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Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA) – Level 3 guidance

Note by the UNCTAD secretariat

Executive summary

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) issued the publication *Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA) – Level 3 Guidance* after deliberations during its seventeenth and eighteenth sessions. At its twenty-third session, ISAR requested the UNCTAD secretariat to reconvene a consultative group to, inter alia, update the SMEGA Level 3 Guidance. Accordingly, a consultative group was reconvened. Revisions proposed by the consultative group were considered at the twenty-fourth session of ISAR.

In concluding its deliberations on the proposed revisions, the twenty-fourth session of ISAR requested that the UNCTAD secretariat incorporate into the document presented at that session comments and suggestions received then, as well as additional comments that interested delegations would submit after the session. The session also requested that the UNCTAD secretariat reconvene a consultative group with a view to finalizing the proposed revisions. Accordingly, a consultative group was reconvened. The secretariat has prepared this note containing a revised version of the SMEGA Level 3 Guidance for consideration and finalization by the twenty-fifth session of ISAR.

[*] ISAR documents were previously issued under the symbol TD/B/COM.2/ISAR/…

I. Background

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

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

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

4. ISAR recognizes that it is likely that the IFRS for SMEs may not be suitable for smaller enterprises, as such enterprises may not produce general-purpose financial statements. In general, their financial statements are not designed to meet the needs of a wide group of users.

5. To meet the needs of smaller enterprises, sometimes referred to as microenterprises, ISAR has developed a single set of guidelines – Level 3 – which meet the needs of those enterprises that do not produce general-purpose financial statements. The Level 3 Guidelines have been developed using a "bottom-up" approach rather than being integrated into the "top-down" approach which characterizes the proposed IFRS for SMEs. The bottom-up approach starts with a realistic consideration of the needs of users and preparers of the financial statements of smaller enterprises.

6. Therefore, in order to meet the financial reporting needs of all enterprises, ISAR is proposing that a three-tiered structure be adopted, as follows:

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

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

(c) Level 3. This level would apply to smaller enterprises that are often owner-managed and have no or few employees. The approach proposed is simplified accruals-based accounting, closely linked to cash transactions. National regulators may permit a derogation for newly formed businesses or new entrants to the formal economy to use cash accounting for a limited time.

7. How exactly the boundaries between the three levels should be specified is a matter that cannot be dealt with adequately without knowledge of the specific economy in which the enterprises operate. The recommendation of ISAR is that there should be a system with at least three levels, but how these levels are defined must be determined by each member State that chooses to apply this approach. The

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

II. Introduction

A. Scope

8. The SMEGA Level 3 Guidance is designed for financial statements of smaller enterprises that are often owner-managed and have no or few employees. Such enterprises should generally follow a simplified accruals-based accounting system that is closely linked to cash transactions.[1] The SMEGA Level 3 Guidance is intended to meet the needs of users and preparers of financial statements for these enterprises.

B. Level 3 accounting framework

9. The income statement and the balance sheet are based on a simplified accruals accounting approach, closely linked to cash transactions. This guidance uses the historical cost measurement basis.

10. Level 3 financial statements will normally be prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

C. The objectives of Level 3 financial statements

11. 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.

D. Users and their needs

12. Financial statements are designed to reflect user needs. The principal users of financial statements of Level 3 enterprises are likely to be:

(a) Owners and management:

- (i) To assess and confirm the performance of the enterprise during the year or period under review (including the levels of income, revenues and costs);
- (ii) For applying for external financing;
- (iii) For financial management purposes (e.g. deciding what portion of profits to retain); and/or
- (iv) As a tool for succession planning and management of wealth.

(b) Lenders and other creditors:

- (i) To assess risk in the credit decision; and
- (ii) To monitor the performance of enterprises that have been given credit.

(c) Government: for macro- and microeconomic planning purposes.

(d) Taxation authorities: for tax assessment purposes.

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

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

(f) Credit agencies: to facilitate the assessment of the advancement of credit from an independent organization that keeps records of the credit status of enterprises.

E. Qualitative characteristics

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

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

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

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

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

14. 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 judgemental.

15. 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.

F. Elements

16. *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.

17. *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.

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

19. *Income:* Income encompasses both revenue and gains. It includes increases in economic benefits during the reporting 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 owners.

20. *Expenses:* Expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to owners.

G. Recognition

21. An item that meets the definition of an element should be recognized if, (1) it is probable that any future economic benefit associated with the item will flow to or from the enterprise, and (2) the item has a cost or value that can be measured with reliability.

H. Measurement

22. The measurement basis most commonly adopted in preparing financial statements is historical cost.

I. Level 3 enterprises and financial management

23. In the day-to-day running of the enterprise, it is widely recognized that managing cash is critical to the survival of an enterprise 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 will be an important component in the financial management of Level 3 enterprises.

III. Basic requirements

24. The following paragraphs set out the basic guidance for Level 3 enterprises.

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

(a) A balance sheet;

(b) An income statement; and

(c) Explanatory notes.

26. Enterprises may wish to include other statements that are likely to enhance the overall transparency and quality of the information they provide to users; for example, a cash flow statement.

27. 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.

28. An enterprise should prepare its financial statements using simplified accruals-based accounting, closely linked to cash transactions.

29. The following information should be prominently displayed:

(a) The name of the reporting enterprise;

(b) The balance sheet date and the period covered by the income statement; and

(c) The presentation currency.

30. Financial statements should be prepared at least once a year.

31. Financial statements should include comparative figures for the previous period.

32. 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.

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

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

(b) 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) Cash.

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

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

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

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

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

36. As a minimum, the face of the balance sheet should include the line items shown in annex I.

37. An enterprise should disclose the movement of owners' equity during the reporting period.

38. As a minimum, the face of the income statement should include the line items shown in annex II. A more detailed presentation using the same structure is shown in annex III.

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

40. 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 when arriving at the purchase price.

41. 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.

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

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

44. 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:

(a) Additions;

(b) Disposals;

(c) Depreciation; and

(d) Other movements.

45. Lease payments, whether deriving from an operating or finance lease, should be recognized as an expense as they become payable. If the payments are material, these should be disclosed in the notes to the financial statements.

46. The value of the lease should not be shown either as an asset or a liability on the balance sheet. However, if the total remaining payments on the lease are material, this should be disclosed in the notes to the financial statements.

47. 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).

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

49. The cost of inventories should be assigned by using specific identification of the individual costs of items whenever possible. Otherwise, the cost of inventories should be assigned by using the first-in first-out (FIFO) or weighted average cost methods.

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

51. 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.

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

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

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

55. The tax shown in the income statement should be the estimated tax due on the profit or loss for the reporting period.

56. The explanatory notes to the financial statements should also include;

(a) A description of the enterprise’s operations and its principal activities;

(b) A reference to the accounting framework under which the financial statements have been prepared;

(c) Disclosure of significant accounting policies used;

(d) A description of contingencies (possible assets or liabilities whose existence will only be confirmed by the occurrence or non-occurrence of uncertain future events); and

Any other information relevant to understanding the financial statements.

57. For material transactions or events not covered by this guidance, reference should be made to the appropriate requirements in the guidance for Level 2 enterprises.

IV. Model financial statements

A. The financial statements

58. The balance sheet and the income statement are based on a simplified accruals accounting approach.

59. In many cases, Level 3 enterprises will not have the in-house resources to prepare these statements and, in these cases, the statements will need to be prepared by an external party.

60. The formats take into consideration the cost/benefit issues of Level 3 enterprises. In order to ensure that the statements are useful to owner-managers and other users of financial statements of typical Level 3 enterprises, the costs of preparing the statements need to be weighed against the benefits.

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

B. Balance sheet – annex I

62. 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.

C. Income statement – annexes II and III

63. 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 they have correctly anticipated the level of costs and profit margins in their pricing.

64. 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 on which the mark-up is calculated, which are described in the statement as "direct operating costs".

65. Direct operating costs will vary from enterprise to enterprise. For example, annex III 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 operating costs.

66. 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 enterprises are indirect (i.e. related to overheads).

67. The headings under "indirect costs" are to 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 between different types of enterprises.

D. Cash flow statements – annex IV

68. The primary purpose of a cash flow statement is to provide relevant information about the cash movements of an enterprise in a given period. Although it is not required under this guidance, a model cash flow statement is provided in annex IV.

Annex I. Model balance sheet

XYZ Ltd.
balance sheet
as of December 20X2
(in currency units, CU)

	20X2 CU	20X1 CU
Assets		
Non-current assets		
Property, plant and equipment	190 000	190 000
Current assets		
Raw materials	18 200	9 100
Finished goods	34 000	21 000
Trade receivables	26 000	34 000
Cash and bank	6 800	11 500
	85 000	75 500
Total assets	**275 000**	**265 600**
Owners' equity and liabilities		
Owners' equity as of 1 January	132 900	114 700
Earnings for the year	55 600	48 200
Owners' drawings for the year	(45 000)	(30 000)
Owners' equity as of 31 December	143 500	132 900
Non-current liabilities		
Loans	105 500	117 000
Current liabilities		
Bank borrowings	2 500	12 500
Taxes payable	4 600	2 200
Trade payables	18 900	1 000
Total liabilities	131 500	132 700
Total owners' equity and liabilities	**275 000**	**265 600**

Annex II. Model income statement format

XYZ Ltd.
income statement
for the year ended 31 December 20X2
(in CU)

	CU
Revenue Direct operating costs	
Contribution	
Indirect costs	
Profit before interest and other financing costs	
Less: Interest and other financing costs	
Profit after interest and other financing costs	
Less: Tax	
Profit after tax	

Annex III. Model income statement

XYZ Ltd.
income statement
for the year ended 31 December 20X2
(in CU)

	20X2 **CU**	**20X1** **CU**
Revenue	325 000	283 000
Direct operating costs		
Opening inventories	21 000	00.0
Cost of goods produced	205 600	189 000
	226 600	189 000
Closing inventories	34 000	21 000
Total direct operating costs	192 600	168 000
Contribution	132 400	115 000
Indirect costs		
Salaries	34 350	35 700
Depreciation – office equipment	1,500	0.00
Lease rent	15 600	13 500
Motor vehicle expenses	6 500	5 700
Insurance	1 300	1 100
Telephone	1 700	1 500
Light and heating	1 150	900
Total indirect costs	67 100	58 400
Profit before interest and other financing costs	65 300	56 600
Interest expense	1 300	1 200
Profit after interest and financing costs	64 000	55 400
Tax	8 400	7 200
Profit after tax	**55 600**	**48 200**

Annex IV. Model cash flow statement (optional)

XYZ Ltd.
cash flow statement
for the year ended 31 December 20X2
(in CU)

	20X2 CU	20X1 CU
Profit after tax	**55,600**	**48,200**
Adjustments for:		
Interest expense	1 300	1 200
Tax	8 400	7 200
Depreciation	13 500	12 000
(Increase) decrease finished goods inventory	(13 000)	(21 000
(Increase) decrease raw materials inventory	(9 100)	(9 100)
(Increase) decrease receivables	8 000	(4 000)
Increase (decrease) trade payables	17 900	1 000
Total adjustments	**27 000**	**(42 700)**
Cash generated from operations	**82 600**	**5 500**
Interest paid	(1 300)	(1 200)
Income taxes paid	(6 000)	(5 000)
Net cash from operating activities	**75 300**	**(700)**
Cash flow from investing activities		
Purchase of equipment	(13 500)	
Net cash used in investing activities	(13 500)	
Cash flows from financing activities		
Payment to loans and borrowings	(21 500)	
Owners' drawings	(45 000)	(30 000)
Net cash used in financing activities	**(70 600)**	**(51 500)**
Net increase (decrease) in cash and bank	(4 700)	(30 700
Cash and bank balance on 1 Jan	11 500	42 200
Cash and bank balance on 31 Dec	**6 800**	**11 500**