

## **CONSULTATION PAPER ON PROPOSED FRAMEWORK FOR DIFFERENTIAL REPORTING**

The Accounting Standards Council (ASC) is considering the possibility of differential reporting for Small and Medium Sized Enterprises (SMEs) in Singapore, and is seeking feedback on this proposal.

### **INTRODUCTION**

The ASC's mandate is to develop, review, amend and approve financial reporting standards for entities that are under its purview, i.e. companies, charities, co-operatives and societies, while taking into account:

- (a) The information needs of the stakeholders of the entities;
- (b) Facilitation of comparability, disclosure and transparency;
- (c) Compatibility with relevant international standards; and
- (d) Singapore's reputation as a trusted international business and financial hub.

2. In 2008, the ASC formed a dedicated taskforce to consider the issue of differential reporting for SMEs, and how it could be applied in Singapore if considered appropriate. Differential reporting is the notion that some entities should be allowed to depart from particular requirements of accounting standards or entire accounting standards in preparing their financial statements. The composition of the taskforce can be found in ANNEX A.

### **PROPOSAL ON ADOPTING A DIFFERENTIAL REPORTING FRAMEWORK**

3. The objective of financial statements is to provide useful information about an entity's financial position, performance and any changes of these to a wide range of users, e.g. creditors, suppliers, shareholders. It is thus important that financial statements should be prepared according to the highest standards to ensure the accuracy and relevance of the information reflected in the financial statements. Currently, **all** Singapore-incorporated companies, regardless of their size or the level of public interest in them, are required to prepare accounts in accordance with the Financial Reporting Standards (FRS) issued by the ASC.

4. There are however several reasons why it may be appropriate for the SMEs, to adopt a differential reporting framework. First of all, users of financial statements of SMEs may have different informational needs. Literature suggests that the main uses for SME financial statements by banks are to determine capacity to repay and to assess profitability, security and liquidity. Owners on the other hand, utilise financial reports for a variety of functions including, ascertaining remuneration awards and dividend payouts, monitoring performance and capital expenditure, budgeting, planning, and for purposes associated to loans and financing. For example, SMEs typically obtain capital from shareholders, directors and suppliers, and shareholders and directors often pledge their

personal assets so that the SME can obtain bank financing. Consequently, there may be a need for expanded related party disclosure requirements for SMEs.

5. Secondly, one purpose of having proper financial statements is to provide shareholders with the means to assess the performance of their investment and the effectiveness of the management team. This is especially crucial for large listed entities, where due to the diffused shareholdings, shareholders typically depend on the entity's external financial reporting as their only means to obtain financial information about the entity. This argument is less relevant in the case of an SME given that the majority of them are owner-managed. These owner-managers not only have access to information, but also the ability to determine the form and content of the information they require. As there is no separation of ownership and management, the stewardship purpose of financial statements based on accounting standards is thus less significant.

6. Finally, while the benefits of comprehensive, transparent and comparable financial reporting cannot be over-emphasized, applying comprehensive financial standards comes with a cost. Businesses need to employ more qualified personnel, implement new processes and controls, and train personnel from accounts receivable clerks to the CEO and audit committee members. Furthermore, as the International Financial Reporting Standards (IFRS) have moved towards the fair value model, more judgment is required in the valuation of assets and financial instruments. This increased complexity may be too onerous for small companies and is likely to outweigh the benefits arising from the use of IFRS.

***Question 1: Do you agree that Singapore should adopt a differential reporting framework for SMEs? If yes, what do you see as the reason(s) justifying such a framework. Specifically, we would like to have your comments and views on whether such a differential framework should be justified on one or more of the following premises:***

- a) that SME has less public accountability than that of big enterprises? If yes, please specify in what aspects the level of public accountability of SME will defer from that of big enterprises;***
- b) that the general purpose financial information needs for SME being different from that of the big enterprises? If yes, please specify the main sources and areas of the differences in the informational needs of users of the general purpose financial reports of SME; and***
- c) that the cost and complexity for SME to follow the full financial reporting standards outweigh the benefits? If so, please specify where and what you see as the main sources of the undue costs and complexity that exist with the existing full standards.***

## **PRACTICES IN OTHER JURISDICTIONS**

7. Several countries have already adopted a differential reporting framework for their SMEs. These include Australia, Canada, the European Union (EU), Hong Kong, Malaysia, New Zealand, and the United Kingdom (UK). For more details on the practices in other jurisdictions, please refer to ANNEX B.

### **OBSERVATIONS REGARDING PRACTICES IN OTHER COUNTRIES**

8. Countries typically design their differential reporting framework based on three assumptions about the costs and benefits of complying with financial reporting standards:

- (a) More benefits are derived from the general purpose financial reports of entities with public accountability because the reports of such entities are likely to have more users;
- (b) There is generally no accountability requirement when all of the owners of an entity are also members of its governing body. However, where the owners and the governing body of an entity are different, an accountability requirement arises. In this case, the value of the entity's general purpose financial reports to users may be expected to increase, and greater benefit is likely to be derived; and
- (c) The larger the entity, the more extensive the group of users benefiting from the information provided in its general purpose financial reports, and the greater the benefit likely to be derived.

9. Working on the three broad assumptions above, most countries that have adopted a differential reporting framework has made it a pre-requisite that a publicly accountable entity should not qualify for differential reporting. This is consistent with the approach adopted by the International Accounting Standards Board (IASB). An entity is deemed to have public accountability (and therefore should use full IFRSs) if it has issued debt or equity securities in a public market or it holds assets in a fiduciary capacity for a broad group of outsiders (e.g. of such an entity include bank, insurance company, securities broker/dealer, pension fund, mutual fund and investment bank).

### **CURRENT PRACTICES IN SINGAPORE**

10. Currently in Singapore, there is no legal definition of an SME. There are however several working definitions of an SME adopted by different agencies. For instance, the Ministry of Trade and Industry (MTI) defines an SME in the manufacturing industries as one with net fixed assets investment of S\$15 million or less. In non-manufacturing industries, an SME is an enterprise with less than 200 employees. The Association of Small and Medium Sized Enterprises (ASME) defines an SME, for the purpose of corporate membership, as a company with net fixed assets of S\$30 million and less than 300 employees.

11. On the other hand, the Companies Act provides for the existence of an Exempt Private Company (EPC), which is widely used in Singapore as a vehicle for small businesses. The EPC status is automatically granted to a private company that has less

than 20 members and no corporate shareholder. Based on statistics gathered as at January 2008, more than 69% of all Singapore-incorporated companies are EPCs, of which more than 60% of the EPCs are owner-managed.

12. Presently, a solvent EPC<sup>1</sup> is exempted from having to file a balance sheet and profit and loss account with its annual report with the Accounting and Corporate Regulatory Authority. In addition, an EPC that is dormant or has annual revenue less than S\$5 million is exempted from the need to get its accounts audited.

### **PRELIMINARY VIEWS OF THE TASKFORCE ON DIFFERENTIAL REPORTING FRAMEWORK FOR SMEs**

13. Drawing from the practices in other jurisdictions, the Taskforce is of the view that a differential reporting framework should be applicable only to an entity that satisfies two conditions, namely,

- a) it is not publicly accountable (i.e. it does not issue debt or equity securities in a public market or holds assets in a fiduciary capacity for others); and
- b) it satisfies the “size-test” to be regarded as an SME.

14. As a proxy for size, the Taskforce notes that countries would typically look at how companies fare on three main criteria, namely total assets, annual turnover and headcount. Countries would also modify the threshold set for each criterion to suit the unique business realities as well as the stage of development of the country<sup>2</sup>. For instance, in Hong Kong, a higher threshold on gross asset value is imposed to take into account the fact that real estate in Hong Kong commands a relatively higher price compared to countries like Australia and the UK.

15. In the case of Singapore, the Taskforce proposes that an entity would qualify as an SME if it satisfies **two of the following three** criteria:

- (a) net assets do not exceed S\$15 million;
- (b) annual turnover does not exceed S\$ 15 million; and
- (c) average number of employees does not exceed 200.

For the proposed net assets and annual turnover figures, the Taskforce is setting the threshold at S\$15 million, which is consistent with the current threshold used by MTI in defining an SME in Singapore. This proposed threshold for net assets and annual turnover is also comparable to the thresholds adopted in other Asian jurisdictions such as Hong Kong and Malaysia. In respect of the number of employees, the Taskforce notes that 200 is the threshold used by MTI in defining an SME in the non-manufacturing

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<sup>1</sup> An EPC certificate is granted when the EPC passed the solvency test.

<sup>2</sup> This means that a company that qualifies for differential reporting in the EU on account of it being small would in fact be classified as medium or large in countries like Malaysia and Hong Kong, and thus not be eligible for differential reporting in these countries.

industries and is also comparable to headcount figure used in the UK in determining a Medium-Sized Company.

16. The Taskforce is mindful that one issue with the use of quantitative criteria like annual turnover, net assets and average headcount, is that due to changes in these figures, it is possible for a company to cross the thresholds such that it may not qualify for an SME on a year-on-year basis. To address this issue, the Taskforce proposes that a system should be set in place to cater to the volatility of a company's net assets, turnover and number of employees. Specifically, it is noted that in the UK, a company qualifies as a "small" or "medium-sized" in its first financial year, or in any subsequent financial year if it fulfils the conditions in that year and the year before. If the company ceases to be small or medium-sized, the exemption continues for the first year that the company does not fulfill the conditions. This will continue uninterrupted if the company reverts to being small or medium-sized the following year.

17. The Taskforce notes that in countries such as Malaysia and New Zealand, one of the criteria for an entity looking to apply differential reporting is that all of its owners must also be of the entity's governing body. A variation of this criterion is the requirement that all the owners of the entity must consent unanimously to the application of a differential reporting framework. This is practised in countries such as Canada and Hong Kong. The rationale is that where the owner is not part of the body that makes the operational and financing decisions relating to the entity, he may not be privy to certain information that is considered necessary to make the right decisions. In such instances, the owner is reliant upon the general financial statements as the source of information and hence it is important that the financial statements are prepared according to IFRS.

18. Going by the data provided by ACRA, only 41% of Singapore-incorporated companies are both EPCs and owner-managed<sup>3</sup>. Hence the Taskforce is of the view it would be unduly onerous if this is included as one of the qualifying criteria for an entity considering the adoption of the differential reporting framework.

19. Under the proposed Singapore differential reporting framework, an entity that qualifies for differential reporting would have the choice of either following the full Financial Reporting Standards as prescribed by the ASC or the SME-FRS in full. The Taskforce is of the view that a choice should be given as some SMEs may have aspirations to be listed on the Singapore Exchange and for these SMEs, it would actually be less costly for them to adopt the FRS right from the start, instead of incurring the transitional cost of migrating from SME-FRS to the full FRS.

***Question 2: Do you agree that the differential reporting framework should only be applicable to an entity that has no public accountability (i.e. does not issue shares or debts in a public market and does not hold assets in a fiduciary capacity for others) and satisfies the size criteria to be regarded as an SME?***

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<sup>3</sup> Based on ACRA's data that 69% of companies here are EPCs out of which, only 60% are owner-managed, this means that only 41% of Singapore-incorporated companies are both EPCs and owner-managed.

***Question 3: Do you agree that an entity should be deemed to be an SME if it satisfies any two of the following criteria?***

- (a) net assets not exceeding S\$15 million;***
- (b) annual turnover not exceeding S\$15 million;***
- (c) average number of employees not exceeding 200.***

***If not, please specify the reasons. If the disagreement has to do with the thresholds set, please specify what should be the ideal threshold for each criterion. If you think there are other more appropriate criteria that should be used e.g. total assets, total expenditure, please also specify what they should be.***

***Question 4: Do you agree that we should adopt the UK's system of allowing the exemption to continue for the first year that the company does not fulfill the size criteria? If not, please suggest an alternative framework.***

***Question 5: Do you think that one of the qualifying criteria for an entity applying the differential reporting framework should be that all of its owners must be members of the entity's governing body or that there should be unanimous consent from all its owners to adopt the differential reporting framework?***

***Question 6: Do you agree that an entity that qualifies under the differential framework should be given a choice to either follow the SME-FRS in its entirety or the Singapore FRS?***

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**ANNEX A**

**COMPOSITION OF THE SME-IFRS TASKFORCE**

<b>Name</b>	<b>Title</b>
1) Ms Chen Yew Nah (Chairman)	Managing director, DP Information Group
2) Mr Gurdip Singh	President & CEO of Crescendas MEC (S) Pte Ltd, representative from ASME
3) Mr Voo Hui Ming	Manager, Financing & Incentive Management, SPRING
4) Mr William Chia Soon Hin	First Vice President, Business Development Group Head, UOB
5) Mr Lee Kok Hooi	Partner, PWC
6) Mr Ow Fook Chuen	Deputy Chief Executive, Accounting and Corporate Regulatory Authority

**PRACTICES IN OTHER JURISDICTIONS**

**AUSTRALIA**

1. Australia has a differential disclosure regime under which financial reporting requirements are set according to the type of entity, principally on the basis of the level of public interest in the entity. The types of entities can be classified as:

- (a) disclosing entities (mainly listed corporations and registered managed investment schemes) that have listed securities or have issued shares and other securities;
- (b) unlisted public companies and large proprietary companies; and
- (c) small proprietary companies (a small proprietary company is one that meets at least two of the three criteria: gross operating revenue of less than A\$10 million, gross assets of less than A\$5 million, and/or less than 50 employees).

Under the Corporations Law, all disclosing entities are required to maintain records which accurately record their financial transactions and which would enable the preparation of financial statements and the audit of these financial statements.

2. The Australian Corporations Law states that small proprietary companies have to prepare a financial report only if shareholders with at least five percent of the votes give the company the direction to do so, or if it is controlled by a foreign company. In addition, the direction may specify that the financial report does not have to comply with some or all of the accounting standards.

**CANADA**

3. The Canadian Accounting Standards Board implemented an Accounting Recommendation on Differential Reporting in 2002. An entity qualifies for differential reporting options when it *does not have public accountability and all the owners of the entity consent unanimously* to the application of a differential reporting exemption. Qualifying entities are granted a number of disclosure exemptions but also a few different measurement treatments (e.g. the long-term contracts may be accounted for using the completed contract method, qualifying companies have the option to account for subsidiaries using either the cost or the equity method, etc). An entity that opts for differential reporting must disclose how it qualified and what exemptions it has applied.

**EUROPEAN UNION (EU)**

4. In the EU, the distinction between group (consolidated) financial statements and individual company financial statements has been used by regulators as a convenient way of separating smaller companies from larger ones. Consolidated financial statements are required only when the group meets certain size thresholds.

5. On 6 May 2003, the European Commission adopted a new SME definition which replaced the old definition with effect from 1 Jan 2005. Under the revised SME definition, the first step to qualify as an SME is to be considered as an enterprise, which is defined to be “any entity engaged in an economic activity, irrespective of its legal form”. An SME then has to satisfy the staff headcount criteria, plus either the turnover or balance sheet ceiling. The new definition offers this choice because, by their nature, enterprises in the trade and distribution sectors tend to have higher turnover figures than those in manufacturing. Providing an option between turnover and the balance sheet total, which reflects the overall wealth of an enterprise, ensures that SMEs engaged in different types of economic activity are treated fairly.

Table 2: Definition of SME in the European Union

<b>Enterprise category</b>	<b>Headcount</b>	<b>Turnover</b>	<b>or</b>	<b>Balance sheet total</b>
Medium-sized	< 250	≤ € 50 million		≤ € 43 million
Small	< 50	≤ € 10 million		≤ € 10 million
Micro	< 10	≤ € 2 million		≤ € 2 million

## **HONG KONG**

6. In August 2005, the Hong Kong Society of Accountants (HKSA) issued a SME-Financial Reporting Framework that set out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the SME-FRS. The Hong Kong SME-FRS sets out the recognition, measurement, presentation and disclosure requirements for an entity that prepares and presents the financial statements in accordance with the SME-FRS. Entities that qualify for reporting under the SME-Financial Reporting Framework and preparing financial statements in accordance with the SME-FRS would include Hong Kong companies that apply section 141D of the Companies Ordinance<sup>4</sup>, do not have public accountability and have the unanimous agreement of all the shareholders in adopting the reporting framework.

7. Companies incorporated outside of Hong Kong could still qualify to use this SME accounting standard provided they do not have public accountability and they procure unanimous shareholders agreement to adopt the SME-FRS. Finally the companies would also need to meet at least two of the following three criteria:

- (a) annual revenue of less than or equal to HK\$50 million;
- (b) gross assets of less than or equal to HK\$50 million; and
- (c) headcount of less than or equal to 50.

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<sup>4</sup> Section 141D of the Hong Kong Companies Ordinance does not apply to a private company which-  
(a) has any subsidiary or is a subsidiary of another company formed and registered under the Ordinance; or  
(b) carries on banking business and holds a valid banking license; or (c) is a corporation licensed under the Securities and Futures Ordinance (Cap 571) to carry on a business.

## MALAYSIA

8. Currently, the Malaysian Accounting Standards Board (MASB) has approved two separate sets of accounting standards, namely Financial Reporting Standards (FRS) that is applicable to all entities other than private entities<sup>5</sup> and the Private Entities Reporting Standards (PERS) that is applicable to all private entities. Private entities are given a choice to either adopt the PERS in its entirety or the FRS. In 2000, the MASB issued the Statement of Principles, SOP1 – Exempt Enterprises. In defining an exempt enterprise, SOP1 premises that the concept of a reporting enterprise is tied to the information needs of users and the nature of general purpose financial statements. The need to prepare general purpose financial statements is linked to the existence of dependent users who rely on those statements. Three surrogates are identified as indicators of circumstances where dependent users exist for such enterprises:

- (a) Public accountability;
- (b) Separation between owners and governing body of an enterprise; and
- (c) Size

The MASB believes that the larger the enterprise the more likely the existence of dependent users.

9. In Malaysia, an enterprise is considered to be an exempt enterprise when:

- (a) the enterprise does not have public accountability;
- (b) at balance sheet date, all of its owners are members of the enterprise's governing body; and
- (c) the enterprise is not large, namely it fulfils two of the following three criteria,
  - i) an annual gross revenue of less than RM10 million;
  - ii) assets of less than RM5 million at the end of the financial year; and
  - iii) less than 50 employees for the financial year.

10. Under the exempt enterprise framework, the MASB would grant partial exemption on a standard by standard basis. The presumption is that all incorporated enterprises must follow FRS in the preparation of their financial statements unless the provisions of that standard specifically exempt them, with exemption given based on considerations of cost-benefit criterion.

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<sup>5</sup> A private entity is a private company that is (a) not itself required to prepare or lodge any financial statements under any law administered by the Securities Commission or the Bank Negara Malaysia; and (b) is not a subsidiary or associate of, or jointly controlled by, an entity which is required to prepare or lodge any financial statements under any law administered by the Securities Commission or the Bank Negara Malaysia.

## **NEW ZEALAND**

11. In New Zealand, the Financial Reporting Standards Board of New Zealand implemented a Framework for Differential Reporting in February 1994. An entity qualifies for differential reporting options when it does not have public accountability and:

- (a) at the balance sheet date, all of its owners are members of the entity's governing body; or
- (b) the entity satisfies at least two of the following size test:
  - i) total revenue not exceeding NZ\$20 million;
  - ii) total assets not exceeding NZ\$10 million;
  - iii) average number of employees not exceeding 50.

12. Qualifying entities are granted a number of disclosure exemptions but also a few different measurement treatments. The Framework for Differential Reporting allows selective application of the options provided. An entity that opts for differential reporting must disclose how it qualified and what exemptions it has applied.

## **UNITED KINGDOM**

13. In the UK, the Financial Reporting Standard for Smaller Entities (FRSSE) was first issued in November 1997. The FRSSE brings together the relevant accounting requirements and disclosures from the other accounting standards and the Urgent Issues Task Force (UITF) Abstracts, simplified and modified as appropriate for smaller entities. The basic measurement requirements in the FRSSE are the same as those in other accounting standards (although with some slight simplifications), but many of the disclosure and presentation requirements of other standards have not been included in the FRSSE.

14. The FRSSE is a standard that may be applied by companies that qualify as small under the Companies Act 1985 and other entities that would have qualified as "small" had they been incorporated. According to the recently amended UK Companies Act, a company qualifies as small if it satisfies any two of the following three conditions:

- (a) annual turnover not exceeding £6.5 million;
- (b) balance sheet total not exceeding £3.26 million<sup>6</sup>; and
- (c) average number of employees not exceeding 50.

Entities adopting the FRSSE are exempt from applying all other accounting standards and UITF Abstracts. However, it remains open to them to choose not to adopt the FRSSE and to comply with the other UK accounting standards and UITF Abstracts instead or, if they are companies, international accounting standards.

15. In addition, the UK's Accounting Standards Board is considering extending the FRSSE beyond small companies to include medium-sized entities. The qualifying

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<sup>6</sup> The new criteria come into effect on 6<sup>th</sup> April 2008.

conditions for medium-sized companies and groups are based on meeting at least two of the following three criteria: turnover not exceeding £25.9 million; balance sheet total not exceeding £12.9 million; and not more than 250 employees.

## **LIST OF QUESTIONS FOR CONSULTATION**

Question 1: Do you agree that Singapore should adopt a differential reporting framework for Small and Medium-sized Enterprises (SME)? If yes, what do you see as the reason(s) justifying such a framework. Specifically, we would like to have your comments and views on whether such a differential framework should be justified on one or more of the following premises:

- a) that SME has less public accountability than that of big enterprises? If yes, please specify in what aspects the level of public accountability of SME will defer from that of big enterprises;
- b) that the general purpose financial information needs for SME being different from that of the big enterprises? If yes, please specify the main sources and areas of the differences in the informational needs of users of the general purpose financial reports of SME; and
- c) that the cost and complexity for SME to follow the full financial reporting standards outweigh the benefits? If so, please specify where and what you see as the main sources of the undue costs and complexity that exist with the existing full standards.

Question 2: Do you agree that the differential reporting framework should only be applicable to an entity that has no public accountability (i.e. does not issue shares or debts in a public market and does not hold assets in a fiduciary capacity for others) and satisfies the size criteria to be regarded as an SME?

Question 3: Do you agree that an entity should be deemed to be an SME if it satisfies any two of the following criteria?

- (a) net assets not exceeding S\$15 million;
- (b) annual turnover not exceeding S\$15 million;
- (c) average number of employees not exceeding 200.

If not, please specify the reasons. If the disagreement has to do with the thresholds set, please specify what should be the ideal threshold for each criterion. If you think there are other more appropriate criteria that should be used e.g. total assets, total expenditure, please also specify what they should be.

Question 4: Do you think that one of the qualifying criteria for an entity applying the differential reporting framework should be that all of its owners must be members of the entity's governing body or that there should be unanimous consent from all its owners to adopt the differential reporting framework?

Question 5: Do you agree that we should adopt the UK's system of allowing the exemption to continue for the first year that the company does not fulfill the size criteria? If not, please suggest an alternative framework.

Question 6: Do you agree that an entity that qualifies under the differential framework should be given a choice to either follow the SME-FRS in its entirety or the Singapore FRS?