to financial information, that had already been disclosed in an enterprise's financial report. Some of the delegates stated that the level of detail on financial information required by the report might be more appropriate for inclusion in the Management's Discussion and Analysis (MD&A), rather than in a separate report on corporate governance.

The ad hoc group representatives pointed out that the purpose of financial disclosure in relation to corporate governance was to provide explanations for and draw the attention of shareholders and other stakeholders to key issues that might not be immediately understood by users lacking specific expertise in the area of finance and accounting. They emphasized that the disclosed information should be clear to all users. Since most users are not accountants, it would be important to explain to them the major transactions and events underlying the figures that are important for decision-making.

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[1] The Millennium Development Goals (MDGs) are contained in a resolution adopted by the Fifty-fifth session of the General Assembly of the United Nations (6–8 September 2000, New York). The resolution outlines the UN goals for improving living conditions in developing countries. Among other targets, it includes further development of an open trading and financial system that is rule-based, predictable and non-discriminatory, which implies a commitment to good governance, development and poverty reduction. For further details on the MDGs, see *www.un.org*.

It was noted that the location of such disclosures, although worth debating for the sake of harmonization, was not as important as the disclosures themselves. Possible options, based on the ad hoc group's recommendations, were to include a reference to some of the financial information already provided in the notes to the financial statements, to put all such disclosures in a separate section of the annual report, and to provide a stand-alone corporate governance report.

There was discussion of who should apply the proposed recommendations. To what types of enterprises should they apply – listed companies only, or others as well? Should they be extended to SMEs (which might create an additional burden for such enterprises)?

One delegate suggested that the proposed recommendations should apply to publicly listed companies, including mutual funds and financial institutions, but that individual jurisdictions should decide whether they should apply to non-listed companies and, if so, how they should be applied to them. A number of delegates felt that the recommendations should be limited to listed companies only. Other delegates felt that all entities of public interest should apply the recommendations. Several delegates stated that although corporate governance disclosures should be provided by all enterprises, this did not mean that the proposed recommendations should be applied equally to them. The level of detail proposed by the ad hoc group should apply only to listed companies, but smaller companies should not be completely excluded. In support of this position, several delegates noted that many developing countries depended on small enterprises for their economic growth, and that, therefore, limiting disclosure requirements to listed companies would not allow these countries to achieve the goal of poverty reduction in developing countries, which is one of the objectives of improved transparency and reporting. It was also noted in the debate that although the detailed disclosures might not be required of certain enterprises, all enterprises should be made aware of them.

In responding to this debate, the UNCTAD resource person indicated that the recommendations in the report were not exclusive. He drew the delegates' attention to the statement in the report indicating that "this work would be relevant to enterprises eager to attract domestic as well as foreign investment regardless of their legal form and size. The purpose of the work was to highlight the major concerns of international institutional and other investors and creditors and how they might be reassured by disclosures on corporate governance. What organizations disclose and how they do it will depend considerably on local laws and customs."

Some delegates indicated that the report should have contained more explanations regarding differences between corporate governance disclosure requirements for listed companies and those for SMEs. It was suggested that ISAR's work on corporate governance disclosure should also be tied to its current work on accounting by SMEs, and that the issue of corporate governance disclosure by SMEs should be addressed in ISAR's forthcoming guidance on accounting by SMEs. It was also suggested that state-owned enterprises' different needs regarding corporate governance disclosure be addressed.

One delegate suggested that, besides the principle of transparency, the report should also cover other principles of corporate governance, and that public governance and best practices in the area of governing structures should also be considered. Another delegate noted, however, that at present, several organizations were working on a number of aspects of corporate governance, and that, although ISAR needed to work in cooperation with them in this regard, the area in which it could most valuably contribute was that of transparency and disclosure.

It was also noted that other issues suggested by some delegates for inclusion in the report – such as intellectual property, requirements for auditor rotation and criteria for auditor independence – were, although undoubtedly important, outside the purview of the ad hoc consultative group and therefore outside the scope of the report.

Delegates debated the issue of transparency and its relationship to disclosure. One delegate suggested that there should be some clarification (perhaps a paragraph) of the concept of transparency (i.e. a definition and main elements). He maintained that transparency was broader than disclosure and should be dealt with separately from disclosure, especially since it was separately mentioned in the title of the report. Transparency could cover corporate policy, rules and regulations of the enterprise, processes and procedures, specific actions of management and employees, and other issues. The ad hoc group representative responded that disclosure in itself constituted transparency and that those who disclosed things properly were transparent. Another delegate, however, maintained that, in the case of Enron, even though issues were disclosed in notes to financial statements, the company was not perceived as being transparent to its shareholders.

In relation to this debate, some delegates noted that transparency as part of corporate governance included not only external reporting but also internal reporting to the board of directors. Therefore, reporting and disclosure requirements inside the enterprise itself, as well as related issues concerning the responsibilities of directors and external and internal auditors, should be addressed.

Delegates also discussed the overall detailedness of the corporate governance disclosure requirements outlined in the report. One delegate maintained that the extensive list of disclosures presented in the report could become a good starting point for defining priorities in corporate governance disclosures. Some delegates felt that such detailed requirements would be disadvantageous to enterprises, and that the language of the report was too prescriptive. Too much disclosure could conflict with confidentiality and could discourage companies from getting listed.

One of the delegates said that the duty of the board was to promote the success of the enterprise, and if an enterprise provided too extensive a disclosure of its risks, it could risk damaging its business. He said that an enterprise should be required to disclose material information in good faith, but that what was material should be decided by the directors and not by outside bodies. Otherwise, a conflict could occur between the enterprise's duty to its shareholders and its duty to disclose. Investors could make their own judgements. Another delegate noted that although it was important to ensure that the interests of shareholders were respected and to observe the principle of confidentiality, the danger of undermining them as a result of corporate governance disclosures was exaggerated since, in reality, the commercial secrets related to technological processes which were not part of financial reporting.

This delegate maintained that in the light of the recent increase in crimes in the area of corporate finance and reporting, it was important to improve the system outlining the responsibilities of managers for the financial information they provide and their accountability related to corporate governance, including the quality of corporate governance disclosure. This should include matters relating to improving the quality of audits, what kind of training is needed for auditors (considering the increased demand on auditors), how to strengthen penalties for inappropriate financial behaviour by management, and how to improve the methodology of financial reporting. It was noted in the debate that in making disclosures, the principles of cost-benefit effectiveness should be observed. Another delegate indicated that the burden and risk of providing corporate governance disclosures should be weighed against the risk and cost of non-disclosure. An opinion was also expressed that confidentiality should be respected, but should be balanced with accountability: one cannot be accountable without being transparent.

Regarding the level of detail of corporate governance disclosure, one of the delegates maintained that the more general guidance outlined by the Organisation for Economic Co-operation and Development (OECD) corporate governance principles would be a more appropriate reference point for corporate governance disclosures, since it had been developed in broader terms to avoid placing unreasonable costs on, or damaging the competitive position of, an enterprise. More detailed elaboration of these principles might be dangerous and might impose an additional burden on businesses. Although the OECD principles are to be revised, they are cast in sufficiently broad terms to allow developing countries to require the sorts of disclosures that will give investors the confidence to invest in their countries. This viewpoint was supported by another delegate, who maintained that the OECD principles did not, and should not, call for greater disclosure than did the existing standard practices in developed countries, per haps with the exception of disclosure of corporate objectives, which is required by the OECD but is not a common corporate practice.

Another delegate agreed that the OECD principles should be the required point of reference, but felt that being too general and too broad would undermine the effort of developing countries that used certain rules of good governance. He further suggested that it would be useful to have a benchmark of best practices that would allow each enterprise to position itself vis-à-vis these practices without being required to apply them. Enterprises could then at least identify the gaps that existed in this regard. A representative of the ad hoc group indicated that the goal of the report was to emphasize the convergence of messages in leading codes on corporate governance disclosure requirements and to draw attention to prevailing best practices in this area. Another delegate stated that the economic future of developing countries depended on the ability of their inhabitants to invest, but that the lack of trust in directors was growing. Lack of disclosure requirements was, in his opinion, one reason why directors were not being punished for their fraudulent activities. The report called for nothing more than for the directors to confirm that they had acted in good faith, that they had the required competencies and skills, that they had operated within certain parameters, and that they knew the enterprise that they were working for.

Another delegate, having agreed that ISAR should use the OECD principles on corporate governance as a reference point, suggested that referring just to the OECD principles might not be sufficient for accepting or rejecting specific corporate governance disclosures in the light of current corporate failures, changes in corporate governance requirements since those principles were issued, and upcoming revisions of those principles.

Another delegate suggested that ISAR should provide input into the OECD principles when they were next revised. It was pointed out that ISAR and UNCTAD had a critical and important role to play in reviewing and proposing revisions to the OECD principles, and in helping to provide the basic tool kit from which developing countries could select what was most appropriate for them in the implementation of transparency and disclosure principles.

Delegates also debated who would be the users of the proposed corporate governance disclosure requirements. One delegate felt that developing countries would not have sufficient demand for such disclosures, since there were not many investors and stock analysts in these countries. Another delegate felt that providers of capital would be very interested in this type of information. It was also suggested that the input from capital providers reflected in the report should be enhanced and bank representatives should also be consulted. Another delegate noted that the requirements set out in the report were important primarily for citizens of developing countries rather than for foreign investors.

One of the delegates noted that the position of capital providers was reflected in the recent McKinsey survey, which indicated that 71 per cent of 200 institutional investors in 31 countries, collectively responsible for US$ 2 trillion of assets under their management, rated accounting disclosures as the most important factor among 10 factors in their decision-making.

One delegate noted that accounting and disclosure issues were not problems just for developing countries, and that therefore the issue had to be seen in a broader context. Some of the developing countries, especially those in the Middle East, had huge investments in developed countries, and these investors had a right to know what the state of affairs was in these countries. Despite the pressure on regulators and appropriate bodies to address issues related to the recent corporate failures, there were no answers yet on whether those failures were caused by accounting issues, problems in financial markets or shortcomings in corporate governance.

A number of delegates felt that it was important to consider the interests of all stakeholders, not just those of capital markets. In this regard, one delegate emphasized the importance of the fact that the report addressed the issues of environmental and social stewardship and placed them in the broader context of corporate governance. Corporate social responsibility could have serious financial implications, and the disclosure of corporate policy on this matter was important. In this regard, the importance of coordination with other requirements, such as those of the Global Reporting Initiative and the OECD principles for multinational corporations, was mentioned.

Delegates also discussed issues regarding independent verification of corporate governance information, and related disclosures. It was emphasized that, as recommended in the report, there should be a statement about what information had been verified and how it had been verified.

A number of delegates raised issues relating to disclosures on particular financial matters. Some delegates felt that the report's section on financial disclosure should be shortened, with the explanatory parts taken out, since these issues were addressed in standards issued by the International Accounting Standards Board. One delegate suggested that a corporate governance report should just encourage companies to follow accounting principles and that more emphasis should be put on internal control systems to ensure proper financial disclosure. Another delegate felt that transitional economies were still experiencing a lack of guidance on financial disclosure in the context of corporate governance, and other delegates requested that more guidance be provided, especially on the materiality concept, related parties, fair value and other issues requiring professional judgement.

In concluding the debate, ISAR agreed that the report provided useful information and a convergence of views on corporate governance disclosure. It had also anticipated some of the new requirements, contained in the Sarbanes-Oxley Act of 2002, by the New York Stock Exchange (NYSE), and by the National Association of Securities Dealers Automated Quotations (NASDAQ). One of the delegates said that ISAR had a vital role to play in continuing this work. A number of delegates suggested that the recommendations in the report be tested quickly with institutional and other investors, and that they be supplemented with examples of best practices. Further work in this area should include development of local case studies and implementation guidance. A delegate suggested that case studies in developing countries include practical examples of how to implement transparency and disclosure requirements on corporate governance, what institutions are needed, what training is required (including that for company directors), and what the implications are for the accounting profession and other professions. Another suggested that, in producing case studies, different countries could concentrate on their most prevalent types of enterprises (e.g. family companies, SMEs). A number of delegates noted that this work should be done in coordination with other global forums and groups, such as the Global Corporate Governance Forum.

Deliberations of the Group of Experts on the report discussed above can be found in the chairman's summary of the informal discussions section of document TD/B/COM.2/ISAR/17. This document is available in under the "Reports" section of the ISAR website at http://www.unctad.org/isar

Introduction

At its tenth quadrennial conference, which was held in Bangkok in February 2000, member States requested UNCTAD to “promote increased transparency and financial disclosure by encouraging the use of internationally recognized accounting, reporting and auditing standards and improved corporate governance”. In response to the above request, the seventeenth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) decided to review existing corporate governance practices and country, company and regional codes and principles. Accordingly, a review was conducted and was presented at the eighteenth session of ISAR, which took place in Geneva from 10 to 12 September 2001.

In concluding the eighteenth session and adopting the provisional agenda for the nineteenth session, the Group of Experts proposed that they work on issues related to corporate governance. Discussions focused on how ISAR could contribute to the improvement of corporate governance practices in member States and on how it could assist developing countries and countries with economies in transition in identifying and implementing best corporate governance practices to achieve better transparency, financial disclosure and accountability. This was not the first time ISAR had taken up this issue. In 1989, at its seventh session, it agreed on disclosure by boards of directors. The current work revisits and expands that work.

Through informal consultations conducted in a two-day workshop on 13 and 14 September 2001 and e-mail and fax communications thereafter, it was agreed that work be focused on disclosure requirements on corporate governance with a view to developing guidelines. Most experts justified this specific topic as one that is consistent with ISAR’s mandate to promote better transparency and disclosure and which would add value to existing initiatives. During the discussions it was noted that:

- Transparency and disclosure have been recognized as the major elements of a sound corporate governance system by most codes and rating models of corporate governance;

- Recent events in financial markets reveal the need to implement these codes or translate them into practical action according to the particular business environment;

- Disclosure requirements on corporate governance although outlined as an important issue, have not yet been specifically and comprehensively addressed by any intergovernmental organization;

- Focusing on such a specific topic would be the best use of and consistent with ISAR’s expertise in providing guidance on international best practices in reporting and disclosure; and

- Such guidance on implementation might be particularly useful for developing countries and for countries with economies in transition.

Once the Commission on Investment, Technology and Related Financial Issues approved the topic, an ad hoc consultative group consisting of experts from a wide cross-section of countries and organizations was formed. A list of the members of the consultative group of experts appears in Annex 4. The group held consultations through electronic means and met in Geneva on 22 and 23 April 2002. This report contains the outcome of those consultations.

The objective of the informal consultations was to produce recommendations on corporate governance disclosures to help developing countries and countries with economies in transition apply generally accepted principles of corporate governance, given their particular economic, legal, social and cultural environments. The exercise starts with the main recommendations for disclosure relevant to corporate governance contained in such basic documents as the OECD Principles of Corporate Governance (OECD Principles), the Report of the Cadbury Committee on the Financial Aspects of Corporate Governance (Cadbury Report), the King Report on Corporate Governance for South Africa (King Report), the Commonwealth Association for Corporate Governance Guidelines (CACG Guidelines), pronouncements of the European Association of Securities Dealers (EASD) and the International Corporate Governance Network (ICGN), past ISAR Conclusions and others.

Reference is made in this report to the recommendations contained in the foregoing reports, since one objective is to illustrate the convergence of opinion on the content of corporate governance disclosures. Another objective of this report is to encourage countries and/or companies to develop their own codes tailored to their particular legal requirements and cultural traditions by giving examples of existing best practices.

During the informal consultations it was emphasized that ISAR's guidance on corporate governance disclosures would be a voluntary technical aid for regulators and companies in developing countries and countries with economies in transition as well as other countries and companies that may choose to use it. What organizations disclose and how they do it will depend considerably on local laws and customs. Therefore, the purpose of the work is to highlight the major concerns of international institutional and other investors and creditors and how they might be reassured by disclosures on corporate governance. This work would be relevant to enterprises eager to attract domestic as well as foreign investment regardless of their legal form or size. Such guidance would also promote awareness in countries and companies that are currently unwilling or unable to follow best practices and to satisfy investors' expectations regarding corporate governance disclosures, and which thus find it harder and probably more expensive to attract investment. In fact, some institutional investors have withdrawn from emerging markets where corporate governance is perceived to be weak.

After addressing the issue of the role of disclosures as part of sound corporate governance systems as outlined by major corporate governance codes and regulations, the informal consultative group considered the content of such disclosures, including financial disclosures, non-financial disclosures and disclosures in relation to annual general meetings. It also considered the timing and means of disclosures as well as disclosure of which code of corporate governance is followed. The following sections present the main conclusions of the group on these issues.

I. Financial disclosures

High-quality financial disclosure is identified as one of the major requirements of sound corporate governance by almost all pronouncements on the subject. Sound financial reporting is also one of the principal responsibilities of the board of directors. It is specifically addressed by the Cadbury Report, OECD Principles, CACG Guidelines, the King Report and a number of country codes.

The ad hoc consultative group agreed that most of the generally accepted international recommendations on financial disclosures could be found in the International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board (IASB). However, it saw reason to emphasize major areas specifically relevant to corporate governance concerning which additional explanations could be helpful to Governments, especially if their current accounting and reporting regulations or practices differed from those outlined in the IFRSs.

In particular, the group stressed the importance of disclosure of the company's financial and operating results, related-party transactions and critical accounting policies.[2]

The group agreed that enterprises should disclose all the financial information necessary for shareholders and other stakeholders to properly understand the nature of their business and how it was being developed for the future. In particular, any accounting policies to which the published results of the enterprise are especially sensitive should be disclosed, and the impact of alternative accounting decisions discussed. Information presented should include discussion of the effects of critical accounting policies applied, the judgements made in their application, and the likelihood of materially different reported results if different assumptions were to prevail. For example, a disclosure of the consolidation policies of an enterprise could include an assurance by the board of directors that they have ascertained that all subsidiaries and affiliated entities, including special-purpose ones, that are subject to consolidation as per the accounting and reporting standards applicable to the enterprise, have been properly consolidated. Disclosure requirements of this nature may discourage management from manipulating the accounting and reporting requirements and maintaining assets and liabilities off the enterprises' balance sheet and distorting fair presentation of its financial position and performance.

The group recognized that enterprises should disclose all related-party transactions and in addition any related-party relationships where control exists. At a minimum, disclosure should be made of the nature, type and elements of the related-party transactions. Even related-party relationships where control exists, irrespective of whether there have been transactions with parties under common control, should be disclosed. The decision-making process for approving related-parties transactions should also be disclosed. Members of the board and managers should disclose any material interests in transactions or other matters affecting the company.

The group recognized that the concept of materiality may differ from country to country. Therefore, some explanations of the principles or rules guiding the concept of materiality might be appropriate.

Critical accounting policies that are key to the portrayal of an enterprise's financial condition and operating results should be disclosed. The application of accounting policies involves management's assessment of matters that are inherently uncertain and the assessment of which can be subjective and complex. Therefore, a requirement to disclose these policies and outline the judgements made in their application, with mention of the fact that different assumptions might have resulted in materially different reported results, would help investors to better understand the strengths and weakness of the reported financial information. Furthermore, clearly identifying the inherent risks and the estimates used in the preparation of the reported information gives investors a better understanding of the risks they are taking in relying on the judgement of management.

For example, in some cases, accounting rules allow management to deviate from historical cost and present certain assets on a fair value basis. However, while for certain assets deep markets may exist and fair value can be obtained with reasonable objectivity, this may not be the case for others. Situations of the latter kind may invite management to exercise great latitude and influence the direction of earnings in its favour. For instance, in a recent case of financial fraud that brought down an enterprise, it is alleged that the management computed the fair value of certain assets on the basis of a highly inflated price that the company used for selling the product to one of its affiliates. The board of directors may provide additional assurance to shareholders and other stakeholders by disclosing that the board or its audit committee has reviewed fair value computations, if any, and that

[2] Non-italicized text is explanatory text; the italicized text represents recommendations of the consultative group made during its April meeting or during the virtual discussions which followed.

the computations were conducted in an objective manner and any intercompany transactions used as benchmarks in the process were of an arms'-length nature.

II. Non-Financial Disclosures

A. Company Objectives

The ad hoc consultative group agreed that the objectives of the enterprise should be disclosed. The objectives of enterprises may vary according to the values of society. In many, but by no means all, countries the primary corporate objective is to maximize the long-term return to shareholders (shareholder value). This objective appears in many codes throughout the world.

However, although there is an increasing awareness throughout the world that shareholder requirements must be met in order to attract and retain long-term, low-cost capital, the emphasis on shareholder value maximization is not universal. In the United Kingdom, proposed revisions of the Companies Act would include a statement of directors' duties which would emphasize that the primary duty of a director is to "promote the success of the company for the benefit of its members as a whole". The King Report argues that the "directors must … always strive to increase shareholder value while having regard for the interests of all other stakeholders" (Ch 5:27.7).

Overall, alongside the growing awareness of the requirements of shareholders, there is awareness of the need to address the interests of other stakeholders in order to maximize shareholder value in the long run. For example, if the enterprise knowingly damages a stakeholder's interest, it faces "reputation risk" that could affect shareholder value. The General Motors Board Guidelines acknowledged that "the board's responsibilities to shareholders as well as customers, employees, suppliers and the communities in which the corporation operates are all founded on the successful perpetuation of the business". This suggests that rather than pitting shareholder value against stakeholder value, an approach adopted by a large proportion of the academic community, there may be reason to believe that both sets of interests are compatible in the long run.

B. Ownership and Shareholders' Rights

The ad hoc group recognized that the ownership structure should be fully disclosed to all shareholders. It was also recognized that changes in the shareholdings of substantial investors should be disclosed to the market as soon as a company became aware of them. The ownership structure of an enterprise is of great importance in an investment decision, especially with regard to the equitable treatment of shareholders. In order to make an informed decision about the company, investors need access to information regarding its ownership structure.

In some countries disclosure is required when certain thresholds of ownership are passed. The German Code for Corporate Governance states that as soon as the company becomes aware that another party has obtained, exceeds or no longer holds 5, 10, 25, 50 or 75 per cent of the voting rights in the company, this information must immediately be published (II.2.i).

The group took the view that disclosure should be made of control structure and of how shareholders or other members of the organization can exercise their control rights through voting or other means. It also stated that any arrangement under which some shareholders may have a degree of control *disproportionate to their equity ownership, whether through differential voting rights, appointment of directors or other mechanisms, should be disclosed.*

In an extreme case, a company might have a single shareholder or group of shareholders with majority control of the company, either through holding the majority of the company's outstanding equity or through holding shares with superior voting rights. A majority shareholder group might be the management of the company and might gain more through a non-value-maximizing action than it would lose as a result of lost shareholder returns. In the case of such a conflict of interests, without safeguards for minority shareholders, the latter group may be adversely affected.

This issue is emphasized by a number of codes. For example, the OECD Principles suggest that disclosure should be made of major shareholders or others that control the company, including information on special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, significant cross-shareholding relationships and cross-guarantees. The Peters Report (Netherlands) recommends that "the Board of Directors should take stock of the influence available to investors in the company and report its findings in writing to them" (Recommendation 5.4.3).

A number of statements advocate a "one share, one vote" principle at the international level. Examples are found in the OECD's Principle I and in the International Corporate Governance Network.

However, actual practice might be different. For example, in the European Union, many member States do allow shares with multiple or no voting rights. This is seen as uncontroversial from an investor perspective as long as the differentials in voting rights are disclosed to all potential purchasers. The European Association of Stock Dealers does not support such deviations but allows flexibility, noting that if deviations cannot be avoided they should at least not apply in the same share class (EASD Principles, Recommendation II.2).

The strongest opposition to divergences from the one share, one vote principle is found in the Euroshareholders Guidelines (Guideline II). In contrast, the Hellebuyck Commission (France) viewed multiple voting rights as a way to reward the loyalty of certain shareholders (I.C.3) but felt that "it could be abused and used in a manner contrary to the spirit of reasonable governance".

The group agreed that rules and procedures governing the acquisition of corporate control in the capital markets and extraordinary transactions such as mergers and sales of substantial portions of corporate assets should be disclosed.

In most governance systems, it is generally considered good practice to set aside authority over certain issues for shareholder approval at a general meeting. Such issues include the power to amend the articles or other organic documents, approve new share issues, select auditors, elect directors, approve the accounts and distribution of dividends, and approve extraordinary transactions such as mergers, acquisitions and takeovers.

C. Governance Structures and Policies

1. The structure, role and functions of the board

The group took the view that the composition of the board should be disclosed, in particular the balance of executive and non-executive directors. Where there might be issues that stakeholders might perceive as challenging the independence of non-executive directors, companies should disclose why those issues are not significant and do not impinge on the independence of the directors.

One of the main issues in relation to the board structure and its disclosure is the assurance that whatever structure exists in the company, it ensures the board's independent leadership. Some countries would give more emphasis to the need for a clear division of responsibilities between the chairman and the chief executive officer (CEO) (Cadbury Report, para. 4.9) The later Combined Code in United Kingdom did support this view, although it was slightly more pragmatic, acknowledging that some companies had successfully combined these roles.

However, there is no general agreement on this point. In France, Italy and Spain the general practice has been to combine the roles. In France this requirement has been enshrined in law. However, the Vienot II Report has suggested that the law be changed to allow corporations greater flexibility in choosing their preferred structure. Italy and Spain have accepted the view that measures are called for to balance the power at the head of the corporation but that separating the positions is not among the strategies to be considered.

If the roles of chairman and CEO are combined, the proportion of independent directors within the board structure assumes greater importance. For example, Cadbury recommended that where the roles were combined, there should be a strong independent element on the board and that there should be a lead non-executive director to whom issues regarding the executive management could be addressed. This idea is followed by both the Indian and Malaysian codes. However, the definition of an independent director varies in different countries, therefore, a reference to a particular approach used in defining director independence might be useful in disclosing and discussing the board structure.

The group took the view that the board's role and functions must be fully disclosed. Most guidelines and codes of best practice emphasize the stewardship function of the board and distinguish its responsibilities from those of management. However, there are differences in the specificity with which the board's role is explained. For example, the Dey Report (Canada), the Vienot Report (France), Malaysia's Report on Corporate Governance, Mexico's Code of Corporate Governance, the King Report (South Africa) and the Korean Stock Exchange Code specify board functions as strategic planning, risk identification and management, selection, oversight and compensation of senior management, succession planning, communications with shareholders, integrity of financial controls and general legal compliance. However, others such as the Hong Kong Stock Exchange Code simply refer to directors' responsibility to ensure compliance with listing rules. The degree of difference may reflect the degree to which company law or listing standards specify board responsibilities.

2. Board committees

The group noted that it was becoming a common practice for boards to establish board committees to share the workload, ensure efficient fulfilment of the board's functions and address some potential conflicts of interest.

The ad hoc consultative group suggested that such governance structures be disclosed. In particular, the group agreed that the board should disclose structures put in place to prevent conflicts between the interests of the directors and management on the one hand and those of shareholders and other stakeholders on the other. These structures may include committees or groups to which the board has delegated responsibility for oversight of executive remuneration, audit matters, appointments to the board, and the evaluation of management performance.

It was also agreed that the composition and functions of any such groups or committees should be fully disclosed. Where any director has taken on a specific role for the board or within one of these structures, this should be disclosed.

Internationally, there has been consensus that although a board has collective responsibility, the use of committees delegating the responsibility for certain key board functions is advisable. This is especially true where executives may find themselves facing conflicts of interest – for example, in the areas of audits, remuneration and director nomination. As a general rule, codes have recommended that such committees be staffed by non-executive or outside directors, particularly independent directors. A number of codes address this issue, also outlining the need for clear terms of reference for such committees (Australia, South Africa, India, Malaysia).

D. Members of the Board and Key Executives

1. Duties and qualifications

The group recommended that the duties of individual directors be disclosed. It was agreed that the number of directorships held by an individual director should be disclosed.

The group took the view that if shareholders were to be confident that directors were performing in their interests, they needed to know what performance entailed, or, to put it more simply, what the duties of the directors were. Shareholders also need to be aware of the number of directorships that any individual director holds. Many codes are silent on this issue, including the Combined Code of the United Kingdom (although the National Association of Pension Funds recently (May 2002) advocated that (non-executive) directors holding more than five posts be required to justify how they were able to do so, and that full-time executive directors should not take on more than one outside directorship).

The King Report states that executive directors should be encouraged by their companies to take non-executive appointments in other companies, provided the number of non-executive appointments does not adversely affect the director's executive responsibilities to his or her own company. The Dey Report advocates that the nominating committee assign a maximum figure, and the Malaysian Code also refers this area to the nominating committee. Meanwhile, the Indian Code advocates that no single director should hold directorships in more than 10 listed companies.

The experts took the view that there should be sufficient disclosure of the qualifications and biographical information of all board members to assure shareholders and other stakeholders that the members can effectively fulfil their responsibilities. There should also be disclosure of the mechanisms which are in place to act as "checks and balances" on key individuals in the enterprise.

Most governance guidelines and codes of best practice address topics related to directors' qualifications and board membership criteria. These may include experience, personal characteristics, core competencies, availability, diversity, age, skills such as the understanding of manufacturing technologies, international background, and so on. Some codes specifically require financial literacy (NACD) or knowledge of business and financial technology (Brazilian Institute of Corporate Governance).

There should be disclosure of the types of development and training that directors undergo at induction and on an ongoing basis (continuing education).

Recently some countries have started to require specific training for directors. For example, Malaysia requires that directors attend courses designed to ensure that they are equipped to be competent directors.

Facility for professional advice

The group took the view that on certain legal and financial matters, directors might discharge their duties more effectively if allowed access to an independent external source.

Therefore, the group suggested that the board disclose facilities which may exist to provide members with professional advice. The board should also disclose whether that facility has been used during the year in question.

One important area where this procedure may be of use is with regard to nomination committees (Bosch, Guideline 4). The Merged Code in Belgium also points out the need for an agreed procedure for using such a facility, a point also mentioned in the Dey (Canada), Vienot (France), Mertanzis (Greece) and Olivencia (Spain) reports. Excessive use of outside advice may be a waste of shareholder funds and lead to questions about the efficacy of current management; on the other hand, if used correctly, such expertise may enhance the ability of directors to increase shareholder value.

2. Evaluation mechanism

The ad hoc group agreed that the board should disclose whether it has a performance evaluation process in place, either for the board as a whole or for individual members. Disclosure should be made of how the board has evaluated its performance and how the results of the valuation are being used. Along with the duties and responsibilities of directors, shareholders will need to know how directors were evaluated, what criteria were used and how they were applied in practice, particularly with reference to remuneration.

Commonwealth Association of Corporate Governance Guidelines stress that evaluations should be based on objective criteria, including "the performance of the business, accomplishment of long-term strategic objectives and development of management". The Preda Code (Italy) and IAIM Guidelines (Ireland) leave to the remuneration committee the selection of appropriate criteria and determining whether these criteria have been met.

An important aspect of performance is the attendance of directors at board meetings. In the "merit criteria" of the Kuala Lumpur Stock Exchange (KLSE), the first factor listed under the board of directors is "the frequency of board meetings and level of attendance by directors". Specific requirements regarding the frequency and procedures of board meetings can be found in the Indian Code, the King Report and the Combined Code of United Kingdom.

Valuation procedures may also vary. Guidelines from Finland, Germany, the Netherlands and the United Kingdom stress that non-executive members of the board should meet without members of the management present in order to facilitate discussion of sensitive management issues. The Berlin Initiative Code specifies that evaluations should be conducted annually by the personnel committee and should deal with the board as a whole as well as with individual contributions.

3. Directors' remuneration

The ad hoc consultative group took the view that directors should disclose a transparent and accountable mechanism for setting directors' remuneration. Disclosure should be as full as possible to demonstrate to shareholders and other stakeholders that pay is tied to the company's long-term performance as measured by recognized criteria. Information regarding pay packages should include salary, share options and other associated benefits, financial or otherwise, as well as reimbursed expenses. Where share options are used as incentives but are not treated as expenses in the accounts, their cost should be fully disclosed using a widely accepted pricing model.

The current level of disclosure relating to directors' remuneration varies widely. In the United Kingdom the report of the company's remuneration committee must identify each director and specify his or her total compensation package, including share options. Recently added regulations also require companies to put their remuneration report to a shareholder vote at each annual general meeting. The Indian Code stipulates that a table containing details of each director's remuneration and commissions should form a part of the directors' report, in addition to the usual practice of having it as a note to the profit and loss statement. Switzerland is introducing new disclosure requirements for the publication of directors' salaries.

The group stated that the length of directors' contracts as well as the nature of compensation payable to any director for cancellation of service contract should be disclosed. Specific reference could be made to any special arrangement that might relate to severance payments to directors in the event of a takeover.

4. Succession planning

The group took the view that the board should disclose whether it has established a succession plan for key executives and other board members to ensure that there is a strategy for sustaining the business. It also recognized that there might be confidentiality issues and that the details of any individual plan should not necessarily be publicly disclosed.

While current performance is of the utmost importance, it is also imperative that performance not be allowed to suffer because of board members' resignations or retirements. It is important to ensure board continuity and smooth transitions.

OECD Principle V.D.2 stresses that overseeing succession planning is a key function of the board, while the Dey Report (Canada) considers it an important stewardship duty of the company. Vienot Report I (France) recommended that "it should be the permanent responsibility of the selection committee to be in a position to propose successors at short notice", although clearly this would require confidentiality.

5. Conflict of interest

The group suggested that conflicts of interests affecting members of the board should, if they were not avoidable, at least be disclosed. The board of directors should disclose whether it has a formal procedure for addressing such situations, as well as the hierarchy of obligations to which directors are subject.

E. Material Issues Regarding Employees and Other Stakeholders

The group recommended disclosure of whether there was a mechanism protecting the rights of other stakeholders in a business.

OECD Principle III concerns itself with ensuring that the rights of stakeholders protected by law are respected. Even where no legislation exists, it is considered good practice to make additional commitments, as corporate reputation and performance may require recognition of broader interests. For example, revisions of the Company Law in the United Kingdom are expected to include requirements that boards disclose the impacts of their decisions on communities, employees and suppliers. The CACG Guidelines require that a board identify the corporation's internal and external stakeholders and agree on a policy for how the corporation should relate to them.

The most contentious stakeholder issue, however, is most likely the role of employees in corporate governance. For example, in the European Union various practices exist whereby employees elect some of the supervisory directors, can be given a right to nominate one or more directors or can have an advisory voice on certain issues discussed by the board. This allows stakeholders a role in the governance process without diluting the property rights of shareholders. Employee stock ownership plans and other employee stock ownership vehicles can permit employees and/or their representatives in trade unions and on work councils greater involvement in corporate governance as shareholders. The latter issue is particularly controversial and should be subject to additional disclosure.

F. Environmental and Social Stewardship

The group took the view that the board should disclose its policy and performance in connection with environmental and social responsibility and the impact of this policy and performance on the firm's sustainability. The issue was addressed earlier by ISAR in its agreed conclusions on Accounting and Financial Reporting for Environmental Costs and Liabilities. ISAR noted that an enterprise's environmental performance could affect its financial wealth and hence its sustainability. Its surveys found that environmental disclosures were qualitative, descriptive, partial and difficult to compare. Taking into consideration best practices, the ISAR guidance helps enterprises to understand which environmental transactions and events need to be reported in financial statements and associated notes.

The Global Compact and the Global Reporting Initiative encourage both environmental and social responsibility and disclosure thereof. These are also specifically addressed by the King Report (South Africa), by the Association of British Insurers in its Disclosure Guidelines on Socially Responsible Investment and by others.

Growing interest in social responsibility rankings and indices has brought direct pressure on corporations to conduct responsible stakeholder relations. In the United Kingdom, the Association of British Insurers has announced that it expects boards to assess risks and opportunities in social, environmental and ethical matters and that it considers these issues to be intertwined with corporate success. United Kingdom regulations have required investment fund companies to disclose whether they have policies on social investment, and the new Company Law is expected to include requirements that boards disclose the impacts of their decisions on communities, employees and suppliers. Australia, Belgium, France, Germany and Sweden have also introduced legislation on socially responsible investment.

G. Material Foreseeable Risk Factors

In recent years, much attention has been paid to the role of the board in risk assessment or management and internal controls. Therefore, the ad hoc consultative group addressed the issue of risk management disclosures.

The group took the view that the board should make appropriate disclosures and give appropriate assurances regarding its risk management objectives, systems and activities. In particular, it was agreed that the board should disclose existing provisions for mitigating the possible negative effects of risk-bearing activities. The board should report on internal control systems and their effectiveness.

This issue is emphasized in most codes and principles. The OECD Principles point out that users of financial information and participants in the marketplace need information on foreseeable material risks, including risks specific to industries or geographical areas, dependence on certain commodities, financial market risk and derivative risks. However, such disclosure is only considered to be effective when it is tailored to the individual industry or company. The issue is also addressed in detail by the CACG Guidelines, the King Report, the Combined Code, the Cadbury Report and the Turnbull Report in the United Kingdom.

H. Independence of Auditors

The group agreed that the board should disclose that it had confidence that the auditors are independent and their integrity had not been compromised in any way. The process for interaction with and appointment of internal and external auditors should be disclosed.

OECD Principle IV.C states that independent external audits should provide an objective assurance of the way in which the accounts have been prepared. The issue is also addressed by the Cadbury Report, the Blue Ribbon Committee Report on Improving the Effectiveness of Corporate Audit Committees (United States), the Merged Code (Belgium), the Dey Report (Canada) and the Preda Report (Italy), which also discusses communication between the audit committee and external auditors.

A number of issues regarding the external audits such as the need for auditor rotation and possible conflicts of interest involved in providing non-audit services, are being debated to ensure that external audits serve public interests in the intended manner. Therefore, disclosure in these areas may provide stakeholders and potential investors with useful information. Disclosure may include the selection and approval process for external auditors, the length of the relationship (e.g. whether the same auditor has been used for more than five years and whether there has been a rotation of auditors), who governs the relationship with the auditor, whether auditors do any non-audit work and what percentage of the total fees paid to the auditor involves non-audit work.

III. Annual General Meetings

The group discussed the need for disclosure of the process for holding annual general meetings. Notification of the agenda should be made in a timely fashion, and the agenda should be made available in the national language (or one of the official languages) of the enterprise and, if appropriate, an internationally used business language.

The OECD Principles outline a general consensus as to the nature of shareholder meetings and the requirement to make shareholder participation as simple and effective as possible and ensure the equitable treatment of all shareholders. The Principles state that shareholders should be able to participate effectively and vote in the general meetings of the company. They should be informed of the rules and, to this end, be furnished with information regarding the date, location and agenda of the meeting as well as the issues to be decided.

In most governance systems, it is generally considered good practice to put several issues to shareholder approval at a general meeting. These rules may vary in different countries, and therefore information on the subject would be useful for investors. This area deserves more attention.

IV. Timing and means of disclosure

The group agreed that all material issues relating to corporate governance of the enterprise should be disclosed in a timely fashion. The disclosure should be clear, concise, precise and governed by the "substance over form" principle. Some issues may require continuous disclosure. Relevant information should be available for users in a cost-effective way.

The location of corporate governance disclosures within the annual report is not generally defined: some disclosures are in the notes to the accounts, others in the directors' report, still others in a separate report of the remuneration committee or the audit committee or in a separate corporate governance report. Some degree of harmonization of the location of corporate governance disclosures would be desirable to enable users of financial statements to access the relevant data more readily. Possible approaches include putting all disclosures on corporate governance in a separate section of the annual report or providing a stand-alone corporate governance report.

Some information related to corporate governance may require immediate disclosure, and some codes address this issue. In some cases, the requirements are contained in listing requirements. For example, in Malaysia listing requirements call for immediate disclosure of a number of transactions, including acquisition or loss of a contract; a change in the management, external auditor or board structure; the borrowing of funds; commencement of or involvement in litigation and any material development arising therefrom; the commencement of arbitration proceedings or proceedings involving alternative dispute resolution methods; and a number of other types of events.

It is widely recognized that traditional channels of communication with stakeholders, such as annual reports, should be supported by other channels of communication taking into account the complexity and globalization of financial markets and the impact of technology. The OECD Principles state that the Internet and other information technologies provide the opportunity for improving information dissemination.

The King Report, which also emphasizes the need for critical financial information to reach all shareholders simultaneously, supports this. It also states that, considering costs involved in printing and distributing annual financial statements to all shareholders, consideration should be given to the electronic distribution of a summarized or abbreviated annual financial statement to all shareholders, with a clear indication of how the complete annual financial statements can be obtained.

Whatever disclosures are made and whatever channels used, a clear distinction should be made between audited and unaudited financial information, and means of validation of other non-financial information should be provided.

V. Best practices for compliance with corporate governance

The ad hoc consultative group recognized that, where there was a local code on corporate governance, enterprises should be encouraged to disclose the extent to which they followed its recommendations and to explain any failures to follow recommendations. Where there is no local code on corporate governance, international companies should be encouraged to follow best practices. The use of "comply or explain" mechanisms in many countries allows investors greater access to information about the corporation and is to be encouraged.

VI. Conclusions

This report has considered a range of areas in which disclosure may be advantageous to users of corporate information. It has discussed disclosure relating to financial and non-financial information, the objectives of the company, ownership structure and control devices, board composition and functions, environmental and social responsibility and risk management. It has examined disclosure on the annual meeting and the protection of shareholder and stakeholder rights. Finally, it has looked at the timing and means of disclosure and disclosure on the adoption of best practices in compliance with corporate governance requirements.

In looking at areas where disclosure is necessary, the report has given examples from best practice codes from a number of countries. Although the review of such regional and national codes is by no means exhaustive, an attempt has been made to present a balanced review.

One of the central tasks of the nineteenth session of ISAR is to evaluate this report and the conclusions of the ad hoc consultative group. If the nineteenth session finds these conclusions useful, it could discuss the elaboration of further guidance embodying both the generally accepted best practices outlined here and ways and means of implementing these practices and producing a guideline for national standard setters on corporate governance disclosures.

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— Chapter II —

Accounting by small and medium-sized enterprises

Summary

In introducing the agenda item, the chairperson stated that ISAR's eighteenth session had asked the ad hoc consultative group to further refine the draft guidelines on accounting by SMEs taking into account the recommendations of the eighteenth session. The ad hoc consultative group had also been requested to elaborate on the guidance for Level 3 entities so that interim guidance could be developed as soon as possible. During the intersession period, the ad hoc consultative group had exchanged views by electronic mail as well as at a meeting in Geneva in April 2002. The chairperson drew delegates' attention to the relevant documentation on the agenda item, namely documents TD/B/COM.2/ISAR/16 and addenda 1 through 4.

The chairperson reminded delegates that the International Accounting Standards (IAS) issued by the International Accounting Standards Board (IASB) had been used as a basis for the preparation of the proposed guidelines. However, neither members of the IASB nor its staff had endorsed the proposed guidelines.

The chairperson drew the attention of participants to the report of ISAR on its eighteenth session (TD/B/COM.2/ISAR/13). He reviewed other important points on which the eighteenth session had reached consensus and also recalled tasks that the eighteenth session had asked the ad hoc consultative group on accounting by SMEs to perform. He said that the urgent need for guidance on accounting by SMEs and the three-tiered approach had been reconfirmed. He also reminded participants that the proposed guidance was not a standard but rather a voluntary technical aid for member States that might wish to use it.

Following his introductory remarks, the chairperson invited the representative of the IASB, who was also an observer in the ad hoc consultative group on accounting by SMEs, to provide an update on activities at the IASB regarding its project on accounting by SMEs, and to provide his personal estimate on when the IASB would issue an exposure draft on this subject. The representative from the IASB stated that in May 2002 the IASB had added an "active research project" to its agenda. He stated that the purpose of this active research project was to evaluate various alternatives available for addressing the needs of SMEs and make a formal proposal to the Board. The alternatives the representative mentioned included systems used in Canada, New Zealand, the United Kingdom and the United States as well as recent proposals from Hong Kong (China).

The IASB would be forming an advisory panel of experts to advise it on the various alternatives for formulating a formal proposal. The representative stated that, according to his personal estimate, formal proposals would be presented to the IASB in about 12 months or longer. He also stated that the IASB was aware of the requirements in the European Union for listed companies to adopt IAS by 2005 and also the desire of the European Commission that its member States have the opportunity to extend the IASs to SMEs. The IASB's timetable took these facts into consideration, and it intended to make available proposals by that time.

The chairperson thanked members of the ad hoc consultative group on accounting by SMEs for their contributions to the project. He then invited the two representatives of the ad hoc consultative group to introduce the proposed guidelines for accounting by SMEs for Levels 2 and 3 respectively.

The ad hoc consultative group representative who introduced the proposed guidelines for Level 2 SMEs stated that the guidelines were based on a set of IAS that SMEs were likely to encounter. The text in the proposed guidelines was primarily composed of the "black italicized letter" text of the IAS selected. Where amplification was felt to be appropriate, however, the ad hoc consultative group had provided it. Standards that were relevant only to a specialized area, as well as complex standards, had been excluded from the proposed guidelines. If SMEs in Level 2 were to encounter transactions that could not be addressed within the proposed guidelines, they would refer to the full IAS for guidance. Compliance with the proposed guidelines did not mean compliance with the IAS. He indicated that the IAS on which the guidelines were based were listed in appendix 3 of addendum 3 (TD/B/COM.2/ISAR/16). The ad hoc group representative also emphasized that the proposed guidelines were made as simple as possible in view of the fact that the implementation of the guidelines was going to require extensive communication and education tasks to familiarize preparers and users of accounts. He mentioned the IASB's improvements project and the possibility that some of the text of the proposed guidelines would change as a result of the project. He drew attention to the need to update the proposed guidelines in view of this fact. He also stated that the proposed guidelines could eventually be superseded by guidance from the IASB.

The ad hoc consultative group representative who introduced the proposed guidelines for Level 3 SMEs (contained in addendum 4 of document TD/B/COM.2/ISAR/16) discussed various elaborations that had been made on the proposals presented at the eighteenth session. The proposals included an accounting and reporting framework, basic requirements and model financial statements consisting of an income statement and a balance sheet. The ad hoc consultative group had taken the position that cash flow information was important for managing SMEs, and it recommended that owner-managers keep cash records that would be sources for primary entry for the financial statements. However, if a cash flow statement was necessary for a particular SME, then the preparer would refer to the requirements for Level 2 SMEs for guidance. This would also be the case for all other events or transactions that were not addressed in the proposed guidelines for Level 3. In discussing the link between the guidelines for Level 3 and those for Level 2 and IAS, the ad hoc consultative group representative stated that the relationship would be a top-down approach from IAS to Level 2 and then to Level 3. This was different from the proposal discussed at the eighteenth session that suggested a bottom-up approach from Level 3 to Level 2 systems. In elaborating on the application of simple accruals in Level 3, the ad hoc group representative cited the case for lease payments deriving from operating as well as finance leases or hire purchase contracts and explained that these would be recognized as expenses on a cash basis, as opposed to accruals. He also discussed a format for a Level 3 income statement as well as model financial statements, including the rationale for the presentation.

In concluding their introductory remarks, the two ad hoc group representatives asked participants to comment on how helpful they thought the guidelines were, whether there were ways to make them more practical, and whether there should be wider formal consultations on the drafts.

Many participants, including some from developed economies, said that they found the draft guidelines to be very useful in their countries. One delegate stated that these documents would be useful for SMEs and micro-finance institutions. They could be used to generate financial information for taxation purposes as well, and his country's chamber of commerce would be interested in them. Another delegate cited consultations conducted in his country that reaffirmed the need to provide less burdensome accounting and reporting systems for SMEs, rather than requiring them to comply with full IAS. In addition, another delegate said that the approaches used in his country were similar to those in the draft guidelines, with certain adaptations to the local environment. His Government was providing lower-level SMEs with free accounting software. A delegate shared his observations on a multi-tiered accounting system that was being implemented in his region and that resembled the draft guidelines, and he stated that feedback from the implementation exercises in his region had been encouraging.

Many delegates were of the view that since many of the IAS on which the draft guidelines were based were being looked at by the IASB as part of its "improvements" project, and since amendments of varying degrees were likely on these IAS, the draft guidelines needed to be revised to incorporate the relevant expected amendments. On the other hand, several delegates expressed the view that IAS would be undergoing improvements constantly and that it would not be wise to wait for the completion of the IASB "improvements" project before issuing the guidelines under discussion. Some delegates stated that issuing the guidelines as they were, rather than delaying them, would result in more benefits than costs.

Certain delegates were of the view that the draft guidelines were not specific enough in defining the dividing line between levels, particularly between SMEs in Level 2 and those in Level 3. There were also questions regarding the varying intensity of labour utilized by SMEs in different sectors and the validity of number of employees as a criterion for classifying SMEs. There were a few interventions regarding reporting periods that were shorter or longer than 12 months. There was a general understanding that the guidelines should indicate the general approaches to these issues while leaving the specifics for member States to decide.

Some delegates expressed the view that the draft guidelines seemed to be geared mainly towards financial reporting by SMEs, without regard to their needs for fiscal reporting and national statistics. There were also concerns that the guidelines did not include charts of accounts that were traditional in certain reporting regimes. Other delegates found that it would not be realistic to try and accommodate all these suggestions in the proposed guidelines. Member States could adapt the guidelines to meet their specific requirements.

Some delegates expressed concern that the conceptual framework contained in the draft guidelines was not detailed enough and did not incorporate all the elements contained in the IASB framework. However, there was general agreement that the guidelines for SMEs needed to be fairly succinct. As a result, many components of the guidelines were presented in an abridged form. One delegate questioned the ad hoc consultative group's decision to simplify the standard on impairment of assets. A representative of the ad hoc consultative group explained that, because of the highly complex nature of that particular standard, simplification was considered necessary. Some delegates questioned the need for SMEs to state their accounting policies as set out in the draft guidelines, and asked whether it would not be sufficient for them just to state that they were in compliance with the guidelines for Level 2 or 3, as the case might be. A similar question was also asked regarding the auditing of financial reports prepared under the proposed guidelines. There was general agreement that SMEs needed to state the basis on which the financial statements had been prepared. This would be helpful for auditing purposes as well. In addition to specifying the basis of accounting, SMEs were also required to state significant accounting policies that they had applied in generating their financial statements. One delegate felt that requiring SMEs to provide explanatory notes would be too burdensome.

There were several exchanges of views on the ad hoc consultative group's decision to incorporate only the segment of the IAS 8 "improvements" exposure draft that dealt with the hierarchy of the IAS. A number of delegates felt that proposed "improvements" to other IAS should have been incorporated. A representative of the ad hoc consultative group clarified its position by stating that it felt the hierarchy element and its inclusion were particularly important. Because of the time constraints under which the consultative group was operating, it was not feasible for it to incorporate other proposed "improvements". It was also noted that these "improvements" had yet to be finalized by the IASB and that a number of them could be reversed or modified.

One delegate pointed out that the draft guidelines retained many of the alternatives contained in the IAS, and felt that, in view of the lack of adequate training of accountants in developing countries, it would be preferable to eliminate alternatives that required significant professional judgement. It was noted, however, that eliminating alternatives offered by IAS for listed companies would mean that SMEs would have to comply with requirements that would be more stringent than those for Level 1 enterprises; this could be viewed as defeating the main objective of the whole exercise.

There were several interventions regarding the exclusion from the draft guidelines of items such as consolidations or group accounting, accounting in inflationary economies, discontinuing operations and extraordinary items. The general consensus seemed to be that these particular items did not occur frequently in an SME environment. However, if they were to occur, then SMEs would consult the full IAS for guidance.

A delegate noted that the proposed guidelines did not include guidance for SMEs transitioning from their former systems to implementing the guidelines that were being proposed. The ad hoc consultative group, however, had felt that providing guidance on first-time application was not within its mandate. Nevertheless, there was a general view that SMEs in such a circumstance could refer for guidance to the IFRS that would be issued on first-time application.

A number of editorial comments were made. These will be taken into consideration in preparing the draft guidelines that will be circulated for wider consultations.

Several delegates commented on the draft model income statement and balance sheet for Level 3 enterprises that were contained in the draft guidelines. It was suggested that including owner's drawings in the income statement as well as the balance sheet did not add value for users. Other delegates did not see any harm in providing such information, since it was considered helpful in gauging the amount of profits retained in the business. The point was made that as one worked towards providing useful information for institutions such as micro-credit agencies, one moved further away from most conventional presentations in order to cater to their specific needs. There were also questions regarding consistency in the use of terminology (e.g. *profit* and *earnings*). One delegate pointed out that the draft guidelines for Level 3 SMEs allowed the recording of lease payments on cash basis, which he considered to be inconsistent with the definition of liabilities that was provided in the proposed guidance.

Some delegates were concerned that the proposed guidelines for Level 3 SMEs did not include guidance on preparing a cash flow statement. There was a view that even though at this level an enterprise was not likely to be engaged in financing or investing activities, a cash flow statement could be useful for understanding the nature of its activities and its cash generating capacity. Other delegates felt that, since such SMEs conducted almost all their operations on a cash basis, an income statement would be enough to indicate the cash flow of the firm. One delegate stated that since Level 3 SMEs rarely engaged in borrowing, providing guidance on preparing tax reports would be sufficient.

The chairperson requested participants at the session who had provided suggestions to confirm their input by sending written comments to the secretariat. Representatives of the ad hoc consultative group would then review the drafts and make amendments, including editorial ones, as considered necessary.

Delegates exchanged views on the need for wider consultations and for field-testing the proposed guidelines. Many were of the view that the guidelines could benefit from such consultations and field-testing. There were discussions regarding who would be conducting field tests. A representative from one accounting organization indicated that her association would be willing to coordinate field tests of the Level 3 guidance among its members. It was generally agreed that all interested entities would be welcome to conduct field tests; the more feedback received, the better the resulting guidance would be.

Delegates also noted the work that the IASB was going to conduct on accounting by SMEs. A number of delegates suggested that the final version of the guidelines for Level 2 SMEs be passed along to the IASB. A number of delegates also felt that the guidelines on accounting by SMEs issued by ISAR could provide an interim solution until a standard on accounting by SMEs was finally issued by the IASB.

There was some discussion on whether the guidance provided by ISAR could remain in effect once the IASB had issued guidance on accounting by SMEs. The chairperson noted that the purpose of ISAR's work was to provide a voluntary technical tool for accounting by SMEs. This tool should be consistent with the framework of the IFRS and should ensure a harmonized approach among member States and regional and international organizations in implementing standards issued by the IASB. Accordingly, the ISAR guidance on accounting by SMEs would be reviewed by taking into consideration developments at the IASB.

Introduction

At its seventeenth session, 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) face in maintaining proper accounting records and generating meaningful financial information. The session called on an ad hoc consultative group to recommend possible approaches that would meet the accounting needs of SMEs and take into consideration the obstacles the sector faced. Accordingly, an ad hoc consultative group consisting of experts from a wide cross-section of countries was formed. The ad hoc group conducted a series of consultations during the inter-session period and presented its report to the Group's eighteenth session, which took place in Geneva from 10 to 12 September 2001.

The eighteenth session reviewed the report and deliberated on the general approaches recommended. The Group agreed on a three-tiered approach (see paragraph 9 of document TD/B/COM.2/ISAR/12 for details) to the accounting needs of SMEs. The Group called on the ad hoc consultative group to continue its work and provide further refinements, and to present its report to the nineteenth session. Accordingly, the ad hoc group (see list of members in appendix 4 in TD/B/COM.2/ISAR/16/Add.3) conducted a series of consultations and is now presenting its work for consideration by the nineteenth session of the Group.

The recommendations of the ad hoc group are presented in five separate reports, which are contained in TD/B/COM.2/ISAR/16 and Addenda 1 through 4. The first four reports concern SMEs at Level 2. The first report (TD/B/COM.2/ISAR/16) contains an introduction, a conceptual framework and Guideline 1, a presentation of financial statements. The second report (TD/B/COM.2/ISAR/16/Add.1) consists of Guidelines 2 through 7. The third report (TD/B/COM.2/ISAR/16/Add.2) contains Guidelines 8 through 15. The fourth report (TD/B/COM.2/ISAR/16/Add.3) contains definitions, examples and references to source material for the Guidelines. Finally, the fifth report (TD/B/COM.2/ISAR/16/Add.4) is a Guideline for Level 3 SMEs.

That Guideline is an initiative of the Group. ISAR has produced guidelines and recommendations on specific accounting issues for a number of years. Some of its recent guidelines addressed topics such as qualification requirements for professional accountants and accounting and financial reporting for environmental costs and liabilities. The object of the current initiative is to recommend to member States an approach they can use to create an all-embracing regulatory framework for the accounting of all commercial entities in their jurisdictions. This approach suggests a three-tiered system of differential reporting, with requirements that are cost-effective in relation to the targeted user/preparer groups and that allow growing businesses to evolve within a consistent accounting framework.

The evolution of a regulatory framework for accounting in a country is usually the result of the accretion over time of often unrelated pieces of regulation designed to meet specific circumstances existing at a particular moment. This frequently results in a patchwork of rules that do not interact coherently and from which many entities may escape.

The emergence of the International Accounting Standards Board (IASB) as the international standard setter of reference for financial reporting for listed companies has opened the door to a new era in accounting and provides an excellent opportunity for Governments to review and reform their regulatory structure for accounting in a way that is consistent with both international developments and local economic realities.

Structure linked to International Financial Reporting Standards

The seventeenth session of the Group debated research on the accounting needs of SMEs and concluded that

(a) developing countries and countries in transition to a market economy would benefit from an accounting architecture based on International Financial Reporting Standards (IFRS) [3]; and

(b) within this overall structure, there had to be guidelines that would meet the needs of a diverse group of entities with very different economic profiles, and this could best be provided for with a three-tiered structure.

The research of the Group had shown that since IFRS have been created largely for transnational enterprises operating from developed-country bases, it is difficult to apply them to SMEs in developed countries and even more difficult to do so in significantly different economic environments where the professional infrastructure is limited and the general level of business education does not extend to accounting. This is the case in many developing countries and countries with economies in transition. Further, many businesses in these countries are not profitable enough to be able to afford what professional help is available. The Group therefore concluded that its proposed three-tiered structure should allow entry at the lowest level with very simple accounting, while allowing entities that later expanded to move to a middle tier whose accounting requirements were more in line with the basic tenets of IFRS. It was thought that such entities could mostly afford to pay for the technical support needed to comply with these rules.

The Group decided at its eighteenth session to adopt recommendations based on the economic and social characteristics of business entities and including the following three tiers:

Level 1: Listed entities whose securities are publicly traded and those with a significant public interest should follow IFRS.

Level 2: Significant commercial, industrial and business entities that issue neither public securities nor financial reports to the general public may follow a single set of requirements derived from the IFRS and consistent with them, but embodying only requirements for the simplest and most regularly encountered transactions.

Level 3: The smallest entities that are owner-managed and have few employees should follow a simple accruals-based accounting system, closely linked to cash transactions, and with a

[3] In line with the new *Preface to International Financial Reporting Standards*, this document uses the generic term *IFRS* to refer to all international accounting standards and interpretations in force, as well as to International Financial Reporting Standards as such.

derogation for businesses to use cash accounting for a limited time when establishing their accounting systems.

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 entities operate. The recommendation of the consultative group is that there should be a system with at least three levels, but how these 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 country's enterprise structure.

SME Guidelines on Accounting and Financial Reporting (SMEGA)

This document and the accompanying addenda contain a proposed accounting and reporting framework that would meet the needs of enterprises at Level 2. It represents a considerable step up from Level 3 and is based on IFRS (essentially those in force on 1 January 2002, albeit with some modification in the light of the IASB programme), but at the same time it addresses itself to a limited number of situations and transactions within the scope of IFRS. Hence, an entity following these Guidelines could not be considered in compliance with IFRS. This framework is believed to be an inclusive set of requirements that meets the needs of the vast majority of situations and transactions likely to be encountered by medium-sized businesses. However, member States may wish to provide additional guidance. The SMEGA are intended to be used by individual entities, not groups (but where an SME is structured as a group, it should apply the relevant IFRS), and do not include any provision for accounting in an inflationary environment.

The overall aim of the consultative group that prepared the SMEGA was to select, from within the existing IFRS, a group of requirements meeting the everyday needs of SMEs. The consultative group took the view that, to be useful and cost-effective in a developing country or transitional economy, the SMEGA should be as short as possible and should concentrate on measurement approaches that are feasible within the available infrastructure (which does not prohibit a move to a more sophisticated approach as infrastructure and resources improve) and that enable investors and creditors to make informed decisions. Similarly, the group kept in mind the SMEGA's potential usefulness as fixing a cognitive base (body of knowledge) that could be the cornerstone of a training programme for book-keeping and accounting staff members.

In general terms, it was felt that the larger the number of requirements and the greater their complexity, the larger the cost of training staff members to apply the requirements, and the less cost-effective the SMEGA. While a function of the IASB may be to address the need for rules for both frequently and infrequently encountered transactions and situations, the consultative group considered that the SMEGA (a) should provide rules relating to groups of enterprises with international operations; and (b) should not provide guidance for transactions or cases less likely to be encountered by SMEs, in order to provide the greatest possible benefit for the smallest cost.

The consultative group, having reviewed similar work by national standard setters, has therefore analysed the IFRS in force and has drawn from them a condensed set of rules intended for medium-sized businesses. Each standard and interpretation was reviewed in the light of the *Framework for the Preparation and Presentation of Financial Statements* as relevant (see footnote 1) to small and medium-sized entities. Where the group considered that the costs of including a standard were likely to exceed the benefits, it omitted the standard or, in a few cases, adapted it.

As far as the group is aware, no empirical research is available concerning the types of transactions carried out by SMEs that could be used to guide these choices. Members of the group had been chosen because of their knowledge of small businesses, and they applied this experience of the sector, together with comments from the debate at the eighteenth session of ISAR, in arriving at their conclusions. While ISAR does not have a formal due process, the different stages in the evolution of the SMEGA have been presented to member States and other interested parties for comment and discussion.

No accounting rules can be regarded as set in concrete, and the objective was to arrive at what the group felt was a workable set of rules, in the hope that these could be applied and subsequently improved on in the light of experience. No specific arrangements have been made by ISAR for a continuing update of the Guidelines. However, the expectation of the consultative group was that there would be a periodic review, and that modifications could systematically be presented to the annual session of ISAR. The consultative group was also mindful of the probability that the IASB would in due course take up the issue of accounting by SMEs. However, the work of the group could provide a useful contribution and interim guidance until a definitive standard was agreed on, a process that usually takes several years.

Conceptual framework

The consultative group took the view that any abridged set of requirements to form the SMEGA should be informed by the IASB *Framework* and be consistent with it, in order to support the link between the two and the possibility that growing entities would move from Level 2 to Level 1. It therefore developed a conceptual framework for SMEs that in turn informed the development of the SMEGA, based on the IASB literature.

Scope

The SMEGA are intended for the preparation of general-purpose financial statements, and for SMEs in developed and developing countries as well as in economies in transition. Such statements are prepared annually and are intended to meet the information needs of a wide range of users.

Users

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

Objectives

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

Underlying assumptions

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

Qualitative characteristics

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

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

Reliability: Information is reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it is said to represent.

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

Constraints: 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.

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

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.

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.

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

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.

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

Recognition

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

The measurement base most commonly adopted by enterprises in preparing their financial statements is *historical cost*.

Transactions not covered by SMEGA

The consultative group takes the view that SMEs do not generally have very complex transactions and that therefore the SMEGA should be able to provide a basic set of requirements that will cover nearly all cases. However, there may be cases where an entity has a transaction which falls outside the

SMEGA, and it is suggested that in this case the preparer look for rules within the following hierarchy:

(a) full IFRS;
(b) interpretations;
(c) appendices to standards;
(d) implementation guidance;
(e) the definitions, recognition criteria and measurement concepts set out in the conceptual framework; and
(f) previous conclusions of the Group; pronouncements of other standard setters using a similar conceptual framework to develop accounting standards; other accounting literature and accepted industry practice, to the extent that these are consistent with items (a) to (e) above.

Management should use its judgement in developing an accounting policy that results in information that is relevant to the needs of investors and creditors and is reliable in nature.

Where management bases its accounting policy on IFRS, it should be guided by user needs in making disclosures. In such a case the entity is not then obliged to comply with the full IFRS and should continue to describe itself in its accounting policy note as complying with the SMEGA.

ACCOUNTING AND FINANCIAL REPORTING GUIDELINES FOR LEVEL 2 SMEs (SMEGA)

Guideline 1. Presentation of Financial Statements

Components of financial statements

1.1. A complete set of financial statements includes the following components:

(a) a balance sheet;

(b) an income statement;

(c) a statement showing either:

(i) all changes in equity; or

(ii) changes in equity other than those arising from capital transactions with owners and distributions to owners;

(d) a cash flow statement; and

(e) *accounting policies*[4] and explanatory notes.

Overall considerations

1.2 Financial statements should present fairly the financial position, financial performance and cash flows of an enterprise. The appropriate application of the Guidelines, with additional disclosure when necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation as appropriate for SMEs. In the event that the Guidelines do not cover a transaction undertaken by an enterprise, the enterprise should look to the full set of International Financial Reporting Standards (IFRS) for authoritative guidance, as set out below and in the introduction to this document.

1.3 An enterprise whose financial statements are drawn up in compliance with the Guidelines should specify in its accounting policy note that the Guidelines are the requirement followed. There should be no reference to IFRS, nor may the entity hold itself out as complying with IFRS in any form.

1.4 Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

1.5 In the extremely rare circumstances when management concludes that compliance with a requirement in the Guidelines would be misleading, and that therefore departure from a requirement is necessary in order to achieve a fair presentation, an enterprise should disclose:

(a) that management has concluded that the financial statements fairly present the enterprise's financial position, financial performance and cash flows;

(b) that it has complied in all material respects with applicable Guidelines, except for departing from them in order to achieve a fair presentation; and

(c) the nature of the departure, including the treatment that the Guidelines would require, the reason why that treatment would be misleading in the circumstances and the treatment adopted.

[4] Appendix 1 includes a glossary. When terms given in the glossary are first mentioned in the SMEGA, they are shown in italics.

1.6 When preparing financial statements, management should make an assessment of an enterprise's ability to continue as a going concern. Financial statements should be prepared on a going-concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt on the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going-concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the enterprise is not considered to be a going concern.

1.7 An enterprise should prepare its financial statements, except for cash flow information, on the accrual basis of accounting.

1.8 The presentation and classification of items in the financial statements should be retained from one period to the next unless

(a) a significant change in the nature of the operations of the enterprise or a review of its financial statement presentation demonstrates that the change will result in a more appropriate presentation of events or transactions; or

(b) a change in presentation is required by the Guidelines.

1.9 Each material item should be presented separately in the financial statements. Immaterial amounts should be aggregated with amounts of a similar nature or function and need not be presented separately. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item judged in the particular circumstances where its presentation comes into question.

1.10 Assets and liabilities should not normally be offset in the financial statements. However, some offsetting is required or permitted in exceptional circumstances, as mandated by the Guidelines (e.g. paragraph 2.6). Offsetting may also take place where gains, losses and related expenses arising from the same or similar transactions are not material.

1.11 Unless the Guidelines permit or require otherwise, comparative information with respect to the previous period should be disclosed for all numerical information in the financial statements. Comparative information should be included in narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

Structure and content

1.12 Each component of the financial statements should be clearly identified. In addition, the following information should be prominently displayed, and repeated when it is necessary for a proper understanding of the information presented:

(a) the name of the reporting enterprise or other means of identification;

(b) the balance sheet date or the period covered by the other financial statements, whichever is appropriate to the related component of the financial statements; and

(c) the *reporting currency*.

1.13 Financial statements should be presented at least annually. When, in exceptional circumstances, an enterprise's balance sheet date changes and annual financial statements are presented for a period longer or shorter than one year, an enterprise should disclose, in addition to the period covered by the financial statements:

(a) the reason why a period other than one year is being used; and

(b) the fact that comparative amounts for the income statement, changes in equity, cash flows and related notes are not comparable.

Balance sheet

1.14 Each enterprise should determine, on the basis of the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet. Paragraphs 1.16 to 1.20 of this Guideline apply when this distinction is made. When an enterprise chooses not to make this classification, assets and liabilities should be presented broadly in order of their liquidity.

1.15 Whichever method of presentation is adopted, an enterprise should disclose, for each asset and *liability* item that combines amounts expected to be recovered or settled both before and after 12 months from the balance sheet date, the amount expected to be recovered or settled after more than 12 months.

1.16 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 or a cash-equivalent asset that is not restricted in its use.

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

1.17 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.

1.18 An enterprise should continue to classify its long-term interest-bearing liabilities as non-current, even when they are due to be settled within 12 months of the balance sheet date, if:

(a) the original term was for a period of more than 12 months;

(b) the enterprise intends to refinance the obligation on a long-term basis; and

(c) that intention is supported by an agreement to refinance, or to reschedule payments, which is completed before the financial statements are authorized for issue.

The amount of any liability that has been excluded from current liabilities in accordance with this paragraph, together with information in support of this presentation, should be disclosed in the notes to the balance sheet.

1.19 At a minimum, the face of the balance sheet should include line items presenting the following amounts:

(a) property, plant and equipment;

(b) *intangible;*
(c) financial assets (excluding amounts shown under (e) and (f));
(d) *inventories;*
(e) trade and other receivables;
(f) cash and cash equivalents;
(g) trade and other payables;
(h) tax liabilities and assets;
(i) *provisions;*
(j) non-current interest-bearing liabilities; and
(k) issued capital and reserves.

1.20 Additional line items, headings and subtotals should be presented on the face of the balance sheet when such presentation is necessary to present fairly the enterprise's financial position.

1.21 An enterprise should disclose the following, either on the face of the balance sheet or in the notes:

(a) for each class of share capital:
   (i) the number of shares authorized;
   (ii) the number of shares issued and fully paid, and issued but not fully paid;
   (iii) par value per share, or that the shares have no par value;
   (iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the year;
   (v) the rights, preferences and restrictions attaching to that class, including restrictions on the distribution of dividends and the repayment of capital;
   (vi) shares in the enterprise held by the enterprise itself; and
   (vii) shares reserved for issuance under options and sales contracts, including the terms and amounts;
(b) a description of the nature and purpose of each reserve within owners' equity;
(c) the amount of dividends that were proposed or declared after the balance sheet date but before the financial statements were authorized for issue; when dividends have been proposed but not formally approved for payment, the amount included (or not included) in liabilities; and
(d) the amount of any cumulative preference dividends not recognized.

An enterprise without share capital, such as a partnership, should disclose information equivalent to that required above, showing movements during the period in each category of equity interest and the rights, preferences and restrictions attaching to each category of equity interest.

Income Statement

1.22 At a minimum, the face of the income statement should include line items which present the following amounts:
(a) *revenue;*
(b) the results of *operating activities;*
(c) finance costs;
(d) *tax expense;*

(e) profit or loss from *ordinary activities;* and

(f) net profit or loss for the period.

Additional line items, headings and subtotals should be presented on the face of the income statement when such presentation is necessary to present fairly the enterprise's financial performance.

1.23 All items of income and expense recognized in a period should be included in the determination of the net profit or loss for the period unless the SMEGA require or permit otherwise.

1.24 When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

1.25 Circumstances that may give rise to the separate disclosure of items of income and expense in accordance with paragraph 1.24 include the following:

(a) the write-down of inventories to *net realizable value* or property, plant and equipment to recoverable amount, as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of property, plant and equipment;

(d) disposals of long-term investments;

(e) discontinued operations;

(f) litigation settlements; and

(g) other reversals of provisions.

Information to be Presented Either on the Face of the Income Statement or in the Notes

1.26 An enterprise should present, either on the face of the income statement or in the notes to the income statement, an analysis of expenses using a classification based on either the nature of expenses or their function within the enterprise.

1.27 Enterprises classifying expenses by function should disclose additional information on the nature of expenses, including *depreciation* and amortization expense and staff costs.

1.28 An enterprise should disclose, either on the face of the income statement or in the notes, the amount of dividends per share, declared or proposed, for the period covered by the financial statements.

Changes in equity

1.29 An enterprise should present, as a separate component of its financial statements, a statement showing the following:

(a) the net profit or loss for the period;

(b) each item of income and expense, gain or loss which, as required by the Guidelines, is recognized directly in equity, and the total of these items; and

(c) the cumulative effect of changes in accounting policy and the correction of *fundamental errors*.

In addition, an enterprise should present, either within this statement or in the notes, the following:

(d) capital transactions with owners and distributions to owners;

(e) the balance of accumulated profit or loss at the beginning of the period and at the balance sheet date, and the movements for the period; and

(f) a reconciliation between the *carrying amount* of each class of equity capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.

Notes to the financial statements

1.30 The notes to the financial statements of an enterprise should:

(a) present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and events;

(b) disclose the information required by the SMEGA that is not presented elsewhere in the financial statements; and

(c) provide additional information that is not presented on the face of the financial statements but that is necessary for a fair presentation.

1.31 Notes to the financial statements should be presented in a systematic manner. Each item on the face of the balance sheet, the income statement and the cash flow statement should be cross-referenced to any related information in the notes.

1.32 The accounting policies section of the notes to the financial statements should describe the following:

(a) the measurement basis (or bases) used in preparing the financial statements; and

(b) each specific accounting policy that is necessary for a proper understanding of the financial statements.

1.33 An enterprise should disclose the following, if the information is not disclosed elsewhere in information published with the financial statements:

(a) the domicile and legal form of the enterprise, its place of incorporation and the address of the registered office (or principal place of business, if different from the registered office);

(b) a description of the nature of the enterprise's operations and its principal activities; and

(c) either the number of employees at the end of the period or the average number for the period.

Guideline 2. Cash Flow Statements

Presentation of a cash flow statement

2.1 The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

2.2 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Cash flows arising from income taxes should be separately disclosed within the operating activities section. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

Investing activities

2.3 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Financing activities

2.4 The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the enterprise.

2.5 An enterprise should report cash flows from operating activities using either:

(d) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(e) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

2.6 An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from financing and investing activities, except to the extent that cash flows described in paragraph 2.7 are reported on a net basis.

2.7 Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short.

2.8 Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

2.9 An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

Cash and cash equivalents

2.10 Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. To qualify as a cash equivalent, an investment must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents – for example, in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

2.11 Bank borrowings are generally considered to be *financing activities*. However, in some countries, bank overdrafts that are repayable on demand form an integral part of an enterprise's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates between being positive and being overdrawn.

Other disclosures

2.12 An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by the enterprise.

Guideline 3. Property, Plant and Equipment

3.1 An item of property, plant or equipment should be recognized as an asset when:

(a) it is probable that future economic benefits associated with the asset will flow to the enterprise; and
(b) the cost of the asset to the enterprise can be measured reliably.

3.2 An item of property, plant or equipment that qualifies for recognition as an asset should initially be measured at its cost.

3.3 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. Examples of directly attributable costs include the following:

(a) the cost of site preparation;
(b) initial delivery and handling costs;
(c) installation costs;
(d) professional fees such as for architects and engineers; and
(e) the estimated cost of dismantling and removing the asset and restoring the site, to the extent that it is recognized as a provision under Guideline 8.

3.4 Administration and other general overhead costs are not a component of the cost of property, plant and equipment unless they can be directly attributed to the acquisition of the asset or bringing the asset to its working condition. Similarly, start-up and similar preproduction costs do not form part of the cost of an asset unless they are necessary to bring the asset to its working condition. Initial operating losses incurred prior to an asset's achieving planned performance are recognized as an expense.

3.5 The cost of a self-constructed asset is determined using the same principles as for an acquired asset.

3.6 An item of property, plant or equipment may be acquired in exchange or part exchange for a dissimilar item of property, plant or equipment or other asset. The cost of such an item is measured at the *fair value* of the asset received, which is equivalent to the fair value of the asset given up adjusted by the amount of any cash or cash equivalents transferred.

3.7 Subsequent expenditure relating to an item of property, plant or equipment that has already been recognized should be added to the carrying amount of the asset when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the enterprise. All other subsequent expenditure should be recognized as an expense in the period in which it is incurred.

3.8 Expenditure on repairs or maintenance of property, plant and equipment is made to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of the asset. As such, it is usually recognized as an expense when incurred. For example, the cost of servicing or overhauling plant and equipment is usually an expense since it restores, rather than increases, the originally assessed standard of performance.

3.9 Major components of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of usage, or aircraft fixtures such as seats and galleys may require replacement several times during the life of the airframe. The components are accounted for as separate assets because they have useful lives different from those of the items of property, plant and equipment to which they relate. Therefore, provided the recognition criteria in paragraph 3.1 are satisfied, the expenditure incurred in replacing or renewing the component is accounted for as the acquisition of a separate asset and the replaced asset is written off.

Measurement subsequent to initial recognition

Benchmark treatment

3.10 Subsequent to initial recognition as an asset, an item of property, plant or equipment should be carried at its cost less any accumulated depreciation (3.19) and any accumulated *impairment losses* (3.25).

Allowed alternative treatment

3.11 Subsequent to initial recognition as an asset, an item of property, plant or equipment should be carried at a revalued amount (its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses). Revaluations should be made with sufficient regularity so that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

3.12 The fair value of land and buildings is usually the market value. This value is determined by appraisal, which is normally undertaken by professionally qualified valuers.

3.13 The fair value of items of plant and equipment is usually the market value determined by appraisal. When there is no evidence of market value because of the specialized nature of the plant and equipment and because these items are rarely sold, except as part of a continuing business, they are valued at their depreciated replacement cost.

3.14. When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is either:

(a) Restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount (this method is often used when an asset is revalued by means of an index to its depreciated replacement cost); or
(b) Eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. For example, this method is used for buildings that are revalued to their market value. The amount of the adjustment arising on the restatement or elimination of accumulated depreciation forms part of the increase or decrease in carrying amount, in accordance with paragraph 3.16.

3.15. When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

3.16 When an asset's carrying amount is increased as a result of a revaluation, the increase should be credited directly to equity under the heading of revaluation surplus. However, a revaluation increase should be recognized as income to the extent that it reverses a revaluation decrease of the same asset previously recognized as an expense.

3.17 When an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognized as an expense. However, a revaluation decrease should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of that same asset.

3.18 The revaluation surplus included in equity may be transferred directly to retained earnings when the surplus is realized. The whole surplus may be realized on the retirement or disposal of the asset. However, some of the surplus may be realized as the asset is used by the enterprise; in such a case, the amount of the surplus realized is the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. The transfer from revaluation surplus to retained earnings is not made through the income statement.

Depreciation

3.19 The *depreciable amount* of an item of property, plant or equipment should be allocated on a systematic basis over its *useful life*. The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. The depreciation charge for each period should be recognized as an expense unless it is included in the carrying amount of another asset.

3.20 The economic benefits embodied in an item of property, plant or equipment are consumed by the enterprise principally through the use of the asset. However, other factors such as technical obsolescence and wear and tear while an asset remains idle often result in the diminution of the economic benefits that might have been expected to be available from the asset. Consequently, all the following factors need to be considered in determining the useful life of an asset:

(a) the expected usage of the asset by the enterprise (usage is assessed by reference to the asset's expected capacity or physical output);
(b) the expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used, the repair and maintenance programme of the enterprise, and the care and maintenance of the asset while idle;
(c) technical obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or the service output of the asset; and
(d) legal or similar limits on the use of the asset, such as the expiry dates of related *lease*s.

3.21 Land and buildings are separable assets and are dealt with separately for accounting purposes, even when they are acquired together. Land normally has an unlimited life and, therefore, is not depreciated. Buildings have a limited life and, therefore, are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the useful life of the building.

3.22 A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the sum-of-the-units method. Straight-line depreciation results in a constant charge over the useful life of the asset. The diminishing balance method results in a decreasing charge over the useful life of the asset. The sum-of-the-units method results in a charge based on the expected use or output of the asset. The method used for an asset is selected based on the expected pattern of economic benefits and is consistently applied from period to period unless there is a change in the expected pattern of economic benefits from that asset.

3.23 The useful life of an item of property, plant or equipment should be reviewed periodically and, if expectations are significantly different from previous estimates, the depreciation charge for the current and future periods should be adjusted.

3.24 The depreciation method applied to property, plant and equipment should be reviewed periodically and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method should be changed to reflect the changed pattern. When such a change in depreciation method is necessary, the change should be accounted for as a change in accounting estimate and the depreciation charge for the current and future periods should be adjusted.

Impairment

3.25 At each balance sheet date, the entity should review the carrying value of all tangible and intangible fixed assets and consider whether the continued use of the asset, or group of assets forming a cash generating unit, is likely to generate cash flows sufficient to absorb the amortization of the cost of the asset. In the event that the future flows are expected to be insufficient, the carrying value should be reduced.

Retirements and disposals

3.26 An item of property, plant or equipment should be eliminated from the balance sheet on disposal or when the asset is permanently withdrawn from use and no future economic benefits are expected from its disposal.

3.27 Gains or losses arising from the retirement or disposal of an item of property, plant or equipment should be determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset and should be recognized as income or expense in the income statement.

Disclosure

3.28 The financial statements should disclose, for each class of property, plant and equipment:

(a) the measurement bases used for determining the gross carrying amount (when more than one basis has been used, the gross carrying amount for that basis in each category should be disclosed);
(b) the depreciation methods used;
(c) the useful lives or the depreciation rates used;
(d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
(e) a reconciliation of the carrying amount at the beginning and end of the period showing:
  (i) additions;
  (ii) disposals;
  (iii) increases or decreases during the period resulting from revaluations;
  (iv) impairment losses recognized in the income statement during the period (if any);
  (v) impairment losses reversed in the income statement during the period (if any);
  (vi) depreciation; and
  (vii) other movements.

Comparative information is not required for the reconciliation in (e) above.

3.29 The financial statements should also disclose the existence and amounts of restrictions on title, as well as property, plant and equipment pledged as security for liabilities.

3.30 When items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

(a) the basis used to revalue the assets;
(b) the effective date of the revaluation; and
(c) whether an independent valuer was involved.

Guideline 4. Leases

Classification of leases

4.1 The classification of leases is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibility of losses from idle capacity or technological obsolescence and of variations in return caused by changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's *economic life* and of gain from appreciation in value or realization of a residual value.

4.2 Whether a lease is a *finance lease* or an *operating lease* depends on the substance of the transaction rather than the form of the contract. Following are examples of situations that would normally lead to a lease's being classified as a finance lease:

(a) the lease transfers ownership of the asset to the lessee by the end of the *lease term*;
(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the *inception* of the lease, it is reasonably certain that the option will be exercised;
(c) the lease term is for the major part of the economic life of the asset, even if title is not transferred;
(d) at the inception of the lease, the present value of the *minimum lease payments* amounts to at least substantially all of the fair value of the leased asset;
(e) the leased assets are of a specialized nature such that only the lessee can use them without major modifications.

4.3 Following are indicators of situations that, individually or in combination, could also lead to a lease's being classified as a finance lease:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease);
(c) the lessee has the ability to continue the lease for a secondary period at a rent substantially lower than market rent.

Finance leases

4.4 Lessees should recognize finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payments, the discount factor is the *interest rate implicit in the lease*, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

4.5 Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

4.6 A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for leased assets should be consistent with that for depreciable assets that are owned.

4.7 If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

4.8 Lessees should disclose for finance leases, for each class of asset, the net carrying amount at the balance sheet date and the basis on which *contingent rent*s have been recognized in the income statement.

Operating leases

4.9 Lease payments under an operating lease should be recognized as an expense in the income statement on a straight line basis over the lease term unless another systematic basis is representative of the time pattern of the user's benefit.

4.10 All incentives for the agreement of a new or renewed operating lease should be recognized as an integral part of the net consideration agreed for the use of the leased asset. The lessee should recognize the aggregate benefit of incentives as a reduction of rental expense over the lease term.

4.11 Lessees should disclose the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;
(ii) later than one year and not later than five years; and
(iii) later than five years.

Sale and leaseback

4.12 A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payment and the sale price are usually interdependent since they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends on the type of lease involved.

4.13 If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should not be immediately recognized as income in the financial statements of a seller-lessee. Instead, it should be deferred and amortized over the lease term.

4.14 If a sale and leaseback transaction results in an operating lease and it is clear that the transaction is established at fair value, any profit or loss should be recognized immediately. If the sale price is below fair value, any profit or loss should be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

4.15 For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognized immediately.

Guideline 5. Intangible Assets

Definition

5.1 An enterprise *control*s an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Recognition and initial measurement of an intangible asset

5.2 An intangible asset should be recognized if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
(b) the *cost* of the asset can be measured reliably.

5.3 An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

5.4 An intangible asset should be measured initially at cost.

5.5 Internally generated goodwill should not be recognized as an asset.

Internally generated intangible assets

(i) Research phase

5.6 No intangible asset arising from *research* (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

(ii) Development phase

5.7 An intangible asset arising from *development* (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;
(b) The enterprise's intention to complete the intangible asset and use or sell it;
(c) its ability to use or sell the intangible asset;
(d) how the intangible asset will generate probable future economic benefits (among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset);
(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

5.8 Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as intangible assets.

Recognition of an expense

5.9 Expenditure on an intangible item should be recognized as an expense when it is incurred, unless it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 5.2 to 5.8).

5.10 Expenditure on an intangible item that was initially recognized as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognized as part of the cost of an intangible asset at a later date.

5.11 Subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense when it is incurred unless:

(a) it is probable that this expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and
(b) this expenditure can be reliably measured and attributed to the asset.
If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

5.12 After initial recognition, an intangible asset should be carried at its cost less any accumulated amortization and any accumulated impairment losses. If fair value can be determined by reference to an *active market*, revaluation is an allowed alternative treatment.

Amortization

Amortization period

5.13 The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed 20 years from the date when the asset is available for use. Amortization should commence when the asset is available for use.

5.14 If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and
(b) renewal is virtually certain.

Amortization method

5.15 The amortization method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortization charge for each period should be recognized as an expense unless another Guideline permits or requires it to be included in the carrying amount of another asset.

Residual value

5.16 The *residual value* of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or
(b) there is an active market for the asset and:
    (i) residual value can be determined by reference to that market; and
    (ii) it is probable that such a market will exist at the end of the asset's useful life.

Review of amortization period and amortization method

5.17 The amortization period and the amortization method should be reviewed at least at the end of each financial year. If the expected useful life of the asset is significantly different from previous estimates, the amortization period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortization method should be changed to reflect the changed pattern. Such changes should be accounted for as changes in accounting estimates by adjusting the amortization charge for the current and future periods.

Recoverability of the carrying amount: impairment losses

5.18 An enterprise should estimate the recoverable amount of intangible assets at least at the end of each financial year, even if there is no indication that the asset is impaired. The recoverable amount should be determined under paragraph 3.25 and impairment losses recognized accordingly.

Retirements and disposals

5.19 An intangible asset should be derecognized (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

5.20 Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognized as income or expense in the income statement.

Disclosure

5.21 The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

(a) the useful lives or the amortization rates used;
(b) the amortization methods used;
(c) the gross carrying amount and the accumulated amortization (aggregated with accumulated impairment losses) at the beginning and end of the period;
(d) the line item(s) of the income statement in which the amortization of intangible assets is included; and
(e) a reconciliation of the carrying amount at the beginning and end of the period showing:
    (i) retirements and disposals;
    (ii) impairment losses recognized;
    (iii) impairment losses reversed;
    (iv) amortisation recognized during the period; and
    (v) additions and other changes in the carrying amount during the period.

Comparative information is not required.

5.22 The financial statements should also disclose:
(a) if an intangible asset is amortized over more than 20 years, the reasons why the presumption that the useful life of an intangible asset will not exceed 20 years from the date when the asset is available for use is rebutted.
(b) a description, the carrying amount and remaining amortization period of any individual intangible asset that is material to the financial statements of the enterprise as a whole; and
(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities.

Guideline 6. Inventories

6.1 Inventories should be measured at the lower of cost and net realizable value.

6.2 The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

6.3 The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by using specific identification of their individual costs.

6.4 The cost of inventories, other than those dealt with in paragraph 6.3, should be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas.

Recognition as an expense

6.5 When inventories are sold, the carrying amount of those inventories should be recognized as an expense in the period in which the related revenue is recognized. The amount of any write-down of inventories to net realizable value and all losses of inventories should be recognized as an expense in the period in which the write-down or loss occurs. The amount of any reversal of any write-down of inventories arising from an increase in net realizable value should be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

Disclosure

6.6 The financial statements should disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used;
(b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the enterprise; and
(c) the carrying amount of inventories pledged as security for liabilities.

6.7 The financial statements should disclose either:

(a) the cost of inventories recognized as an expense during the period; or
(b) the operating costs, applicable to revenues, recognized as an expense during the period, classified by their nature.

Guideline 7. Government Grants

7.1 *Government grants* are assistance by *government* in the form of transfers of resources to an enterprise in return for past or future compliance with certain conditions relating to the operating activities of the enterprise.

7.2 Government grants, including non-monetary grants at fair value, should not be recognized until there is reasonable assurance that:

(a) the enterprise will comply with the conditions attaching to them; and
(b) the grants will be received.

7.3 Government grants should be recognized as income over the periods necessary to match them with the related costs they are intended to compensate, on a systematic basis. They should not be credited directly to shareholders' interests.

7.4 In most cases the periods over which an enterprise recognizes the costs or expenses related to a government grant are readily ascertainable, and thus grants in recognition of specific expenses are recognized as income in the same period as the relevant expense. Similarly, grants related to depreciable assets are usually recognized as income over the periods and in the proportions in which depreciation on those assets is charged.

7.5 A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the enterprise, with no future related costs, should be recognized as income of the period in which it becomes receivable, as an extraordinary item if appropriate.

7.6 Government *grants related to assets*, including non-monetary grants at fair value, should be presented in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

7.7 *Grants related to income* are sometimes presented as a credit in the income statement, either separately or under a general heading such as "Other income"; alternatively, they are deducted in reporting the related expense.

7.8 A government grant that becomes repayable should be accounted for as a revision to an accounting estimate. Repayment of a grant related to income should be applied first against any unamortized deferred credit set up in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or where no deferred credit exists, the repayment should be recognized immediately as an expense. Repayment of a grant related to an asset should be recorded by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognized to date as an expense in the absence of the grant should be recognized immediately as an expense.

Government assistance

7.9 Excluded from the definition of government grants in paragraph 7.1 are certain forms of *government assistance* that cannot reasonably have a value placed on them and transactions that cannot be distinguished from the normal trading transactions of the enterprise.

7.10. Examples of assistance that cannot reasonably have a value placed on them are free technical or marketing advice and the provision of guarantees. An example of assistance that cannot be distinguished from the normal trading transactions of the enterprise is a government procurement policy that is responsible for a portion of the enterprise's sales. The existence of the benefit might be unquestioned, but any attempt to segregate the trading activities from government assistance could well be arbitrary.

7.11 The significance of the benefit in the above examples may be such that disclosure of the nature, extent and duration of the assistance is necessary so that the financial statements will not be misleading.

7.12 Loans at nil or low interest rates are a form of government assistance, but the benefit is not quantified by the imputation of interest.

7.13 Government assistance to enterprises meets the definition of government grants even if there are no conditions specifically relating to the operating activities of the enterprise other than the requirement to operate in certain regions or industry sectors. Such grants should therefore not be credited to equity.

Disclosure

7.14 The following matters should be disclosed:

(a) the accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements;
(b) the nature and extent of government grants recognized in the financial statements and an indication of other forms of government assistance from which the enterprise has directly benefited; and
(c) unfulfilled conditions and other contingencies attaching to government assistance that has been recognized.

Guideline 8. Provisions

8.1 A provision should be recognized when:

(a) an enterprise has a *present obligation* (legal or constructive) as a result of a past event, excluding those arising from executory contracts, except where these are onerous;
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognized.

Probable outflow of resources embodying economic benefits

8.2 For a liability to qualify for recognition, there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Guideline, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur (i.e. the probability that the event will occur is greater than the probability that it will not). Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 8.19).

Reliable estimate of the obligation

8.3 The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision.

Contingent liabilities

8.4 An enterprise should not recognize a *contingent liability*.

8.5 A contingent liability is disclosed, as required by paragraph 8.19, unless the possibility of an outflow of resources embodying economic benefits is remote.

Contingent assets

8.6 An enterprise should not recognize a *contingent asset.*

8.7 Contingent assets are not recognized in financial statements, since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

8.8 A contingent asset is disclosed, as required by paragraph 8.20, where an inflow of economic benefits is probable.

Measurement

8.9 The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

Risks and uncertainties

8.10 Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

8.11 The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

8.12 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognized for the reimbursement should not exceed the amount of the provision. Gains from the expected disposal of assets should not be taken into account when measuring a provision.

8.13 In the income statement, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.

8.14 Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

8.15 A provision should be used only for expenditures for which the provision was originally recognized.

8.16 Provisions should not be recognized for future operating losses.

8.17 If an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision.

Disclosure

8.18 For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period; and

(b) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.

8.19 Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable, an estimate of its financial effect, measured under paragraphs 8.9 and 8.10.

8.20 Where an inflow of economic benefits is probable, an enterprise should disclose a brief description of the nature of the contingent assets at the balance sheet date and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 8.9 and 8.10.

8.21 Where any of the information required by paragraphs 8.19 and 8.20 is not disclosed because it is not practicable to do so, that fact should be stated.

8.22 In extremely rare cases, disclosure of some or all of the information required by paragraphs 8.18 to 8.20 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an enterprise need not disclose the information but should disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

8.23 Examples of accounting for provisions are given in Appendix 2, part A.

Guideline 9. Revenue

Measurement of revenue

9.1 Revenue should be measured at the fair value of the consideration received or receivable.

Sale of goods

9.2 Revenue from the sale of goods should be recognized when all the following conditions have been satisfied:

(a) the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
(b) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
(c) the amount of revenue can be measured reliably;
(d) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Rendering of services

9.3 When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognized by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) the amount of revenue can be measured reliably;
(b) it is probable that the economic benefits associated with the transaction will flow to the enterprise;
(c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and
(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

9.4 When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognized only to the extent of the expenses recognized that are recoverable.

9.5 Goods include goods produced by the enterprise for the purpose of sale and goods purchased for resale, such as merchandise purchased by a retailer or land and other property held for resale.

9.6 The rendering of services typically involves the performance by the enterprise of a contractually agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. Some contracts for the rendering of services are directly related to *construction contract*s – for example, those for the services of project managers and architects.

9.7 Revenue includes only the gross inflows of economic benefits received and receivable by the enterprise on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value-added taxes are not economic benefits flowing to the enterprise and, hence, do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the enterprise. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

Interest, royalties and dividends

9.8 Revenue arising from the use by others of enterprise assets yielding interest, royalties and dividends should be recognized on the bases set out in paragraph 8.9 when:

(a) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
(b) the amount of the revenue can be measured reliably.

9.9 Revenue should be recognized on the following bases:

(a) interest should be recognized on a time proportion basis;
(b) royalties should be recognized on an accrual basis in accordance with the substance of the relevant agreement; and
(c) dividends should be recognized when the shareholder's right to receive payment is established.

9.10 Revenue is recognized only when it is probable that the economic benefits associated with the transaction will flow to the enterprise. However, when uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognized as an expense rather than as an adjustment of the amount of revenue originally recognized. Some examples of revenue recognition issues are given in Appendix 2, part B.

Disclosure

9.11 An enterprise should disclose:

(a) the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
(b) the amount of each significant category of revenue recognized during the period, including revenue arising from:
    (i) the sale of goods;
    (ii) the rendering of services;
    (iii) interest;
    (iv) royalties; and
    (v) dividends; and
(c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

Guideline 10. Borrowing Costs

10.1 *Borrowing costs* may include:

(a) interest on bank overdrafts and short-term and long-term borrowings;
(b) amortization of ancillary costs incurred in connection with the arrangement of borrowings;
(c) finance charges in respect of finance leases; and
(d) *exchange difference*s arising from *foreign currency* borrowings to the extent that they are regarded as an adjustment to interest costs.

Borrowing costs: benchmark treatment

10.2 Borrowing costs should be recognized as an expense in the period in which they are incurred.

Borrowing costs: allowed alternative treatment

Recognition

10.3 Borrowing costs should be recognized as an expense in the period in which they are incurred, except to the extent that they are capitalized in accordance with paragraph 10.4.

10.4 Borrowing costs that are directly attributable to the acquisition, construction or production of a *qualifying asset* should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Guideline.

10.5 Examples of qualifying assets are inventories that require a substantial period of time to bring them to a saleable condition, manufacturing plants, power generation facilities and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Borrowing costs eligible for capitalization

10.6 To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

10.7 To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization should be determined by applying a capitalization rate to the expenditures on that asset. The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period should not exceed the amount of borrowing costs incurred during that period.

10.8 The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when:

(a) expenditures for the asset are being incurred;

(b) borrowing costs are being incurred; and
(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

10.9 Capitalization of borrowing costs should be suspended during extended periods in which active development is interrupted.

10.10 Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

10.11 When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalization of borrowing costs should cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.

Disclosure

10.12 The financial statements should disclose:

(a) the accounting policy adopted for borrowing costs;
(b) the amount of borrowing costs capitalized during the period; and
(c) the capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

Guideline 11. Income Taxes

Current tax

11.1 *Current tax* for current and prior periods should, to the extent unpaid, be recognized as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess should be recognized as an asset.

11.2 The benefit relating to a tax loss that can be carried back to recover current tax of a previous period should be recognized as an asset.

11.3 Current tax liabilities (assets) for the current and prior periods should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.

11.4 *Deferred tax assets* and *liabilities* may be recognized if the enterprise wishes to do so.

Income statement

11.5 Current tax should be recognized as income or an expense and included in the net profit or loss for the period, except to the extent that the tax arises from a transaction or event that is recognized other than in the income statement.

11.6 Current tax should be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity.

Presentation

11.7 Tax assets and tax liabilities should be presented separately from other assets and liabilities in the balance sheet. Deferred tax assets and liabilities, if recognized, should be distinguished from current tax assets and liabilities.

11.8 When an enterprise makes a distinction between current and non-current assets and liabilities in its financial statements, and has decided to account for deferred taxes, it should not classify deferred tax assets (liabilities) as current assets (liabilities).

11.9 An enterprise should offset current tax assets and current tax liabilities if, and only if, the enterprise:

(a) has a legally enforceable right to set off the recognized amounts; and
(b) intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Disclosure

11.10 The major components of tax expense (income) should be disclosed separately.

Guideline 12. Accounting Policies

12.1 Management should select and apply an enterprise's accounting policies so that the financial statements comply with all the requirements of the SMEGA. Where there is no specific requirement, management should look in turn to the following for guidance:

(a) full IFRS;
(b) interpretations;
(c) appendices to standards;
(d) implementation guidance;
(e) the definitions, recognition criteria and measurement concepts set out in the conceptual framework; and
(f) pronouncements of other standard setters that use a similar conceptual framework to develop accounting standards; other accounting literature; and accepted industry practice, to the extent that these are consistent with items (a) to (e) above.

Management should use its judgement in developing an accounting policy resulting in information that is relevant to the needs of investors and creditors and is reliable in nature.

Where management bases its accounting policy on IFRS, it should be guided by user needs in making disclosures. In such a case the entity is not then obliged to comply with the full IFRS, and should continue to describe itself in its accounting policy note as complying with the SMEGA.

12.2 An entity should select and apply its accounting policies for a period consistently for similar transactions, other events and circumstances, unless the Guideline elsewhere specifically requires or permits categorization of items for which different policies may be appropriate.

12.3 A change in accounting policy should be made only if it is required by the Guideline or if it results in a more relevant and reliable presentation in the financial statements of the effects of transactions or other events on the entity's financial position, financial performance or cash flows.

12.4 The following are not changes in accounting policies:

(a) the adoption of an accounting policy for transactions or other events that differ in substance from those previously occurring; and
(b) the adoption of a new accounting policy for transactions or other events that did not occur previously or were immaterial.

12.5 A change in an accounting policy that is made following an amendment to the Guideline should be accounted for in accordance with the transitional provisions, if any, issued with the Guideline.

12.6 Where application of a change in the Guideline has a material effect on the current period or any prior period presented, an entity should disclose the following:

(a) the fact that the change in accounting policy is made in accordance with the change in the Guideline, with a description of those provisions;
(b) the amount of the adjustment for the current period and for each prior period presented;
(c) the amount of the adjustment relating to periods prior to those included in the comparative information; and
(d) the fact that comparative information has been restated, or that restatement for a particular prior period has not been made because it would require undue cost and effort.

12.7 A change in an accounting policy other than one mandated under paragraph 12.5 should be applied retrospectively. The opening balance of retained earnings for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented should be adjusted, where applicable, as if the new accounting policy had always been in use.

12.8 Comparative information presented for a particular prior period need not be restated if restating the information would require undue cost or effort. When comparative information for a particular prior period is not restated, the new accounting policy should be applied to the balances of assets and liabilities as at the beginning of the next period, and a corresponding adjustment should be made to the opening balance of retained earnings for the next period.

12.9 When a change in an accounting policy has an effect on the current period or any prior period presented, or may have an effect in subsequent periods, an entity should disclose the following:

(a) the reasons for the change;
(b) the amount of the adjustment for the current period and for each prior period presented;
(c) the amount of the adjustment relating to periods prior to those presented; and
(d) that comparative information has been restated, or that restatement for a particular prior period has not been made because it would require undue cost or effort.

Changes in accounting estimates

12.10 The effect of a change in an accounting estimate should be recognized prospectively by including it in profit or loss in:

(a) the period of the change, if the change affects that period only; or
(b) the period of the change and future periods, if the change affects both.

12.11 The nature and amount of a change in an accounting estimate that has an effect on the current period or is expected to have an effect in subsequent periods should be disclosed.

Errors

12.12 The amount of the correction of a fundamental error should be accounted for retrospectively. An error should be corrected by:

(a) either restating the comparative amounts for the prior periods in which the error occurred; or
(b) when the error occurred before the earliest prior period presented, restating the opening balance of retained earnings for that period, so that the financial statements are presented as if the error had never occurred.

12.13 Comparative information presented for a particular prior period need not be restated if restating the information would require undue cost or effort. When no restatement of comparative figures takes place, the opening balance of retained earnings for the next period should be restated for the cumulative effect of the error before the beginning of that period.

Disclosure

12.14 An entity should disclose:

(a) the nature of the error; and
(b) the amount of the correction for each prior period presented.

Guideline 13. Foreign Exchange Rates

Foreign currency transactions

13.1 A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the *exchange rate* between the reporting currency and the foreign currency at the date of the transaction.

13.2 At each balance sheet date:

(a) foreign currency *monetary items* should be reported using the *closing rate;*
(b) non-monetary items that are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and
(c) non-monetary items that are carried at fair value denominated in a foreign currency should be reported using the exchange rate that existed when the values were determined.

13.3 Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or as expenses in the period in which they arise.

Disclosure

13.4 An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period; and
(b) the amount of exchange differences arising during the period that is included in the carrying amount of an asset.

13.5 When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

Guideline 14. Events after Balance Sheet Date

14.1 An enterprise should adjust the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date.

14.2 The following are examples of adjusting *events after the balance sheet date* that require an enterprise to adjust the amounts recognized in its financial statements, or to recognize items that were not previously recognized:

(a) the resolution after the balance sheet date of a court case which, because it confirms that an enterprise already had a present obligation at the balance sheet date, requires the enterprise to adjust a provision already recognized, or to recognize a provision instead of merely disclosing a contingent liability;

(b) the receipt of information after the balance sheet date indicating that an asset was impaired at the balance sheet date, or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. For example:
   (i) when the bankruptcy of a customer occurs after the balance sheet date, it usually confirms that a loss already existed at the balance sheet date on a trade receivable account and that the enterprise needs to adjust the carrying amount of the trade receivable account; and
   (ii) the sale of inventories after the balance sheet date may give evidence about their net realizable value at the balance sheet date;

(c) the determination after the balance sheet date of the cost of assets purchased, or the proceeds from assets sold, before the balance sheet date;

(d) the determination after the balance sheet date of the amount of profit-sharing or bonus payments, if the enterprise had a present legal or *constructive obligation* at the balance sheet date to make such payments as a result of events before that date; and

(e) the discovery of fraud or errors indicating that the financial statements were incorrect.

14.3 An enterprise should not prepare its financial statements on a going concern basis if management determines, after the balance sheet date, either that it intends to liquidate the enterprise or to cease trading, or that it has no realistic alternative but to do so.

14.4 An enterprise should not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the balance sheet date.

14.5 An example of a non-adjusting event after the balance sheet date is a decline in market value of investments between the balance sheet date and the date when the financial statements are authorized for issue. The fall in market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances that arise in the following period. Therefore, an enterprise does not adjust the amounts recognized in its financial statements for the investments. Similarly, the enterprise does not update the amounts disclosed for the investments as at the balance sheet date, although it may need to give additional disclosure under paragraph 14.7.

14.6 If an enterprise receives information after the balance sheet date about conditions that existed at the balance sheet date, the enterprise should, in the light of the new information, update disclosures that relate to these conditions.

14.7 Where non-adjusting events after the balance sheet date are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions, an enterprise should disclose the following information for each significant category of non-adjusting event after the balance sheet date:

(a) the nature of the event; and
(b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

14.8 The following are examples of non-adjusting events after the balance sheet date that may be of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions:

(a) announcing a plan to discontinue an operation, disposing of assets or settling liabilities attributable to a discontinuing operation, or entering into binding agreements to sell such assets or settle such liabilities;
(b) major purchases and disposals of assets, or expropriation of major assets by government; and
(c) the destruction of a major production plant by a fire after the balance sheet date;

14.9 If dividends to holders of equity instruments are proposed or declared after the balance sheet date, an enterprise should not recognize those dividends as a liability at the balance sheet date.

14.10 An enterprise should disclose the date when the financial statements were authorized for issue and who gave that authorization. If the enterprise's owners or others have the power to amend the financial statements after issuance, the enterprise should disclose that fact.

Guideline 15. Related-Party Disclosures

15.1 This section deals only with those *related-party* relationships described in (a) to (d) below:

(a) enterprises that, either directly or indirectly through one or more intermediaries, are under common control with the reporting enterprise;
(b) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them *significant influence* over the enterprise, and close members of the family of any such individual;
(c) key management personnel (i.e. those persons having authority and responsibility for planning, directing and controlling the activities of the reporting enterprise, including directors and officers of companies and close members of the families of such individuals); and
(d) enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in (b) or (c) or over which such a person is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

In considering each possible related-party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

15.2 In the context of this Guideline the following are deemed not to be related parties:

(a) two companies simply because they have a director in common, notwithstanding paragraph 15.1 above (but it is necessary to consider the possibility, and to assess the likelihood, that the director would be able to affect the policies of both companies in their mutual dealings);
(b) (i) providers of finance;
(ii) trade unions;
(iii) public utilities; and
(iv) government departments and agencies, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of an enterprise or participate in its decision-making process); and
(c) a single customer, supplier, franchisor, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

Disclosure

15.3 The following are examples of situations where *related-party transaction*s may lead to disclosures by a reporting enterprise in the period they affect:

(a) purchases or sales of goods (finished or unfinished);
(b) purchases or sales of property and other assets;
(c) rendering or receiving of services;
(d) agency arrangements;
(e) leasing arrangements;
(f) transfer of research and development;
(g) licence agreements;

(h) finance (including loans and equity contributions in cash or in kind);
(i) guarantees and collaterals; and
(j) management contracts.

15.4 Related-party relationships where control exists should be disclosed irrespective of whether there have been transactions between the related parties.

15.5 If there have been transactions between related parties, the reporting enterprise should disclose the nature of the related-party relationships as well as the types of transactions and the elements of the transactions necessary for an understanding of the financial statements.

15.6 The elements of transactions necessary for an understanding of the financial statements would normally include:

(a) an indication of the volume of the transactions, either as an amount or as an appropriate proportion;
(b) amounts or appropriate proportions of outstanding items; and
(c) pricing policies.

15.7 Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related-party transactions on the financial statements of the reporting enterprise.

Appendix 1. Definitions

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements.

Accounting profit is net profit or loss for a period before deduction of tax expenses.

An ***asset*** is a resource
- (a) controlled by an enterprise as a result of past events; and
- (b) from which future economic benefits are expected to flow to the enterprise.

An ***active market*** is a market where all the following conditions exist:
- (a) the items traded within the market are homogeneous;
- (b) willing buyers and sellers can normally be found at any time; and
- (c) prices are available to the public.

Amortization is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Carrying amount is the amount at which an asset is recognized in the balance sheet after deduction of any accumulated depreciation and accumulated impairment losses thereon.

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

The ***closing rate*** is the spot exchange rate at the balance sheet date.

A ***construction contract*** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A ***constructive obligation*** is an obligation that derives from an enterprise's actions where,
- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A ***contingent asset*** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

A ***contingent liability*** is

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognized because

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) the amount of the obligation cannot be measured with sufficient reliability.

Control is ownership, either directly or indirectly through subsidiaries, of more than one half of the voting power of an enterprise, or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise.

Contingent rent is that portion of the lease payments which is not fixed in amount but is based on a factor other than the passage of time (e.g. percentage of sales, amount of usage, price indices, market rates of interest).

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition, production or construction.

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of

(a) deductible temporary differences;

(b) the carry forward of unused tax losses; and

(c) the carry forward of unused tax credits.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

Economic life is either

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Events after the balance sheet date are events, both favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. Two types of events can be identified:

(a) those providing evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and
(b) those indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

The ***exchange difference*** is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

The ***exchange rate*** is the ratio for exchange of two currencies.

Extraordinary items are income or expenses arising from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly.

The ***fair value*** of an asset is the amount for which an asset could be exchanged, or a liability settled, between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's-length transaction.

A ***finance lease*** is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise.

Foreign currency is a currency other than the reporting currency of an enterprise.

Forgivable loans are loans that the lender undertakes to waive repayment of under certain prescribed conditions.

Fundamental errors are errors discovered in the current period that are of such significance that the financial statements of one or more prior periods can no longer be considered to have been reliable at the date of their issue.

Government refers to government, government agencies and similar bodies, whether local, national or international.

Government assistance is action by government designed to provide an economic benefit specific to an enterprise or range of enterprises qualifying under certain criteria. Government assistance for the purpose of this Guideline does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants are assistance by government in the form of transfers of resources to an enterprise in return for past or future compliance with certain conditions relating to the operating activities of the enterprise. They exclude those forms of government assistance which cannot reasonably have a value placed on them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Grants related to assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

Guaranteed residual value is,

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Historical cost assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

An ***impairment loss*** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

The ***inception*** of the lease is the earlier of the date of the lease agreement or the date of a commitment by the parties to the principal provisions of the lease.

The lessee's ***incremental borrowing rate of interest*** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

An ***intangible asset*** is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

The ***interest rate implicit in the lease*** is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) the minimum lease payments; and

(b) the unguaranteed residual value to be equal to the fair value of the leased asset.

Inventories are assets

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

A ***lease*** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

The ***lease term*** is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

A ***legal obligation*** is an obligation that derives from
- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law.

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

Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee. However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, and if, at the inception of the lease, it is reasonably certain that the option will be exercised, then the minimum lease payments comprise the minimum payments payable over the lease term and the payment required to exercise this purchase option.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Net realizable value is 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.

A ***non-cancellable lease*** is a lease that is cancellable only
- (a) upon the occurrence of some remote contingency;
- (b) with the permission of the lessor;
- (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
- (d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

An ***obligating event*** is an event that creates a legal or constructive obligation that results in an enterprise's having no realistic alternative to settling that obligation.

An ***onerous contract*** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

An ***operating lease*** is a lease other than a finance lease.

Ordinary activities are any activities undertaken by an enterprise as part of its business and related activities in which the enterprise engages in furtherance of, incidental to, or arising from these activities.

Property, plant and equipment are tangible assets that

(a) are held by an enterprise for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

A ***provision*** is a liability of uncertain timing or amount.

A ***qualifying asset*** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Related party: Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions.

A ***related-party transaction*** is a transfer of resources or obligations between related parties, regardless of whether a price is charged.

Reporting currency is the currency used in presenting the financial statements.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Residual value is the net amount an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Significant influence is (for the purpose of SMEGA) participation in the financial and operating policy decisions of an enterprise without having control of those policies. Significant influence may be exercised in several ways, usually by representation on the board of directors but also by, for example, participation in the policy-making process, material intercompany transactions, interchange of managerial personnel or dependence on technical information.

The ***tax base*** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Tax expense (tax income) is the aggregate amount included in the determination of net profit or loss for the period in respect of current tax and deferred tax.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, on which income taxes are payable (recoverable).

Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either

(a) *taxable temporary differences*, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) *deductible temporary differences*, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Useful life is either

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

Appendix 2. Examples

A. Recognition of provisions

Example 1: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On the basis of past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event: The obligating event is the sale of the product with a warranty, which gives rise to a *legal obligation*.

An outflow of resources embodying economic benefits in settlement: Probable for the warranties as a whole.

Conclusion: A provision is recognized for the best estimate of the costs of making good under the warranty products sold before the balance sheet date.

Example 2: Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to install smoke filters in its factories by 30 June 2000. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 December 1999:

Present obligation as a result of a past obligating event: There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion: No provision is recognized for the cost of fitting the smoke filters.

(b) At the balance sheet date of 31 December 2000:

Present obligation as a result of a past obligating event: There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement: The likelihood of incurring fines and penalties for non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion: No provision is recognized for the costs of fitting smoke filters. However, a provision is recognized for the best estimate of any fines and penalties that are more likely than not to be imposed.

Example 3: A Court Case

After a wedding in 2000, 10 people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are under way seeking damages from the enterprise, but it disputes its liability. Up to the date of approval of the financial statements for the year to 31 December 2000 for issue, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year ending 31 December

2001, its lawyers advise that, because of new developments in the case, it is probable that the enterprise will be found liable.

(a) At the balance sheet date of 31 December 2000:

Present obligation as a result of a past obligating event: On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion: No provision is recognized. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At the balance sheet date of 31 December 2001:

Present obligation as a result of a past obligating event: On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement: Probable.

Conclusion: A provision is recognized for the best estimate of the amount required to settle the obligation.

Example 4: Refurbishment Costs – No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event: There is no present obligation.

Conclusion: No provision is recognized.

The cost of replacing the lining is not recognized because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions; even the intention to incur the expenditure depends on the company's deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognized, the depreciation of the lining takes into account its consumption (i.e. it is depreciated over five years). The relining costs then incurred are capitalized, with the consumption of each new lining shown by depreciation over the subsequent five years.

B. Revenue recognition

The following examples illustrate the application of the SMEGA in a number of commercial situations in order to clarifying their meaning. The examples focus on particular aspects of a transaction and do not constitute comprehensive discussions of all the relevant factors that might influence the recognition of revenue. The examples generally assume that the amount of revenue can be measured reliably; that it is probable that the economic benefits will flow to the enterprise; and that the costs incurred or to be incurred can be measured reliably. The examples do not modify or override the standard.

Sale of goods

Since laws vary from country to country, the recognition criteria in this standard will be met at different times. In particular, the law may determine the point in time at which the enterprise transfers the significant risks and rewards of ownership. Therefore, the examples in this section of the appendix need to be read in the context of the laws relating to the sale of goods in the country in which the transaction takes place.

1. *"Bill and hold" sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing.*

   Revenue is recognized when the buyer takes title, provided that:

   (a) it is probable that delivery will be made;
   (b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognized;
   (c) the buyer specifically acknowledges the deferred delivery instructions; and
   (d) the usual payment terms apply.

   Revenue is not recognized when there is simply an intention to acquire or manufacture the goods in time for delivery.

2. *Goods shipped subject to conditions, including the following situations:*

   (a) *Installation and inspection.*
   Revenue is normally recognized when the buyer accepts delivery and installation and inspection are complete. However, revenue is recognized immediately upon the buyer's acceptance of delivery when:
      (i) the installation process is simple in nature (e.g. the installation of a factory-tested television receiver which only requires unpacking and connection of power and antennae); or
      (ii) the inspection is performed only for purposes of final determination of contract prices (e.g. for shipments of iron ore, sugar or soya beans).
   (b) *On approval when the buyer has negotiated a limited right of return.*
   If there is uncertainty about the possibility of return, revenue is recognized when the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed.
   (c) *Consignment sales under which the recipient (buyer) undertakes to sell the goods on behalf of the shipper (seller).*
   Revenue is recognized by the shipper when the goods are sold by the recipient to a third party.
   (d) *Cash on delivery sales.*

   Revenue is recognized when delivery is made and cash is received by the seller or its agent.

3. *Layaway sales, in which the goods are delivered only when the buyer makes the final payment in a series of instalments.*
   Revenue from such sales is recognized when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognized when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer.

4. *Orders in which payment (or partial payment) is received in advance of delivery for goods not presently held in inventory (e.g. the goods are still to be manufactured or will be delivered directly to the customer from a third party).*
   Revenue is recognized when the goods are delivered to the buyer.

5. *Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the buyer has a put option to require the repurchase by the seller of the goods.*

The terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognized. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue.

6. *Sales to intermediate parties, such as distributors, dealers or others, for resale.*
Revenue from such sales is generally recognized when the risks and rewards of ownership have passed. However, when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale.

7. *Subscriptions to publications and similar items.*
When the items involved are of similar value in each time period, revenue is recognized on a straight line basis over the period in which the items are despatched. When the items vary in value from period to period, revenue is recognized on the basis of the sales value of the item despatched in relation to the total estimated sales value of all items covered by the subscription.

8. *Instalment sales, under which the consideration is receivable in instalments.*
Revenue attributable to the sales price, exclusive of interest, is recognized at the date of sale. The sale price is the present value of the consideration, determined by discounting the instalments receivable at the imputed rate of interest. The interest element is recognized as revenue as it is earned, on a time proportion basis that takes into account the imputed rate of interest.

9. *Real estate sales.*
Revenue is normally recognized when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and, therefore, the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognize revenue. In either case, if the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognized as the acts are performed. An example is a building or other facility on which construction has not been completed.

In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements that include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determine how the transaction is accounted for. It may be accounted for as a sale, or as a financing, a leasing or some other profit-sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

A seller must also consider the means of payment and evidence of the buyer's commitment to complete payment. For example, when the aggregate of the payments received, including the buyer's initial down payment or continuing payments by the buyer, provide insufficient evidence of the buyer's commitment to complete payment, revenue is recognized only to the extent that cash is received.

Rendering of services

10. *Installation fees.*
Installation fees are recognized as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product, in which case they are recognized when the goods are sold.

11. *Servicing fees included in the price of the product.*
When the selling price of a product includes an identifiable amount for subsequent servicing (e.g. after sales support and product enhancement on the sale of software), that amount is deferred and recognized as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable profit on those services.

12. *Advertising commissions.*
Media commissions are recognized when the related advertisement or commercial appears before the public. Production commissions are recognized by reference to the stage of completion of the project.

13. *Insurance agency commissions.*
Insurance agency commissions received or receivable that do not require the agent to render further service are recognized as revenue by the agent on the effective commencement or renewal dates of the related policies. However, when it is probable that the agent will be required to render further services during the life of the policy, the commission, or part thereof, is deferred and recognized as revenue over the period during which the policy is in force.

14. *Admission fees.*
Revenue from artistic performances, banquets and other special events is recognized when the event takes place. When a subscription to a number of events is sold, the fee is allocated to each event on a basis that reflects the extent to which services are performed at each event.

15. *Tuition fees.*
Revenue is recognized over the period of instruction.

16. *Initiation, entrance and membership fees.*
Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognized as revenue when no significant uncertainty as to its collectability exists. If the fee entitles the member to services or publications to be provided during the membership period, or to the purchase of goods or services at prices lower than those charged to nonmembers, it is recognized on a basis that reflects the timing, nature and value of the benefits provided.

17. *Franchise fees.*
Franchise fees may cover the supply of initial and subsequent services, equipment and other tangible assets, and know-how. Accordingly, franchise fees are recognized as revenue on a basis that reflects the purpose for which the fees were charged. The following methods of franchise fee recognition are appropriate:

    (a) Supplies of equipment and other tangible assets.
    The amount, based on the fair value of the assets sold, is recognized as revenue when the items are delivered or title passes.

(b) Supplies of initial and subsequent services.
Fees for the provision of continuing services, whether part of the initial fee or a separate fee are recognized as revenue as the services are rendered. When the separate fee does not cover the cost of continuing services together with a reasonable profit, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable profit on those services, is deferred and recognized as revenue as the services are rendered.

The franchise agreement may provide for the franchisor to supply equipment, inventories, or other tangible assets at a price lower than that charged to others or a price that does not provide a reasonable profit on those sales. In these circumstances, part of the initial fee, sufficient to cover estimated costs in excess of that price and to provide a reasonable profit on those sales, is deferred and recognized over the period during which the goods are likely to be sold to the franchisee. The balance of an initial fee is recognized as revenue when performance of all the initial services and other obligations required of the franchisor (e.g. assistance with site selection, staff training, financing and advertising) has been substantially accomplished.

The initial services and other obligations under an area franchise agreement may depend on the number of individual outlets established in the area. In this case, the fees attributable to the initial services are recognized as revenue in proportion to the number of outlets for which the initial services have been substantially completed.

If the initial fee is collectable over an extended period and there is a significant uncertainty that it will be collected in full, the fee is recognized as cash instalments are received.

(c) *Continuing franchise fees.*
Fees charged for the use of continuing rights granted by the agreement, or for other services provided during the period of the agreement, are recognized as revenue as the services are provided or the rights used.

(d) *Agency transactions.*
Transactions may take place between the franchisor and the franchisee which, in substance, involve the franchisor's acting as agent for the franchisee. For example, the franchisor may order supplies and arrange for their delivery to the franchisee at no profit. Such transactions do not give rise to revenue.

19. *Fees from the development of customized software.*
Fees from the development of customized software are recognized as revenue by reference to the stage of completion of the development, including completion of services provided for post-delivery service support.

Interest, royalties and dividends

20. *Licence fees and royalties.*
Fees and royalties paid for the use of an enterprise's assets (e.g. trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognized in accordance with the substance of the agreement. As a practical matter, this may be on a straight line basis over the life of the agreement – for example, when a licensee has the right to use certain technology for a specified period of time.

An assignment of rights for a fixed fee or nonrefundable guarantee under a noncancellable contract that permits the licensee to exploit those rights freely such that the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery. Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognized at the time of sale.

In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognized only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

Appendix 3. Source Material

The SMEGA for Level 2 SMEs are drawn from *International Accounting Standards and Interpretations.* The standards that have been included are:

SMEGA	IAS	Comments
1	1	
2	7	
3	16, 36	The SMEGA for Level 2 include impairment guidance but do not follow IAS 36 measurement rules. SIC 10 is also included.
4	17	SIC 15 is included.
5	38	
6	2	
7	20	
8	37	Discounting of provisions is not required.
9	18	
10	23	
11	12	
12	8	This version takes into account modifications proposed in the IASB exposure draft of May 2002.
13	21	
14	10	
15	24	

The SMEGA for Level 2 do not include the following standards:

11	Construction contracts
14	Segment reporting
19	Employee benefits
22	Business combinations
26	Accounting and reporting by retirement benefit plans
27	Consolidated financial statements
28	Accounting for investments in associates
29	Financial reporting in hyperinflationary economies
30	Disclosures in the financial statements of banks
31	Financial reporting of interests in joint ventures
32	Financial instruments: disclosure and presentation
33	Earnings per share
34	Interim financial reporting
35	Discontinuing operations
39	Financial instruments: recognition and measurement
40	Investment property
41	Agriculture

Appendix 4. Members of the Ad Hoc Consultative Group on Accounting by SMEs[5]

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IFAC representative on accounting by SMEs
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Mr. Ashok Chandak
The Institute of Chartered Accountants of India
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Mr. Colin M. Fleming (**observer**)
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Mr. Ndung'u Gathinji
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[5] Opinions expressed by the experts do not necessarily reflect those of the organizations they are affiliated with.

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ACCOUNTING AND FINANCIAL REPORTING GUIDANCE FOR LEVEL 3 SMALL ENTERPRISES

Introduction

Level 3 guidance and financial statements are designed for small enterprises that are owner-managed and have few employees. Such enterprises should follow a simple accrual-based accounting system that is closely linked to cash transactions, and with a derogation for businesses to use cash accounting for a limited time when establishing their accounting systems. This guidance is consistent with the guidance for Level 2 (as set out in TD/B/COM.2/ISAR/16 and Addenda 1–3). While Level 2 SMEs are likely to be economically significant, those at Level 3 constitute the smallest enterprises. This document consists of an accounting and reporting framework, related basic requirements and model financial statements.

I. Conceptual framework

Scope

Level 3 enterprises typically have significant 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 are intended to meet the needs of users and preparers of financial statements for these enterprises.

Components of financial statements

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

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

Level 3 Accounting framework

The two statements – the income statement and the balance sheet – are based on a simple accruals accounting approach broadly consistent with IAS 1. This guidance sets out the accounting and reporting requirements that apply to SMEs in Level 3. The guidance requirements do not involve compliance with IFRS but are based on the historical cost and accruals measurement approach, which is the basis of IFRS. To ensure that the Level 3 financial statements are a part of a coherent framework within the three levels, Level 3 guidance rules are linked with those for Level 2 and IFRS.

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.

The Objectives of Level 3 Financial Statements

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

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

(a) management;
(b) lenders and other creditors:
(c) government;
(d) taxation authorities; and
(e) SME agencies.

The following is a summary of the likely needs of these users of annual financial reports of Level 3 enterprises:

(a) 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.

(b) Lenders and other creditors:
- to assess risk in the credit decision; and
- to monitor the performance of enterprises that have been given credit.

(c) Government: For macro- and micro-economic planning purposes

(d) Tax authorities: For tax assessment purposes

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

Qualitative characteristics

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

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

Reliability: Information is reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it is said to represent.

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

Constraints: 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.

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

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.

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.

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

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.

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

Recognition

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

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

It is unlikely that Level 3 entities 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

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.

II. SMEGA Level 3 – Basic Requirements

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.

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

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

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.

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.

An enterprise should prepare its financial statements on the accrual basis of accounting.

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.

Financial statements should be presented at least annually.

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.

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

(a) is expected to be disposed of for cash 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 disposed of for cash within 12 months of the balance sheet date; or
(c) is cash on hand.

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

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.

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

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

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

The income statement should follow the structure and use the headings shown in Annex 1.

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.

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.

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

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.

Lease payments, whether deriving from an operating or finance lease, and payments under hire purchase (HP) contracts should be recognized as an expense (on a cash basis, not on an accruals basis). If the payments are material, the expense should be shown under a specific lease payment heading in the formatted income statement.

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 taken for assets acquired under HP contracts.

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).

The cost of inventories should comprise all costs of purchase and other costs incurred in bringing the inventories to their present location and condition.

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.

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

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.

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

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

Any significant gains or losses should be separately disclosed.

III. Level 3 Model Financial Statements

The Financial Statements

The two statements – the income statement and the balance sheet – are based on a simple accruals accounting approach broadly consistent with IAS 1. To ensure that the Level 3 financial statements are a part of a coherent framework within the three levels, Level 3 guidance rules are linked with IFRS.

The Costs and Benefits of the Financial Statements

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 of typical Level 3 enterprises, the costs of preparing the statements need to be weighed against the benefits to other users and particularly the enterprise itself. For example, potential providers of external financing are likely to require the two financial statements in order to assess the risks involved in the proposed transaction.

Users and Their Needs

The objective of the proposed financial statements is to help users extract information that can be helpful in developing the business. Therefore, the design of the statements is intended to reflect users' needs.

Income Statement: Annex 1 and 2

Rationale

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.

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”.

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.

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 overhead).

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 owner’s capital” in the balance sheet in Annex 3.

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

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

Historical cash flow statements have been excluded from the set of financial statements at this level because there is little evidence suggesting that users at this level find such 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

Level 3 Model Income Statement (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 ======

— Chapter III —

International Accounting and Reporting Issues

As part of the efforts to improve the information content of the Review of International Accounting and Reporting Issues, the secretariat added this chapter. It contains articles contributed by prominent authors. The first article presents developments in accounting education and training in the Baltic countries. It presents issues that accounting professionals in countries with economies in transition face. The second article presents recent developments on international accounting education standards and trends in global accounting education. The last article provides a closer look into the proceedings of the International Accounting Standards Board.

Development of Accounting Education and Training in Estonia, Latvia and Lithuania[6]

Toomas Haldma, Vilma Paupa and Jonas Mackevicius

Introduction

The basic stages of the accounting reform carried out in a transition economy include the strengthening of the accounting profession, accounting education and training, and implementation of the underlying principles of accounting used in market economies. To introduce the development of accounting education and training in the Baltic countries – Estonia, Latvia and Lithuania – which were part of the Soviet Union during the previous decade, we should take into consideration some historical aspects which influenced the development of the accounting system and consequently also the system of respective education and training.

During the previous decade, the development of accounting education and training in the Baltic countries bore the following imprints of a centrally planned economy:

- Long-term isolation from market economy and the development of economic thought;
- Loss of fundamental knowledge of international economics science and education (a centrally governed economy was the only accepted line);
- Differences in the economic terminology used in the former USSR and market economy countries.

In the period of centrally planned the prestige of accounting was extremely low in the USSR. For example, in a 1990 opinion poll among secondary school pupils it was ranked ninety-first among ninety-two professions (Smirnova et al., 1995). In a centrally planned economy there was no scope for accounting innovation (Bailey et al., 1995).

When independence was regained in 1991, the economic situation in the three Baltic countries changed dramatically. Besides other transformations, an entirely new role was attributed to accounting by the market forces. The need for a conscious shaping of business targets, performance and the system of their implementation expanded the scope of accounting in practice, laying particular

[6] This article was contributed by Professors Toomas Haldma, University of Tartu, Estonia, Vilma Paupa, University of Latvia, Latvia and Jonas Mackevicius, University of Vilnius, Lithuania.

emphasis on the role and responsibility of accounting executives (financial director, chief accountant) in the preparation of financial decisions.

When companies' book-keeping systems are being transformed into accounting systems, a certain rapid conceptual progress has to be achieved, mainly by changing the state of mind of practitioners and academicians. In order to meet the new accounting requirements, additional comprehensive and conceptual training and retraining schemes were necessary and needed to be adopted and carried out to help replace the stereotypes of centrally planned economy by entirely different approaches that characterize accounting in a market economy. This serves as a basis for the improvements on accounting profession.

The present paper examines the development of accounting education and training in Estonia, Latvia and Lithuania in association with practical aspects: how the actual accounting practice is influenced by educational developments and how training and retraining have been improved within the change of the accounting framework. The paper makes a contribution to the existing accounting education literature. It has to be admitted that the number of studies focusing on developments in accounting education in the transition countries is fairly limited. Thus, at a more general level, our findings may shed light on the development of accounting training in other developing societies currently undergoing rapid changes. Although we will examine the position of accounting education in three Baltic countries, there are many features of contingencies that have influenced this area in other transition economies in a similar way.

Objectives of accounting education

In the course of transition from a centrally planned to a market economy, a company's accounting system is affected by two mutually connected changes related to the ways in which accounting information is utilized (Alver et al., 1996, p. 3):

(1) a change from the State to the business community as the primary user;
(2) a change from the passive role to an active role in the stimulation of economic activity.

The accounting training, retraining and research involve students as well as practitioners and professors. In the transition economies the main objectives to be achieved in this process were as follows (Haldma, 1994):

(1) Incorporation into the harmonized international accounting, and international education and research environments;
(2) Systematic and comprehensive accounting education, both internally within the accounting area and externally in interaction with other related areas (marketing, financial management, etc.);
(3) Transition from the stereotypes of a centrally planned economy to entirely new approaches characteristic of accounting in a market economy;
(4) Linkages between the current accounting environment and the practical demand for building a bridge across the gap between the former accounting environment and the new one;
(5) Development of an appropriate curriculum of accounting at the universities and other institutions of higher education.

In the early 1990s, when designing the system of accounting training and retraining, we had to consider the following factors:

Firstly, the main task of this system was to provide professors and practitioners with market economy related knowledge;

Secondly, the companies, organizations, academic institutions and others were continuing their activities for a long time in parallel with the retraining process;
Thirdly, the national business legislation was being improved continuously.

All these parameters had to be taken into consideration simultaneously in a coordinated way.

Initial position in the accounting education and training environment

To characterize the accounting training, retraining and research environment, we have analysed various features which have had a substantial impact on its development. The main results of the SWOT (strengths, weaknesses, opportunities and threats) analysis of the initial position of the accounting education and training environment in the Baltics at the beginning of the 1990s will be provided below.

Strengths

- Growing need and interest in improving accounting education among students, managers and university lecturing staff;
- Practitioners had wide experience from the transition process and the requirements for retraining were practical and particular;
- Continual process of transition in the field of accounting;
- Expansion of international contacts and opportunities for upgrading, renewal training for lecturers and research cooperation at the universities and other institutions in market economy countries;
- Growing demand for internal consulting services and research contracts on the part of company managements;
- Competition between the universities and retraining centres.

Weaknesses

- The concept and system of economic education and business retraining (incl. accounting) and its implementation lacks complexity and clarity;
- Low average command of foreign languages (even of English and German) among the professors as well as students;
- Lack of modern study-materials in the native languages;
- Undeveloped business terminology (including accounting terminology in the native languages;
- Weak access to and low awareness about the international accounting system;
- Lack of accounting training and research staff with good practical experience and knowledge of contemporary accounting areas (including management accounting).

Opportunities

- *Incorporation of the Baltic countries into the European and world-wide economic environment;*
- *Growing demand for accounting education to conform to international standards;*
- *Growing market demand for educated accounting professionals with market economy skills;*
- *Expansion of international interest in contributing to the development of accounting environment in the Baltic states;*
- *Retraining of practitioners, internal consulting services and research contracts contribute practical feedback and provide practical experience to university professors (in particular in case of on-the-job-training);*
- *Particular programmes of Business Administration (Master's Programme (MBA), Certification Programmes), paid by practitioners, will improve the financial position of the*

universities and also the salaries of professors involved in lecturing on the above mentioned programmes;
- *Incorporation of universities into the European and world-wide education framework;*

Threats

- Interest in teaching and research as a career was declining while salaries in other fields of business were much higher;
- Relatively advanced average age of professors at the universities.

I. Development of the accounting framework

Owing to the collapse of centrally planned economies in the late 1980s and early 1990s the situation in business administration changed dramatically. The transformation process from a centrally planned to a market economy required extensive changes to be made in the organisation of accountancy and accordingly in the education and training process of qualified accounting specialists everywhere in the Central and Eastern European post-socialist countries (Bailey et al., 1995; Garrod and McLeay, 1996; Krzywda, Bailey and Schroeder, 1998).

The accountancy reform in the Baltic States began in the autumn of 1990. As the Baltic States based their systems of laws on Codified Roman Law principles, one of the first priorities was to set up an accounting regulation system based on the laws of accounting. However, in the first few years following the introduction of national laws on accounting some disharmony between the legal requirements and the actual accounting practice occurred, as many accountants with their Soviet-era background failed to grasp the intrinsically different nature of financial accounting in the conditions of market economy.

The accounting regulations enforced by the Baltic countries during 1991–1996 contributed their integration into the international accounting environment. Therefore, among the other improvements made in accounting during the transition period, the first priority was given to financial accounting. This approach was justified, as it was first and foremost necessary to guarantee that the companies of the country would be able to prepare their financial statements in compliance with national accounting regulations and the generally accepted accounting principles. The idea that the companies should carefully observe the stipulations of accounting regulations was adamantly supported by the “big six” auditing companies operating in the Baltic.

In the second half of the 1990s, the development of the business environment in the Baltic States was affected by the following events:

- conceptual changes and improvements in the regulatory context;
- ownership changes (the most intensive period of privatization was 1993–1995);
- development of the capital market (the stock exchanges opened in Vilnius in 1994, in Riga in 1995 and in Tallinn in 1996);
- recession on the Eastern markets (the Asian crises in 1997, the Russian crisis in 1998).

In the main, these systematic factors, increased competition and raised production quality standards required adoption of a more sophisticated and market-sensitive external (financial accounting) as well as internal management accounting systems.

The transition from a command to market economy decentralized the decision-making process. The need for a conceptual development of management accounting systems grew rapidly. The survey carried out among the administrative staff (general directors, financial directors, chief accountants, etc.) of more than 80 Estonian companies in spring 1994 demonstrated that only in 3% of companies the accounting emphasis as "hot points" has remained on compiling financial statements, whereas in 75% of the companies it has been removed to the area of cost and managerial accounting. Financial statement analysis served as a target in 22% of the total amount of firms (Haldma, 1995).

According to Enthoven, in the conditions of a centrally planned economy, cost and management accounting were not treated as independent branches, but as integral parts of unitary financial accounting (Enthoven et al., 1993). Under a centrally planned economy, several aspects of cost accounting were introduced by Estonian companies, but this served the objectives of financial accounting, statistics and centralised management. At that point, we fully agree with Enthoven. However, it has to be admitted that in the highly centralized decision-making framework, flexible rearrangements in the companies' management systems on external environmental impacts were not needed. Therefore, we argue that within the Soviet accounting framework, management accounting existed in a very narrow sense. Hence, during the first stage of transition, the management accounting system was a conceptually new issue in the development of those companies' accounting systems, whose design and introduction necessitated a conceptual change in the thinking of the companies' financial personnel. While in market economy countries the fundamental nature of management accounting systems and practices has remained the same throughout recent decades (Drury et al., 1993), the application of accounting within the management process has changed to some degree (Bromwich and Bhimani, 1994). At the same time, both accounting as a whole and financial as well as management accounting in the Baltic States and the other transition economies underwent evolutionary changes in the 1990s.

Proceeding from the previous statements, we argue that the conceptual changes in financial accounting characteristic of the Eastern and Central European transition countries served as a precondition for the design, introduction and improvement of cost accounting and management accounting, and the development of companies' management accounting systems. Market economy countries have not experienced such a conceptual change in financial accounting in such a short time during the last decades. We support Virtanen et al. (1996) and Scherrer (1996) who say that the evolution of financial accounting has influenced the development of cost accounting and management accounting.

In what follows we will describe the main aspects of the development of the accounting system of each country separately.

Estonia

We can follow the development of the Estonian accounting system during the last decade as a process consisting of three stages.

First stage – introductory stage (1990-1994)

The first step towards the formation of a market economy accounting environment in Estonia was taken with the passing of the Estonian Regulation on Accounting in 1990. As pointed out by Bailey (Bailey et al., 1995, p. 688), this event marked the beginning of the spread of accounting disharmony within the territories comprising the USSR. The introduction of subjective elements (depreciation rates, inventory valuation methods, assets valuation methods, etc. decided by companies) into accounting practice, formation of a particular accounting policy, change from cash-basis accounting to accrual-basis accounting, and introduction of some (unfortunately, not all, but proceeding from the particular circumstances, this was also intelligible) underlying accounting principles – the realization principles, the matching principle and the historical cost principle constituted an extremely radical change in the accounting framework of Estonia.

Second stage – system building stage (1995-2002)

The next, more substantial and complex step of the accounting reform in Estonia was related to the Estonian Accounting Law (EAL), which was enacted in 1994 and came into effect on 1 January 1995. In the period of enforcement the law was in conformity with the Fourth EU Company Directive and

International Accounting Standards (IAS). Subsequently, the Estonian Accounting Board merged the requirements of the European directives with the IASC conceptual framework and treatments by carefully choosing alternatives to the directives that result in convergence. After the directives vis-à-vis the international accounting harmonization issue were monitored, Estonia's strategy was deemed both feasible and wise at the end of the 1990s (Ilisson, 1999, p. 41).

The accounting framework and procedures in Estonian companies and institutions are legally regulated by the following items:

- Estonian Accounting Law (EAL);
- Accounting standards issued by the Estonian Accounting Standards Board;

Between 1995 and 2000 the Estonian Accounting Standard Board issued 16 accounting standards (EAS) to improve particular aspects of accounting in Estonia. This set included standards concerning accounting aspects of the Conceptual Framework of Generally Accepted Accounting Principles; Revenue Recognition under the Revenue Principle; Liquidation and Termination Balance Sheet Preparation; Business Combinations; Balance Sheet Accounts; Income Statement Accounts; Equity Method; Leases; Consolidated Accounts of Credit Institutions; Government Grants; Interim Report Preparation; Earnings Per Share; Segment Reporting; Long-term Construction Contracts; and Consolidated Accounts.

Consequently, the accounting framework in Estonia is regulated both by the Estonian Accounting Law and by the Estonian Accounting Standards. This has a number of advantages in the first period of accounting regulation creation (transition period) and enables the transition process to be flexible. Comparing the specifications of the issues handled in the Estonian accounting regulatory acts (EAL, EAS) and in the International Accounting Standards, it is evident that in the IAS the issues are discussed in greater detail. However, the regulatory accounting acts used in Estonia are in line with the International Accounting Standards and the requirements of the new European accounting harmonization policy.

Third stage – system improving stage (since 2003)

The third step of the accounting reform in Estonia was arranged through the new version of EAL, which was enacted in November 2002, and a new set of Estonian Accounting Standards (11 standards). Both of them came into effect on 1 January 2003. In 2003 an additional 6–7 standards will be enacted.

The main characteristics of the new EAL and EAS are the following:
- Clear orientation to the IFRS
- Broadening scope: the EAL and EAS will be implemented for governmental institutions.

Latvia

The first stage of the formation of an accounting environment in Latvia was ushered in when the newly drafted Law on Accounting and the Law on Annual Accounts were enacted in October 1992. The former lays down the general rules of accounting and record keeping, as well as forms of organizing accounting. It also includes rules about stock-taking, preparation of statements and accounting management. The latter involves regulations on balance preparation, profit and loss calculation, stipulations about exceptional items, separate profit and loss items, valuation order, and instructions on how to draft and sign enterprises' annual documents.

The next stage can be traced back to 1996. Further developments in the field of accounting continued, and the legislation was substantially amended. The main purpose of these changes was to attain a closer approximation of Latvian laws to the Fourth EU Directive and the International Accounting Standards. It was only at this stage that Latvian enterprises started to compile cash flow statements.

Currently the following principal laws regulate accounting in the Republic of Latvia:

- Law On Accounting;
- Law On the Annual Accounts;
- Law On Consolidated Annual Accounts;
- Finance and Capital Market Commission Law.

At the moment four Latvian Financial Accounting Standards are in force. This set includes the standards on preparation of financial statements, inventories, cash flow statement, profit or loss of the accounting period, and fundamental errors and change of accounting policy.

Lithuania

Reorganization of accounting in Lithuania from a socialist accounting system to that of market economy was first brought up in 1988-1989 when a group of academics and practitioners started to proclaim the need to work out a Lithuanian Accounting Law. The draft of the accounting law was discussed for a long period and finally in June 1992 the Law on the Principles of Accounting was enacted. This law involved the most general principles, not containing any detailed provisions on the contents of financial statements (Mackevicius and Bartaska, 1998).

In June 1995 the Institute of Audit and Accounting was established; its main responsibilities include the coordination and improvement of both financial accounting and reporting, and auditing.

An essential step in the Lithuanian accounting reform was made in November 2001, when the Lithuanian Parliament (*Seimas*) enacted the following accounting regulations:

- Law On Accounting;
- Law On Annual Accounts;
- Law On Consolidated Annual Accounts.

During the last year, the Institute has prepared a set of drafts of 15 national accounting standards, which are currently under discussion.

II. Development of accounting education and curricula at the Baltic universities

The rapid development of large numbers of small and medium-size firms and enterprises, joint ventures, and the privatization of large State enterprises create an increasing demand for well-educated, highly skilled accountants and auditors (Kasalis, et al., 2000). These requirements have a direct impact on the substance and methods of accounting training and retraining. At the Baltic universities academic studies are offered at three different levels: those of bachelor (usually 4 years), master (2 years) and doctor. At present the academic system adopting the 3 years (bachelor) plus 2 years (master) pattern.

Academic training at a more advanced level presumes continuous expansion of research activities. The accounting departments of the Baltic universities are involved in several national and international research projects which is the only way to be incorporated into the international education and research framework. The results of accounting research provide a basis for improving the content of the accounting courses offered. The universities also have a tradition of holding joint trans-Baltic accounting conferences. We argue that during the transition period, the international and national accounting legislations serve as a driving force for training in financial accounting and auditing. As mentioned above, during the first stage of transition, management accounting was a conceptually new issue in the development of the companies' accounting system. Therefore, the academic and professional training, research and consulting projects carried out by academics have a profound influence on management accounting practice. In our opinion, these aspects have to be taken into consideration in the curricula design process. Below we will describe the main characteristics of the accounting education and training in each country separately.

Estonia

At the undergraduate level (four years), accounting is taught by four Estonian universities: the University of Tartu; Tallinn Technical University; Estonian Agricultural University and the Estonian Business School.

The University of Tartu and Tallinn Technical University redesigned their accounting curricula in 1993, and Estonian Agricultural University and the Estonian Business School followed suit in 1995. In the first half of the 1990s, the need to create and develop conceptually different management accounting systems was growing rapidly. In 1992-1994, the Estonian universities incorporated management accounting courses into their curricula as an independent discipline. Obviously, the accounting curricula in all the universities are very similar. In all of them, such subjects as the Basics of Accounting, and Management Accounting are among the core (compulsory for all students of the faculty) courses. At Tartu University the accounting major includes eight different courses (intermediate accounting, tax accounting, financial statement analysis, accounting for non-profit organizations, cost accounting, auditing, accounting information systems and management control), while at Tallinn Technical University, Estonian Agricultural University and the Estonian Business School the corresponding number is six accounting courses.

At the first stage of curriculum design in accounting it was necessary to lay more stress on international comparative studies. Generally, two different approaches to internationalizing the business curriculum have been developed. One approach treats international business as a single discipline, whereas the other one broadens the existing academic areas so that the discussion of domestic topics is expanded to include international aspects (Stolowy and Tenenhaus, 1998).

Therefore, first at Tartu University the course International Accounting was introduced. In 1998 it was replaced by a Controlling (Management Control) course, as it was necessary to pay more attention to internal accounting. International accounting aspects were taught at the Intermediate Accounting, Financial Statement Analysis, Auditing and other courses.

Latvia

Accounting is taught at three Latvian universities and higher schools: the University of Latvia, the Latvian University of Agriculture and the Latvian School of Banking.

The University of Latvia is the leading university in the area of accounting education. The main part of the study programme at the University of Latvia is academic. The Institute of Accounting at the University of Latvia has developed and offers internationally accredited studies in two directions:

1. academic studies at three levels (bachelor's, master's and Ph. D.);
2. higher professional studies.

The bachelor's degree in economics with a specialization in accountancy, internal control or financial analysis can be acquired after successful completion of a four-year study programme; extensive specialization in accountancy starts from the fifth semester. In the eighth semester, having completed their theoretical studies, the students write and defend their bachelor's thesis and take a complex final exam, testing the knowledge acquired in the following courses: Accountancy, Financial Analysis, Audit and Internal Control. The subjects "International Accountancy Standards" and "International Audit Standards" belong to the curriculum of the Master's programme.

The radical changes in the national economy called for an increasing number of highly skilled accountants; therefore, the five-year higher professional studies programme "Accountancy, Control and Audit" was developed by the Institute of Accountancy and was first launched in September 1995. Upon graduation the students will acquire the professional qualification of an economist with specialization in accountancy, financial analysis and audit.

To accommodate market economy requirements, a special one-year programme "Economist-Accountant" was developed, mainly directed to persons who received their university diploma in the 1980s. Only persons already holding a university degree are eligible for this intensive study programme, on the completion of which they will receive the qualification of "Economist–Accountant". These studies can form the basis for further education in the Master's programme. This one-year programme is very popular among older professionals who have practical work experience, but wish to improve their theoretical knowledge.

Lithuania

Accounting training has been concentrated into two Lithuanian universities: the University of Vilnius and the Lithuanian University of Agriculture.

At the University of Vilnius, accounting is taught at two academic levels – those of bachelor and master. The students of the baccalaureate programme in accounting are offered all main accounting-analytical disciplines: financial accounting, management accounting, audit, financial analysis, comparative international accounting and accounting history.

The master's study programme in accounting and auditing includes such courses as accounting theory and practice, international comparative accounting, audit theory and practice, cost calculation, accounting and financial analysis, enterprise activity analysis, and accounting and auditing seminars.

III. Development of the accounting profession

The success of transforming companies' book-keeping systems into real accounting systems largely depends on changing the preparation of practitioners. The number of students graduating from higher schools and universities with a diploma or a degree in accounting, for example in Estonia, is about ten times smaller than the number of chief accountants and financial directors in companies with more than 20 employees. Consequently, retraining of practitioners forms a wide field of accounting education as seen both from the qualitative and quantitative aspects.

As a sound contribution to the development of the accounting profession, professional licensing (certification) activities are either forecast or have already started in all the Baltic countries. To a larger or lesser extent the national programmes of certification examinations are based on the "Guidelines on National Requirements for the Qualification of Professional Accountants" (ISAR Guidelines), which was adopted in 1999 at the sixteenth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Financial Reporting.

Estonia

In January 2001 the Vocational Law was enacted in Estonia. It created basic conditions to organize the labour market in improving circumstances and served as a prerequisite for improvements in the accounting profession and the certification of the profession. Improvements in the accountant profession are coordinated by the Estonian Association of Accountants (founded in 1996).

Benchmarks for the qualifications of professional accountants are:

- ISAR Guidelines "Guidelines on National Requirements for the Qualification of Professional Accountants", (1999);

- UK National Vocational Qualification Guidelines.

The Estonian Vocational System includes five vocational levels. The accounting professional requirements are distinguished on three levels. Proceeding from this statement, a professional accountant will be certified at three different levels: Book-keeper I, Accountant II, Accountant III.

The components of the knowledge required for certification are as follows:

I. General knowledge (includes 9 areas, e.g. general economics, communication, business ethics, statistics, computers, languages (Estonian and foreign) etc.);

II. Professional knowledge (includes 19 areas, e.g. financial accounting, cost accounting, managerial accounting, tax accounting, auditing and internal control, business planning, business software, business and commercial law, accounting terminology etc.);

III. Supplementary knowledge (5 areas, e.g. international accounting, accounting in different organizations (non-profit a.o.), consolidated financial statements, foreign languages).

Professional values

For all three certification levels there are different requirements levels concerning the components of knowledge mentioned above. Generally, all three certification levels are more oriented to regulating the competence of accounting technicians with primarily higher (secondary) education.

Latvia

The practical and theoretical issues stemming from the previous stages highlighted the need to establish a professional accountants' and auditors' society. Therefore the Latvian Accountants' Association was created. Its main tasks are to consult practising accountants, to organize professional training courses and to help the members of the Association with various legal issues.

Professional certification of accountants, along the lines of international standards and experience, has been organised by the Association since 1999 (Paupa, 2000). Much work has been done to develop the training programmes and certification requirements, and to organize the certification process. The certification process of accountants with a higher economic education and at least five years' working experience has started. In addition to these requirements, candidates must pass examinations in the following subjects: microeconomics; macroeconomics; financial accounting; management accounting; financial management and analysis; tax system of the Republic of Latvia; business law; and audit and internal control.

To help candidates prepare for the examinations, courses are organized by the Accountants' Association, which can also be attended by other members of the Association who wish to expand and update their knowledge. The first 120 Latvian accountants have already received their certificates.

Similar issues are being addressed by the Latvian Sworn Auditors' Association, which organizes the training and licensing of auditors. The activities of both associations are approved, and their members are involved in various governmental commissions and working groups committed to further development of accountancy and relevant legislation.

Lithuania

Professional certification of accountants in Lithuania is coordinated by Lithuanian Association of Accountants and Auditors, which was founded in 1990. Candidates for the status "Certified Accountant" have to pass examinations in three areas: accounting, taxation and business law. Currently, there are more than 70 certified accountants in Lithuania.

IV. Conclusion

The transitional framework of the accounting process in the post-socialist countries is unique as regards its conceptual aspects. The accounting profession in the transition economies needs conceptual retraining. It is not a mere renewal training which can be arranged by means of some refresher courses.

We suggest that the legal accounting environment serves as a factor influencing the development of accounting education and training. This is characteristic of countries in transition. Subsequently, we conclude that the conceptual change in financial accounting characteristic of the Eastern and Central European transition countries served as a precondition for the design and introduction of management accounting and for the development of companies' management accounting systems. Market economy countries have not experienced such a radical change in financial accounting in such a short period of time. Educational institutions must take this aspect into consideration in the design of their curricula.

During the last decade, the accounting education systems of Estonia, Latvia and Lithuania have accommodated to the rapid changes in the accounting environment. Thanks to the continuous improvements in academic and professional training, a visible step has been taken towards incorporation of Baltic accounting education into the international accounting education framework.

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Proposed International Education Standards for Professional Accountants and Trends in Global Education[7]

Michael Walsh

Introduction

The Education Committee of IFAC published proposed International Education Standards for Professional Accountants (IES) for comment in July 2002 (see www.ifac.org). This paper discusses the background as to why IFAC thought it was necessary to produce education standards. It describes the previous papers which the standards are based on and summarizes what is in the draft IES.

Enforcing standards is much harder than writing them. This paper therefore considers some of the implementation issues which may also be of some interest or contention.

Background

IFAC is the world-wide organization for the accountancy profession. Its mission is to develop and enhance the profession to enable it to provide services of consistently high quality in the public interest. IFAC is composed of more than 150 professional accounting bodies from every part of the globe, representing more than 2.5 million accountants in public practice, education, the public sector, industry and commerce.

The current and anticipated environment demands that the international profession builds confidence in the accountancy profession, responds to the challenges presented by globalization, addresses the requirements of investors and regulators and meets the expanding needs of business. Given the current environment, IFAC needs to demonstrate its ability to issue high-quality standards and guidelines, encourage harmonization and consistent application of standards world-wide, enforce the use of standards and impose sanctions as necessary, and be the primary source of pronouncements for the international accounting profession.

The mission of the IFAC Education Committee is to serve the public interest by the world-wide development and enhancement of education for professional accountants, leading to harmonized standards. The Committee has already published extensive and comprehensive guidance on education. This includes IEGs (International Education Guidelines) 2, 9, 10, 11, and various other IFAC education papers.

Going back further, IEG 9 drew on the work of the Accounting Education Change Commission (which operated for seven years starting in 1987), which in turn drew on the Bedford Committee report of 1986.

The Standards have on the whole followed the previous guidance, with some updating and re-formatting. There is, however, rather more on key skills following IFAC's Discussion Paper on competence and there is a glossary of definitions.

Why standards?

In November 2001 the IFAC Board agreed that the IFAC Education Committee should produce IES to complement the existing International Accounting and Auditing Standards. The Committee produced a draft set of Standards in less than twelve months.

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[7] This article was contributed by Michael Walsh, Director of the Association of Chartered Certified Accountants and Education Consultant to the International Federation of Accountants.

The original motivation for stricter global standards goes back to the East Asia financial crisis in 1998. The accountancy profession came under pressure from the World Bank, the United Nations Conference on Trade and Development (UNCTAD), the Securities and Exchange Commission (SEC) in the United States and others. IFAC together with the big accounting firms and other stakeholders therefore set up the International Forum for Accountancy Development (IFAD). This in turn led to the creation of the Transnational Auditors Committee (TAC) of IFAC and the Forum of Firms (FoF).

The FoF consists of over 20 transnational audit firms including the Big 4. TAC is the Executive Committee of the FoF. They soon saw that they did not have education standards and needed some quickly as part of their quality control systems.

The Standards are part of the attempt by the profession to set and implement consistent standards for every aspect of the profession world-wide. A set of robust and codified IES is vital to the achievement of higher compliance and harmonization of accounting, auditing and ethical standards. The IES are intended to provide an important and necessary framework for introducing newly qualified accountants to their public interest responsibilities and for reinforcing that commitment throughout their careers.

Subsequent to IFAC's decision to produce IES, the justification for standards has of course been heightened by the Enron collapse and its successors. This seems to have shifted the emphasis to greater national regulation rather than international regulation. Nevertheless, in an interconnected global economy poor standards in one part of the world can have serious repercussions in other parts of the world.

For example, the transnational audit firms are themselves global players and their brand names are assumed to be equally valid wherever they are used (or at any rate they used to be). Be that as it may, transnational audits are relied on by investors who are not necessarily familiar with and do not rely on the standards of national bodies. It would help the free movement of capital across borders if this area of uncertainty could be reduced by means of common global standards.

The competence of professional accountants would appear to be crucial to this goal. Competence is far wider than just technical expertise. It includes professional values and ethics and the IES address this area as well.

Types of standards

The whole notion of global standards and what the meaning of what global is can be confusing. The terms "global", "international" and "transnational" are used interchangeably when in fact they are slightly different.

"Global" means world-wide. A global Standard should apply across the planet without distinction for national boundaries.

"International" means between or among nations. International Standards may not apply to all countries without distinction for national boundaries. They may apply to regions or groups such as the European Union, but national differences still play a part. Law and tax, for instance, are always national. International standards have to be adapted to meet local needs.

"Transnational" means across borders but not all borders. Transnational Standards may apply to regions or groups but national differences do not play a part. Transnational standards may not need to be adapted but may not apply everywhere.

The IES have to be flexible enough to allow for all these options. Not surprisingly, the IES are quite general. The plan is to produce further detail for those bodies which require further guidance.

Nature of the Standards

The Standards deal with the pre-qualification requirements of professional accountants plus Continuing Professional Development (CPD). The qualifications of member bodies, however, vary at the point of membership, which can lead to some confusion. For example, on admission to membership:

- Members may enter public practice and audit. There is usually a statutory licence attached to this.
- Members may not enter public practice or audit (mainly management accountants, but this is not a concept well understood in continental Europe), although they may perform internal audit work.
- Members may enter public practice and audit but only after fulfilling further requirements, e.g. more practical experience.

Comparing qualifications at the point of membership does not necessarily mean that one is comparing like with like. Therefore, different standards may apply.

There are also quite marked variations in membership and licensing systems. In some countries licences are awarded by statutory regulators and membership of a professional body is voluntary, e.g. the Russian Federation and the United States. In other countries, membership of a professional body is mandatory before a licence can be granted by that body, e.g. the United Kingdom.

The Standards are flexible enough to cover all these options, but member bodies will obviously not all adopt exactly the same qualifications. Some will emphasize audit, others management accounting and some will cover both audit and management accounting but add on post-membership requirements usually in the audit area.

Although the Standards lay down benchmarks for all professional accountants, this does not mean all accountants are the same nor that they have the same qualifications. Nevertheless, the Standards lay down benchmarks which IFAC member bodies are expected to meet by means of a suitable mix of the key components.

In conjunction with the TAC, the IFAC Education Committee may also produce specialist requirements for transnational auditors. Professional bodies may also wish to specify other post-membership specialist qualifications, perhaps in finance. IEG 11 covers a number of post-membership IT competencies.

Format

The draft Standards all follow the same format. The paragraphs in bold are the prescriptive parts which member bodies of IFAC will be expected to meet once the Standards are finalized. Internally, the Standards all follow the same structure:

- Preface
- Definitions
- Effective date
- Acknowledgements
- The standard itself

Guiding principles

This paper establishes a framework to underpin the statements issued by the Education Committee, including standards, guidelines and papers. It sets out the objectives and operating procedures of the Education Committee and the consultative process it intends to follow. It also explains the nature, scope and authority of the committee's statements.

The paper includes over 30 definitions which have been used throughout the standards. This helps to make the standards consistent and clarifies what they mean. Many of them are copied from previous IFAC documents.

Quite an important definition, taken from the IFAC *Code of Ethics for Professional Accountants*, states that *professional accountants ... are members of an IFAC member body*. This may seem a circular definition, but in many respects the IES expand on what is required to become a professional accountant. The implication is that members of a member body of IFAC meet the criteria laid down by the IES for pre-qualification education as well as CPD.

Introduction to IESs

The introduction to IES provides background information about the purpose, scope and development of IES. It states that *the goal of accounting education and experience is to produce competent professional accountants capable of making a positive contribution over their lifetimes to the profession and society in which they work.* Admission to membership of an IFAC member body is recognition that, at a given point in time, a person is deemed to have met the requirements for a professional accountant.

This slightly begs the question of what competence might be, but the Guiding Principles give the following definition: *Competence is being able to perform a work role to a defined standard, with reference to real working environments.* This definition places performance outcomes at work at the heart of competence both on qualifying and throughout a career. Competence is to do with practice rather than theory.

The overall goal is to combine the various elements required to produce competent professional accountants in a suitable fashion. The exact combination may vary, provided that the same ultimate goal is achieved.

Elements of education

The elements which make up the education package consist of:

- Entry requirements
- Professional education
- Professional skills and general education
- Experience requirements
- Professional values and ethics
- Assessment of professional competence; and
- CPD

Each of these elements merits a Standard of its own. Overall, the education and experience of accountants should provide a foundation of knowledge, skills and professional values that enable them to continue to learn and adapt to change throughout their professional lives.

Individual IESs

Entry requirements

This Standard prescribes entry requirements for candidates beginning the qualifying process for becoming professional accountants.

The main feature is that the Standard does not require a degree to start on the qualifying process. Candidates can start with a qualification which would allow them to start a degree. In this case other types of education have to make up the difference. In the UK for example, professional accounting qualifications pre-date accounting degrees and the professional bodies still set virtually entire accounting syllabuses.

There have been concerns about what constitutes degrees and degree entry qualifications. ACCA uses the UK NARIC (National Academic Recognition Information Centre) database which uses UK degrees as its benchmark. It is produced under contract to the UK Department of Education and Skills.

The UK NARIC has been a member of the European network of NARICs throughout the European Union since the early 1980s. It is also the UK representative in a wider operation of European Network of Information Centres (ENIC) across Europe, Australia, Canada, New Zealand and the United States.

Content of professional education programmes

This is one of the big Standards, and some might think it is the core Standard. The Standard prescribes the professional education candidates must have in order to qualify as professional accountants. It prescribes the content of professional education programmes under three major headings:

- Organizational and business knowledge
- IT knowledge
- Accounting, finance and related knowledge

The only change here compared with IEG 9 is that finance is mentioned explicitly. Each main heading is expanded by a limited number of sub-headings. Member bodies are expected to include all or substantially all of them.

Organizational and business knowledge

In IEG 9 Organizational and business knowledge consisted of:

- Economics
- Business environment
- Quantitative methods
- Organizational behaviour
- Operations management
- Marketing
- International business

The following subjects have been added:

- Financial markets
- Globalization
- Corporate governance and business ethics

The additions reflect both the widening field of accountancy and its global reach together with the growing importance attached to corporate governance issues and finance.

IT knowledge

The IT requirement is derived from IEG 11 as revised this year. It covers:

- General knowledge of IT
- IT control knowledge
- IT control competences
- IT user competences
- One of, or a mixture of, the competences of the roles of manager, evaluator or designer of information systems

Even though this is a large requirement it certainly does not constitute a full IT syllabus. It concentrates on IT controls because this is any area accountants and auditors are likely to be able to compete with IT specialists. IEG 11 spells out the body of general knowledge and IT control knowledge required in more detail. IEG 11 also sets out in more detail IT competences for users, managers, evaluators, and designers of information systems.

Compared with the old IEG 11, the emphasis on IT controls is new as well as the various lists of competences.

Accounting, finance and related knowledge

The accounting, finance and related knowledge component is probably at the heart of the Standard. It includes:

- Financial accounting and reporting
- Management accounting and control
- Taxation
- Business and commercial law
- Audit and assurance
- Finance and financial management
- Strategic decision making
- Professional values and ethics

Compared with IEG 9, only Strategic decision making has been added. To modernise the subject headings, control is mentioned in the context of management accounting and assurance is mentioned in the context of audit.

Professional skills and general education

This Standard prescribes the personal and professional skills that candidates should have in order to qualify as professional accountants. These are intellectual and general skills not related to a specialist area. They may be grouped in many different ways.

For the purpose of the Standard, professional skills have been grouped under five main headings (IEG 9 had only three) consisting of:

- Intellectual skills
- Technical and functional skills
- Personal skills
- Interpersonal and communication skills
- Organisational and business management skills

This analysis draws on IFAC's Discussion Paper on Competence. A broad general education is one way of gaining these skills, although practical experience may be another.

Professional values and ethics

This Standard is based entirely on IEG 10. It prescribes in more detail the professional values and ethics that professional accountants need in order to acquire during their programmes of education and practical experience. The aim of the Standard is to ensure that candidates for membership of an IFAC member body are equipped with the appropriate professional values and ethics to function as professional accountants.

The IFAC *Code of Ethics for Professional Accountants* serves as the basis for ethical requirements for professional accountants in each country. This Standard prescribes that a framework of professional values and ethics should be a part of the education and training programme of professional bodies. It also prescribes the main topics which should be covered.

The Standard covers both education within an academic environment and training in the work place.

Experience requirements

This follows IEG 9 in suggesting that candidates need three years of practical experience in addition to academic and professional studies. This is the European Union's requirement but not in some States in the United States. In order to allow for this discrepancy the proposed Standard allows some study time to count towards the practical experience requirement so long as it has a strongly practical orientation.

The Standard also lays down requirements for the monitoring of practical experience by member bodies.

Assessment of professional competence

This Standard prescribes the requirement for a process of assessment of a candidate's professional competence before admission to the profession.

Not all professional bodies assess candidates for admission to membership. Some bodies accept an accounting degree as an entry requirement. The Standard, however, requires professional bodies to set their own test in addition to academic qualifications beyond first degree level. This test may include an assessment of practical experience.

The final test should be at or near the end of the qualifying process. IFAC is commissioning further research on assessment methods in particular on how to assess competence.

Continuing professional education and development.

This Standard prescribes that member bodies should establish a CPD requirement for all their members. It builds on IEG 2.

The requirement may be based on CPD hours or on competences achieved. If it is hours then the requirement is for 120 hours in every three-year period with not less than 20 hours in any one year.

If it is based on competences, then the requirement should be based on objectively verifiable results.

Member bodies should monitor compliance with these requirements and provide for disciplinary action for non-compliance.

IEG on Continuing professional education and development

A Guideline on CPD also gives some advice on how the Standard can be implemented, for instance in regard to input- and output-based systems as well as compliance systems.

Next steps

IES are really only the beginning of a wider process. The intention is to issue further guidance in a number of areas with the aim of helping member bodies implement the Standards. The draft Standards were open for comment for six months to the end of 2002 and it is the intention of the IFAC Education Committee to try to issue a revised set during 2003.

Other issues

The IES do not exist in a vacuum. Many other issues need to be considered.

Implementation and timetable

Implementation is an issue which is being dealt with by another IFAC Committee – the Compliance Committee. One issue is how far IFAC should be educating its member bodies to meet its standards and how far it should be acting to enforce its standards on its member bodies. This is not a problem which is likely to be resolved quickly or easily. National regulatory and other international bodies may think this is their job or they may wish to encourage IFAC to take a position either way.

If IFAC deals with the issue of compliance, should there be stricter entry rules for member bodies wishing to join IFAC? Should IFAC expel non-conformers? If so, when? These are issues which will have to be worked through. Public expectations, however, demand high standards which are seen to be enforced if not by IFAC then by other public regulators.

Regulation

There are a number of candidates to act as regulators. Traditionally, these have been national regulators, public or private. IFAC has set up a Compliance Committee to regulate its member bodies as well the TAC to act as the regulator for transnational firms. UNCTAD has also published an education benchmark which could form the basis of a global standard. It is not clear how this will be enforced or monitored globally. The trend at the moment seems to be back to national regulators but with international bodies setting standards.

Global profession?

Is accountancy a global profession? Are the transnational firms as global as they seem? They may share common brand names, but do they share common standards? It will be part of TAC's remit to find this out. Perhaps the profession is not as global as was once thought. The split between audit and consultancy may be permanent. In any event, international standards must be flexible enough to allow for national and cultural differences.

Trends in global education

There has been a convergence on International Financial Reporting Standards and International Standards of Auditing which will continue. This makes it easier to envisage a common core curriculum with law and tax variants (the ACCA model). But accountants also need common values and ethics. This may in the end be the crucial issue. (ACCA has just launched a diploma in corporate governance.)

Delivery

In many parts of the world there is a shortage of high-quality tuition or even basic education. This in itself poses problems for some member bodies of IFAC to meet the IES. There have been high hopes that the Internet could deliver education and training world-wide. It has become clear that the internet is not a cheap alternative to classroom teaching. One still has to provide student support, if not face-to-face tuition, and this can be expensive. There is no quick solution.

Recognition

The adoption of IES may make mutual recognition of qualifications easier. There are two forms of recognition: statutory and market. National regulators grant statutory recognition. This may be translated into mutual recognition agreements such as the European Union's Mutual Recognition Directive or the International Qualifications Assessment Board system in the United States. This type of recognition can take years to negotiate.

But market recognition may be more important at the transnational level. Accountants with globally recognized qualification standards are able to find work across frontiers almost regardless of legal constraints.

Globalization

Is globalization a good thing? On the face of it the big firms have benefited hugely from globalization. But now this is not quite so certain. The problems starts with national regulation. If this is weak or fails then firms can be in trouble within national jurisdictions (e.g. Enron and Andersen). But regional failures such as the East Asia crisis can threaten financial instability across national frontiers.

Controlling all these risks at the same time is a challenge for even the most sophisticated firms and their regulators. Education and training has a part to play in this, not just in respect of technical expertise but perhaps even more importantly in respect of professional values and ethics. The world needs competent professional accountants.

SUMMARY

In late 2001, the IFAC Education Committee was given the mandate by the IFAC Board to produce a set of IES which would complement international accounting and auditing standards. The original motivation sprang from the East Asia crisis, but obviously Enron, Worldcom and so on have reinforced the wisdom of IFAC's decision and made professional standards more urgent.

The Standards largely draw on existing guidance, notably IEG 9. There has been some updating and reformatting together with some additions mainly in the area of professional skills taken from IFAC's Discussion Paper on Competence.

There are six pre-qualification standards and one post-qualification standard. They cover: entry requirements, content of professional education programmes, professional skills and general education, professional values and ethics, experience requirements, assessment of professional competence and CPD. There is also a statement of guiding principles, an introduction and a guideline on CPD.

The Exposure Drafts were issued in July 2002 with comments due by the end of the year. The comments will be considered in 2003 and final versions may be issued later in 2003. The proposed effective date is 1 January 2005.

This is only the beginning. IFAC will issue further guidance where required and will commission further research into assessment methods. This still leaves a number of issues outstanding: implementation and enforcement, regulation and who should take charge, the future of the global profession, trends in global education towards convergence of subject matter, delivery of tuition world wide, mutual recognition of qualifications and the long-term risks of globalization.

The International Accounting Standards Board and its proceedings[8]

Peter Walton

Introduction

The International Accounting Standards Board has been in existence for more than two years now and has therefore established some kind of evidence of how it works and what are its preoccupations. It does, of course, have its official “due process”, but it is now possible to observe that alongside this there are unofficial processes that complement these. Equally, while the Board has its formal *Framework* to guide it in its standard-setting, it is clear from the actual debates which take place what are other issues which are often also taken into account in coming to decisions. This article sets out to discuss both the official and the unofficial ways in which the IASB works.

The IASB remains based in London, as was the IASC, and its language of operation is exclusively English. Indeed, only four of the fourteen Board members do not have English as their mother tongue, and most of the staff are also Anglophone although from a very wide variety of countries. In theory, like the US Financial Accounting Standards Board (FASB) on which it is modelled, the IASB holds standard-setting meetings in public, although it frequently closes the meeting for "administrative" matters and it is apparent from comments made by Board members and staff in the open meetings that much discussion and drafting takes place "off-line" (as the IASB jargon has it). However, it is the public part of the debate which enables this analysis to be made.

The papers debated by the Board are prepared largely by the permanent staff. The IASB may appoint external advisory committees if it wishes, and has done so for its insurance contracts project and accounting for small and medium-sized enterprises, but it is not obliged to do so under its constitution, and when it does so, it tends to use them more as a focus group for comment. In principle, the mechanics of its "due process" are that once the Board has agreed to put a project on its agenda, it is the staff that take it forward. Staff are assigned to the particular project and they write papers setting out the issues. The Board members read these and then discuss them at the public Board meetings, as well as outside the meetings by e-mail etc. When the staff feel they have enough "tentative decisions" they write a draft exposure draft, which is similarly discussed at the formal meetings. An informal part of the process is that the International Financial Reporting Interpretations Committee (IFRIC) may be asked to do a “fatal flaw” review of the exposure draft at a late stage, to scrutinize the draft for any practical problems.

In due course the Board arrives at a "ballot draft" on which they vote. Eight votes are necessary in favour for the exposure draft to be published.[9] Board members who are strongly against a proposal may write a "dissenting opinion" explaining the reasons for their opposition. Following FASB practice, the exposure draft also includes a "Basis for Conclusions" in which the staff sets out the Board's reasoning for the decisions it has made. The Basis for Conclusions has long been an established part of US standard-setting but only came into the IASC’s approach relatively late. It is a key element of the IASB’s literature. It explains what issues were considered by the Board in reaching a decision and why they made that decision. It is usually helpful in understanding the proposals, and anyone commenting on the exposure draft is well advised to reflect the content of the Basis for Conclusions in their own representations.

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[8] Professor Peter Walton, ESSEC Business School, France contributed this article.

[9] This may prove to be significant. The seven member FASB used to have a 5-2 majority requirement, which was changed in 2002 to a 4-3 majority because it was felt that the super majority had caused the FASB to fail to reach decisions.

The exposure draft is published and anyone who is interested has usually two months (three or even four months for more complex issues) to respond. The staff then analyse the comment letters and bring their analysis to the open meeting for the Board to discuss. So far, the staff position tends to be that comments that go over arguments that the Board had already considered in the drafting process are disregarded, and only comments that raise issues not previously discussed may lead to the exposure draft being amended.

Another part of due process is the possibility of holding public hearings. This is again an optional element, but the Board chose to use it when debating the amendments to its financial instruments standards (IAS 32 and 39). The Board members said that the experience was useful but exhausting (World Accounting Report, April 2003, p. 3). Tom Jones said "I think the round table is a great way to deal with tricky issues…It is a good way to let people express their views. The respondents now understand our views better and we understand their complaints better". The round tables, held in March 2003, did result in the Board reconsidering past decisions.

Public hearings are an exception. The standard due process consists of the staff, after analysis of comments and discussion, preparing a new ballot draft, and if approved, the standard is issued. The ballot itself is not carried out at the public meeting. It is possible that the discussion on the exposure draft may lead to a re-thinking of some part of the proposed standard. The final standard should not include anything which has not been previously exposed, so there may be a re-exposure of all or part of the proposal. This procedural requirement is considered by the Board when discussing reactions to the original exposure draft and tends to militate against any tendency to seek a different solution to that exposed.

The process outlined above applies where the IASB is dealing with a project without any partners. However, it sees fulfilment of its convergence brief as involving working on projects with liaison standard setters and a number of projects involve national standard-setters. For example, the IASB has worked closely with France on its standard on the first time application of IFRS, with the United Kingdom on its project for reporting financial performance and with the United States on accounting for business combinations and revenue recognition. The United States has even gone so far as to suggest using identical wording on standards which derive from joint projects, although this is likely to prove difficult with technical expressions running through a number of pre-existing standards and having understood definitions.

While the same due process takes place on joint projects, the IASB staff will typically work closely with the staff of the national standard-setter involved. The national staff may also participate in IASB meetings either in person or through a telephone link. The IASB and the national board keep in touch with each other's tentative decisions and the projects are discussed in detail at national standard-setter liaison meetings. So far such joint projects have not reached final standards, but the process seems in practice to involve a certain amount of divergence of views as it proceeds.

IFRIC

The old Standard interpretations Committee created by the IASC has been replaced by the IFRIC. This is a 12-man technical expert group drawn from the international audit firms, preparers and analysts. It is chaired currently by the IASB's director of technical operations and includes observers from IOSCO, the European Commission and the IASB itself.

The IFRIC is supposed to draft Interpretations of IASB standards in response to submissions from constituents. Chairman Kevin Stevenson has made significant efforts to link IFRIC's work to that of interpretations bodies of national standard-setters (and in particular the US Emerging Issues Task Force). A new area which is emerging will be liaison with European stock exchange regulators. Some of these may be asked by registrant companies to give pre-clearance on international reporting issues, and in any event, regulatory decisions taken on the ground will create precedents. A major problem for the future will be to ensure that damaging precedents are not created at national level, nor that competing interpretations of the same subject start to appear.

When IFRIC debates an issue it is required to prepare an exposure draft, which has to be seen by the IASB before being published. If at least five IASB members object, the exposure draft is not published and the subject comes to the IASB for debate. Due process involves reviewing comments and issuing a final Interpretation, with the IASB's formal approval necessary.

Constraints

The decisions that the Board makes within this process are constrained by a number of issues. Above all, the process is linked to a conceptual framework for financial reporting (the IASB's *Framework for the preparation of financial statements*). Hoarau (1995) has contrasted this kind of approach with the French approach, where typically interested groups come together to discuss an individual technical issue and reach a consensus conclusion which balances the different needs of the participants – standard-setting by social compromise. A characteristic of the consensual approach is that standards are incremental and may well demonstrate a lack of consistency over time. This could be said to apply to the old IASC approach.

The new IASB is committed to writing standards that are consistent with its conceptual framework. Indeed, commentators have observed that some members take a very restricted interpretation of the framework. For example, Jim Leisenring, for ten years a member of the FASB, has been quoted (Walton 2002) as saying that the overriding principle to be followed in setting standards is that assets and liabilities should be valued at fair value at balance sheet date, and any change in these values from balance sheet to balance sheet is shown in the income statement. In general, discussion around the Board table frequently cites the conceptual framework, and any lobbyist or commentator who fails to structure an argument around the framework is probably wasting their time.

The *Framework* as currently published does not mention any preference for a measurement attribute, but a number of Board members have an apparent preference for fair value (effectively current market value), which seems in accord with the FASB's views. The views expressed are that use of fair value takes away the subjectivity of company-specific values ("entity-specific value") and the irrelevance of historical cost. Proponents think company balance sheets should show the current market value of assets and liabilities, and not historical cost. They complain that historical cost permits smoothing and obscures actual economic performance. Prepapers complain that a fair value approach makes reported earnings very volatile. Fair valuers say that profits are volatile, and investment would be safer if users understood that and were prepared to look into earnings statements in detail and better understand where earnings came from and what the risks associated with them are.

The second visible constraint is that of convergence. As indicated, convergence on high-quality standards is the IASB's principal aim, and while in theory this means convergence on standards from any jurisdiction, in reality convergence with US GAAP is a high priority. The IASB and the FASB signed a document in 2002 (the "Norwalk agreement") after a joint meeting of the two Boards at the FASB's Connecticut headquarters, stating that both would address convergence in a number of ways, including a short-term convergence project to amend existing standards, and pursuit of joint projects in areas such as reporting performance and revenue recognition.

Convergence with the United States explicitly recognises that foreign companies listed in the United States do not like to produce the "20F reconciliation statement" in which they have to show how the calculation of their profit and equity by foreign rules compares with the numbers under US rules (e.g. see Bay & Bruns 2003). The US Securities and Exchange Commission has not withdrawn this requirement for IAS, despite IOSCO endorsement of the standards, and in practice convergence aims at removing the main differences which occur in the reconciliation statement. There is political support for this with the European Commission publicly welcoming the Norwalk agreement and the acting chief accountant of the SEC, for example, telling US auditors at the annual SEC reporting conference in December 2002 that they must be prepared for changes to US rules to facilitate convergence.

Although some commentators feel that convergence is a euphemism for the IASB changing its rules to comply with the United States, this is not necessarily the case. The process agreed between the Boards is that the staff looking at this take the most recently-agreed standard on any particular subject, whichever Board issued it, and start from the assumption that this represents the best position. The IASB is amending its business combination rules to reflect the FASB's Statements 141 and 142, while the FASB has exposed the IASB's proposed statement on stock options. The relative strengths of the FASB and the IASB have probably been impacted by US financial reporting scandals. It is, nonetheless, far too early to say what will eventually emerge from the convergence process.

A key word in Board discussions is consistency (Walton, 2002). It is clearly a preoccupation that the standards should be consistent (a) with the IASB conceptual framework, (b) internally with the other standards in the IASB literature, and (c) if possible with US GAAP. This is quite difficult to achieve, but one of the reasons for the Board's 2001 Improvements project, that is in the process of changing a significant number of old IASC standards, was to improve the internal consistency and remove unnecessary obstacles to convergence.

The drive for consistency is itself constrained by the need to write standards that do not provide preparers with opportunities for avoidance or manipulation and that are capable of being applied practically. Within technical debates the preparer representatives on the Board (e.g. Harry Schmid, formerly of Nestlé, Hans-Georg Bruns, formerly of Daimler-Chrysler, and Tom Jones, formerly of Citicorp) are often to be found debating the cost and impracticality of providing measurements while analysts (Tony Cope, Bob Garnett) and others insist on the necessity to provide information to the markets and block off avenues to manipulation of financial reports. In effect, anti-abuse rules may take priority over purity of application of the conceptual framework.

Europe

European endorsement of the IASB has been a key element in the rise to prominence of the standard-setter and the process by which Europe will adopt individual standards may prove to be a significant element in the IASB's processes. The EU Regulation which imposes the use of IFRS for listed companies also provides for IFRS to be endorsed by a process known as "comitology" – a committee of EU member States' representatives (the Accounting Regulation Committee – ARC) must formally approve each IFRS for it to have the force of law within the EU. In theory, the ARC could amend standards as they pass through, and the European Parliament also has the right to comment on standards while they are before the ARC. This may open up opportunities for pressures to be exerted through the European system, although the ARC is supposed only to indicate whether or not it thinks the standard complies with EU law, and the Commission may, if it does not agree with an ARC decision, appeal to the Council of Ministers. Philippe Danjou, chief accountant of the Commission des Opérations de Bourse (COB) has referred to the possibility of amending IFRS as the standard-setting equivalent of a nuclear weapon.

However, the European Commission has no direct voice in the IASB's processes, so it has no means of debating the content of the standards. Instead the Commission works with a private sector body financed by European lobbying organizations. The European Financial Reporting Advisory Group (EFRAG) has been organized by the Fédération des Experts-comptables Européens and other groups to interact with the IASB and provide assessments of the content of standards for the Commission.

The working group of EFRAG is called the Technical Experts Group (TEG) and consists of nine individuals drawn from EU member states. The TEG meets for two days every month to debate issues currently before the IASB and to respond to invitations to comment. TEG liaises with all European national standard-setters and attempts to coordinate European input to the IASB. Tom Jones, IASB deputy chairman, and Kevin Stevenson, director of technical operations at the IASB, provide liaison with the IASB, although France, Germany and the UK also have individual liaison members on the IASB (Gilbert Gélard, Hans-Georg Bruns and Geoffrey Whittington).

Not all EU member States have stock exchange regulatory mechanisms, such as that of the COB, that include examining the financial statements of listed companies. Once IFRS are in use in Europe, compliance monitoring will be done by national regulators. This means that some countries will have to change their current systems but also that it is necessary to have in place a tight coordination between national regulators on issues such as interpretation and application of IFRS. In 2002 member states created the Committee of European Securities Regulators (CESR) whose job will be to coordinate regulatory activity. The CESR has two financial reporting sub-committees, one of which, chaired by Philippe Danjou, will deal with financial statement preparation issues. This sub-committee will also monitor IASB standard-setting and will work closely with the IFRIC on the interpretation and application of standards. Clearly, the effort of taking IFRS unamended into Europe would be compromised if the subsequent application of the standards was treated differently in different member states.

The question of interpretation of standards is also significant as far as the major audit firms are concerned. The implementation of IFRS represents a major business opportunity for the "Big Four" international audit firms. There are no formal consultation mechanisms between the Big Four and the IASB. However, one of the two part time members of the Board (John Smith) is a partner in a Big Four firm. These firms each have a special technical unit, usually referred to as the "IAS desk", which monitors the IASB's activity and advises internally on client queries arising from the application of IAS. Their IAS specialists meet with each other regularly to compare notes and cooperate on joint projects. They have also had at least one meeting with the Board. In addition, the IASB staff sometimes seeks comments on proposals during the drafting stages and IAS desks have been asked to do "fatal flaw" reviews of exposure drafts. However, the Big Four have so far appeared reluctant to table issues formally at the IFRIC (World Accounting Report, October 2002, p. 3).

Conclusions

Clearly the standard-setting process is always a compromise between competing pressures and competing objectives. In addition, where there is a relatively small collection of individuals involved consistently, there is also the interplay between them which evolves over time. For the first time international standards are being created by a professional team. This should mean that they are produced more efficiently and that their contents conform much more closely to a consistent model. The criticism of this approach is that it leads to a less representative system, also that standards are dominated by a view of reporting which is remote from the real world.

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