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AN EVALUATION OF THE EFFECTIVENESS OF THE INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR SMES

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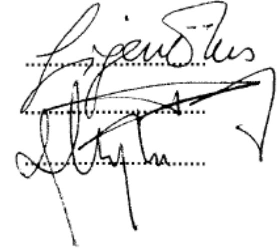

ÖNSÖZ

Küçük ve orta büyüklükteki işletmeler (KOBİ) günümüz ekonomilerinin fazla göz önünde olmayan ancak büyük önem arz eden aktörleridirler. Ekonomin diğer aktörleri gibi globalizasyon sürecinin sonuçlarından etkilenmektedirler. Ancak gerek yapısal, gerekse finansal özellikleri itibari ile KOBİ'ler bu etkilere büyük işletmelerden daha farklı şekillerde maruz kalmaktadırlar. KOBİ'lerin kendilerine has özelliklerinden dolayı alınacak tedbirlerin ve yapılacak düzenlemelerin onların ihtiyaçları çerçevesinde hazırlanması gerekmektedir.

Bu çalışmada Uluslararası Muhasebe Standartları Kurulu tarafından oluşturulmakta olan "KOBİ'ler için Uluslararası Muhasebe Standartları", bu standartların uygulamaya geçirilmesi ve KOBİ'lerin ihtiyaçlarını karşılamadaki yeterlilikleri incelenmiştir. Bu hususlar ele alınırken aynı zamanda KOBİ'lerin genel özellikleri, ülkemizde de uygulanacak olan Basel II ilkeleri, hazırlık aşamasında olan yeni Türk Ticaret Kanunu Tasarısı ve halen Türkiye'de uygulanmakta olan muhasebe ilkeleri de göz önünde bulundurulmuştur.

Bu çalışmanın hazırlanma sürecinde benden değerli katkılarını ve desteğini esirgemeyen Doç. Dr. Figen Öker hocama teşekkürlerimi sunar, çalışmanın tüm ilgililere yararlı olmasını dilerim.

İstanbul, 2007 **Hıfzullah ÖZKAYA**

ABSTRACT

The effects of the globalization are felt by almost every business entity in the world. Among those entities the Small and Medium-Sized Enterprises are the both the weakest and the most important institutions. As a result there have been considerations for the protection of these delicate entities in the eve of the newly emerging capital environments like the Basel II capital accords. The new Draft IFRS for SMEs is seen as an important commitment for the solution of the problems of the SMEs. Consequently in this work it has been tried to establish an overall opinion about the current problems of the SMEs and built an understanding of how the new IFRS for SMEs will address these problems. While building this awareness, the Turkish statutory accounting practice and ongoing efforts of the new Turkish Trade Law proposal are also considered as important parameters of this new environment for the SMEs.

I would like to express my gratitude to Associate Professor Mrs. Figen Öker for her contribution and support. I hope this work would be beneficial for all interested parties.

Hıfzullah ÖZKAYA

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ABBREVIATIONS

APEC	Asia-Pacific Economic Cooperation
BCBS	Basel Committee on Banking Supervision
BCSO	Botswana, Central Statistics Office
BIS	Bank of International Settlements
BRSA	Banking Regulation and Supervision Agency
CBRT	Central Bank of Republic of Turkey
CEO	Chief Executive Officer
CMB	Capital Markets Board of Turkey
ECIA	External Credit Assessment Institution
EDF	The Expected Default Frequency Model
ENSR	European Network for SME Research
ESRF	Economic and Social Research Foundation
EU	European Union
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GNI	Gross National Income
IADB	Inter-American Development Bank
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IBGE	Brazilian Statistical Institute
IFC	International Finance Organization
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
ILO	International Labour Organization
IRB	Internal Ratings Based Approach
ISA	International Standards on Auditing

ISAR	Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (UNCTAD)
LSE	Large-sized Enterprises
MNSO	Malawi, National Statistical Office
NAED	North Africa Enterprise Development
NTSA	National Treasury of South Africa
NZMED	New Zealand, Ministry of Economic Development
OECD	Organisation for Economic Co-operation and Development
PME	Poland, Ministry of Economy
RSMERC	Russian Federation, Russian SME Resource Center
SBA	United States Small Business Administration
SME	Small and Medium Sized Enterprises
Turkstat	Turkish Statistical Institute
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
USCB	U.S. Census Bureau

1. INTRODUCTION

In the age of the globalization "the bigger the better" has became the motto of the corporate firms. Despite the slowdown trends in the world economies, every CEO of the Fortune 500 company has somewhere in his mind an idea of merging with one of the archrivals of his company or acquisition of one of the competitors in the sector. Desire to reach every, even the shallowest, market of the world, cost reductions, tax regulations, narrow profit margins push firms to operate on very big economies of scale which eventually increases the average size of the companies that aim to operate globally. It is an anticipated result of high financial leverages and unbearable capital investments that those firms held. However among this quagmire of "the big boys", there are unnoticed, modest, hard working small firms which account nearly 40 % of the total GDP and 50 % of the total employment in the world.

These small and medium-sized enterprises (SMEs) are forced to achieve their contributions to the economies amid the fierce competition of "the big boys" in a very unstable financial environment, quaked by unexpected capital flows, crisis, and regulations in favour of the large-sized enterprises. Moreover they are now threatened with cutting of their main life source, the bank credits.

Consequently in the first section of this work general characteristics and problems of the SMEs are tried to be examined. Firstly a general framework for the SME definitions has been aimed to build and secondly an overall opinion about the SMEs' advantages and disadvantages has been attempted to establish.

Nevertheless not everything is against for the SMEs. There are also significant efforts that have been taken in order to ameliorate the environment for SMEs. Among these efforts, the considerations in Basel II accord for SMEs and the new proposal IFRS for SMEs will be examined in this work.

Accordingly in the second section the new requirements of the Basel II accord and its affects on the SMEs will tried to be explained. In order to build the overall awareness in the third section also the main component of the Basel II accords; the credit rating concept will also be examined and tried find out with possible recommendations to SMEs.

Consequently in the fourth section, considering the facts and findings of the previous sections, the effectiveness of the Draft IFRS for SMEs in solving the problems of the SMEs will also be examined.

After elaborating the new Draft IFRS for SMEs from an international perspective, also a comparison will be made through the Turkish statutory accounting practice. Furthermore it has been tried to estimate the possible effects of the new Draft to the financial statements of the Turkish SMEs. From this framework the possible effects of the prospective Turkish Trade Law was also considered

The overall awareness will also be supported by the illustrative examples with the financial statements that were prepared by both the Draft IFRS for SMEs and Turkish statutory accounting practice.

2. SMALL And MEDIUM – SIZED ENTERPRISES

2.1. DEFINITIONS OF SMALL AND MEDIUM-SIZED ENTERPRISES

One of the main obstacles of this thesis is putting the SME definition in a narrow and straight definition which could not be achieve somehow due to the social and economical facts of the real world. Geographical differences still accompany by the deep economical and social differences. There is no common definition that contains all dimensions of the SMEs, if exists it would not be expected to reflect all the characteristics of the economies, industries and societies (ILO, 1997, UNCTAD, 2000) and this makes much harder for the researchers to reach a general solution and legislators to enact a comprehensive regulation. Consequently according to many institutions there is no common definition that captures all characteristics of the SMEs

Definitions can be made with the selected criteria. Therefore choosing the relevant criteria is very critical in constructing definitions. This is one of the reasons for the redundancy of the SME definitions. There should be a commonly agreed criteria that can applicable all of the SMEs in the world. For instance when one set the assets size as the definition criterion for the SMEs, resulting definition ranges in USA, compare to in Turkey or other developing country would be profoundly different.

The variations in definitions could be stem from the mere GDP figures or other parameters like the purchasing power parity or per capita income of the countries. Moreover mostly the official SME definitions in the world are drawn with some political or even social motives, especially when the issue comes to granting economical privileges to certain interest groups.

Consequently one can ended up with so many different SME definitions depending on the overall perspective and purpose of the classification effort of the related business

entities. Nevertheless in order to build a more convenient structure the definitions of the legal text and regulations are chosen as the moving point. For example for the Basel II capital accord the SME definition will be taken as the definition stated within the accord itself which is drawn by the credit size that a SME held or the annual turnover rate rather than the number of the employees that a SME has.

Furthermore generally the implementation of the most of the international organizations' regulations like Basel II frameworks or International Standards on Auditing (ISA) is conducted by the regional legal authorities. In Turkey the supervisory agency for the Basel II is the Banking Regulation and Supervision Authority (BRSA) and its rights and obligations was determined by the law. Consequently the legal definitions of the BRSA in Turkey should be taken as the starting point when considering a regulation about the Basel II.

The same conclusion can be made for the scope of the draft IFRS for SMEs. The draft does not put a common SME definition except the establishment of the non-public accountability criteria for the SMEs. It essentially leaves the classification work to the regional authorities. Consequently one should look at the national legal definitions in Turkey in order to understand what kind of business entities could use the draft IFRS for SMEs. It is therefore this work mainly focused on the definitions that are made by the international and regional accords and regulations that are most probably effective on the SMEs' new capital environments.

2.1.1 SME Definition and Classification Criteria

In defining the SME concept, the most common parameter in the world is the number of the employees that the firms held. Then the total net assets and net annual sales come. Since the income figures of the regions and countries changes dramatically, the employee number approach makes more sense than the sales figure or assets size classifications.

Indeed most of the studies (Ayyagari, Meghana, Beck, Thorsten and Demirgüç-Kunt, Asli, 2003) or the institutional definitions held the classification by the employee number prior against the sales figures or asset size.

Since the main themes of this work are the Basel II accord and the draft IFRs for SMEs, the legal definitions in Turkey, the definitions of the International Accounting Standards Board (IASB), the European Union, Basel Committee of Banking Supervision and US are mainly used as benchmark definitions. Then we have depicted a global database about the definitions of SMEs in the world provided by International Finance Corporation (Kozak, Leventhal, 2005).

2.1.2 Definition in Turkey

There are also many SME definitions in Turkey reflecting the wide-range of SME policies in different institutions. According to the variation of the SME promotions, bank loans, these definitions change. However currently a new regulation has been enacted to achieve some solidarity in the face of the EU membership in the definition of SMEs in Turkey, regulation number 2005/9671 (Ministry of Industry and Trade, 2005) which defines the SMEs as fallows;

Table 1: The classification of the SMEs according to the regulation number 2005/9671.

Employee #	Scale	Asset Size	Yearly Revenue (In Million YTL)
0-9	Micro	$0 < X \leq 1$ m	$0 < X \leq 1$ m
10-49	Small	1 m $< X \leq 5$ m	1 m $< X \leq 5$ m
50-249	Medium	5 m $< X \leq 25$ m	5 m $< X \leq 25$ m
≥250	Big	$X > 25$ m	$X > 25$ m

Although it was pointed in the text of the regulation that the state institutions could adapt the size thresholds of the entity scales according to their policies, most of the time the legal classifications go around the limits. Nevertheless for the convenience of the paper this definition has been taken as the main SME classification in Turkey.

2.1.3 The EU Definition

EU has decided with regulation 2003/361/EC (the EU Commission, 2003) that

1. The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.
2. Within the SME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million.
3. Within the SME category, a micro enterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million.

Table 2: The SME definition in the European Union.

	Criteria		
Enterprise Category	**Employee Number**	**Net Annual Sale**	**Total Asset Size**
Medium-sized	< 250	≤ € 50 Million	≤ € 43 Million
Small	< 50	≤ € 10 Million	≤ € 10 Million
Micro	< 10	≤ € 2 Million	≤ € 2 Million

According to this definition in 2005 the biggest 500 manufacturer list of İstanbul Chamber of Industry only the first 421 would be counted as big enterprises while the rest counted as medium-sized (The average exchange rate in 2005 is 1.6695 YTL for 1 €). This factor will also be emphasized later in the section where the Basel II is examined.

2.1.4 Definition in USA

There is common clear SME definition in the USA. Instead they have used very detailed different standards for different sectors (SBA, 2006a). Furthermore both the classification factor and the size of that factor could vary significantly according to the sectors. Therefore it is very hard to generalize the business entities under a common standard. In order to provide an overall idea about the definitions a summary table is presented for the SME's size standards.

Table 3: Summary Table for SME Standards in USA.

Industry Group	**Size Standard**
Manufacturing	500 employees
Wholesale Trade	100 employees
Agriculture	750000
Retail Trade	\$6.5 million
General & Heavy Construction (except Dredging)	\$31 million
Dredging	\$18.5 million
Special Trade Contractors	\$13 million
Travel Agencies	\$3.5 million (commissions & other income)
Business and Personal Services	\$6.5 million
Except:	
Architectural, Engineering, Surveying, and Mapping Services	\$4.5 million
Dry Cleaning and Carpet Cleaning Services	\$4.5 million

2.1.5 IASB's Definition

IASB in fact does not hold a common normative definition for the "appropriate" size of SMEs. The board states that its standards are used in more than 100 countries and instead of putting a rigid definition the board holds more flexible approach leaving the definition of the SMEs to local authorities considering the GDP and GDP related

discrepancies among the countries. For instance the assets size or sales volume threshold for the micro-sized entity is in Turkey YTL 1 million whereas in the EU it is Euro 2 million.

Nevertheless the board underlines in the "Basis for Conclusion in Exposure Draft" that their main focus was on the entities with employee number around 50 which is general the most "typical" SME size. This fact is testifies by the SME size data brought by the International finance Corporation in 2005. The major concentration of the SME number is around the micro and small sized SMEs with the employee numbers equal or less than 50 regardless the income level of the countries.

Apart from the definition size of the SMEs the IASB considered to use another term other than the SME for the scope of the newly establishing standards. Since the Board has concluded that the full IFRS is suitable for the publicly accountable entities and therefore a more compact version of IFRS would be named with the IFRS for Non-Publicly Accountable Entities. But because of the common usage of the SME term in world, the board had to come back to the SME term. This indicates the level of recognition of the SMEs both as a term and as real, existing business units.

2.1.6 Definition of the CBRT

The CBRT sector balance sheet report data was used in this research. In the works CBRT uses The European Commission establishment "The Bank of Harmonized Data on company accounts'" classification (CBRT, 2005) which is the official EU classification of the enterprises in Europe (the classification that was mentioned above). According to this;

- small-sized enterprises: net sales below 10 million Euro,
- medium-sized enterprises: net sales between 10 to 50 million Euro,
- big-sized enterprises: net sales above the 50 million Euro.

The CBRT used the average exchange rate in 2005 (1 € equals to 1.6695 YTL) in classifying the firms in the data. Consequently according to this classification most of the Turkish business entities were classified as SME. Therefore it can be argued that the classification method of the CBRT is not very appropriate for the economic structure of the Turkish businesss entities.

2.1.7 The Definition of the SMEs In Basel II Accord

The new Basel accord implicitly held the EU definition for the SMEs. For an entity to be classified as a SME, it should have annual sales lower or equal to 50 million Euro (BCBS, 2005).

As it has been mentioned above according to this definition most of the Turkish business entities would be classified as SME in the Basel II accord. The effect of this classification will be examined in the Basel II section of this work.

2.1.8 SME Definitions In the World

In order to have an idea about the global SME definitions a definition summary of the SMEs around the world that was created by Marta Kozak, Shiri Leventhal, (2006) has been put on the paper.

From the table it can be seen that the employee number that the business entities held generally is used as the major classification criterion for the entities around the world rather than the asset size or turnover amounts.

Additionally it can be seen that the average employee numbers for SME classifications are roughly same as in the classifications of in Turkish and EU regulations of SMEs. Consequently although classifications according to the total asset size or annual net

sales criteria differ among the countries and organizations, the generally classification with the employee numbers are roughly same in the world.

Finally as it can bee seen from the table the average employee number of the SMEs is around 50. Consequently according to the table it can be argued that the IASB's decision (IASB, 2007) of considering a typical SME as a business entity with 50 employees while preparing the IFRS for SMEs is pretty accurate.

Table 4: SME classifications of the countries, (Kozak, Marta, Leventhal, Shiri, 2006).

Economy	Income Group	Year of SME Data	Source of SME Data	SME Definitions (number of employees, unless otherwise noted)[a]		
				Micro	Small	Medium
Albania	Lower middle	2001	UNECE	1	2-10	> 10
Algeria	Lower middle	2001	NAED			< 250
Argentina	Upper middle	1994	FUNDES	s ≤ 170,000	s ≤ 1,000,000	s ≤ 8,300,000
Armenia	Lower middle	2001	UNECE			< 100
Australia	High	2000	OECD	0-9	10-99	100-499
Austria	High	2003	EC	0-9	10-49	50-249
Azerbaijan	Lower middle	2001	UNECE		< 50	50-249
Belarus	Lower middle	2001	UNECE	0-9	10-49	50-249
Belgium	High	2003	EC	0-9	10-49	50-249
Bolivia	Lower middle	1995	FUNDES	0-10	11-19	20-49
Bosnia and Herzegovina	Lower middle	2001	UNECE	0-9	10-49	50-249
Botswana	Upper middle	2003	BCSO	0-4[f]	5-49	50-99
Brazil	Lower middle	2001	IBGE	0-9	10-49	50-249
Bulgaria	Lower middle	2001	UNECE	0-9	10-49	50-249
Canada	High	2000	OECD	0-9	10-99	100-499
Chile	Upper middle	1997	FUNDES	0-4	5-49	50-199
China	Lower middle	2000	APEC[g]			
Colombia	Lower middle	1990	FUNDES	0-9	10-49	50-199

Costa Rica	Upper middle	2000	FUNDES	0-10	11-30	31-100
Czech Republic	Upper middle	2001	UNECE	0-9	10-49	50-249
Denmark	High	2003	EC	0-9	10-49	50-249
Egypt, Arab Rep.	Lower middle	2002	NAED			< 99
El Salvador	Lower middle	1998	FUNDES	0-4	5-49	50-99
Estonia	Upper middle	2001	UNECE	0-9	10-49	50-249
Finland	High	2003	EC	0-9	10-49	50-249
France	High	2003	EC	0-9	10-49	50-249
Georgia	Lower middle	2001	UNECE	0-9	10-49	50-249
Germany	High	2003	EC	0-9	10-49	50-249
Greece	High	2003	EC	0-9	10-49	50-249
Guatemala	Lower middle	1999	FUNDES	0-10	11-25	26-60
Hong Kong, China	High	2000	APEC[g]	0-4	5-19	20-99
Hungary	Upper middle	2001	UNECE	0-9	10-49	50-249
Indonesia	Lower middle	2000	APEC[g]	1-5	5-19	20-99
Ireland	High	2003	EC	0-9	10-49	50-249
Italy	High	2003	EC	0-9	10-49	50-249
Jamaica	Lower middle	1996	IADB	1-2	3-4	5-9
Japan	High	2000	APEC[g]	0-4	5-19	20-99
Korea, Rep.	High	2000	APEC[g]	0-4	5-19	20-99
Kyrgyz Republic	Low	2001	UNECE			
Latvia	Upper middle	2001	UNECE	0-9	10-49	50-249
Lithuania	Upper middle	2001	UNECE	0-9	10-49	50-249
Macedonia, FYR	Lower middle	2000	UNECE			
Malawi	Low	2000	MNSO	0-4	5-20	21-50
Malaysia	Upper middle	2000	APEC[g]			Manuf. <100, non-manuf. < 50
Mexico	Upper middle	1998	FUNDES	0-30	31-100	101-500
Moldova	Low	2001	UNECE	0-19	20-75	
Morocco	Lower middle	2002	NAED			< 200
Netherlands	High	2003	EC	0-9	10-49	50-249
New Zealand	High	2003	NZMED	0-9	10-99	100-499
Nicaragua	Low	1996	IADB			≤ 100
Norway	High	2003	EC	0-9	10-49	50-249
Panama	Upper middle	1998	FUNDES	i ≤ 150,000	i ≤ 1,000,000	i ≤ 2,500,000
Paraguay	Lower middle	1997	IADB	1-5	6-20	21-100
Peru	Lower middle	1994	IADB	0-10	11-49	50-199

Philippines	Lower middle	2000	APEC[g]	0-4	5-19	20-99
Poland	Upper middle	2001	PME	0-9	10-49	50-249
Portugal	High	2003	EC	0-9	10-49	50-249
Romania	Lower middle	2001	UNECE	0-9	10-49	50-249
Russian Federation	Lower middle	2003	RSMERC	FE & IE[i]	< 100	< 250
Serbia and Montenegro	Lower middle	2001	UNECE	0-9	10-49	50-249
Singapore	High	2000	APEC[g]	0-4	5-19	20-99
Slovak Republic	Upper middle	2001	UNECE	0-9[j]	10-49	50-249
Slovenia	High	2001	UNECE	0-9	10-49	50-249
South Africa	Lower middle	1997	NTSA	0-9[j]	10-49	50-100[j]
Spain	High	2003	EC	0-9	10-49	50-249
Sweden	High	2003	EC	0-9	10-49	50-249
Switzerland	High	2003	EC	0-9	10-49	50-249
Tanzania	Low	1996	ESRF	1-5	6-20	
Thailand	Lower middle	2000	APEC[g]	0-4	5-19	20-99
Ukraine	Lower middle	2001	UNECE		< 50	
United Kingdom	High	2003	EC	0-9	10-49	50-249
United States	High	2002	USCB	0-9	10-99	100-499
Uzbekistan[k]	Low	2003	IFC	0-10	11-40	41-100
Venezuela, RB	Upper middle	2000	FUNDES	0-10	11-50	51-100
Vietnam	Low	2000	APEC[g]		< 30	<200

a. s. = annual sales (in U.S. dollars); **i** = annual gross income (in U.S. dollars).

d. Data are from "Small and Medium Enterprises Across the Globe: A New Database," by Meghana Ayagari, Thorsten Beck, and Asli Demirguc-Kunt. They are an average for the 1990s and based on the official country definition of SMEs.

f. Includes working proprietors and unknown.

g. Data are APEC's best guess for 2000 or the latest available data (1998-2000).

i. FE = farm enterprises; IE = individual enterprises.

j. Except in the mining, electricity, manufacturing, and construction sectors.

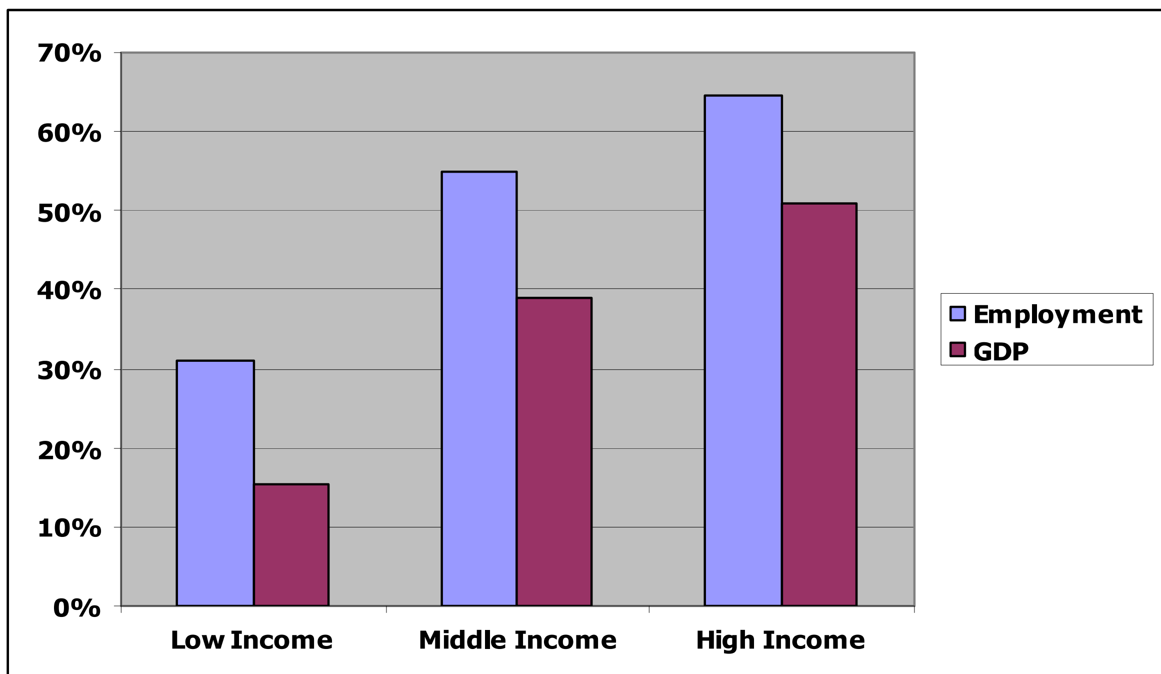
k. The SME definitions apply only to manufacturing.

2.2 ROLES OF SMES IN TODAY'S WORLD

SMEs are both the invisible and the indispensable part of the world economies. They are invisible because an average citizen in the world cannot name properly 5 SME if he or she is not an accountant or worker of a SME, because in general they are not known by their original names or brands. In daily news only the names of big companies and banks are stated and in the media it can be hardly seen a SME advertisement.

However they hold nearly 40 % of the total GDP in middle income countries and this figure goes up to 50 % in developed countries (Ayyagari, Meghana, Beck, Thorsten and Demirgüç-Kunt, Asli, 2003). There are more dramatic figures when the employment levels of the SMEs are considered in world economies. In high and middle income countries SME employment holds more than half of the total employment numbers, reaching nearly 65 % of the total employment in high income countries.

Graph-1: SME sectors contribution to employment and GDP (median values), Ayygari, Beck, Demirgüç-Kunt (2003).



Also on the contrary of the common belief that the SMEs are the characteristics of the developing countries, SMEs contribute bigger portions in the economies of the high income countries which is also acknowledged by the data prepared by Marta Kozak and Shiri Leventhal, (2006). Consequently it can be easily appreciated that there is much way to improve the figures of the SMEs in developing countries, like Turkey in order to reach efficiency of the SMEs in the high income countries.

Therefore neither regional jurisdictions nor supranational authorities can neglect SMEs as an actor from social and economic policies especially in developing countries if these policies were to entail comprehensive solutions or regulations for the economies as a whole.

2.2.1 The Characteristics of the SMEs in the World

Table 5: SME structures and participation in the economies. (Kozak, Marta, Leventhal, Shiri, 2006).

Economy	**Income Group**	**Structure of the SME Sector (% of all SMEs)**			**SME Participation in the Economy**		
		Micro	Small	Medium	SMEs	SMEs per 1,000 people	SME employm. as % of total
Albania	Lower middle	94.3	3.8	1.9	54,142	17.3	75.0
Algeria	Lower middle				580,000	18.8	
Argentina	Upper middle	91.4	7.8	0.8	891,300	26.4	70.2[d]
Armenia	Lower middle				34,000	11.0	25.8
Australia	High	73.0	24.8	2.2	1,075,000	54.0	50.0
Austria	High	86.9	11.2	1.9	267,000	33.1	66.1
Azerbaijan	Lower middle	80.1		19.9	58,623	7.2	2.7[e]
Belarus	Lower middle	68.6	29.0	2.3	25,404	2.5	
Belgium	High	93.4	5.7	0.9	437,000	42.2	69.3
Bolivia	Lower middle	99.7	0.2	0.1	501,333	67.0	
Bosnia and	Lower middle	85.3	11.3	3.4	30,000	7.4	53.0

Herzegovina							
Botswana	Upper middle	57.4	40.1	2.5	16,466	9.7	
Brazil	Lower middle	92.9	6.2	0.9	4,667,609	27.1	56.5
Bulgaria	Lower middle	92.6	5.8	1.6	224,211	28.3	64.7
Canada	High	75.2	23.1	1.7	1,994,000	63.0	60.0
Chile	Upper middle	82.8	15.1	2.1	522,106	35.7	86.5
China	Lower middle				8,000,000	6.3	78.0
Colombia	Lower middle	96.1	3.9		684,646	19.6	67.2[d]
Costa Rica	Upper middle	79.7	20.3		73,518	19.3	54.3
Czech Republic	Upper middle	97.4	2.1	0.5	1,985,004	194.2	64.3
Denmark	High	87.8	10.2	2.0	205,000	38.1	78.4[d]
Egypt, Arab Rep.	Lower middle				2,500,000	42.2	
El Salvador	Lower middle	97.3	2.6	0.1	476,900	79.3	52.0[d]
Estonia	Upper middle	77.8	18.7	3.5	32,801	24.0	65.3
Finland	High	93.7	5.4	0.9	221,000	42.4	59.2
France	High	93.2	5.8	1.0	2,495,000	41.8	62.7[d]
Georgia	Lower middle	48.7	38.2	13.1	7,257	1.4	7.3
Germany	High	88.3	10.2	1.5	3,008,000	36.4	70.4[d]
Greece	High	97.5	2.1	0.3	771,000	72.2	74.0[d]
Guatemala	Lower middle	77.7	16.7	5.6	173,699	15.7	32.3
Hong Kong, China	High	87.4	7.7	4.9	292,000	43.8	61.0
Hungary	Upper middle	85.1	12.2	2.7	153,107	15.0	45.9
Indonesia	Lower middle				16,000,000	77.6	88.0
Ireland	High	85.6	12.4	2.0	97,000	24.6	72.1[d]
Italy	High	95.6	4.0	0.4	4,486,000	77.8	73.0[d]
Jamaica	Lower middle				93,110	37.2	100.0
Japan	High	57.2	35.2	7.5	6,139,735	48.4	78.0
Korea, Rep.	High	73.4	18.0	8.6	2,700,000	57.4	73.0
Kyrgyz Republic	Low				22,670[h]	4.6	63.2
Latvia	Upper middle	73.0	22.3	4.7	32,571	13.8	20.6
Lithuania	Upper middle	80.3	16.0	3.7	56,214	16.1	31.6
Macedonia, FYR	Lower middle				128,802[h]	63.6	64.3
Malawi	Low	91.3	8.5	0.2	747,396	72.5	38.0
Malaysia	Upper middle				19,000	0.8	12.0
Mexico	Upper middle	96.0	3.1	0.9	2,786,011	29.3	48.5
Moldova	Low	80.3	19.7		20,518	4.8	

Morocco	Lower middle				450,000	15.2	
Netherlands	High	90.7	7.5	1.6	570,000	35.2	58.5[d]
New Zealand	High	92.6	7.0	0.4	294,714	73.5	75.9
Nicaragua	Low				25,301	5.6	78.6
Norway	High	91.6	7.1	1.3	238,000	52.2	61.5
Panama	Upper middle	83.5	13.7	2.8	40,985	14.8	72.0[d]
Paraguay	Lower middle	77.5	16.6	5.9	8,858	1.8	77.0
Peru	Lower middle	95.8	3.3	0.9	235,995	10.1	67.9[d]
Philippines	Lower middle	91.4	8.2	0.4	817,976	10.7	66.0
Poland	Upper middle	99.2		0.8	1,654,822	42.8	61.8
Portugal	High	93.5	5.6	0.9	693,000	68.0	81.6[d]
Romania	Lower middle	91.5	6.9	1.5	402,359	18.0	40.2
Russian Federation	Lower middle	60.0	10.6	29.5	8,441,000	58.9	49.0
Serbia and Montenegro	Lower middle	87.0	9.4	3.6	63,732	6.0	
Singapore	High	68.9	24.9	6.2	54,000	13.4	52.0
Slovak Republic	Upper middle	81.7	13.8	4.5	61,689	11.5	32.1
Slovenia	High	82.7	13.1	4.2	48,541	24.6	20.3
South Africa	Lower middle	92.0	7.0	1.0	900,683	22.0	39.0
Spain	High	93.5	5.8	0.7	2,674,000	65.1	76.0
Sweden	High	93.6	5.6	0.8	485,000	54.2	56.5[d]
Switzerland	High	89.2	9.3	1.7	343,000	46.7	75.3
Tanzania	Low				1,000,000	32.8	25.0
Thailand	Lower middle	79.4	18.5	2.0	350,000	5.8	18.0
Ukraine	Lower middle				233,607	4.8	5.4
United Kingdom	High	89.7	9.0	1.4	2,226,000	37.6	56.4[d]
United States	High	79.3	19.9	0.8	5,644,063	19.6	50.2
Uzbekistan[k]	Low				229,600	9.0	57.0
Venezuela, RB	Upper middle		76.9	23.1	11,314	0.5	
Vietnam	Low				200,000	2.5	85.0

Notes

b. Leasing is a form of financing in which one party provides another an asset for use for a specified period for specified payments (for a more detailed explanation of the indicator, see the companion note).
c. Index based on a set of key investment climate indicators (for a more detailed explanation of the indicator, see the companion note). The higher the index, the better the investment climate.

d. Data are from "Small and Medium Enterprises Across the Globe: A New Database," by Meghana Ayagari, Thorsten Beck, and Asli Demirguc-Kunt. They are an average for the 1990s and based on the official country definition of SMEs.
e. Data are for small enterprises only.
g. Data are APEC's best guess for 2000 or the latest available data (1998-2000).
h. All enterprises in the economy.
i. FE = farm enterprises; IE = individual enterprises.

From the table some major ideas can be extracted about the role and structure of the SMEs. Firstly the most of the SMEs are composed of the micro-sized enterprises which generally have less than 10 employees. This fact is also applicable to Turkey where the major portion of the SMEs consists of the micro-sized entities (Turkstat, 2003).

Table 6: The basic facts about SMEs and large enterprises, in Europe-19, 2000, Observatory of European SMEs 2002.

	Unit	SME	LARGE	TOTAL
Number of enterprises	(1 000)	20,415	40	20,455
Employment	(1 000)	80,790	40,960	121,750
Occupied people per enterprise		4	1020	6
Turnover per enterprise	Million €	0.6	255	1.1
Share of exports in turnover	%	13	21	17
Value added per occupied person	€ 1 000	65	115	80
Share of labour costs in value added	%	63	49	56

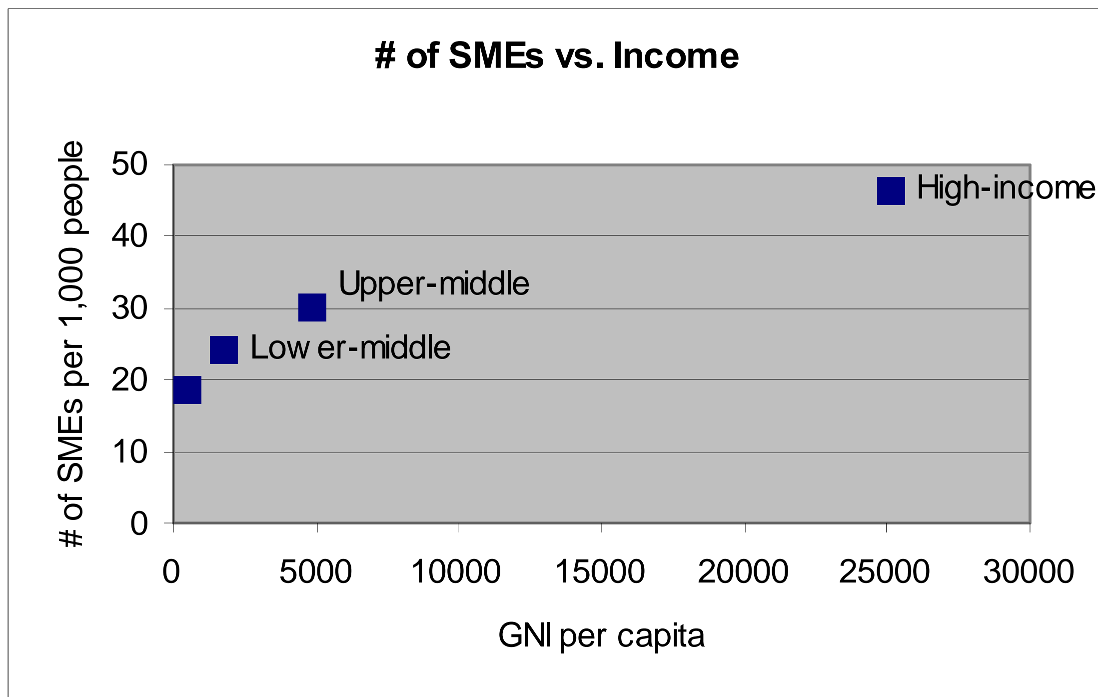
The same result was obtained from the ENSR enterprise survey (2002). According to this survey the average employment number per SME in EU is 4. This number only increases to 6 if it is considered in the all of the enterprises. Furthermore the 93 % of all European enterprises have less than 10 employees.

Therefore when considering the SME concept one cannot ignore the micro-sized entities by just looking the small and medium ones. This factor also will be discussed in the IFRS for SMEs section of this work.

Secondly from the tables it has been founded that high income countries tend to have higher number of SMEs which is also shown as in the graphic below. Consequently the sheer number of the SMEs per person could indicate the income level of the countries.

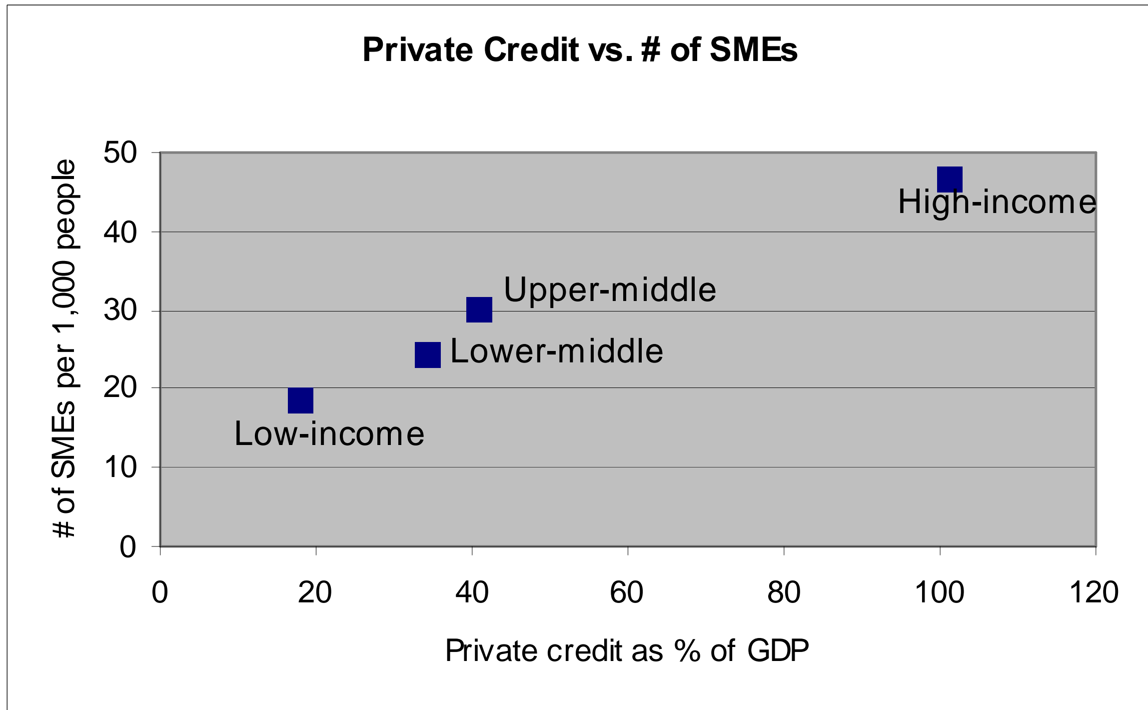
This fact is against the common idea that the SMEs in general tend to operate mostly in low income countries. Therefore it can be argued that a strong SME structure is very much correlated to the general performance of the economy. From this perspective one can understand the role of the SMEs in the general economic systems and the SME concept is not related to the low-income countries.

Graph 2: Number of the SMEs Related with Income, (Kozak, Marta, Leventhal, Shiri, 2006).

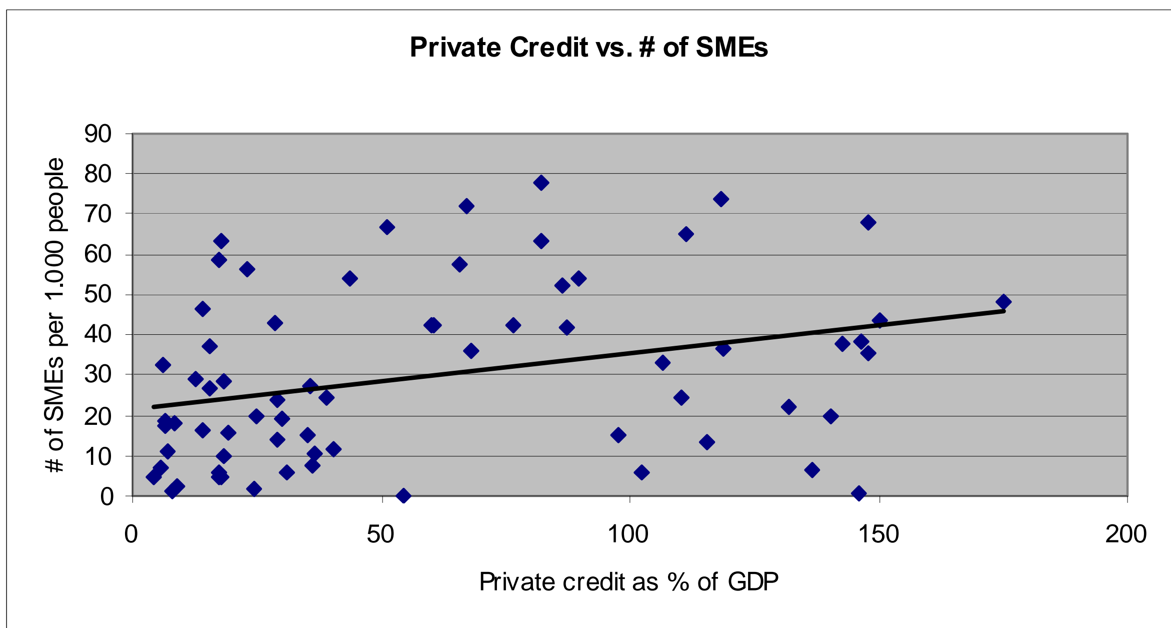


In the two graphs below it can be seen the relationship between the credit structure of a country and SME number. There is a strong relationship between the private credit amounts and the SME numbers. As the share of the private credit increases also the number of the SMEs increases. According to this fact major portion of the SME finance derives from the small, private credits which are the bottleneck in the finance of the SMEs. Private credits are in the aspect of their structure, costs, and maturities not appropriate for SME financing. This is one of the major challenges of our work, increasing and improving the access of the SMEs to capital.

Graph 3: Private credit and SMEs number comparison, (Kozak, Marta, Leventhal, Shiri, 2006).



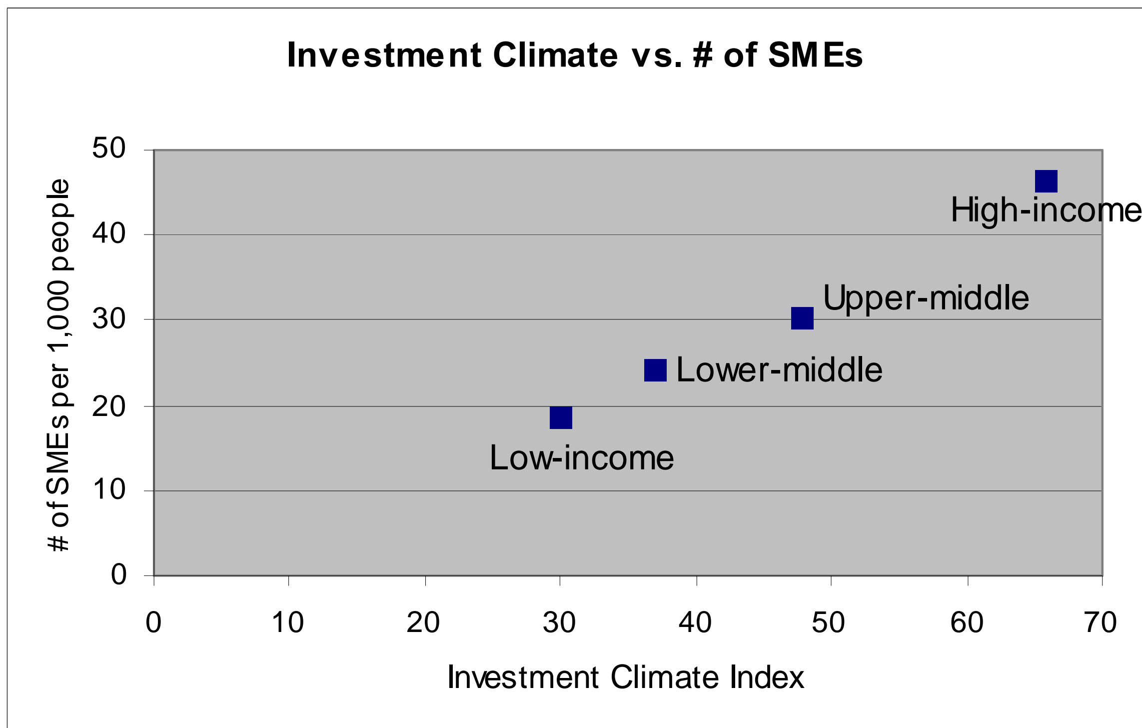
Graph 4: Relation between the private credit and number of SMEs, (Kozak, Marta, Leventhal, Shiri, 2006).



Also the investment climate is important factor for the SMEs. The investment climate refers to country specific risks, transaction costs of investment and operating in the private sector (IFC, 2005). The barriers for entering and exiting from the market, legal regulatory practices, labor market, cost of capital, infrastructure and cost of other inputs for the establishment of a business and reasonable production levels are the major components of the investment climate (IFC, 2005).

More suitable investment climates eventually lead more private investment thus increasing the total economic value and welfare. Therefore higher investment climate figures provide more access to the SMEs and the number of the SMEs increase as it can be easily seen from the graph below.

Graph 5: Investment climate index and the number of SMEs, (Kozak, Marta, Leventhal, Shiri, 2006).



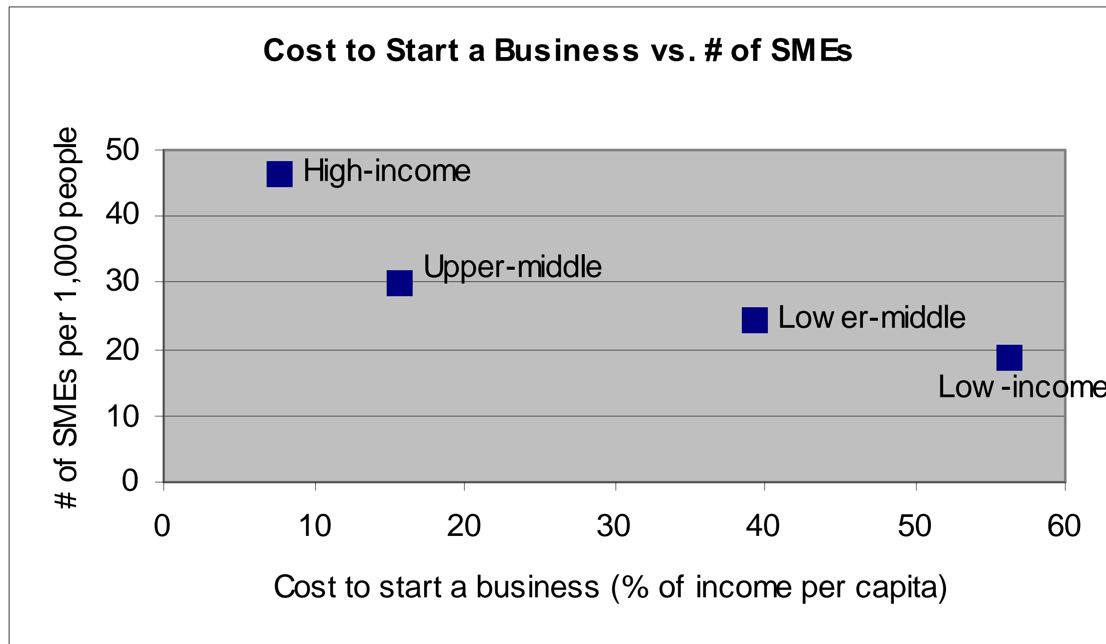
2.2.2 The advantages of SMEs

SMEs in general have major advantageous over the big companies. The idea of the "significance of being insignificant" works very well with the SMEs. They are, first of all, the most flexible business entities in the economies. Due to their sizes, volume of production, and very low operating leverages they can adapt changes in technologies, new production methods, or cost increases very rapidly. They can easily adapt themselves to the changes in the market, shifts in demand and supply levels.

They have low level of investments per employee and therefore the employment in SMEs is less costly compare to LSEs (Large Scale Enterprises) (OECD, 2004). Consequently creating employment with SMEs is easier than creating employment with LSEs which requires high levels of investment to become operable.

Establishing a SME is much easier than establishing a LSE. SME requires much less capital, labor and time. This factor encourages the private entrepreneurship especially in the low-income countries like Turkey where the concentration of capital is not very favorable for the private investors. Form this aspect SMEs are open to new ideas, innovations more than the LSEs. Therefore SMEs are the major power behind the private entrepreneurship in a country and this is a very important factor for economic growth of a country.

Graph 6: Cost to start a business and the number of SMEs, (Kozak, Marta, Leventhal, Shiri, 2006).



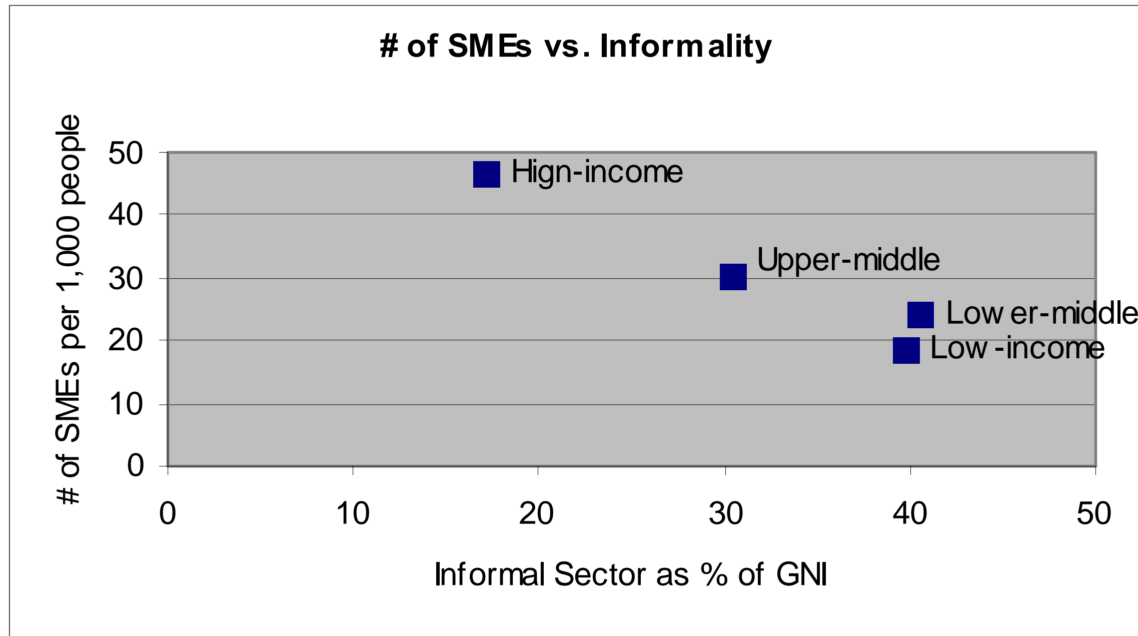
However as it can be understood from the graph above in the developed countries the cost of starting a business relative to the GDP per capita is lower than the low-income countries. This factor should be considered when promoting the SMEs in the economies.

Due to their flexible structures and low level of operating costs SMEs do not have less regional disadvantages than the LSEs in terms of logistics. This factor allows SMEs to operate remote regions and create employment opportunities in those areas. Furthermore this factor eases the social and economic gaps between the developed and less-developed regions of a country.

SMEs also are cures for the informal sectors in the economies. Although the sheer SME numbers are not directly related to the informal sector more than the level of income, the high income countries with higher numbers of SMEs per person tend to have lesser informal economies as percentage of their income. Therefore strong SME structures also provide transparency and accountability to the economies. Eventually this will led to more

proper functioning market economies that have lower market inefficiencies and closer to the pareto-optimum levels in the aspect of the social welfare.

Graph 7: Informal sector as percentage of GNI and the number of SMEs, (Kozak, Marta, Leventhal, Shiri, 2006).



SMEs are also auxiliary production units for the big industries in the economies. For example in the production of the spare parts for the big automotive industry is can be conducted by SMEs. This kind of mutual relationships exists in other sectors and is beneficial both for the economic growth and employment levels.

2.2.3 Disadvantages and Problems of SMEs

According to the research of the SME observatory in the EU (2001) the major four obstacle of the SMEs in Europe were stated as;

- the lack of skilled labor; 20 %
- access to finance; 13 %

- administrative regulations; 12 %
- infrastructure, use of technology 6 %

Another survey conducted by the Grand Thornton in 2002 generally points the same figures with the SME Observatory Data (EU, 2002) for the EU countries. Again here the lack of skilled labor comes forward as the main obstacles for the SMEs against the main short-term expansion plans. The other obstacles are the lack of demand in the economy, the cost of finance and working capital which can be referred as the access to capital, and the lack of infrastructure and professional management teams.

On the other hand according to this research when it is looked at from the figures of Turkey, it can be seen that the major problems for the Turkish SMEs are the cost of finance which goes along with the lack of demand for products. It can be argued that in 2002 SMEs was severely affected by the economic crises which hit both the interest rates and so the cost of debt and the domestic demand which is vital for most of the SMEs. However these problems have been always stands as the major obstacles for the SMEs in Turkey. These factors will be discussed in the next sections.

Table 7: The main constraints on the short-term expansion plans of the SMEs (%), Grand Thornton, (2002).

	Lack of Infrastructure	**Lack of Professsional Management**	**Cost of Finance**	**Lack of Demand to the Products**	**Shortage of Skilled Labour**	**Lack of Working Capital**
Austria	5%	11%	37%	26%	42%	7%
Belgium	7%	15%	17%	22%	38%	19%
Finland	15%	11%	14%	37%	27%	22%
France	11%	12%	13%	21%	44%	19%
Germany	5%	10%	34%	40%	36%	8%
Greece	18%	5%	29%	24%	22%	20%
Ireland	10%	24%	14%	28%	45%	22%
Italy	10%	8%	20%	29%	46%	15%
Luxembourg	4%	12%	21%	12%	63%	19%
Netherlands	9%	16%	18%	16%	38%	14%
Portugal	8%	4%	30%	23%	37%	27%
Spain	15%	7%	24%	23%	43%	16%
EU (euro) average	**9%**	**10%**	**25%**	**30%**	**39%**	**14%**

Denmark	12%	11%	23%	27%	25%	14%
Sweden	17%	12%	11%	40%	35%	12%
United Kingdom	6%	16%	16%	32%	25%	19%
EU (non-euro) average	8%	15%	16%	32%	26%	17%
EU average	9%	11%	24%	30%	37%	15%
Norway	15%	12%	14%	27%	32%	13%
Poland	0%	8%	46%	33%	10%	48%
Switzerland	6%	9%	19%	35%	38%	9%
Turkey	**15%**	**10%**	**51%**	**49%**	**17%**	**26%**
Survey average	**9%**	**11%**	**24%**	**31%**	**36%**	**15%**

2.2.3.1 Lack of Skilled Labor

As it can be seen from the data, the lack of the skilled labor is the major problem for SMEs. In general due to low levels of economic compensations, working conditions, regional problems, and brand prestige, the attractiveness of the SMEs is not very high in the employment markets. Therefore SMEs cannot be supplied enough skilled labor and compete with the LSEs.

Consequently due to the lack of skilled labor the financial reporting departments of the SMEs cannot deal with the complexity of the IFRS and this is a major factor for the emergence of the new IFRS for SMEs which was aimed to be a less costly solution for SMEs in financial reporting.

2.2.3.2 Access to Finance

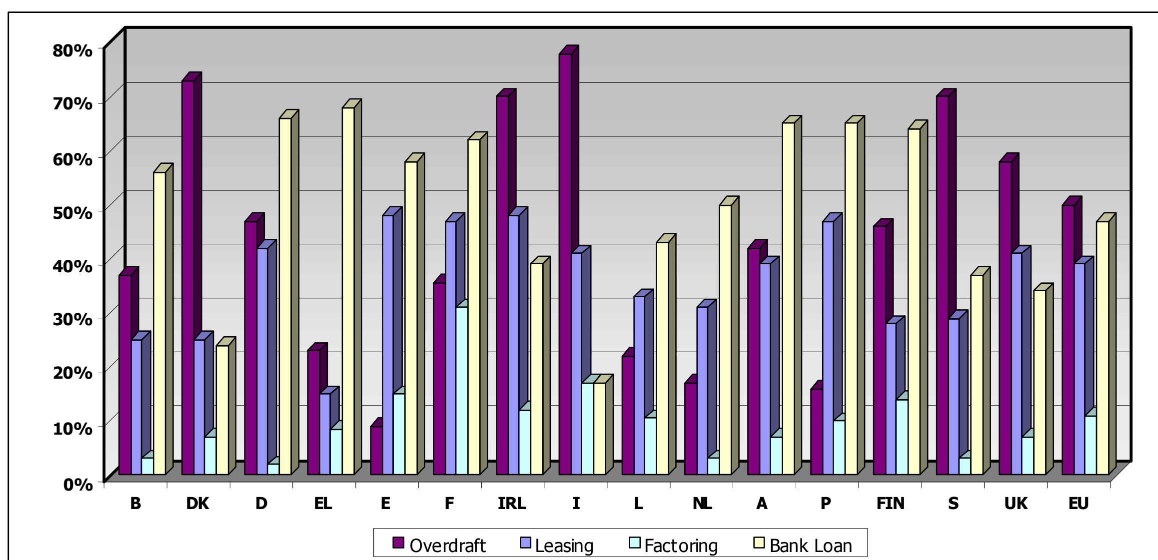
The two main financing items in the balance sheet are the financing from outside sources which are the liabilities and inside financing which is the equity of the firms. In the equity side the SMEs do not have many choices. The SMEs cannot offer their shares to the public firstly because they are not able to meet the requirements of the capital markets;

- the financial requirements; such as the total asset size thresholds,
- the financial reporting requirements, such as quarterly presentation of the audited financial statements to the public,

- the legal structures of the SMEs do not allow, most of the SMEs do not have separate legal entity,
- and the lack of corporate governance; the owners of the SMEs simply do not want to sell shares of their companies.

Consequently the remaining financing item is outside financing. In generally SMEs cannot afford to issue corporate bonds and bills due to their low levels of credit scores and high costs of issuances. Therefore it is widely acknowledged that the main sources of the SMEs in the world still are the bank capital (The EU Commission, 2003, Yüksel 2006,, Jacobson, Lindé, Roszbach 2005)

Graph 8: The debt structure of the SMEs in EU-15 Countries (%),Grand Thornton, The European Business Survey (2001).



This fact is acknowledged by a business survey conducted by the Grant Thornton (2001) among the EU-15 countries. As it can be seen from the graph the major item in the medium-sized enterprise finance is bank instruments; the overdraft accounts and bank loans. Also the leasing is another source of finance.

Table-8: Capital and reserves (equity), by sector, enterprise size, and country, in 2000, percentage of total capital, Grand Thornton, (2002).

	Manufacturing		Retail Trade		Transportation, Communication	
	Small	**Medium**	**Small**	**Medium**	**Small**	**Medium**
Austria	19.69*	33.08	5.34*	31.48	8.14*	41.95
Belgium	38.4	36.41	29.33	27.13	32.8	34.62
Denmark	29.61	35.93	26.21	34.15	26.8	24.45
France	36.9	36.88	35.81	31.05	28.99	27.04
Finland	38.75	43.61	31.64	39.59	31.47	40.19
Germany*	20.57	27.95	11	13.13	n.a.	n.a.
Italy	27.92	26.83	24.95	20.77	39.68	26.93
Netherlands	34.45	34.94	35.95	30.11	30.44	26.67
Portugal	34.28	38.45	31.99	30.91	20.98	27.94
Spain	42.68	45.26	40.34	43.21	44.66	68.04
Sweden	32.33	31.35	28.35	23.79	21.98	14.21

* Data refers to 1999.

n. a. = no data available.

Manufacturing refers to the following sectors of NACE Rev. 1: 13-22 and 24-36.

Retail Trade refers to the following sectors of NACE Rev. 1: 52.1-52.6 and 50.5.

Transportation and Communication refers to the following sectors of NACE Rev. 1: 60-64.

Small enterprises are those with an annual turnover of less than € 7 million.

Medium-sized enterprises are those with an annual turnover between € 7 million and € 40 million.

Another picture which is emphasized in the SME observatory paper (EU, 2002) is the position of the small-sized enterprises. They have low levels of equity compare to the medium-sized firms which makes the bank financing vital for the small-sized firms. In general the initial investments of the small-enterprises are not adequate and the bank financing becomes a must for them.

2.2.3.3 Administrative Regulations

Most of the time, SMEs have problems with the complexity of the official or unofficial regulations. Firstly because they do not have necessary skills to deal with complex regulations and secondly they do not have enough sources to use or invest in order to comply with those regulations.

It can be argued that the Basel II regulations will push the SMEs in a hard position for their financing behaviors. However also it can be said that because of their flexible

structures and adaptation capablities in the long run the SMEs will solve their problems and comply with the regulations.

2.2.3.4 Lack of Infrastructure

Application of the technology needs both capital investment and skilled labor. Furthermore, generally investments in technology return to the firms in the long run, creating high operating leverages that increase SMEs' operation risks. Therefore the lack of infrastructure becomes another problem for the SMEs.

2.2. SMEs in Turkey

In Turkish economy SMEs have a major place. Although they have similarities with the SMEs in Europe like in terms of the employment structure, focused industries or dependency of bank financing, they are different in the aspects of total assets size and average employment numbers.

Table 9: Structure of the Turkish SMEs, Turkstat Gsis 2002.

Size category by number of workers			
Employee Number	**Classification**	**Number**	**Percentage**
1 to 9	Micro	1,657,271	96.32%
10 to 49	Small	53,246	3.09%
50 to 249	Medium	8,271	0.48%
250 and over	Large	1,810	0.11%
Total		**1,720,598**	**100.00%**

According to the last general counting of industrial and working places conducted by Turkstat in 2003, 99.89 % of the total number of the business entities falls into the classification of the SME in Turkey. In other words they hold less than 250 employees. In 2001, 64 % of the total employment was provided by the SMEs (Turkstat, 2003). Even just

these indicators alone can show the importance of the SMEs in the economy in terms of entrepreneurship and employment

According to the same figures 96.32 % of the total number of enterprises are micro-sized enterprises, employee levels less than 10 persons which is again roughly same levels as in the European enterprises; 93 % (Turkstat, 2003). The major portion of the employment is realized by the trade sector which also the most important sector in Turkey. Indeed the most of the SMEs are working in this sector. After the trade the manufacturing sector comes as second in creating employment.

Table 10: Structure of the Turkish SMEs, Turkstat Gsis 2002.

Sectors	Entity #	%	Employee #	%
Trade	794,715	46.19%	2,048,264	32.38%
Manufacturing	246,899	14.35%	2,043,815	32.31%
Transportation, communication	244,490	14.21%	500,104	7.91%
Hotels, restaurants	163,112	9.48%	526,845	8.33%
Other service activities	90,919	5.28%	213,400	3.37%
Leasing	90,473	5.26%	325,697	5.15%
Construction	35,702	2.07%	229,400	3.63%
Health	31,546	1.83%	99,966	1.58%
Financial services	13,538	0.79%	123,178	1.95%
Education	5,692	0.33%	76,435	1.21%
Mining	1,809	0.11%	80,341	1.27%
Utilities	1,703	0.10%	57,591	0.91%
Total	**1,720,598**	**100.00%**	**6,325,036**	**100.00%**

The average employment number per enterprise (all the enterprises are included) is 3.68 which is lesser than the European average employment level; 6. This shows us that in fact the average firm size in terms of employment level in Europe is bigger than in Turkey. However there are also significant differences among the EU countries in average employee numbers; Greece 2, Italy 3 whereas 10 in Ireland, Luxembourg and Netherland

(European Commission, 2003, Table 6). It can be argued that this figures are affected by the macro economic structure and characteristics of the countries.

The most labor intensive sectors according to Turkstat data (2003) are the mining, utility, and education sectors. The powerhouses of the Turkish economy, manufacturing, construction, trade and tourism sectors have less average employment numbers.

Table 11: Average Employment of the Turkish business entities according to the sectors, Turkstat Gsis 2002.

Sectors	**Average Employee Number Per Entity**
Mining	44.41
Manufacturing	8.28
Utilities	33.82
Construction	6.43
Trade	2.58
Transportation, Communication	2.05
Financial Sectors	9.10
Leasing	3.60
Education	13.43
Health	3.17
Social works	2.35
Tourism	3.23
Total	**3.68**

Table 12: Characteristics of the Manufacturing Sector in Turkey, OECD (2004c).

Manufacturing Sector	Value Added			
Size category	**In USD Millions**			
by number of workers	**1992**	**%**	**2001**	**%**
1 to 9	2,874	7.37%	1,632	5.68%
10 to 49	2,506	6.42%	1,947	6.77%
50 to 249	6,678	17.12%	6,187	21.52%
250 and over	26,952	69.09%	18,988	66.04%
Total	**39,011**	**100.00%**	**28,754**	**100.00%**

According to the OECD report in 2004 for the SMEs in Turkey, in the manufacturing sector, SMEs create the 64 % of the total employment. However they are not as efficient as the LSEs, contributing 34 % of the total value added (OECD, 2004c). In here it can be also argued that the micro-sized enterprises held a major portion in the employment, creating 31 % of the total employment in the manufacturing sector.

2.2.1. The Financial Conditions of the SMEs in Turkey

The crisis and instability of the Turkish economy put the SMEs in a harder place than the SMEs in the world. Most of the time predictions about the economic parameters happen to be wrong. The inflation rates with the high reel interest rates also increase the financial burden on the SMEs. Due to the low levels of capital concentration, the cost of financing for SMEs also increases.

In addition to these problems, the appreciated New Turkish Lira decreases the competitiveness of the SMEs in the external markets. Furthermore exporter SMEs fights with the free trade regimes of the Customs Union of the EU and the World Trade Organization (WTO).

As the major customers of banks, SMEs are also very much affected from the fluctuations in the banking system. Due to their low liquidity levels they are the first ones that go bankrupted in the times of financial distresses.

Table 13: Major ratios of the selected Turkish business entities, CBRT (2006).

Indicator	Small	Medium	Big
Equity / Total Liability	51.3%	51.5%	53.4%
Bank Credits / Total Liability	18.9%	20.0%	17.1%
Trade Payables / Total Liability	13.4%	15.1%	15.1%
Current Ratio	128.9%	141.9%	162.3%
Receivables Turnover in days	76	67	52
Net Profit / Net Sales	-1.3%	2.8%	5.6%
Net Profit / Total Assets	-0.5%	2.4%	6.3%

The figures above were taken from the CBRT's research of "Sector Balance Sheets" (CBRT, 2006). The classification that the CBRT has used was;

- small-sized enterprises: net sales below 10 million Euro,
- medium-sized enterprises: net sales between 10 to 50 million Euro,
- big-sized enterprises: net sales above the 50 million Euro.

Therefore the firm sizes could be different from the classifications that are made by the employee numbers. Nevertheless the figures prove that there is not much difference in the internal financing ratios and bank credit ratios of the companies. This is mainly due to the financial conditions of the country. However, small firms have lower liquidity and profitability ratios, and longer turnover days for their receivables. In addition to this the collateral quality of the SMEs often is not enough to obtain cheaper capital (Yüksel, 2005). Combination of these factors decreases the ability of the SMEs to access to capital. As a result of these factors the SMEs become very fragile to the economic recessions, entering into the liquidity crisis immediately in case of an economic crisis.

Considering this fragile financial structure of the SMEs the importance of the new Basel II capital requirements can be understood easily. This issue will be examined in detail in the prospective sections.

Considering all these factors stated previously,, it has been seen that the SMEs are hold major roles both in the world and in Turkish economies. Their flexibility brings dynamism to the economies creating employment and increasing the total output levels. However they have problems in finding skilled labor, accessing finance, complying with regulations and building strong infrastructures. With the introduction of the Basel II environment SMEs would go through hard times, seeing an increase in their problems. It is clear that they should take necessary precautions against these problems. One of the most effective precautions would be the use of new IFRS for SMEs.

3. BASEL CAPITAL ACCORDS

3.1. History

The very foundational principle of the banking system is the trust of the depositors to the banks that they can have their money back in case they wanted it so. Without this kind of trust, borrowing and lending functions of the banks would not work. They would just operate, as safe boxes for the capital owners. Therefore in order to preserve this trust banks need solid operating regulations, most importantly, the capital requirements.

The Bank of International Settlements (BIS) was founded in 1930 in order regulate the international monetary transactions between banks. Later with the globalization of the markets and increasing international transactions, a need for a regulatory agency had been arisen.

Consequently in order to build such kind of regulation and the trust an international organization was founded in 1974 as the Basel Committee on Banking Supervision (BCBS). Although the organization does not have any kind of obligatory power or authority on the sovereign states (BIS, 2007), it is the sole organization in the world that works for development of international standards for banking and publicizing of those standards. From this committee the most important regulations in the banking industry has been arisen; the Basel capital accords.

3.1 Basel I

Basel I was proposed in 1988 requiring the minimum capital requirements of the banks as 8 % of the risk that they are exposed. With the proposed risk weights (table 14) that are regulated according to "the club rule" that entails the membership of the OECD, the capital requirements of the banks were determined.

Table 14: Risk Weights of the 1988 Basel Accord.

OECD sovereigns	0 %
Non-OECD sovereigns: local funded, local currency	0 %
Multinational development banks	20 %
OECD-based banks	20 %
Non-OECD sovereigns	20 %
Non-OECD-based banks	
Maturity < 364 days	20 %
Maturity > 364 days	100 %
Residual mortgages	50 %
Private sector obligations	100 %

After its establishment the Basel I requirements were gradually started to implemented all over the world. However the Basel I accord has its shortcomings. Firstly the only considered risk in the Basel I is the credit risks. There are however operational risk and market sourced risks within the system. Secondly the risk classification of the Basel I is not complex enough to deal with the modern tools of finance. The classification of the credit risk was done according to being a member of OECD and this decreases the risk sensitiveness of the system (Yüksel, 2004). This means assuming the country risks of Turkey and Germany as same. Therefore the banks could easily choose risky operations that do not increase their capital requirements and thus there would be mispriced risk in the system. This factor decreases the confidence of the system. Another short-coming of the accord is it has the same treatment for all types of the banks which have different weights on different operations and different structures of risk (Yüksel, 2004).

Nevertheless Basel I was decided to put on operation after 3 year transitional period in 1989 and it was also adapted in Turkey in 1989 (BRSA, 1989) and was on operation until 2007.

In 1996 due the criticisms about the risk structure of the Basel I, the market risk had been added to the determination of the capital requirements (BIS, 1996). This regulation had been also acknowledged in Turkey by the BRSA (2001).

However, in spite of the revisions made, the criticisms about the capital requirements prevailed. Due to the one-size fits all characteristic of the Basel I, strong incentives about the capital arbitrages were produced (Rowe, Jovic, Beutler, 2002, Wall, Peterson, 1996)

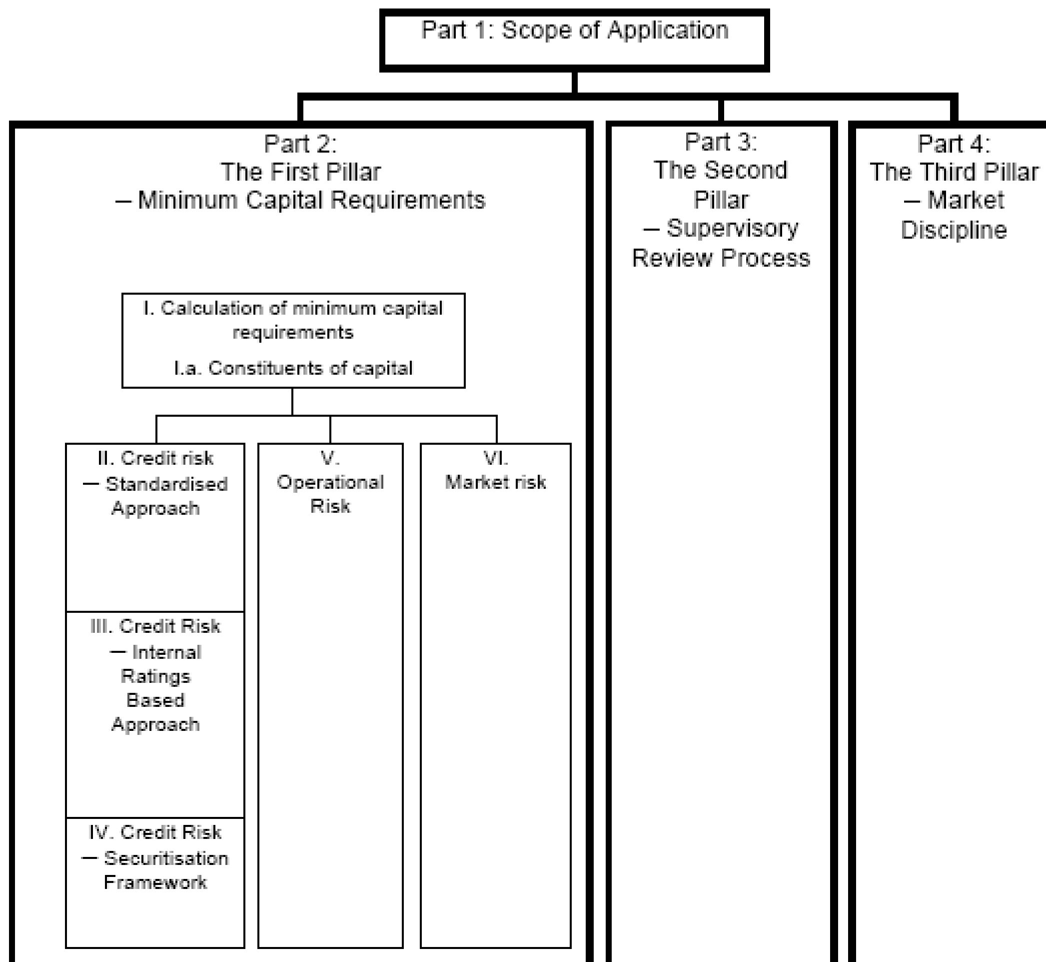
Finally in June 1999 a consultative paper was introduced and the development of the Basel II process has been started. After the many consultative papers, in 2004 the Basel II framework and in 2006 a revised framework were issued and Basel II has been started to implemented. In many countries the standardized and foundation approaches have been started to be practicing (BCBS, 2007) and it is expected that the advanced approaches will be put into practice by 2008 and 2009.

Although it was not determined in our country the application date of the Basel II standardized approach was set as the beginning of 2008 and the advanced approaches in 2009 (BRSA, 2005).

3.1 The major differences of the Basel II from Basel I

In overall view Basel II has set out more comprehensive and complex requirements that the previous one for the banking sector. As a matter fact it was grown by the criticisms of the previous accord which was ineffective and therefore the new one is somewhat developed as a reaction to the old one.

Graph-9: The structure of the Basel II Capital Accord, BCBS (2005).



The Basel II has three pillars; in the first pillar the new capital requirements were regulated. Leaving out the "one size fits all" approach of the old Basel, new requirements are regulated according. The second pillar entails the supervisory processes of the applications the capital adequacy requirements. The third pillar comes from the old Basel I requirements, adding up the market risk into the calculation of the capital requirements of the banks.

3.2. Calculation of the Capital Requirements for SMEs Credits According to the Basel Requirements

There is no distinction for capital requirements to risks (credit) of SMEs in the Basel I. Therefore currently SMEs credits have 8 % capital requirements or in other words they have 100 % risk weight.

In contrast to the one way approach to the calculation of the capital requirements of the Basel I, Basel II framework has provided banks two main approaches for determining the minimal capital requirements; the standardized approach and Internal Rating-Based (IRB) approach. Furthermore the standardized approach has the simplified standardized approach and the IRB approach has advanced IRB approach as their sub-versions.

3.2.1. The Standardized Approach

The Standardized entails a simplified version as "simplified standardized approach". However due to the BCBS argument in the Basel II accord; the standardized "(…) *approach should not be seen as another approach for determining regulatory capital. Rather, it collects in one place the simplest options for calculating risk-weighted assets*" (BCBS, 2005).

According to the simplified approach the SMEs risk weights of the credits on the corporate portfolio is 100 % and on the retail portfolio risk weights is 75 %. The only difference of this approach is the division of the credits into two portfolio and different risk weights. Under this approach if a SME would classify under the retail portfolio capital requirement of its credit would be 0.08 X 0.75 = 0.06 which is 25 % less than the current capital requirements (Yüksel, 2005).

On the other hand the standardized approach gives risk weights to the credits in corporate portfolio according to the credit scores of its barrowers. Related risk weights to each credit score were defined in the Basel II framework. These are (BCBS, 2005, par 66);

Table-15: Risk weights for external credit assessments, BCBS, (2005).

External credit assessment	**Risk weights**
AAA to AA-	20 %
A+ to A-	50 %
BBB+ to BB-	100 %
Below BB-	150 %
Unrated	100 %

For the risks in the retail portfolio the framework again entails 75 % risk weight which is the same as in the simplified standard approach. Consequently again it is advantageous for a SME to be included in the retail portfolio

As it is understood from the table the worst option for a SME placed in the corporate portfolio in the standardize approach is to have a credit rating under the (BB-) level which has the risk weight 150% 50 % more than even an unrated firm. It is obivious that in this approach considering the risks of getting a score below the BB- rate, which is significantly high for a SME in Turkey, it is better for a SME not to have a credit rating score and thus having a standard risk weight, 100 %. In such a case there would not be any change for a SME from the current situation.

3.2.2. The Internal Ratings Based Approach (IRB)

In order to implement the internal ratings based approach banks have to fulfill the requirements, which has been emphasized in the credit rating section of this work. It is also specified in the Basel II framework that the bank should have the consent of the legal authority (BCBS, 2005).

In the IRB approach banks may rely on their own estimations of risk components in determining the capital requirements for a given credit exposure (BSCB, 2005). These measurable risk components are the probability of default (PD), loss given default (LDG), the exposure of default (EAD), and the effective maturity (M). Nevertheless the Basel II framework also adds that in some cases the values of these measurements can be directly given by the supervisory authority (BSCB, 2005).

Under the IRB approach also the categorization of the risk exposures is allowed (BSCB, 2005). These categories could be; the corporate, retail, sovereign, bank and equity. The related categories to our work are again the corporate and retail exposures. The classification requirements of the SMEs again are the same as in the standardized approach; 50 million Euro turnover or 1 million Euro total risk thresholds.

3.2.2.1. Foundation and Advanced Approaches of the Internal Ratings Based Approaches (IRB)

Each classes of risks that were noted previously the under the IRB approach have three key elements (BCSB, 2005)

- ***Risk components;*** *estimates of risk parameters provided by banks some of which are supervisory estimates.*
- ***Risk-weight functions;*** *the means by which risk components are transformed into risk-weighted assets and therefore capital requirements.*
- ***Minimum requirements;*** *the minimum standards that must be met in order for a bank to use the IRB approach for a given asset class.*

Under the foundation approach to IRB framework banks provide their own estimates of PD and rely on supervisory estimates for other risk components (BCSB, 2005, par 245).

Whereas under the advanced approach to IRB banks can use their own estimates of PD, LGD and EAD, and their own calculation of M, subject to meeting minimum standards (BCSB, 2005, par 245). Furthermore for the both approaches banks are required to use the risk-weight functions provided in the Basel II framework for the purpose of deriving capital requirements.

3.2.3. Calculation of the Capital Requirement; SMEs under the corporate portfolio

The capital requirement calculation for SMEs that are on the corporate portfolio under IRB approach is specified in the Basel II framework as (BSCB, 2005);

Correlation (R) = 0.12 × (1 – EXP(-50 × PD)) / (1 – EXP(-50)) +
0.24 × [1 – (1 – EXP(-50 × PD)) / (1 – EXP(-50))]
– 0.04 × (1 – (S–5) / 45) This line is the firm-size adjustment of the SMEs (Please refer to below)

Maturity adjustment (b) = (0.11852 – 0.05478 × ln(PD))^2

Capital requirement (K) = [LGD × N[(1 – R)^-0.5 × G(PD)
+ (R / (1 – R))^0.5 ×G(0.999)] – PD x LGD]
x (1 – 1.5 x b)^-1 × (1 + (M – 2.5) × b)

Risk-weighted assets (RWA) = K x 12.5 x EAD

Where;

PD : Probability of default, 1 to 0

S : Total annual sales in millions of Euro

LGD : Loss given default, 1 to 0

EAD : Exposure at default, in Euro

N : Cumulative distribution function for a standard normal random variable

G : Inverse cumulative distribution function for a standard normal random variable

3.2.3.1. Firm size adjustment for SMEs

The term "– 0.04 × (1 – (S–5) / 45)" in the Correlation formula was put in order to reflect the firm size effects of the SMEs to the formula. –S term is the total annual sales of the SMEs and it ranges from Euro 5 million to 50 million. The annual sales below the 5 million Euro is treated as it is 5 million Euro.

3.2.4. Calculation of the Required Capital for SMEs under the retail portfolio

For SMEs credits under the retail portfolio is determined by the formula below.

Correlation (R) = 0.03 × (1 – EXP(-35 × PD)) / (1 – EXP(-35)) +0.16 × [1 – (1 – EXP(-35 × PD)) / (1 – EXP(-35))]

Capital requirement (K) = LGD × N[(1 – R)^-0.5 × G(PD) + (R / (1 – R))^0.5 × G(0.999)]– PD x LGD

Risk-weighted assets = K x 12.5 x EAD

Consequently it can be noted that under the IRB approach the calculation of the capital requirements are very complex and can vary according to the portfolio with in which the credit was classified and the amount of the annual net sales. For instance the in the retail portfolio, the correlation formula is multiplied by 0.03 and there is adjustment for the size-effect whereas in the corporate portfolio the coefficient is 0.12 and there is a size adjustment for SMEs.

3.3. The Regulations of the Basel II for the SME Credits

In the Basel II framework the SMEs are defined as the entities with annual sales less than 50 million Euro. However in align with the abolishment of the one size fits all rule of the Basel I, depending on the creditor's customer portfolio new groups of risks are to be established. Unlike the corporate segment where the risk groups is based on primarily rating grades these groups could be based on barrowers or transactions constructing pools with homogeneous risk patterns, assessments. (Rowe, Jovic, Beutler, 2002). Therefore for SMEs, which are one of the main customers of the banks, a segment oriented IRB approach would be necessary. Consequently due to the considerations about the effects of the Basel II on SMEs, working groups started to shape the solutions for the SMEs in the Basel II framework.

The proposals for segmenting the SMEs have started to be discussed in 2001 and in July 2002 the Basel committee agreed that (BIS, 2002, p1);

> *"in recognition of the different risks associated with SME borrowers, under the IRB approach for corporate credits, banks will be permitted to separately distinguish loans to SME borrowers (defined as those with less than Euro 50 mn in annual sales) from those to larger firms. Under the proposed treatment, exposures to SMEs will be able to receive a lower capital requirement than exposures to larger firms. The reduction in the required amount of capital will be as high as twenty percent, depending on the size of the borrower, and should result in an average reduction of approximately ten percent across the entire set of SME borrowers in the IRB framework for corporate loans.*
>
> *In addition, banks that manage small-business-related exposures in a manner similar to retail exposures will be permitted to apply the retail IRB*

treatment to such exposures, provided that the total exposure of a bank to an individual SME is less than Euro 1 mn. A similar threshold will be established in the standardised approach".

This regulation for SMEs means a potential reduction in the required capital amount by 20 % according to the size of the entity (Rowe, Jovic, Beutler, 2002) which leads an average reduction of 10 % for an entire portfolio of SMEs in the IRB approach for corporate loans. In such a case the critical factor for an SME is being in the retail portfolio of the banks. The BCBS proposes four criteria for the eligibility of the retail portfolio. These are (BCBS, 2005, par 70);

- ***Orientation criterion:*** *The exposure is to an individual person or persons or to a small business;*
- ***Product criterion:*** *The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases (e.g. instalment loans, auto loans and leases, student and educational loans, personal finance) and small business facilities and commitments. Securities (such as bonds and equities), whether listed or not, are specifically excluded from this category. Mortgage loans are excluded to the extent that they qualify for treatment as claims secured by residential property*
- ***Granularity criterion:*** *The supervisor must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. One way of achieving this may be to set a numerical limit that no aggregate exposure to one counterpart28 can exceed 0.2% of the overall regulatory retail portfolio.*
- ***Low value of individual exposures:*** *The maximum aggregated retail exposure to one counterpart cannot exceed an absolute threshold of €1 million.*

Consequently there are two main criteria for a SME to be included in the retail portfolio. These are;

- having annual sales amount lesser than Euro 50 million or,
- do not having credit amount in one banking group more than Euro 1 million.

3.4. The effects of Basel II for SME Credits

Basel II capital accord has very complex structure compare to the Basel I. therefore the effects of it would as complex as its structure and there are many dimensions of the effects of it. However since in this work the SMEs are the major part, only the effect of the Basel II to the SMEs were examined.

The main question for SMEs about the Basel II is whether it will increase their ability to access capital or not. The importance role of the banks for the financing of the SME activities was emphasized before. In Europe and in Turkey the major portion of the SME financing is done through the banking system.

Main difference of the Basel II is the change in the method of the calculation of the minimum capital requirements of the banks, making the calculation more risk sensitive. This risk calculation mainly is done through the credit rating methods. Although the credit rating is not a new concept the SMEs have not met it yet. It was mainly used for the public companies which issues debt instruments in the public markets in order to raise capital. The SMEs never have been able to do this kind of practices. Consequently in order to understand the implications of the Basel II, the first question should be how the SMEs will be scored and which score they will get.

The second parameter is the credit risk calculation approaches that has been examined previously and which the banks will use. Because the effects of the Basel II changes according to which approach is being used. As it has been shown there are

combinations of the approaches and for every combination the risk parameters of a SME changes.

For example in the standardized approach a SME in a retail portfolio with no rating score would get a 75 % percent of the risk weight resulting a 6 % of the capital requirement. However if the advanced IRB approach is used for SME in a corporate portfolio, a 15 % capital requirement could be calculated in the PD level of 20 %. This amount of the capital requirement is more than two times of the capital requirement that is calculated under the standardized approach for the retail portfolio.

Accordingly, the third parameter is the credit portfolio that the SME enters. In general the risk weights of the corporate portfolios are higher than the retail portfolio. For example for in the standardized approach the risk weights of the corporate portfolio is 100 % which means 8 % capital requirement and retail portfolio has 75 % risk weight which means 6 % capital requirement.

A fourth parameter is the net volume of the sales of the SME in the IRB approaches. The volume range can be change between Euro 5 million to 50 million, over 50 million is same as the 50 million and less than 5 million is same as the 5 million in the equation. Consequently according to the net sales volume the capital requirements for the SME credit change.

The fifth parameter is the collaterals that the SME has in the IRB approaches. Because of the volatile nature of the IRB approach, the framework gives emphasis on the collaterals and each collateral has different amount of risk mitigation (BCBS, 2005).

Consequently, according to these parameters the effects of the Basel II to the SMEs change. Therefore it would be more beneficial for the SMEs to understand the Basel II and evaluate their advantages and disadvantages against the Basel II regulations.

3.4.1 Emprical Researchs About the Effects of the Basel II to the SME Credits

Edward Altman and Gabriele Sabato (2005) have worked together using the credit data from US, Italy and Austria, to estimate the effects of the Basel II. The results of their analysis show that for all the three a minimum of 20% of small and medium sized enterprises must be classified as retail in order to maintain the SME capital requirement at least at the current level (8%). In addition to this the percentage of SMEs to be considered as retail should be at least 40% if the banking organizations will want to enjoy a lower capital requirement under the Basel II Advanced IRB approach versus the Standardized approach. They argue that the result would not be very different considering the different PD calculations of the banks. They concluded that after a cost adjustment in the initial stages, the SMEs will access to bank financing easier and cheaper than before if the large banks would find the SME lending more profitable.

Another study was made by Jacobson, Linde and Roszbach (2005) with two Swedish banks' portfolios in order to validate whether there is a special treatment for the SMEs in retail portfolio. They argue that SME portfolios are riskier than the corporate portfolios and there is no special treatment under the Basel II for the SMEs.

Consequently the findings are somewhat controversial. Since there are many parameters under the new Basel II framework these differences could stem from numerous factors. However regardless the new reforms are in favour of the SMEs or not, they have to do their best for the compliance of the new requirements. As a matter of fact there would always be some winners and some losers. Furthermore it can be said that the Basel Committee has the consideration for the SMEs and if the things would go very wrong, they will for the most probably readjust the parameters.

In order to have a more comprehensive idea about the new Basel II environment, the credit rating systems should also be examined which is in the next section.

4. CREDIT RATING

The basic rationale of the finance is to maximize the gain for the each unit of risk. Risk is finance can be defined as the probability of default or loss. Every rational individual either tries to decrease the risk for a given level of return or increase the return for a given level of risk. This motive is essential for the market efficiency and pareto optimum levels of risks for the investors. In order to realize this motive, it is needed to know firstly the return level and secondly the related risks to this return level. Although it is theoretically impossible to correctly determine all the risk that an investment contains, investors make rational estimates about the possible default probabilities using the independent variables of world. Otherwise most of the market will suffer from the irrational pricing of the risks and very few of them will gain.

Therefore like every market that pursues market efficiency, credit market also try to correctly price the loans or receivables. Inefficient pricing of the loans and credits mean market failure and can bear dramatic costs for the market actors.

There have been such kinds of inefficiencies in the markets very recently. In 2001 Moody's investor service and Standard & Poor's reported over 200 companies in the world reaching a defaulted debt level of 115 billion dollars (Ong, 2002). Most of the big historical defaulted firms like Enron or WorldCom had investable credit scores prior to their demise. The accounting tricks those were uncovered at Enron, their close relationships with the biggest banks, unfair representation of financial statements by the audit companies and the credit ratings that do not present real condition of the companies have profoundly shaken the trust in the financial markets (Ong, 2002).

In aftermath of these incidents, the issues about the determination of the risk and management of it gained further attention and importance. Capital markets tried to realign themselves while international organizations try to mitigate the tensions by introducing

new regulations to the global markets (Ong, 2002). The new Basel capital requirement accord is one of the main products of these efforts.

Thus the concept of the credit rating gained more attention in the banking systems. Although there were already internal and external rating systems in order to determine the probability of defaults of the credit consumers, it was the first time that the capital requirements of the credit institutions are determined by their risks that are measured by the credit rating systems (Ong, 2002). This new capital environment will certainly bring change and challenges to the business entities.

In this work it has been examined the credit rating concept which will affect SMEs's ability to access capital. As it has been emphasized before, it is very important to understand possible effects of the IFRS for SMEs in the framework of the Basel II requirements. Consequently it is vital to grasp the focus points of the credit rating concept and so that the effectiveness of the IFRS for SMEs can be assessed in the new capital environment of the world.

In the Basel II accord there are two sides of the credit rating; the standardized approach in which the credit ratings are determined by independent rating agencies and the internal ratings-based approach in which the credit ratings are determined by the internal rating bodies of the credit institutions.

4.1. Credit Rating Background

According to Standard & Poor's definition a credit rating is an opinion of the general creditworthiness of an obligor, or the creditworthiness of and obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors (Dinwoodie, 2002).

At first the lenders evaluate the firms with financial ratios derived from the balance sheets of the firms. Considering the quality of the balance sheets and limited information the first credit rating efforts are humble relative to today's complex models. Nevertheless with the improvement in statistical tools, accumulation of long-term default rates and statistics, accounting standards which produce more relevant, consistent and comparable financial information the credit rating methodology has become more efficient.

The first examples of the credit rating agencies were established in US by the beginning of the 20th century, 1909 with introduction of the railway companies bonds. The financing of the vast railway projects in the US in the late 19th century led first systematic publications of bond ratings by John Moody who was the founding father of the Moody's Investors Service in 1900 (Ong, 2002). During this time the rating agencies were supported by the regulatory agencies.

At the beginning ratings are used to enlighten simple investors in the face of unknown financial risks (Hamilton, 2002). Within the time the financial risks became more complex and widespread, the statistical data of defaults was accumulated and the tools for estimating the probability of default have been improved. Consequently the credit rating practices have started to build on more solid foundation. Currently there are two main independent rating companies operate globally; Moody's Investor Services and Standard and Poor's.

The rating industry's reputation was significantly damaged by the demise of the energy firms in the beginning of the 2000s. Enron Corporation had investable rating grade one year prior to its default that is -Baa1- defaulting roughly 10 billion dollars. These inefficiencies have shaken the trust for the credit ratings (Ong, 2002).

On the other hand in the new capital adequacy framework the Basel II accords, in order to make the banking system more sensitive to risk, the credit ratings have become the main determinants of the credit risk. This act had been criticized even by the credit

rating agencies themselves, and they were against the sole use of the credit score for the calculation of the capital requirements of the banks (Ong, 2002).

Not surprisingly this would be the same case when the practices are considered in the IRB approach of the Basel II. Since the internal rating departments of the banks are mainly dependent on the data of the CRAs and take them as benchmarks the same problem exists in the internal credit rating practices (Ong 2002, Matthews 2002 and Brown, 2002).

The BCBS's proposed six broad criteria for external credit assessment institutions (ECAI) are as fallows (BCBS, 2005 par 91);

"Objectivity: *The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience.*

Independence: *An ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating a conflict of interest.*

International access/Transparency: *The individual assessments should be available to both domestic and foreign institutions with legitimate interests and at equivalent terms. In addition, the general methodology used by the ECAI should be publicly available.*

Disclosure: *An ECAI should disclose the following information: its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time.*

Resources: *An ECAI should have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments should be based on methodologies combining qualitative and quantitative approaches.*

Credibility: *To some extent, credibility is derived from the criteria above. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) is evidence of the credibility of the assessments of an ECAI. The credibility of an ECAI is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country."*

4.2. RATING TYPES (Dinwoodie, 2002)

Issue Specific Credit Ratings

Long-Term ratings

- *Note, note programmes, certificate of deposit programmes, syndicated bank loans, bond and debentures ('AA', 'AA'…'D') shelf registrations.*
  Debt types;
    - *Equipment trust certificates*
    - *Secured*
    - *Senior unsecured*
    - *Subordinated*
    - *Junior subordinated*
- *Preferred stock and deferrable payment debts*

Municipal note ratings

Short-term ratings

- *Commercial paper*

- *Put bonds/demand deposits*
- *Certificate of deposit programmes*

Issuer Credit Ratings

Long-term ratings and short-term ratings

- *Corporate credit ratings*
- *Counterparty ratings*
- *Sovereign credit ratings*

4.3. RATING PROCESS

In general independent rating score is requested especially before an initial public offering or registration of a debt issue. Nevertheless with the introduction of the Basel II requirements credit rating will become a more frequent issue and apart from having a credit rating at one time, most of the firms will be under continuous surveillance of the credit rating institutions or banks internal credit rating departments.

4.3.1. Meeting With The Management

After the rating score is requested by the applicant firm, a meeting is scheduled between the management of the firm and the credit team. Beforehand of the meeting the rating team will gather all the publicly available information about the firm and its industry and notes critical points of the applicant (Dinwoodie, 2002). Therefore generally meetings are scheduled several weeks after the rating score request is claimed.

Management meeting is an essential part of the credit rating processes. They are vital for communication of the knowledge between parties, for understanding the issuer, its operations, industry, and industry specific problems, advantages (Dinwoodie, 2002).

Before the meeting, firm managements should gather as much documented evidence as possible for the rating team. Documented evidence will be very helpful in

understanding and verifying the conditions of the firm. These documented evidences should be (Dinwoodie, 2002);

a) *five years of audited financial statements,*
b) *the last several interim financial statements,*
c) *narrative descriptions of operations and products, and*
d) *a draft registration statement, offering memorandum, or equivalent.*

Firm official also should enlighten the rating teams about their prospective targets, financial and operational goals, future cash flows, their ownership structure and capital investment plans (Dinwoodie, 2002). Also the trends in the industry, jurisdictional regulations, operational statistics, and market predictions as well are important for the rating teams. These future indicators of the firm give ideas about possible operational and financial condition of the firm in the future.

Furthermore the firm official should also give information about their accounting practices, information about the financial statements, off-balance sheet items which will provide the rating teams to correctly understand the financial statements of the firm. In this step obviously the financial statement that are prepared according to the IFRS and IFRS for SMEs would help the firms much more than if they would be prepared with a local GAAP or no distinctive GAAP.

4.3.2. Rating Committee

Rating committees is the decision organ for the rating score of the applicant entities (Dinwoodie, 2002). All the collected data and material are discussed there. Analysts, which are specific to the industry of the firm, joins meetings of the committee and briefs with the relevant industry specific statistics, financial statement ratios and comparable data. The results of the analytical tools are also discussed, commented and converted into meaningful analysis.

Afterwards the discussions and meetings, the rating committee decide a rating score for the applicant firm. The names of the members of the committee are never revealed to the applicant firm due to independence rules (Dinwoodie, 2002).

After the credit score is determined the applicant could request the reassessment of the credit score form the rating agency. In such a case the committee re-evaluates the data about the applicant firm and if it would be decided as necessary, renews the credit score.

4.3.3. Surveillance

Initial issuance of the rating score is fallowed by regular surveillance of the applicant firm by the rating agency. Corporate ratings on publicly distributed issues are monitored for at least one year. During the surveillance period any significant positive or negative changes on the parameters of the given credit score will be reflected and consequently the credit of the firm could be re-evaluated.

4.4. ANALYTICAL TOOLS FOR CREDIT RATING

Financial statements are the major components of the rating process and the main part that will affect from the proposed accounting standards of SMEs which is the focus point of this work.

4.4.1. Traditional Ratio Analysis

It is the eldest technique of the analysis of the financial statements. The basic motives of these techniques are firstly to determine the liquidity condition of the company by examining the current assets and liabilities and the profitability of the company by examining the profit margins over the cost and financial and other expenses.

The first systematized study to ratio analysis was conducted by William Beaver (1966). According to Beaver the most significant financial ratio that predicts default is the cash-flow/total debt ratio. Afterwards Beaver's studies were used to improve multivariate discriminative analysis by Edward Altman.

In general ratios measuring the profitability, liquidity and solvency are held as the most significant determinants of the default risks (Altman, 2002).

The most problematic factor of the ratio analysis is to determine the most significant ratio in an analysis of an entity. The weights of the ratios can be changed according industry, economic environments, or any other relevant factor that can affect the general structure of the balance sheets of an industry as a whole. Rather than making a list of financial ratios or grouping into categories like liquidity or profitability ratios, it has been tried to define the most frequent items that appear on the financial ratios (Altman, 2002).

The sales figures; *they are employed mainly in determining the turnover rates of the inventories, assets, receivables. Also they are used in the profitability ratios such as profit margins ratios. Therefore the sales figures in fact could affect most of the important ratios by itself.*

Net income, EBIT and EBITDA; *they are often used in determining the firms' abilities to pay out their costs of financing activities, namely interest expenses. The main ratio from this kind is the interest coverage ratio. Since it is very important for a creditor to know the credit demanding side's ability to cover its cost of credits these income statement items are held major roles in ratio analysis.*

Current assets / liabilities; *they are the most common items in the liquidity ratios and determining the net working capital. In general liquidity*

ratios are the important ratios in the bankruptcy determining models. They are critical items that directly give information about operating and financing conditions about the firm for the short-term expectations. Most often they are joined by inventories, marketable securities or accounts receivables in order to find out more specific liquidity ratios like quick ratio.

Equity and liabilities; *they are usually used in the leverage and capital adequacy ratios. Leverage ratios indicate the amount of the outside financing in the company's assets. In other words the risk level of the company that derives from the outside financing. Furthermore these items are used in the operating performance ratios like return of equity ratio.*

Although they are the important ratios and related items in the balance sheet, the comparative importance of these ratios and items could change according to the risk type, market risk, interest risk or operational risks and the view point of the creditors. For example for short-term credits, a creditor looks the turnover and liquidity ratios most. On the other hand when it comes to the long-term financing a lender would look at the leverage and capital adequacy ratios, profitability levels.

Therefore developing a general model for the financial statement analysis would be very hard task and maybe unnecessary. In order to develop a single model one should confidently answer the questions that Altman (2002) specifies;

1. which ratios are the most important in detecting credit risk problems
2. what weights should be attached to those selected ratios and
3. how should the weights be objectively established.

4.4.2. Multiple Discriminant Analysis (MDA)

Multiple discriminant analysis (MDA) is in essence a statistical tool for analyzing and understanding a certain set of data of a certain group. In other words MDA in its most

simple form attempts to derive a linear combination of characteristics that best discriminates among the selected groups (Altman, 2002). For the distinctive common characteristics that define the group the MDA gives coefficients or weights in order to determine how much effect a certain characteristic has in shaping the selected group.

Consequently when determining the probability of default, MDA can tell us which factors among the many others have the most weights in defining a group of defaulted business entities (Altman, 2002). With the MDA as well as defining characteristics, the interaction between those characteristics of the group can be understood.

The Z-score model, developed by Altman, is a MDA model that tries to define the most common characteristics of the defaulted firms. The coefficients and ratios of the Z-score model are (Altman, 2002);

$$Z = 1.2(X1) + 1.4(X2) + 3.3(X3) + 0.6(X4) + 1.0(X5)$$

(X1) = working capital / total assets
(X2) = retained earning / total assets
(X3) = earnings before interest and taxes / total assets
(X4) = market value equity / book value of total liabilities
(X5) = sales / total assets,
Z = overall index or Z score

X1 working capital / total assets

The working capital/total assets ratio is the indicator of the level of the net working capital to total assets. Working capital consists of the net of the current assets and current liabilities which is one of the basic liquidity tools for the companies. Operational losses will negatively affect this ratio. Shrinking current assets reduce the payment ability of the company to its current liabilities.

(X2) = retained earning / total assets

Retained earnings is the account that is used to disclose the amount of accumulated undistributed profit or loss, that is held in the company, in the balance sheet. The account can also be called as earned surplus.

This measure of cumulative profitability over the time is what the author referred to earlier as a new ratio (Altman, 2002). By looking at this ratio one can have idea about the operational age, use of leverage and profitability in the past years of the company. However it can be thought that the ratio is biased to young firms that have limited operational lifetime and so that they could not build up strong retained earnings figures. Altman (2002) argues that as a matter of fact in the real world young firms do have higher PD than the aged ones by saying that;" *40-50% of all firms that fail do so in the first five years of their existence"*.

On the other hand, higher RE/TA ratio means that the company is self-financing itself, operating under a low leverage. This indicator could make the creditors suspicious about the firm because of the low levels of outside capital. Although this factor could be offset by the considering that the lower levels of cost of equity than the cost of debts could naturally lead companies to internal finance. Furthermore one should also consider the risk levels of outside financing and internal financing.

(X3) = earnings before interest and taxes / total assets

A firm's ultimate strength is the ability to create profit through its assets which are, by definition of the IASB, in their nature held in the company to create future cash flows to the company. Altman argues that due to its ability to measure the true productivity of the assets of the firm without considering the interest expenses of the leverages and tax expenses this ratio is particularly appropriate for studies dealing with credit risk (Altman,

2002). A significant decrease in the earning power of the assets will also decrease the fair value of the assets and if the fair value of the assets goes under the fair value of the liabilities a firm would go bankruptcy.

(X4) = market value equity / book value of total liabilities

Market value of the equity shows the fair value of a firm's assets deducted the liabilities of the firm. This measure indicates the amount of a firm's assets can decline in value (measured by market value of equity plus debt) before the liabilities of the firm surpass the assets of it, or in other words bankruptcy (Altman, 2002).

The prominent factor of this ratio is that it adds the market value concept to the consideration of bankruptcy. However like in our thesis, the focus point could not be always the publicly accountable companies. Therefore for the privately held companies the market value of the equity could be substituted by the book value of net worth, assets minus liabilities. Furthermore a new Z score model was developed for the privately held firms by revising the coefficient of the book value of net worth/book value of total liabilities.

(X5) = sales / total assets,

Asset turnover ratio is another common ratio that used to determine the ability of the company to generate its assets by its sales. Sales figures are most prominent operating figures of the profit oriented business entities. Altman argues that although it has relatively small coefficient in the equation, because of its relations with other variables in the model the S/TA ratio has a high contribution to the model.

There were several tests about with the Z score method for determining its accuracy. Altman (2002) examined 316 firms in three different periods; 1969-1975, 1976-1995, 1997-1999. According to the findings the Z score is between 82 - 94 % accurate

using a cut off score of 2.675 in determining the distress firms' bankruptcy using the financial reporting data prior one period to bankruptcy. On the other hand the type two error (selecting the firm as distressed when it does not go bankrupt) has increase with this cut-off score. According to this, Altman argues that 1.81 score reduces this kind of error (Altman, 2002).

In general firms with Z scores above 3 are accepted as comfortable for the risk of bankruptcy (Altman, 2002).

4.4.3. Revised Z score model

One of the main criticism for the Z score model could the parameter of the market value in the equation and so that the Z score could be use for only the market companies. Since all the firms do not offer their shares to the market it is impossible to know their market value. Altman argues that in such case the equation should be revised by substituting the market value of the firm by the book value of the equity and realign the coefficients in the formula (Altman, 2002);

$$Z' = 0.717(X1) + 8.847(X2) + 3.107(X3) + 0.420(X4) + 0.998(X5)$$

4.4.4. Adaptation of the Z score for emerging markets and non-manufacturers.

In this model the X5 was omitted in order to minimize the potential industry effect that is more likely to take place when such an industry-sensitive variable as asset turnover is included. This model was used to assess the financial health of non-US corporate. In particular, Altman, Hartzell and Peck (1995, 1997) have applied this enhanced z" score model to emerging markets corporate, specifically Mexican firms that had issued Eurobonds denominated in US dollars. The book value of equity was used for X4 in this case (Altman, 2002).

$$Z'' = 6.56(X1) + 3.26(X2) + 6.72(X3) + 1.05(X4) + 0.00(X5)$$

In this model the Z scores below 1.1 signal a distress condition. For the purpose of standardization of the score a constant term of + 3.25 added to the results.

This model is especially important for the emerging market economies like turkey. In determining the PDs of the firms in Turkey this model could be lead both for the external CRAIs and internal credit rating departments of the banks.

4.4.5. The Expected Default Frequency (EDF) Model

The EDF model has been created by KMV corporation, which was bought by moody's in 2002. It is based on a procedure for estimating the PD for a firm that is based conceptually on Merton's (1974) option-pricing model. The main idea of the KMV model is the assumption that when the market value of a firm drops below a certain level, the firm could not meet its obligations. The value of the firm, projected to a given future date, has a probability distribution characterized by its expected value and standard deviation. The area under the distribution below the book liabilities of the firm is PD (Altman, 2002).

The EDF model has three steps. Firstly, the market value and volatility of the firms are estimated from the market values of its stock, the volatility of its stock and the book values of its liabilities (Altman, 2002).

The market value of the equity can be expressed with the value of the call option as (Altman, 2002);

Market value of the equity = f (book value of liabilities, market value of assets, volatility of assets, time horizon)

In the second step, the firm's default point is calculated from the firm's liabilities coming due over time. Using these two values plus the firm's volatility, a measure is constructed that represents the number of standard deviations from the expected firm value to the default point (the distance to default) (Altman, 2002).

$$\text{Distance to default} = \frac{\text{Expected market value of assets} - \text{Default point}}{\text{Expected market value of assets} \times \text{volatility of assets}}$$

Finally a mapping is determined between the distance-to-default and the default rate based on the historical default experience of companies with different distance-to-default values (Altman, 2002).

In the case of private companies that do not issue their shares in a stock market and consequently do not have a fair value of their stocks, the KMV model makes estimations from the historical data of the defaulted companies by making comparison between the characteristics of the privately held company and characteristics of the public companies in the data.

As it can be seen from the definitions EDF model is mainly based on the market related data which is very limited for SMEs that are general privately held companies. Besides the statistical data would not be very helpful for interpolating SMEs' imaginary market value movements because the structure of the statistical data is generally obtained from the relatively big companies that are not comparable with the SMEs.

Consequently analyzing of the EDF model would not be very helpful in this work. Furthermore the IFRS for SMEs can theoretically affects the book value of the firms and do not have measurable impact on the market value of the firms the EDF model cannot be considered as relevant for the case of SMEs.

4.4.6. A General Framework for the Indicators of Default

Apart from the default prediction models Chen and Shimerda have consolidated the main drivers of default under seven factors that seem vital (Ong, 2002). These are;

1. ***Volatility:*** *higher equity volatility implies higher probability of a firm's asset value falling below its level of debt, which implies insolvency. This is only measurable for public companies. Examples are historical volatility, option implied volatility*
2. ***Size;*** *for non-traded companies size proxies for much of equity volatility. Bigger companies are generally more diversified in their exposure to geographies, products and people and this lowers their prospective volatility. Examples are market cap sales*
3. ***Profitability;*** *higher profits lowers default probabilities. Combining profitability with the interest expense makes it a combination of leverage and profitability. Examples are net income/assets, EBIT/Interest and EBIT/Debt*
4. ***Leverage/Gearing:*** *higher leverage implies higher default probabilities. Examples are debt/assets, market capitalization/debt, total liabilities/total assets.*
5. ***Liquidity;*** *lower liquidity (current assets/current liabilities) implies higher default probabilities in all countries, though this effect is reversed for those 3000 or so investment grade companies. Examples are current assets/current liabilities short-term debt/total debt*
6. ***Growth;*** *both high and low growth rates are associated with higher default probability. Examples are year over year sales growth.*
7. ***Inventories****; higher inventory levels imply higher default probabilities. Examples are inventory/sales.*

4.5. BANKS INTERNAL CREDIT RATING SYSTEMS

Another credit rating authority that is determined by the Basel II accord under the concept of Internal Rating Based (IRB) approach is the credit rating departments of the banks. This requirement of the Basel II is arguably a result of the existence of the internal rating departments of the banks (Brown, 2002). However because there has not been any standardization or regulation among the banks in their internal credit rating departments before the Basel II, the production of a single consistent rating models would not be realized in the short-term.

The credit rating systems of the banks in generally less capable of accessing the statistical data and providing solid rating models (Lopez, Saidenberg, 2002). Compare to the strong cumulative default data of the independent rating agencies banks only have internal default data and loss experience.

The IRB approach has set out new parameters for the internal rating systems of the banks. Otherwise the banks are required to use the Standardised Approach and obtain the credit ratings from external independent credit rating institutions. The main problem of the internal rating systems is that; the rating and the cost of credit are related to each other. Low credit scores mean more capital requirements to meet the risks set out the Basel II. However more capital requirements mean more cost to the banks. Therefore a risk of moral hazard emerges in rating systems of the banks. In order to mitigate the moral hazard risk, the BIS try to set out strong and solid regulations for internal credit rating systems and departments of the banks.

The reform proposes three qualities of the internal rating systems; risk sensitivity, accuracy and verifiability (Lopez, Saidenberg, 2002). The capital accord firstly aims risk sensitivity of the system to determinable risks from the credits. Systems should be able to realize timely the correct risks related credit and enable the banks to take measures

against the realized risks. Secondly, the realized risks should be accurately determined. There should not be under or over estimation of the risks. Thirdly there should be enough evidence and documentation about the acknowledged risks.

Consequently in order to achieve efficient internal rating systems, the BIS has set out complex requirements. In order to qualify for the use of IRB approach Basel committee set out minimum requirements composed of twelve broad categories (BCBS, 2004 and Ong, 2002). The first nine of them are required in order to use the foundation approach of the IRB and the least three of them are additionally required for the advanced approach of the IRB. These are;

1. *Criteria to ensure meaningful differentiation of risk;*
    - Banks ratings systems must have two dimensions; the first related to the risk of barrower and the second that is related to specific facility factors (transaction rating)
    - Banks' rating scores should have a minimum of six to nine barrower grades for performing loans and a minimum of two grades for non-performing loans.
2. *Completeness and integrity of rating assignments*
    - For each barrower a rating score has to be assigned before he enters to any kind of portfolio.
    - And each of these rating scores have to be approved by the rating authority
3. *Oversights of the rating system and process*
    - All crucial aspects of the rating methods and PD estimation processes must be approved by internal authorities.
    - These internal rating procedures must be controlled by the internal audit and the credit risk groups.
    - There should be internal groups solely working on the design, application and performance of the internal rating systems.

4. *Criteria and orientation of the rating system*

- A specialize IT system is required for the conduct of the rating process. All aspects of this system must be documented.
- A bank also must have a specific process and clearly defined criteria for determining exposures to each assigned credit score.

5. *Minimum requirements for the estimation of PD*

- In the IRB approach, banks must be able to estimate one-year PDs for each group of their internal rating grades. These estimates must be made in a conservative approach and foresee prospective factors.
- The empirical evidence, historical default rates, or key drivers for prospective defaults that the bank uses must be well documented. Banks can cooperate in developing the estimates of PDs.
- For the estimation of PD the Basel Committee presents three different techniques;
    i. internal measurement of default frequency,
    ii. mapping of internal ratings to external data and
    iii. statistical default models that can be provided from external sources.

  Any combination of these techniques can be used according to the data quality of the credit segments.
- The committee states that a minimum five year time series must be used as the historical horizon.

6. *Data collection and IT systems*

- As the internal credit rating processes are conducted the statistical data of PDs and related information should be preserved.

7. *Use of internal ratings*

- A wider approach for the internal ratings is expected other than solely used determination of capital requirements.

8. *Internal validation*

- Internal validation must be made in align with the requirements ıf the IRB approaches.

9. *Disclosure requirements*

- In order to employ the IRB approach bank must meet the disclosure requirements of the third pillar.

In the article written by Michael Crouchy, Dan Galai and Robert M. Mark (2002) they have pointed the significance of the internal rating systems of the banks by looking at the figure that the 60 % of the outstanding debts held by major banks was rated internally by banks. This is because of the private firms which do not offer their shares to the public and consequently do not have any kind of rating score before. As far as the banks are the primary source of finance for this type of companies, the evaluation of their PDs are on the hands of the internal rating systems.

The rating procedure they operate with has nine steps;

1. A financial analysis of the barrowers financial data; in this step a primary floor rating score is determined according to the financial ratios derived form the financial statements of the company. Most significant ratios are the liquidity, solvency, profitability ratios and cash flows of the firm.

2. Analyzing the managerial capability of the barrower

This step is identical with the management assessments of the ECAIs in the meetings with the managements of the firms. The managerial power of the company is assessed according to the rules of corporate governance, proactive management skills, prospective expectation of the management.

3. Examining the barrower's absolute and relative position within the industry.

Also this step is identical with the ECAIs comparison activities of the firms with its competitors in the same industry.

4. Reviewing the quality of the financial information

In this step the quality of the financial information is assessed. The major factor would be our works main point; the audited and verified compliance with the IFRS.

5. Assessing the country risk

Country risks composed of macro-economic risks stems from the country of the firms where it operates. Furthermore the regulatory and political changes should be considered.

6. Comparing when available, the default rating provided b external rating institutions.

This step applicable for only the public companies that have rating scores from the CRAs. The intention in this step is not aligning scores between the two parts, but more of an additional consideration of employing all related risk factors in the determination of PD of the company.

7. Analyzing the loan structure.

The current loan structure of the company is also very important for the risk analysis. In general banks have an accumulated knowledge about the loan structure in the balance sheets of the companies. After this step a rating score should be determined. The additional two steps are associated with arriving at a final conclusion.

8. Assigning a loss given default

For the each portion of credit the loss given default is determined by looking at the loss level on the case of default of the company.

9. Calculating the activity's loss rating using the PD and LDG.

In this final step the PD and LGD are multiplied and the activity loss is determined.

4.6. HOW CAN THE SMEs RAISE THEIR CREDIT SCORES

One of the main themes of our thesis is SMEs' ability to access capital. Under the capital requirements of the Basel II, global competition worsening economic conditions, government regulations that favour big industries decrease this ability. Consequently SMEs need to adapt themselves to the rigorous requirements of the global capital environment.

From the rating methods it can be seen that the crucial points of the credit rating are; firstly the quality and verifiability of the financial information and secondly the institutionalization level or the application of the corporate governance principles in the entities.

4.6.1. Financial Information

In the aspect of the financial statements the SMEs firstly should increase the quality and reliability of the financial information. This has two dimensions;

- financial reporting compliance with either the full version of IFRS or IFRS for SMEs and
- independent audit of those financial statements in order to validate the compliance with the accounting standards and fair representation of the financial information.

In the fifth section of the OECD (2004b) Principles of Corporate Governance text, it is stated that "t*he corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company".*

Although in many countries financial reporting is mandatory at least for the taxation purposes, the overall quality of these financial statements are in general far away from realizing the expectations of the most of the shareholders. However financial

information is the one of the most important indicator of the transparency of the business activities of a company. Financial information should be reliable and relevant for the needs of the financial statement readers. This is especially important for the protection of the shareholders and stakeholders that do not have direct influence over the management of the companies.

In this point generally accepted accounting principles would help to increase consistency, understandability and comparability of financial information. The IFRS and IAS from this aspect are the most pre-eminent and recognized financial reporting standards all over the world (UNCTAD, 2006).

This uniqueness and the importance of the IFRS and IAS is the major force behind the secondary convenient standards for the SMEs which is the IFRS for SMEs. Consequently applying the principles of the IFRS for SMEs is a major step for a company integrating the corporate governance principles within their organizations. This factor eventually led to increase in their creditworthiness in the eyes of the capital owners.

The quality of the financial data is very vital for the credit rating evaluation processes which it has been tried to describe before. Since all the quantitative credit rating techniques are done through the financial statements the transparency and comparability of the financial information are very critical. With the most simple example, when comparing the stock turnover ratio of a firm with the other competitors it is important to know which accounting technique is used in measuring the values of the stocks. If a firm uses first in –first out technique (FIFO) the amount of the stock is valued with its most current value whereas in the last in-first out technique the inventories are measured with their oldest value and the cost of goods are evaluated with their current value. This difference would eventually affect the stock turnover figures thus comparing the turnover rates of the companies' would be meaningless. We believe the current Turkish Trade Law Proposal (TTP, 2005) would be a milestone since it requires all the companies comply with the IFRS and IAS.

Another aspect of the financial information is the verifiability of it. The financial information represented in the financial statements should be fair and away from any material misstatement. Consequently in order to assure this factor, financial statements should be audited by the independent 3rd party auditors according to the International Standards on Auditing (ISA) which recognized by the most of the countries in the world and also the case in Turkey (CMB, 2006).

After providing the quality and the verifiability of the financial information, SMEs should work to ameliorate the ratios of their financial statements. This would be only possible by increasing the financial performance of the companies. The management performance and the macro-economic conditions are crucial in establishing strong financial ratios in the statements.

4.7.2 Institutionalization and Corporate Governance

Another pillar of the corporate governance principle is the institutionalization of the business entities. This aspect is rather problematic for the SMEs in Turkey although to a lesser degree in the world. Since most of the SMEs are the micro-sized entities, for example roughly 95 % of the SMEs in Turkey (Turkstat, 2003), most of them are governed by families. This also goes for the middle-sized companies in Turkey which are in generally called as "the Anatolian tigers" referring to "the Asia tigers" expression. Most of them are governed with the traditional family structures lacking of basic institutionalization principles. The top management levels of the most of them are occupied different family members and ranking is generally made by the ages of the members.

Consequently in the aspect of the corporate governance and managerial skills, the SMEs need to understand the rules of corporate governance such as the accountability, transparency, fairness and responsibility of their managements (Şenturan, 2006). The

management positions should be distributed according to the merits of the professional individuals.

Application of these rules will bring institutionalized, solid structures for SMEs along with the benefits of high credit scores from the creditors of the new Basel II environment. According to Joseph Weber (2006) corporate governance principles increase the credit notes of the firms which will ameliorate their access to the capital. This fact was also acknowledges by other studies (Ashbaugh-Skaife, Hollis, W. Collins, Daniel, and LaFond, Ryan, 2006)

Apart from these specific aspects, firms should also understand the importance of the credit scores and fallow up the requirements of the credit rating process closely by enabling a healthy information flow between the credit rating institutions and themselves.

5. DRAFT IFRS FOR SMES

5.1. Introduction

In this section it has been tried to analyze the focus point of this work; the draft IFRS for SMEs. The importance of such project for SMEs is obvious in the face of global financial challenges in the world which is mainly comes from the banking system that is the biggest finance sources of the SMEs. In this context forming unique, consistent and qualified set of standards which have delicate cost-benefit balance in financial reporting considering the need and capabilities of SMEs would be a major contribution in solving the problems of SMEs.

The review of the new Draft IFRS for SMEs should be conducted in the light of the delicate balance between the quality of the financial statements and the cost of preparing them. Also the new set of standards should be considered by keeping in mind that they are established in order to answer the needs of SMEs. Otherwise they would be in conflict with their existence because they are issued from an institution, the IASB (2007a), which aims to provide "*single set of (…) global accounting standards*" whereas the singularity of those standards would be broken.

5.2. Background

It is the International Accounting Standards Board's second biggest project, developing a single set of standards for the SMEs that do not have public accountability. Although its development is mainly being conducted under the body of the IASB, the idea was also shared by another International Institution the United Nations Conference on Trade and Development.

Under the roof of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) the idea of "*user-friendly, understandable*

and flexible, financial accounting and reporting system that accommodates the needs of small and medium-sized enterprises (SMEs) at various stages in their development in order to enable them to maintain accounting records and generate meaningful financial information" (UNCTAD, 2002) was issued and after the consequent meetings a three level of SME structure was developed. The first level contains publicly accountable SMEs which were obliged to use full IFRS in their financial reporting works. The second level consists of mid-level SMEs that neither public accountability nor so much little to need a unique set of financial reporting standards. The third level includes the rest of small SMEs that do not need a single set of financial reporting standards. Consequently the ISAR has *"agreed to provide the International Accounting Standards Board with the final output for Level II SMEs and to extend all necessary cooperation to the IASB in its project on accounting by SMEs. ISAR reiterates its request to the IASB to give priority to completing its project"* (UNCTAD, 2002, p3).

In the next phase, backing by the UNCTAD, the IASB has accelerated its efforts to solve the problems of SMEs for financial reporting issues. In June 2004 the Board issued a "Discussion Paper, Preliminary Views on Accounting Standards for Small and Medium-sized Entities" (IASB, 2004), in order to obtain comments about the reasoning, methodology and structure for the prospective set of standards.

Afterwards in order to clarify critical points and discuss possible omissions and simplifications on April 2005 the Board issued "Staff Questionnaire on Recognition and Measurement" (2005).

In order to discuss the questionnaire's question 1 *"what are the areas for possible simplification of recognition and measurement principles for SMEs?"* on 13-14 October 2005 round table meetings were held in London

In the January 2006 a preliminary staff draft of an Exposure Draft of the International Financial Reporting Standard for Small and Medium-sized Entities (SMEs).

After the discussions of the Board and revisions finalized drafts were published in February 2007 with the comment deadline of October 2007. The expected time of issuance of the standards is at end of the 2008 or beginning of the 2009 (IASB, 2007d).

5.3. WHY SMES NEED A SEPARATE ACCOUNTING STANDARDS

In order to understand the need of the SMEs to a single set of accounting standards firstly the reasoning behind the idea of global generally accepted accounting standards (GAAP) should be understood.

The idea behind the global GAAP is the aim of unification of different accounting practices all over the world. Difference accounting practices bring inconsistency to the financial statements. IASB defines its objective in the preface to IFRS as "*to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions'.* Single set means that all entities in similar circumstances should use the same standards (IASB, 2005b).

With the introduction of a single set of high quality GAAP in the world comparability and understandability of financial information would increase no matter how different the economic environments that the firms operate in, or how many different business languages they use. Single set of financial reporting standards means that a French business entity's financial information could be easily understood and relied upon by an investor in Turkey or somewhere else. This picture can only be achieved by a single set of financial reporting standards used all over the world. The effort of converging the two main GAAPs in the world, the US GAAP and IAS-IFRS, is because of willingness to reach this kind of financial reporting standard through all of the financial reporting entities.

Incomparable financial information does not realize the expectations of the financial table users. However today's financial statement users demand accurate, understandable and qualified financial information regardless to the local accounting practices. In the global markets when the flow of information does not match the speed of capital the risk premium and inefficiency in the markets increase. In the end there would be misallocated and mispriced capital. Reliable information ensures the efficiency of the financial markets which is very important for the protection of the investors or in the case of SMEs the creditors mostly.

From this aspect, also true and consistent information is necessary against new capital requirement rules of Basel II. The credit institutions and rating agencies all over the world will demand reliable and comparable information. Those which cannot supply relevant information to the credit authorities will certainly suffer from these capital reforms. The implications of the Basel II, especially IRB approaches, could damage the ability of the SMEs in accessing to capital. In order to avoid this problem, SMEs will have to provide necessary flow of financial information in a consistent well developed financial reporting package. For this kind of effort IFRS for SMEs would be an easier solution for SMEs than aligning with the full version of IFRS.

There are currently two main accounting standard schools in the world; the FASB standards that were put by the USA originated Financial Accounting Standards Board (FASB) and the International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) that were established by the International Accounting Standards Board (IASB) in Europe. As the two main regimes try to reconcile and create a single set of standards (Norwalk Agreement, 2002) that would be around the standards of IASB. Certainly this would give a major advantage for the SMEs that will apply IFRS for SMEs. In the long run they will end up in applying the foremost common accounting standards in the world, and will go ahead of the enterprises that were not met with the IFRS yet.

Furthermore a typical SME which uses the IFRS for SMEs would be encouraged to shift to the full IFRS and go to public by practicing those standards. This factor will obviously enhance the accession of the SMEs both to regional and, (since the IFRS for SMEs would be a global standard) global capital markets.

Uniform set of standards will also affect the structure of the small and medium sized businesses. Although not as much as the full version of it, the accounting standards for SMEs would need more sophisticated and organized accounting or financial reporting departments. In addition to this, increase in both the volume and quality of the financial information will push the managements of the businesses to organize much closer to the rules of corporate governance.

Another aspect of the accounting standards is their necessity of validation. The compliance with the IFRS today in Turkey is checked by the independent 3rd party auditors as it is in the world. It is obligatory for public companies in Turkey to be audited in align with the IFRS and ISA (International Standards on Auditing) against any misinformation of financial table readers (CMB, 2006). Thus the compliance of the financial information to the IAS and IFRS is validated. Obviously it is expected that it should be the same case in application of the IFRS for SMEs. In order to reach cheaper sources of credit, and raise their credit notes, in the afterwards of applying the standards, SMEs will seek to be audited by the independent auditors in order to verify their compliance of the standards. Consequently they will increase the credibility of their financial information and get higher credit ratings.

Especially because of the new Turkish Trade Law Proposal (2005) that entails the obligation for all the business entities to prepare their financial statements according to the IFRS, the Draft IFRS for SMEs would be a more acceptable solution than the full version of IFRS for most of the business entities.

It is highly probable that because of the financial complexity of the new Basel environment, most of the SMEs would use common set of financial standards, demand independent audit, and be governed according to rules of corporate governance. These factors will altogether push the SMEs to the major business league with the big players. In the end they will have more powerful organization structures, more efficient financial reporting departments with easier access to capital. In the long run these components will certainly lead to high and sustainable economic growth.

5.3.1. Why Does not the SMEs Use the Full Version of IFRS

The title of this section has been the most controversial issue of the IFRS for SMEs project till from the beginning. Indeed constructing a new set of accounting standards could breach the aim to establish a single set of accounting standards which is the foundational principle of the IASB. In the next sections this idea will be evaluated.

5.3.2. Full IFRSs are suitable for all Entities

In fact as it was stated in the preliminary discussion paper (IASB, 2004) *"full IFRS are suitable for all entities"*. This point was also emphasized in the comment letters of the global accounting and finance authorities (PricewaterhouseCoopers, Comment Letter 57, 2004). However apart from the appropriateness of the full IFRS, the efficiency of it should be considered for the SMEs.

Fair presentation is the core principle of the IFRSs. Even the intentional deviations from the standards only justified in case of when *"fair presentation override"* situation. It was stated on IAS 1 paragraph 17 *"In the extremely rare circumstances in which management concludes that compliance with a requirement in a Standard or an Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement (…)"*.

However fair presentation has to go along with another aspect of the financial statements which is the cost and benefit analysis of the financial information. Fair presentation should not go beyond the level that the cost of presenting the financial information exceeds the benefit of the financial information to the financial statement readers. Therefore fair presentation should not lead to disclosure of unnecessary but costly financial information in the financial statements. In other words fair presentation does not always lead to creation of a balance between the cost and the benefit of the financial statements. Consequently the tilted cost and benefit balance is the main problem of the SMEs in applying the full version of IFRS.

5.3.3. Cost Benefit Analysis of IFRS for SMEs

One of the main principles of the financial reporting is that the cost of the financial information should be out weighted by the economic benefit of it that it is gained from that financial information. Otherwise it would be meaningless to obtain that financial data from the entities. Immaterial information for decision makers would be a waste of limited resources, and this could be lead even to deception for 3rd parties, sacrificing the relevant information for the irrelevant.

In order to realize a global standard of financial information, the Board has created complicated and sophisticated set of standards. However the implication of those standards brings unnecessary burden to most of the SMEs. The standards include instructions of detailed accounting treatments for complex transactions that an average SME would not face in its financial statements.

Abiding by those standards would breach the cost-benefit principle of the financial information for SMEs. First of all, SMEs in general lack of qualified human resources that can understand, evaluate and practice the complexity of the IFRS. In the previous sections this factor was emphasized as the main obstacle of the SMEs, more than the problems in accessing to the capital. One should have basic technical and intellectual skills about

accounting and financial reporting while dealing with those kinds of complexities. On the other hand attracting those kinds of skills to SMEs costs higher than the bigger and shinier players within the sectors they operate in.

Secondly, the accounting systems, software of the SMEs are not in align with the global financial reporting standards. There are in general, at best possible circumstances, in accordance with the regional statutory accounting rules and regulations. Sometimes they do not have any kind of unique accounting system. Aligning these systems with the necessities of IFRS data requirements needs significant amount of capital investment which is again not very accessible for SMEs in general.

Thirdly, even after with adequate capital investment, and necessary skilled labour, adaptation of the SMEs to those detailed standards will certainly takes time. The opportunity cost of time is also very higher for SMEs since they have limited resources for this kind of projects. The adaptation to a full IFRS would be much harder than adaptation to a simpler and less detailed set of standards. Furthermore IFRS for SMEs could be considered as a transition room to the full IFRS for most of the companies.

Therefore, although the full version of the IFRS is suitable for all entities, due to the cost and benefit analysis for SMEs it is more appropriate to develop a new set of standards according to less sophisticated financial reporting purposes of the SMEs.

5.4. WHO WILL DEVELOP FINANCIAL REPORTING STANDARDS FOR SMES

Another question in the discussion papers is that if there is a need for standards for SMEs who will undertake such project? All over the world it is obvious that the IASB is the most prestigious standard setter body. And the aim of the IASB is stated in the preface of the IFRS (IASB, 2006b) *"to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards (…)".* Therefore according to

its constitution IASB becomes the main institution to establish a new set of standards for SMEs if this was necessary.

Indeed there is no such a global institution that stands solely to develop single set of accounting and financial reporting standards. This effort could not be conducted by regional jurisdictions otherwise it would have ended up with regional standards.

5.4.1. Is Developing a New Set of Standards for SMEs Consistent with the IASB's Mission?

Until currently in the global world the importance of the efforts of the convergence in financial reporting and single set of financial reporting standards have been discussed. However what if the main body of standard setter in the world, the IASB, started to establish a new set of standards for the reporting entities. The establishment of this new set of standards could therefore lead a multiple structure of accounting and financial reporting standards causing confusion among the financial statement readers (IASB, 2005: PricewaterhouseCoopers, Comment Letter 57). In other words developing a new set of standards seems to be inconsistent with the Board's mission, which was developing a single set of standards that are applicable all over the world?

However in the preface of the IFRS the Board is also holding itself responsible in those areas (IASB, 2006b);

- *(..) to help participants in the various capital markets of the world and other users of the information to make economic decisions;*
- *to promote the use and rigorous application of those standards; and*
- *to work actively with national standard-setters to bring about convergence of national accounting standards and IFRSs to high quality solutions.*

Consequently since it has been acknowledged the necessities of a stand alone set of IFRS for SMEs because of the specific factors that have been mentioned above, it can

be seen that in fact developing IFRS for SMEs is in line with those objectives. SMEs have undeniably important roles in the economies of both high and low income countries. However in the global world there has been a lack of an accounting standard for SMEs which is convenient and has the quality of financial reporting. With the IFRS for SMEs the quality of the financial information that the SMEs render will increase which will obviously help the investors and the creditors in making their decisions.

Secondly the basic principles of the full IFRS will be shared by much more business entities in the world. In order to access financing instruments in better terms, to develop and apply rules of corporate governance and get align with the full version of the IFRS, the IFRS for SMEs is bound make significant differences. It is therefore developing a new set of standards for SMEs is consistent with the duties of the IASB for providing solutions in order to comply with the information needs to make economic decisions.

5.5. DO THE NATIONAL STANDARD SETTERS SUPPORT AN IASB INITIATIVE

As it has been mentioned in the historical development of the IFRS for SMEs, the need for a global set of standards for SMEs was emphasized in numerous platforms (UNCTAD, 2000). Also the received comment letters in 2004 has underlined this need, appraised and supported the efforts of the Board (IASB, 2004). Especially in emerging economies like Turkey there is a lack of standardization in financial reporting which in details it has been described in many parts of this work. All the countries that have establish the use of the full version of the IFRS is would be the benefactors of this new project.

5.6. OBJECTIVES OF NEW IFRS FOR SMES

Developing a specialized global set of standards for SMEs is a second ambitious project of IASB. The basic characteristics and problems of the SMEs have been mentioned in previous sections. New standards are intended to be to some extend a cure for these

problems. Objectives of the new IFRS for SMEs were set in the discussion paper of IASB (IASB, 2004);

- *provide high quality, understandable and enforceable accounting standards suitable for SMEs globally;*
- *focus on meeting the needs of users of SME financial statements;*
- *be built on the same conceptual framework as IFRSs;*
- *reduce the financial reporting burden on SMEs that want to use global standards; and*
- *allow easy transition to full IFRSs for those SMEs that become publicly accountable or choose to switch to full IFRSs.*

These objectives are comprehensive enough for the basic principles of the IFRS for SMEs. The importance of the each of the objectives has also been emphasized in the previous sections.

5.7. WHICH ENTITIES WILL USE THE IFRS FOR SMES

Although the term of SME is stated in the name of the new standards, it has to be technically clear that which entities are targeted in these standards. Otherwise confusion would be inevitable among both the preparers and reader of the financial statements. However as much as its importance, it is very hard to define the targeted entities with the new set of standards.

5.7.1. How to Define SMEs, Size Test

The definition for SMEs is maybe the most critical issue of the new standards. As it has been emphasized in the beginning sections, there is no common, unique definition upon which all the authorities in the globe agreed. According to UNCTAD (2000) it is good to have no common definition. Definitions change according to economic development

level, geographical and demographic differences, local law and regulations. Consequently the IASB has to consider all those differences if their claim is establishing a global set of standards for SMEs which can be applicable in every jurisdiction. Indeed the Board agrees with the point and argues that "it is not feasible to develop a quantified size tests that would be applicable and long-lasting in all of those countries".

As the definitions, also the definition methods differ with each other. There are two main criteria; the financial statements criteria such as; total asset size or net annual sales, and the structural criteria; mainly the total employee number. The IASB prefers the employee number criteria and defines a typical SME would have 50 employees (IASB, 2004, 2007a). The Board used the 50-employee as a guideline not as a quantified size test for defining SMEs. This focus point helps the Board to "*decide the kinds of transactions, events and conditions that should be explicitly addressed in the proposed IFRS for SMEs"*.

Indeed as it has been emphasized in the previous sections, for SMEs definitions that this assumption is accurate when the employee figures of the SME definitions from all over the world examined. It can be argued that the average SME employment level is 50 in the SME definitions. This is also the case in Turkey when one considers the SME definitions (Ministry of Industry and Trade, 2005).

However apart from the definitions when it can be seen from the real figures, in Europe the average employment number of the SMEs is 4, (refer to the SMEs stats) while in Turkey the average number of the employment among all the business entities is just 3.68 employees per entity. These results indicate the fact that the vast majority of the SMEs are composed of micro-sized entities, generally more than 90 % of them. Therefore although the average definition is 50 employees, the average employee number the SMEs have is around just 4.Consequently it would be wrong not considering the micro-sized entities from the scope of these standards.

5.8. PUBLIC ACCOUNTABILITY PRINCIPLE

Public accountability is one of the founding principles of the global GAAPs. The Board defines the public accountability as (IASB, 2007a); *"accountability to those present and potential resource providers and others external to the entity who make economic decisions but who are not in a position to demand reports tailored to meet their particular information needs".* The main audiences of the financial tables are the investors and in order to produce clear, understandable, comparable, consisted financial idea of standardization of the accounting practices has emerged. The Board argues that publicly accountable entities should use full version of IFRS no matter what their size is (IASB, 2007a). Otherwise they could use the SME version of IFRS ensuring than the jurisdictional qualifications allow.

This argument, in the potential users of the IFRS for SMEs view, decreases the credibility of enfant version IFRS. Holding this argument means that accepting inadequacy of the IFRS for SMEs in presenting true and fair financial information for decision makers. Indeed many of the respondents to the comment letters are not very comfortable with the public accountability based distinction of the Board.

Indeed when it is been examined through the public accountability principle, the IFRS for SMEs becomes only an accounting practice that ensures standardization and thus comparability of the information, not its quality. This approach will be examined in the fallowing part.

5.8.1. Determinants of Public Accountability

The Board defines the public accountability with those indicators in the basis for conclusions on exposure draft (IASB, 2007a). Article c and d were written on the first discussion paper (IASB, 2004) and later in the exposure draft, they were repealed. The reasons are stated below.

"A business entity has public accountability if;

a. it has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market;

b. it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;

c. it is a public utility or similar entity that provides an essential public service; or;

d. it is economically significant in its home country on the basis of criteria such as total assets, total income, number of employees, degree of market dominance, and nature and extent of external borrowings."

According to the Board the entities which do not have the stated characteristics of the public accountability mentioned above can use the IFRS for SMEs. It can be argued that the Board aimed to distinguish between the public interest (requires full version of IFRS) and private interest (requires IFRS for SMEs) and develop essentially light version of the IFRS for the entities upon which the public does not have particular interest. This factor could decrease the credibility of the new IFRS for SMEs, because in the essence there should be no difference between the public financial statement reader and private company's financial statement readers.

In the article (a) the Board defines the ordinary companies that issue any kind of financial instruments so applying to a regulatory agency. This is the most common definition of the public accountability.

In the article (b) also around the concept of "fiduciary capacity" the public accountability was defined. Institutions that have fiduciary capacity operate on public trust For example insurance companies are expected to abide to the clauses in insurance

contracts. If any doubt had appeared that the company cannot abide the clauses, all the contract owners would have lost their assets.

As a matter of fact in general the size of the financial institutions overrides the regional SMEs definitions both in the asset or turnover amount and the employee number. Capital formations, operating structures, labour forces of these institutions are also more complicated and bigger than average SMEs. The financial operations and instruments like swaps, hedges, futures that they exchange and use everyday are much more sophisticated than an average SME's operation.

Also financial entities also held significant roles and they are embedded significant economic rationale. Banks, insurance companies, pension funds are in generally business entities that build the money supply for the credit demands in a country. Their relative performances are accepted as indicators of a country's economic performances and most of the time they are held as benchmarks for other monetary gains. Especially in Turkish model these kind of financial institutions occupy major places in the economy. They have shareholders, depositors, fund owners whose interests should be watched and protected.

Moreover in many jurisdictions, since their performances and operations are vital for the public interest, they operate under examination of official regulatory agencies and laws. Consequently they fit the principles of the public accountability and required to use full version of IFRS.

In the firstly dispatched discussion paper the articles (c) and (d) were written (IASB, 2004). However after the comments received, the Board decided to repeal these articles. For the article (c) in the comment letters and working groups it was emphasized that not all public utility companies are bigger than the medium-sized company standards. There can be small, regional utility companies for whom the use of full IFRS is not very convenient. Commentators insist that rather than the nature of the business activity the

nature of the user of financial statements should determine whether a company can use the IFRS for SMEs or not (IASB, 2005).

The last article (d) was also firstly placed in the discussion paper 2004 and afterwards due to the related comment it was removed. Most of the respondents argue that like in the article (c) economic significance does not automatically leads to the public accountability (IASB, 2005).

Indeed the economic significance and public accountability are not one to one correlated with each other. This kind of distinction would lead further confusion among the financial statement preparers and readers. There are numerous big firms that operate globally but do not offer their shares to public.

Furthermore, the economic significance concept cannot be clearly defined, and so the extent of the public interest in those companies. Indeed there are certain risks about those kind of big companies in the realm of public interest but it is not clear which indicator it should be looked at to determine the existence and the extend of the public interests in those companies.

This kind of approach would need certainly more detailed parameters to determine the significance level of the entities. And thus it would be contradictory with the preliminary view 3.1 (IASB, 2004) that there will be no size test determining the scope of the IFRS for SMEs.

Consequently the Board has also cancelled the article (d) from the draft. It can be argued that the deletion of the article (c) and (d) has contributed to the convenience of the identification of the targeted audience of the draft IFRS for SMEs. Otherwise the scope of the new IFRS for SMEs would be drawn with vague borders.

5.8.2. The problems of the public accountability distinction of the Board

It can be argued that the most prominent underlying principle of the new IFRS for SMEs is the cost and benefit consideration when preparing the financial information to the outside interests. This factor was often emphasized in the comment letters in 2004. The cost of rendering financial information should not exceed the benefit that the readers obtain from that financial information. For instance theoretically if the amount of the public interest is higher than the cost of disclosing financial information of even a micro-sized entity, this financial information should be disclosed on the financial statements regardless the scale of the business entity. However, the problem is how it can be defined and measured the public interest in a given business entity.

In 25th paragraph of the exposure draft the Board acknowledges (IASB, 2007a) that the main reasoning behind a new set of financial reporting standards for SMEs would be the cost and benefit consideration and argued that *"the cost-benefit trade-off should be assessed in relation to the information needs of the users of an entity's financial statements".* However it becomes confusing when the public accountability criterion is put forward for the eligibility of the business entities in using the IFRS for SMEs.

In such a case, the needs of the stakeholders of SMEs those do not go public and those go public should separately be identified. Accordingly the Board argues that the circumstances of SMEs can be different from the larger, publicly accountable entities. They argue that the readers of financial tables of SMEs have more interest in the short term indicators than the long term predictions whereas shareholders of company would look the overall profitability margins, price-earning ratios and growth trends (IASB, 2007a).

However as also the Board acknowledges (IASB), there are certain concepts that have to be considered when preparing financial statements; fair value accounting or revenue recognition regardless whether the preparer of the financial information is public company or non-public or whether needs of the financial information reader. The Board

therefore admits the dilemma and defends the point by arguing that (IASB 2007a, Par 26) *" (…) differences in the types and needs of users of SMEs' financial statements, as well as limitations in, and the cost of, the accounting expertise available to SMEs, suggested that separate standards for SMEs are appropriate."*

Furthermore while explaining the reasoning behind taking the full version of the IFRS as the base for the IFRS for SMEs the Board acknowledges that (IASB, 2007a, p67) the needs of the financial statement users of the publicly accountable business entities are similar to the readers of SMEs.

In the essence there should not be any difference between financial reporting of a public entity and non-public one. It is very natural that in details the financial information readers could focus on different parts of the financial statements. However since the full version of the IFRS include more comprehensive accounting and financial reporting treatments than the SME version, logically and technically there should be no need to different financial reporting standards. The Board and the commentators of the discussion papers acknowledge that the full version of the IFRS is suitable for all the entities (IASB, 2007).

The IASB admits this dilemma and because of the zero sum game between the cost of the financial information and the quality of the financial information creates this paradoxical situation. This was also pointed out in some comment letters. They commentators argue that the IFRS and IAS were not developed for only the public entities (IASB, 2005). Thus the proposals of developing a new set of standards only for companies that do not have public accountability were considered inappropriate. There are treatments for publicly non accountable firms in the full version of the IFRS. Examples of these were also underlined in the discussion paper 2004 (IASB, 2004) paragraph 9;

- *IAS 14 Segment Reporting: It requires disclosure of segment information only by entities whose equity or debt securities are publicly traded.*

- *IAS 27 Consolidated and Separate Financial Statements: It exempts some parent companies from preparing consolidated financial statements if their debt or equity instruments are not traded in a public market. Similar exemptions are in IAS 28 Investments in Associates and IAS 31 Interests in Joint Ventures.*
- *IAS 33 Earnings per Share: It requires presentation of earnings per share data only by entities whose ordinary shares or potential ordinary shares are publicly traded.*

The financial statements are simply means for the protection of interests of the stakeholders, not a final product to be reached. Consequently according to the needs of the financial statement readers, the means should be aligned. However there should be also a cost-benefit analysis when rendering the financial information to the readers. This is the case in the argument that the Board cannot deal with very specialized needs for a group of financial statement readers. For instance it is certainly inconvenient of the Board to consider reporting needs of managements of firm in their cost accounting policies.

As also the Board has noted (IASB 2007a), in fact it is impracticable to define every different need of the readers and prepare different reporting standards for each of them. Besides if it is considered that the argument that even a smallest SME can report with the full version of the IFRS, then the only material distinction between the full version of the IFRS and SME version would be the cost and benefit considerations. A financial reader who is interested in short-term indicators can also be satisfied with the full version of the IFRS.

Therefore it can be argued that the distinction between the firms according to the public accountability principle is not very proper. However it is also practically impossible to make clear distinction with the cost and benefit criteria. Determining the cost of the financial information and related benefit is nearly impossible. Although it is relatively easy to calculate the cost of financial reporting simply by considering the management fees of

the accounting department and cost of accounting systems, it is almost impossible to calculate benefits of the every reader of the financial statements.

Consequently the public accountability consideration has been put down, because there is no need to establish separate set standards since every business entity and financial statement reader can use the full version of the IFRS given that the new standards are just somewhat light version of the old ones.

Secondly the cost and benefit of analysis of the financial statement has been put down because even the cost of the financial data can be calculated the benefit that is obtained from this financial data cannot be determined correctly.

Thirdly as a global standard setter, the IASB theoretically should not prepare financial reporting standards for the benefit some exclusively groups like creditors of SMEs. This aspect is also acknowledged this fact and makes the point by saying that (IASB, 2007a) *"SMEs often produce financial statements only for the use of owner-managers, or for tax reporting or other non-securities regulatory filing purposes. Financial statements produced solely for those purposes are not necessarily general purpose financial statements"*. Otherwise this would damage the idea of single set of standards by creating different versions of the IFRS.

Finally if a common definition of the SMEs in the world cannot be established and there is no clear indicators of being a SME how can the IASB decide who will use of the new IFRS for SMEs?

The IFRS for SMEs should be considered as an *"allowed alternative treatment"* for SMEs which wants to meet the requirements of full IFRS and thus acquire the benefits of it but cannot bear the burden of financial reporting with full IFRS. In addition to this, the cost and benefit analysis of choosing; whether to report in a distinctive GAAP or whether to use the full version of IFRS or the SMEs version of it, should be leaved to the

managements of the business entities. Of course in the first selection would be meaningless if there is a legal enforcement of using a GAAP in a country.

Moreover because the Board does not have any kind of supranational power yet and the application power of the IFRS still is in the hands of regional jurisdictions, this also should be the case for the IFRS for SMEs. Regional jurisdictions should determine which business entities can use the IFRS for SMEs as an allowed alternative treatment of the full version of IFRS provided that in such country the financial reporting with IFRS or IFRS for SMEs is obligatory.

The distinction of the public accountability of the firms should be made by the legal authorities. The public accountability is clear for the case of an issuance of equity in the stock markets. Consequently the detailed parameters for other distinctions; such as *"the fiduciary capacity",* (IASB, 2007a) can be determined by the legal authorities. For example in Turkey, the Capital Market Board (CMB) regulates the rules of financial reporting for the public companies with the IFRS. And for the insurance companies, which have fiduciary capacity, the financial reporting is regulated by the Undersecretariat of Treasury.

Consequently it would be more appropriate that the IFRS for SMEs should be provided to the SMEs as an allowed alternative treatment of full IFRS. Secondly the business entities that are eligible to use the IFRS for SMEs should be described by the legal authorities in align with the principles that are set in the standards.

5.9. DIFFERENT USER NEEDS (STANDARDS FOR MANAGERIAL DECISIONS)

The Board has considered some options that the IFRS for SMEs should be aligned for different needs such as the determination of the taxable income, or being a basis for managerial decisions. This kind of adjustments to the standards would be against to the essence of the standardization of the accounting policies.

Indeed it is obvious that the IFRS for SMEs was not designed to serve the information needs of the managements of the SMEs. Likely the Draft cannot serve appropriately to the regional jurisdictions for the taxation purposes.

The full version of the IFRS is being used in numerous countries as a global accounting standard and therefore from this aspect it is clear that from a global accounting standard it cannot be expected to meet very special demands of the minority financial statement readers. Otherwise preparation of such kind of standards would be cumbersome and implausible.

5.10. IFRS FOR MICRO-SIZED ENTITIES

In general micro-sized entities are referred for the business entities with employee numbers fewer than 10 which is also included in the Turkish legal definition of SMEs (Ministry of the Industry and Trade, 2005). Moreover according to the 2002 Common Industrial and Workplace count (Turkstat, 2002) in Turkey nearly 95 % of the business entities held employees fewer than 10 and thus can be called as micro-sized entity. Most of them are personal business entities that operate with very simple transactions and since main part of them are referred as second class traders according to the taxation laws and they are not required to held legal accounting books. However even the sheer number of these entities makes them very significant.

The groceries in the remote parts of the streets, small restaurants, workshops for simple production, hairdressers can be examples of these micro entities. Apart from their size it can be argued that they held a major part in the economic morale of the Turkish society. They are the closest types of the business entities to the common people and two way transmitter of the signals of the economy to them.

However the Board is not accepting to (IASB, 2007a) develop even a simpler version of the IFRS for SMEs for these kind of business entities. Some of the respondents

argue that these kinds of business entities are already report for the taxation authorities and developing a set of standards would be helpful for these entities in taxation reporting (IASB, 2005). The Board argues that developing standards for determining the taxable income is not in the scope of the GAAPs but it is in the authority of the regional jurisdictions (IASB, 2007a).

The Board also argues that (IASB, 2007a) although developing a more simple set of standards, even closer to a cash basis accounting, could be a lower cost option for the micro-sized entities, the IFRS for SMEs is also appropriate for these kinds of entities . The IASB added that a simpler version of the IFRS for SMEs would be insufficient for financial statement readers in determining the economic status of the entities and consequently these kinds of financial statements would not improve the ability of accession to capital of the micro-sized entities (IASB, 2007a).

Yet it can be argued that it is impossible to ignore the micro-sized entities when developing a set of standards that aims the SMEs. On the other hand a further division in the new SME standards could lead problems. Firstly new standards require new knowledge and therefore it is very inconvenient to establish another simpler version of the IFRS both for the Board and for the financial statement readers.

Secondly micro-sized entities operate with very simple structures and face simple transactions. Most of the time their revenues are very low and cost of preparing financial information could easily surpass the benefit of that financial information. Consequently in the most of the cases it would be not beneficial to prepare complex financial statements for these kinds of entities. Furthermore if there would be legal obligation to prepare such financial statements, it would be for the taxation purposes and consequently these financial statements are out of the scope of the Board and they should be designed by the regional jurisdictions.

Thirdly in the instances when the cost-benefit criterion is met, preparing financial statements in align to a very simple set of standard, even to a cash basis approach, would not supply qualified financial information to the readers. Therefore the Board argues that the IFRS for SMEs would be the best available option for the micro-sized entities in such cases.

Fourthly in Turkey most of micro-sized entities do not use proper accounting systems or simple accounting books such as general ledger. Therefore it would be meaningless if there would be a separate set of accounting standards for micro-sized entities. Even if such set of standards will established, most of the micro-sized enterprise owners would not understand and apply those standards due to lack of basic accounting skills and knowledge.

It can be said that only very minor part of the micro-sized entities have proper intellectual skills, managerial commitment and economic size that fits the cost-benefit rule to employ a set of accounting standards like IFRS for SMEs Consequently the Board's decision in the attitude of the micro-sized entities seems appropriate.

5.11. TOPICS COVERED IN IFRS THAT ARE OMITTED FROM THE DRAFT IFRS FOR SMES

In this section the omission from the IFRS for SMEs will be discussed. The omissions should be considered as cross references to the full version of the IFRS. When an entity faces with the accounting treatment that was not addressed in the IFRS for SMEs, it is required to look at a particular IFRS or to a section of one (IASB, 2007a, 2007b).

However this kind of treatment may lead the SMEs to a harder position. Due to the omitted accounting treatments, SMEs would face with much more complex accounting treatments of the full version of the IFRS than the overall complexity of the IFRS for SMEs.

In the end an average SME would end up with financial reporting issues most of which was regulated with the full version of the IFRS and thus increase the burden of the SMEs.

Consequently there should be a delicate balance between the complexity of the whole reporting package and the benefit of it. To put it differently, the cost and benefit of the financial information should be smoothly balanced for SMEs, as it has been described the main reasoning behind the new set of standards.

5.11.1. Hyperinflation

Inflation is defined as a rise in the average price of goods over the time (Begg, Fischer, Dornbusch, 2000). If the inflation levels stay very high on an extended period then it can be called the phenomenon as the hyperinflation. The most distinctive sign that is underlined in the IAS 29 for the hyperinflation is (IASB, 2006b); *"the cumulative inflation rate over three years is approaching, or exceeds, 100%"*. Although this was the case for many years for our country, in the last two years the cumulative inflation rate of previous three years has fallen beyond the 100% level. In the end of the year 2006 the cumulative inflation over the previous 3 years is roughly 29 % (CBRT, 2007) which is far below the 100% level. Therefore hyperinflation is no more a relevant concept for Turkey. However this has been realized for only last three year period.

The Board has argued that it is uncommon for SMEs to have a hyperinflationary functional currency (IASB 2007b). It can be argued that the hyperinflation is a common phenomenon for developing countries with in which the SMEs held major roles in their economies. Although it is no more an existing phenomenon for Turkey, hyperinflation is still exists in emerging and least developed countries. Therefore it can be argued that on the contrary to the Board's argument it is not very uncommon for SMEs to have a hyperinflationary functional currency.

Nevertheless the application of the IAS 29 (IASB, 2006b) would not bring much burden to a typical SME that operate under hyperinflationary economies. In general most of the hyperinflationary countries financial reporting issues are already regulated by local GAAPs and general price indexes are constructed in order to determine the effects of the inflation. This was the case in Turkey. Although it did not last very long, between 2004 and 2005 in Turkey hyperinflationary accounting was on practice. There were average price indexes and restatement of financial statements was done in align with IAS 29.

Besides in overall the IAS 29 does not require so much managerial judgment and accounting skill to apply (IASB, 2006b). Consequently a typical SME whose functional currency is a currency of a hyperinflationary economy would not have serious problems in apply the IAS 29.

5.11.2. Equity-settled share-based payment

Share-based payment transactions are defined in both the IFRS 2 (IASB, 2006b) and in the Section 25 Share Based Payments of the IFRS for SMEs (IASB, 2007b) as;

a. *"equity-settled share-based payment transactions, in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options),*
b. *cash-settled share-based payment transactions, in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity, and*
c. *transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments."*

The SME version of the IFRS regulates the transactions in the article (b), cash-settled share-based payment transactions and (c) share-based payment transactions with cash alternatives. However for the article (a) equity-settled share-based payment transactions the IFRS for SMEs refers to the IFRS 2 for the accounting treatment considering the idea that this kind of transaction is uncommon for the SMEs (IASB, 2007a).

However on the contrary it can be argued that the most common type of share-based transaction of SMEs in Turkey is the equity-settled share-based payment transactions. Most often the owners of the SMEs use this kind of transactions as tool for compensation of high level professional workers within the firms. SMEs prefer this kind of transactions in order to hold the skilled professional executives tied to the organizations because of limited levels of cash based compensations and relatively low firm attractiveness.

It is therefore it is not consistent to hold out the equity-settled type transaction. Nevertheless the IFRS 2 (IASB, 2006b) has lay out some measurement simplifications which has made easier the application of it.

5.11.3. Agriculture

In the Basis for Conclusion section of the IAS 41 (IASB, 2006b) it is argued that although "*most of the business organizations involved in agricultural activity are small, independent, cash and tax focused, family-operated business units, (…)",* increasing commercial activity of the agricultural products required a standardization for the financial reporting of those entities. As a matter of fact the IAS 41 has emerged from the expectations very similar to the IFRS for SMEs.

As in the other countries, in Turkey most of the agricultural activities are conducted by SMEs. This fact is also stated in the draft basis for conclusion by arguing that many entities that undertake agricultural activities are SMEs (IASB, 2007a).

However the Board did not amend a separate section for agricultural activities by arguing that typical SMEs do not undertake those activities (IASB, 2007a). In the section of 35, the specialized industries, there are options (IASB, 2007b);

(a) The entity shall apply the fair value model in paragraphs 10–29 of IAS 41 Agriculture to account for those biological assets whose fair value is readily determinable without undue cost or effort, and the entity shall make all related disclosures required by IAS 41.

(b) The entity shall measure at cost less any accumulated depreciation and any accumulated impairment losses those biological assets whose fair value is not readily determinable without undue cost or effort. (…)

Consequently the entities that have difficulties in determining the fair value of its biological assets could choose the second option and measure their assets by their costs less the accumulated depreciation of the assets. This approach has been in aligning with the arguments in the comment letters about the further simplification of the valuation of the biological assets.

This approach has considerably reduced the burden on the SMEs that deals with agricultural activities. Nevertheless if the entities want to report its agricultural activities with the IAS 41 which is also a relative flexible standard, it is welcomed to do so.

5.11.4. Interim Financial Reporting

The section 37 of the IFRS for SMEs draft requires two options of a SME that issues interim financial statements; either to apply IAS 34 or all of the requirements that the IFRS for SMEs proposes (IASB, 2007b).

As also the Board has also argued that interim financial reporting is not very common among the SMEs (IASB, 2007a). Most of the SMEs prepare interim financial statements when there will be a business combination or an application for a high volume credit. It is obvious that the section 37 leaves SMEs enough room. If they choose to apply all the requirements of the IFRS for SMEs, their burden will be just as the same (IASB, 2007b).

Secondly they can choose the IAS 34. Then either they can apply the whole requirements of the full version of the IFRS which is of course practically not necessary to do or they can prepare financial statements in a condensed form as it is described in the standard (IASB, 2007b).

According to this treatment the easiest way would be to apply all requirements of the IFRS for SMEs in their interim financial reporting which is an ideal and reasonable treatment in the interim reporting.

5.11.5. Lessor Accounting for Finance Lease

The section 19 of the IFRS for SMEs entails treatments for accounting for lease transactions. The section contains lease accounting from the three aspect of the lease transactions; accounting for the operating lease from the lessor side, lessee side and accounting for the finance lease from the lessee side (IASB, 2007b). For the accounting for the finance lease from the lessee side the users should refer to IAS 17.

The Board argues that it is very unlikely for typical SME to engage as a lessor in a finance lease (IASB, 2007a). In order to be a lessor in the lease transactions business entities would be obviously greater than the SME thresholds. Therefore it can be said the treatment of the standards is appropriate.

5.11.6. Earnings per Share

Earnings per share transactions are generally disclosed for the information of the shareholders of the publicly accounted business entities. However for a typical SME this would be unnecessary. Most often shareholders of the SMEs are also presented in the management levels. Therefore they have easy access to the formation about earnings per share.

Nevertheless if a SME would like to disclose earnings per share information on the income statement it will refer to the IAS 33 (IASB, 2007b).

5.11.7. Segment Reporting

The core principle of the segment reporting was defined in the newly established IFRS 8 as (IASB, 2006b); *"an entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates"*. The main idea behind this accounting treatment is to provide information to the financial statement readers about different economic environments, related risks to these environments in order to assess the overall operation risk that the entity has.

However, generally SMEs do not operate in multiple economic environments. A typical SME does not have foreign operations or subsidiaries. Therefore it is not very relevant for a SME to disclose segment information on the financial statements.

Consequently the IFRS for SMEs does not address this accounting treatment and make referral to the IFRS 8 for SMEs which would like disclose segment information (IASB, 2007b). However in the IFRS 8 the scope of the requirements of the standards was defined roughly same as the determinants of the public accountability were stated in the proposal of the new IFRS for SMEs (IASB, 2006b).

"This IFRS shall apply to:

- *the separate or individual financial statements of an entity or (b) the consolidated financial statements of a group with a parent:*

- *whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or*

- *that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;"*

Consequently if a business entity which can present its financial statements according to IFRS for SMEs wants to disclose its segments in its financial statements will be automatically excluded from the IFRS 8 and consequently cannot disclose its segment information. Otherwise its financial statements will not be considered comply with the IFRS for SMEs.

5.11.8. Insurance

Insurance companies hold liabilities to customers who cannot demand directly relevant financial information from the management. In other words they hold assets in a fiduciary capacity for outside groups (IASB, 2007a) and therefore have public accountability. Consequently they are not in the scope of the IFRS for SMEs standards.

5.12. RECOGNITION AND MEASUREMENT SIMPLIFICATIONS

Recognition and measurement simplifications are the main reasoning behind a new set of IFRS. Therefore it is essential to perform careful consideration for these simplifications.

There is a delicate balance between cost and quality in the financial statements. Less costly applications could lead a decrease in the quality whereas the quality brings cost to the preparers.

Consequently the simplifications in the IFRSs should be in align with the cost and benefit evaluations of the SMEs. While performing the simplification efforts, it is important to keep in mind the availability of the treatments in the full standards. In other words if there is a simplification in an accounting standard, an entity can choice its accounting practice among a spectrum of treatments that go gradually simple to complex; from the easy option in IFRS for SMEs to the allowed alternative treatments and the main treatment of the full IFRS.

The base framework of the IFRS for SMEs is the full version of the IFRS and IAS. Indeed as the Board has noted it would not be appropriate to make a fresh for a new set of standards for SMEs (IASB, 2007a). Since the main motive is to set standards that are more palliative and less costly for the SMEs as well as they entail the core principles of IFRS, modifying those standards is the best option.

Therefore according to this approach with the comment letters the Board has amended some simplifications on the standards that are applicable to SMEs.

5.12.1. Financial Instruments

The IAS 39, 32 and the IFRS 7 are maybe the most burdensome accounting and financial reporting standards to the business entities, especially SMEs which are generally lack in skilled accounting labour and customized accounting systems to apply the requirements of this standard.

The most of the burden of the standards comes from the definitions, categorization and disclosure requirements of the financial instruments. The section 11 of the IFRS for SMEs deals with the financial instruments combining the three separate standards within it (IASB, 2007b). At the first step the section offers to the user two options; applying the section or referring to the IAS 39 for recognition and measurement and IFRS 8 for disclosure purposes.

Thus because of the simplifications and cross-reference to IAS 39 and IFRS 8 the definitions and classifications were decreased in the section 11 of the IFRS for SMEs. Firstly the groups of the financial instruments are reduced to 2; that are measured at cost or amortized costs and the rest measured with fair value through profit or loss (IASB, 2007b) and thereby putting out the available for sale and held to maturity classifications.

This is a positive simplification for SMEs. In general financial instruments in SMEs do not have much diversified pattern. Although the emergence of new kind of financial instruments and increasing use of hedging items in order to offset the currency or interest rate risk, especially in developing countries where the future expectations and economic conditions are not stable, this pattern did not change much. Anyway with more diversified portfolios it is still burdensome for SMEs to categorize their financial instruments into such detailed categorizations.

For example for the categorization of the held to maturity investments the IAS 39 (IASB, 2006b) dictates that the cash flows and the maturity of the investment should be

determined. Secondly the entity has a positive intention and ability to hold the asset to its maturity. Besides if the entity has sold or reclassified significant amount of it's held to maturity investments then for the next two year there should not be any classification of financial instruments as held to maturity financial instruments.

Also the process of derecognition of a financial asset is very complex. The determination of all risks and rewards of the ownership, the level of control on the asset is burdensome and complex for the SMEs (IASB, 2006b). Although it is still somewhat complex for a typical SME to derecognize a financial asset, it became easier.

Accounting for hedging transactions is another issue that the standards deal with. Compare to other financial techniques hedging is a relatively new technique. It is mainly used in order to reduce unsystematic risks that arise from the market; such as interest risk or currency risk. In Turkey especially for the currency risk hedging instruments have became popular among the firms which deal with export and import transaction with outside world through foreign currencies and the number of those SMEs is very significant.

In order to deal with the hedge accounting treatments in the IAS 39 a firm should have document properly the reasons and the risks that forces to enter hedge transactions and the effectiveness of the hedge instrument to offset these risk through the end of the hedge transaction (IASB, 2006b).

The Board (IASB, 2007b) defines the most likely sorts of hedging items are;

- *interest rate risk of a debt instrument measured at amortised cost;*
- *foreign exchange risk or interest rate risk in a firm commitment or a highly probable forecast transaction;*
- *price risk of a commodity that it holds or in a firm commitment or a highly probable forecast transaction to purchase or sell a commodity; or*
- *foreign exchange risk in a net investment in a foreign operation.*

In the framework level, the conditions for hedge accounting have not been changed. It is still required for the entity to document the relationship between the hedged item and hedging instrument. The disclosure of the risks that are offset with hedging and effectiveness test of the hedge instrument are still required.

For the hedge effectiveness test the draft entails no testing requirement in the middle of the accounting periods (IASB, 2007b). The test is required to make at the end of financial reporting period. Whereas the in the IAS 39 entities required to consider the hedge effectiveness throughout the hedging time period which can be costly for the most of the SMEs (IASB, 2006b).

BC76 Section 11 also differs from IAS 39 with respect to hedge accounting in the following ways (IASB, 2007a):

- *Hedge accounting cannot be achieved by using debt or equity instruments ('cash instruments') as hedging instruments. IAS 39 permits this for a hedge of a foreign currency risk. However, the same effect on profit or loss can be achieved by measuring the cash instrument at fair value, which Section 11 requires for some cash instruments and permits for others. SMEs typically sell the cash hedging instrument when the hedging relationship terminates.*
- *Hedge accounting cannot be achieved with an option-based hedging strategy. Because hedging with options involves incurring a cost, SMEs are more likely to use forward contracts as hedging instruments rather than options.*
- *Hedge accounting for portfolios is not permitted. Hedging portfolios adds considerable accounting complexity because of the need to remeasure all of the hedged items individually at fair value to ensure that the appropriate amounts are derecognised when the instrument is sold and to ensure that the amortisation is appropriate when an instrument is no longer being hedged.*

Indeed as the Board has pointed out these practices are too complex for an average SME to use and the related simplifications are appropriate.

In the section 11 the Board also emphasizes that a SME could opt out for the use of the IAS 39 accounting treatments (IASB, 2007b). This approach is suitable since there would be exceptions among the SMEs that want to employ advanced measurement techniques of the IAS 39 in order to correctly determine for instance the hedge effectiveness through out the period. This kind of treatment would be beneficial in presenting a more detailed risk and return approach in the valuation of the financial assets.

5.12.2. Goodwill Impairment

During the round table meetings and in the comment letters it is argued that (IASB, 2005) for typical SMEs it is pretty burdensome to calculate the recoverable amount of goodwill every year because of costly technical and financial expertise. Therefore it has been proposed that the test of goodwill impairment should be made when there are significant indicators of the impairment and furthermore in order to create guidance for SMEs, a list of indicators of impairment were stated in the section 26 of the IFRS for SMEs (IASB, 2006b).

Most of the SMEs are lack of sophisticated accounting and finance departments, goodwill impairment tests can be quite burdensome for them. Consequently providing basic guidelines for the SMEs in deciding the goodwill impairment would lessen the burden. Thus accounting of the goodwill became much easier for SMEs with this simplification.

Apart from these simplifications the Board has noted that there were proposal about allowing a straight goodwill amortization over a defined useful life. They argue that a simple amortization of the goodwill would be easier than an impairment test of it. However the Board (IASB, 2007b) rejected the proposal with two main arguments. Firstly

the board considers that it is still required technical expertise to assess the amortization amount of the goodwill. Secondly it is not easy to define the useful life of the goodwill for a SME.

5.12.3. Treat all research and development costs as expenses

IAS 38 requires charging the costs as expenses when a project is in the research level and it is not clear that the project is economically viable. Afterwards in the development phase when it becomes clear that the project economically viable, business entities are allowed to capitalize their costs related to the development of the project (IASB, 2006b).

Generally SMEs cannot generate any intangible assets from these kinds of research and development costs. Firstly because they do not very often engage research and development activities and secondly when they engage they cannot or do not fulfill appropriate requirements for generating asset from these costs. Besides the outside creditors of the SMEs do not give much trust to those internally generated assets.

Also this fact is emphasized by the Board and in the section 17 of the standards for SMEs it stated that (IASB, 2007b);

> "*Costs incurred in development activities are also recognised as expenses except for those development costs incurred after specified criteria are met, which are recognised as the cost of an intangible asset. An entity that chooses the capitalisation model as its accounting policy shall follow the requirements of paragraphs 51–67 of IAS 38 Intangible Assets."*

Therefore the SMEs are allowed to charged costs that are incurred after to development phase section 17 of the IFRS for SMEs. Furthermore it is also allowed for SMEs to refer to the IAS 38 and capitalize the costs related to the project as the standard requires (IASB, 2007b).

It can be argued that this simplification is very positive for SMEs which engage research and development activities. It is quite burdensome to fulfill the requirements of the capitalization of the costs in those activities. On the other hand if the SMEs were to choose to capitalize these costs they can refer to the IAS 38.

5.12.4. Cost Method for Associates and Joint Ventures

The Board has noted that in the discussion papers respondents criticize the ineffectiveness of the equity method and proportionate consolidation methods for the SMEs (IASB, 2005). In general SMEs have problems in accession to the qualified information from their investments. This factor decreases the convenience of the equity method of accounting.

The Board also argues that the creditors generally do not trust the financial information rendered through the equity or proportionate consolidation methods because they do not provide useful information about the cash flows of the investments or indirectly the security of the loans (IASB, 2007b).

Therefore the Board has concluded to make the cost and fair value through profit or loss method available in accounting of investment in associates and joint ventures (IASB, 2007a, 2007b). Thus it became easier for a SME to valuate its investments either with fair values, that are available in the market, or the with investment cost for the SME.

5.12.5. Income Taxes – "Timing Differences Plus" Approach

Taxation regulations have a strong impact on Turkish accounting systems. Indeed the Turkish public statutory accounting system Uniform Chart of Accounts is mainly affected from and established for taxation regulations. Thus all of the firms that have legal

obligation to fallow its deferred and prepaid taxes. These amounts in fact could result in significant cash flows as it was emphasized in the previous sections.

Therefore the "current taxes payable" approach in which there is no recognition of the taxes payable is inappropriate as the Board points out (IASB, 2007a).

5.12.6. Less Fair Value for Biological Assets

As it has been described under the heading of agricultural activities, due to the problems about valuation of the biological assets of the SMEs that deals with the agricultural activities, the Board has concluded in the draft that (IASB, 2007a)

> "*SME should be required to use the fair value through profit or loss model only when fair value is readily determinable without undue cost or effort. When that is not the case, the Board concluded that SMEs should follow the cost-depreciation-impairment model"*.

Consequently, section 35 of the draft IFRS for SMEs requires (IASB, 2007b); "*the entity shall measure at cost less any accumulated depreciation and any accumulated impairment losses those biological assets whose fair value is not readily determinable without undue cost or effort".*

5.12.7. Share-Based Payment

The Board has regulated the share-based payments in the section 25 of the new IFRS for SMEs except the equity settled share-based payments (IASB, 2007b). For this kind of transactions section 25 refers to IFRS 2. The Board argues that there is enough flexibility for SMEs in IFRS 2 for equity-settled share-based payments (IASB, 2007a).

The main problem of the SMEs in this kind of transactions is to determine the fair value of the equity. Since they are not a publicly accountable firm, that has its shares on

the stock market and can easily determine the fair value of its equity, they have problems of valuating their equities. The lack of information and technical skills also deepens the problem. In order to solve this kind of problem IFRS 2 offers the option of measuring the equity instruments at its intrinsic value (IASB, 2006b)

5.12.8. Leases

Lease accounting is another major accounting issue for SMEs, because as a financial tool lease transactions are used extensively by SMEs. The measurement simplification enacted by the Board in IFRS for SMEs for the finance leases is in the determination of the fair value of the lease asset. In the IAS 17 while determining the value of the lease asset the entity shall take the lower of the present value of the minimum lease payments and the fair value of the leased property (IASB, 2006b). On the other hand the section 19 of the IFRS for SMEs requires only the fair value of the leased property at the inception of the lease plus any initial direct cost of the lease (IASB, 2007b).

However it can be argued that although the simplification is made by decreasing the valuation method into one, the dismissed method, the calculation of the present value of the minimum lease payments, is in fact the easier one. The determination of the fair value of a lease property, especially if there is no active market for that property, is far more costly and burdensome than simple discounting future cash flows to present.

Determining the net present value of the lease payments should be a benchmark treatment and the fair value option will be considered as an allowed alternative treatment especially in the cases where there is significant difference between the two values.

5.12.9. Transition to IFRS for SMEs

The IFRS 1 first time adoption of the international financial reporting standards requires entities to restate its previous financial information in align with related standards

for purpose of comparability of the financial information (IASB, 2006b). The Board argues that according to the commentators this practice is quite burdensome for SMEs that start to prepare financial statements according to IFRS for SMEs (IASB, 2007a).

In the section 38 of the IFRS for SMEs in the first time adaptation to the standards a practicality exemption has been offered (IASB, 2007a). Consequently if it is impracticable for a SME to present its previous financial information under the IFRS for SMEs, then the SME is not required present any financial information that is prepared under the standards. In such case this exemption should be disclosed.

It can be argued that this will be an encouraging factor to SMEs to make transition to the new standards, without loading burden on the financial reporting efforts. This attitude provides positive motivation to SMEs which are considering presenting their financial statements under the new IFRS for SMEs.

5.13. SIMPLIFICATIONS CONSIDERED BUT NOT ADOPTED

There are also simplifications that were offered by the Board members, commentators in the round table discussion or comment letters. In this section the approach should be the same as it has been described before; preserving a delicate balance between the quality of the financial statements and the cost of preparing those financial statements. Therefore reasoning behind not adopting a simplification should be the effort to increase the quality of the financial information in the statements of SMEs.

5.13.1. Not To Require A Cash Flow Statement

According to the many of the financial statement readers of the SMEs this would be the most inappropriate simplification (IASB, 2005). Cash flow statements are the main financial indicators of most of the SMEs. The off-balance sheet items, inconsistent accounting practices, and simple structure of balance sheets, do not provide enough

information for creditors, outside interests. Besides, most of the financial strength of a SME comes from its ability to create cash against its loans and payables to outside. Therefore it can be argued that the cash flow statements are one of the essential financial statements that provide reasonable information for the decision-makers.

Also the Board has noted that there are some arguments that the preparation of the cash flow statements is burdensome for SMEs (IASB, 2007a). Answering this argument the Board pointed out that constructing a cash flow statement after the preparation of the balance sheet and income statement is relative easier and furthermore SMEs have simpler cash flow structures than big-sized business entities.

Therefore the omission of the cash flow statement could damage the quality of financial information while little effect of reducing the cost of it. Consequently cash flow statement should be an essential part of financial statement set that the IFRS for SMEs requires.

5.13.2. Treat All Lease as Operating Lease

The main difference between the operating lease and finance lease in the financial statements of the lessee is that in the operating lease the lessee does not classify the lease property as an asset whereas in the finance lease it does. In the operating lease the lease payments are considered as the financial expense and showed in the income statement. Whereas in the finance lease one should determine the useful life of the leased asset, any residual value of it, implicit lease rate or the incremental barrowing rate. Consequently the accounting practice of the operating lease is much easier than the finance lease.

The Board has noted that the finance lease in the substance is same as a purchase of an asset on credit and argued that the creditors do not want off-balance sheet financing in the SMEs financial statements (IASB, 2007a). This would be a case when the terms of

the lease agreement transfers all the risks and rewards of the ownership of the leased asset and the lessee applies operating lease accounting.

It is obvious that these kinds of accounting treatment could really caused unrecognized assets in the balance sheet provided that the ownership of these assets practically belongs to the business entities. Besides in Turkey for example for the taxation purposes the operating lease is generally not allowed and that makes this simplification meaningless for the SMEs.

5.13.3. Treat All Employee Benefit Plans as Defined Contribution Plans

Defined benefit plan and defined contribution plan are the two IASB classifications of the post-employment benefits (IASB, 2006b, 2007a). The distinction is made according to the realization of the payments. In the defined contribution plans there is a fixed payment and the contribution that the employee receives is the amount of the payments made and the financial gain that is obtained from the payments (IASB, 2007a).

On the other hand defined benefit plans include benefits that are not only linked to the fixed payments but also to other components or clauses (IASB, 2006b). For instance there can be an increase in the amount of the payments according to the inflation rates. Consequently it is harder to measure the present value of the defined benefit than the defined contribution plan where the benefits are received by fixed payments. There should be estimates and judgements about the gains and losses from a defined benefit plan.

Same as in the accounting for finance lease issue defined above, the Board argues that the creditors do not like off-balance sheet liabilities (IASB, 2007a). So if it was allowed to account all employee benefit plans as defined contribution plans there would be some unrecognized liabilities for the entities which will distort the quality of the financial information of the SMEs.

5.13.4. Completed Contract Method for Long-Term Contracts

In general completed contract method of accounting the construction contracts causes significant fluctuations in the profits levels. On the other hand completed contract method is the easiest way of accounting the construction contracts. However due to deferred loss and income amounts, financial information could be misleading.

The Board argues that the financial statement users prefer the percentage completed method considering that the method reflects financial information more relevant (IASB, 2007a). Although the completed contract method is easiest, because it does not provide financial information fairly the Board opted out in implementing the percentage completion method (IASB, 2007a). This method will obviously increase the quality of the financial information of SMEs that work in the construction sector and thus the access of capital (Göğüş, 2006).

5.13.5. Fewer Provisions

Provisions are the accounts that regulate the income and expense accounts thereby correcting the amounts and increasing the accuracy and fairness of the financial statements. However, generally provisions need accounting, technical and professional skills, internal and external information in order to be correctly measured. These factors eventually increase the burden over the entities. So there is a cost and benefit dilemma in also taking provisions in the balance sheets.

The Board argue the financial statement readers demands information about uncertainties and thus provision on the financial statements (IASB, 2007a). Consequently making fewer provisions could decrease the quality of the financial information dramatically and as a result the Board did not accept the enacting fewer provision in the Draft (IASB, 2007b).

5.13.6. Non-Recognition of Share-Based Payment

Again like in the previous headings non-recognition of share-based payments could distort accuracy of financial statements. The Board argues that this kind of treatment would distort financial statements (IASB, 2007a) and it is also unnecessary because in the IFRS 2 there are already made simplifications.

5.13.7. Non-Recognition of Deferred Taxes

As it has been described in the previous section in some jurisdiction like Turkey taxation regulations have strong effect on the accounting structures of the business entities. Besides again in some jurisdiction because of complex taxation practices all of the business entities including SMEs already recognize their deferred tax assets and liabilities in their financial statements. Therefore it can be argued that marginal cost of recognizing deferred taxes is not too high for most of the SMEs.

On the other hand those assets and liabilities can create significant cash flows to entities (IASB, 2007a) and not recognizing such assets and liabilities in the financial statements could decrease their quality significantly. Consequently non-recognition of deferred taxes in the financial statements would be inappropriate for most of the SMEs.

5.13.8. Cost Model for All the Agriculture

The Board evaluates the proposals that suggest a cost model for all biological assets, giving up the fair value accounting in agricultural activities as inappropriate (IASB, 2007a). It can be argued that in general most of the agricultural products have regular markets and so market prices (IASB, 2007a). Therefore the Board rejected the proposal.

Nevertheless it can be said that there is enough flexibility on the valuation of the biological assets provided in the section 35 of the IFRS for SMEs with the gradual treatment by allowing cost less accumulated depreciation method (IASB, 2007b).

5.13.9. No Consolidated Financial Statements

Another proposal is requiring separate financial statements for all SMEs (IASB, 2005). Consolidated financial statements are rare for SMEs. Nevertheless the Board argues that there are SMEs that organize as legally separate entities but operate as single economic entity (IASB, 2007a). Thus the transactions among these kinds of entities are not necessarily arm's length transactions. Therefore separate financial statements cannot reflect the economic reality of these transactions and this would affect the quality of financial information.

It can be argued that although there are not many SMEs that fit to this case and should present financial information, it is necessary to preserve the consolidated financial statements in the standards in order to present true and reliable financial information for readers.

5.13.10. Recognition of Foreign Exchange Gains and Losses and Revaluation Increases in Profit or Loss

There are two instances when changes in fair value and foreign exchange gain or loss recognized directly in equity (IASB, 2007a);

- *Paragraph 11.37 (of the draft IFRS for SMEs) provides that SMEs shall recognize changes in the fair value of some hedging instruments directly in equity.*
- *Paragraph 30.13 (of the draft IFRS for SMEs) provides that, in consolidated financial statements, SMEs shall recognize directly in equity a foreign exchange difference (gain or loss) arising on a monetary item that forms*

part of the reporting entity's net investment in a foreign operation (subsidiary, associate or joint venture).

The Board's approach in this issue is not clear as in the previous proposals. They argue that recognizing the gains and losses on foreign exchange and cash flow hedge would be consistent with the treatment in section 27 which recognizes the gains or losses of the benefit plans on the income statement (IASB, 2007a).

The Board also wants to wait for the draft of the IAS 1 that allows the entities to prepare a single statement of recognized income and expense and all the components of income and expense would classify in that statement (IASB,, 2007a).

It is possible that this treatment firstly could increase the fluctuations in the income levels of the entities and that will affect the credit notes of the entities in the evaluations of the creditors. Secondly the practice of recognizing these value changes in the equity reflects the idea of taking provisions against related risks. It can be argued that this kind of risk management activity is performed in order to preserve the assets or the liabilities in desired levels and therefore this activity should be presented in the balance sheet to the financial statement readers.

Nevertheless it would be more meaningful to comment after the Board would clarify its approach to this issue.

5.14. ALL OPTIONS IN IFRSS SHOULD BE AVAILABLE IN THE IFRS FOR SMES JURISDICTIONS CAN REMOVE OPTIONS

In general the standards, the IFRS and IAS, have benchmark treatments which are complex and the allowed alternative treatments which are easier to apply. The Board considered the proposal of eliminating the complex options from the IFRS for SMEs and greater comparability would be achieved between the financial statements of the SMEs.

On the other hand the Board argues that although attractiveness of greater comparability among the IFRS for SMEs user, the comparability of the two set of the standards; IFRS for SMEs and the full IFRS, would be reduced. Consequently the Board did not put the idea into practice.

Nevertheless the Board also notifies that in sections below of the IFRS for SMEs provides simpler option in itself and refers to the full version of IFRS for more complex treatments (IASB, 2007a).

5.14.1. Investment Property

Section 15 of the IFRS for SMEs allows cost model for the measurement of the investment property. For the fair value model the section refers to the IAS 40 (IASB, 2007b).

5.14.2. Property, Plant and Equipment

Accounting for property, plant and equipment is regulated by section 16 of the IFRS for SMEs. The section provides two options for remeasuring the PPE; the cost model which requires to measure assets with cost less accumulated depreciation and any impairment loss and the revaluation model which refers to IAS 16 (IASB, 2007b).

5.14.3. Intangible Assets

Section 17 of the IFRS for SMEs deals with intangible assets and it entails the cost model in measurement of the intangible assets (IASB, 2007b). For the revaluation model the section 17 refers to IAS 38 and its disclosure requirements.

5.14.4. Borrowing Cost

The IFRS for SMEs entails in section 24 that requires expense method for borrowing costs. In order to apply capitalization model entities should refer to IAS 23 (IASB, 2007b).

5.14.5. Presenting Operating Cash Flows

The Board argues that the most of the financial statement readers especially the creditors prefers indirect method of presenting the cash flow statements (IASB, 2007a). Indirect method provides more details about the accrual accounting of the SMEs. Therefore the section 7 of the IFRS for SMEs provides guidance cash flow statements with indirect method. For direct method the entities should refer to IAS 7 cash flow statements (IASB, 2007b).

5.14.6. Accounting for Government Grants

Like in the previous sections, the section 23 of the IFRS for SMEs entails accounting treatments and for the fair value accounting of the government grants the entities should refer to the IAS 20 (IASB, 2007b).

5.15. OPTIONAL REVERSION TO FULL IFRSS BY AN ENTITY USING THE IFRS FOR SMES

In this section the Board has considered the argument that an entity using the proposed IFRS for SMEs should be allowed to choose to apply a recognition or measurement principle permitted in a full IFRS that differs from the principle required by the related section of the draft IFRS for SMEs. In other words it means the allowance for

the entities which is applying the IFRS for SMEs, to refer to the full IFRSs whenever they wanted it so.

The respondents that defend the optional reversion to the full IFRS have two different approaches. These are (IASB, 2007a);

a) *"One school would permit SMEs to revert to full IFRSs principle by principle, while otherwise continuing to use the IFRS for SMEs.*
b) *The second school would permit SMEs to revert to full IFRSs in their entirety, standard by standard but not principle by principle, while otherwise continuing to use the IFRS for SMEs. Those who hold this view believe that the recognition and measurement principles in a full IFRS are so interrelated that they should be regarded as an integrated package".*

On the contrary to the optional reversion argument there were those who defend the opinion that either an entity should use the full IFRS or the IFRS for SMEs and report its financial data completely abiding one of them. The Board concluded that this kind of argument is consistent with their attitude and they added that otherwise there would be unregulated mixture of the two sets of standards and this would lead inconsistency and the comparability between the financial statements would be impossible (IASB, 2007a). Furthermore in most of the sections of the IFRS for SMEs there are referrals for the full version of IFRS and it is clear that these referrals can create enough flexibility and in the case that they cannot, there should be explicit referrals within the sections (IASB, 2007b). Therefore it can be argued that the Board is in the right place in refusing a practice of optional reversion to the full IFRS

5.16. DISCLOSURE SIMPLIFICATIONS

In this section the Board emphasizes the reasons of the disclosure simplifications that have been amended to IFRS for SMEs (IASB, 2007a).

a) *Some disclosures are not included because they relate to topics covered in IFRSs that are omitted from the draft IFRS for SMEs (see paragraphs BC57–BC65).*
b) *Some disclosures are not included because they relate to recognition and measurement principles in full IFRSs that have been replaced by simplifications proposed in the draft IFRS (see paragraphs BC70–BC93).*
c) *Some disclosures are not included because they relate to options that are not included in the draft IFRS for SMEs but are available to SMEs by explicit cross-reference to the full IFRS (see paragraphs BC108–BC115).*
d) *Some disclosures are not included on the basis of users' needs or cost-benefit considerations (see paragraphs BC25, BC26 and BC120).*

It can be argue that the disclosure simplifications made like in the article of (a) and (b) are appropriate because either they became null because of omissions or simplifications of related standards. The disclosure simplifications related article (c) was made because of the treatments that refer to the full version of IFRS so therefore they are appropriate.

For the disclosure simplifications that were made in align with the article (d) the Board argues that they have tried to balance between the needs of the financial statement readers and the cost that SMEs bear in order to prepare those financials statements. The Board argues that while the disclosure simplifications are made they have considered that (IASB, 2007a);

a) *Users of the financial statements of SMEs are particularly interested in information about short-term cash flows and about obligations, commitments or contingencies, whether or not recognised as liabilities. Disclosures in full IFRSs that provide this sort of information are necessary for SMEs as well.*

b) *Users of the financial statements of SMEs are particularly interested in information about liquidity and solvency. Disclosures in full IFRSs that provide this sort of information are necessary for SMEs as well.*
c) *Information on measurement uncertainties is important for SMEs.*
d) *Information about an entity's accounting policy choices is important for SMEs.*
e) *Disaggregations of amounts reported on the face of SMEs' financial statements are important for an understanding of those statements.*
f) *Some disclosures in full IFRSs are more relevant to investment decisions in public capital markets than to the transactions and other events and conditions encountered by typical SMEs with around 50 employees.*

Again here the simplifications should be done according to the needs and capabilities of the SMEs which are in fact very hard to determine. We believe all these considerations above are relevant in preparing the IFRS for SMEs. What can be added to that is the importance of the disclosure of the income statements of the SMEs and so the indicators of the profitability. Since the profitability ratios are other important ratios that are used mainly in financial analysis of the firms, they also holds a major place in the financial reporting package of the SMEs.

5.17. WHY A SEPARATE VOLUME RATHER THAN ADDED SECTIONS IN EACH IFRS

There are two options of publishing the IFRS for SMEs; firstly as a separate volume, and secondly as amendments that are put in the end of each related standards of the full IFRS set. We believe that a separate volume is more appropriate than the bound volume with the full set of the IFRSs. The advantages that the Board has mentioned are (IASB, 2007a);

a) *ease of use for those seeking to apply the IFRS for SMEs. If the IFRS for SMEs addresses the transactions, events and conditions typically*

encountered by SMEs with around 50 employees, much of the material in full IFRSs would not normally have application for SMEs,

b) *the IFRS for SMEs can be drafted in a simplified language without the details that are needed in full IFRSs.*

In addition to these it can be considered that publishing the IFRS for SMEs as a separate volume will emphasize that these standards are stand alone standards and can be use as a separate form of financial reporting by the SMEs although they are based on full IFRS. This will increase the credibility of the new standards in eyes of the practitioners. A separate volume with thinner physical appearance will add up to the popularity of these standards among the financial statement preparers of the SMEs.

5.18. WHY ORGANISATION BY TOPIC

In the aspect of the organization by topic IFRS for SMEs are different from the full version of IFRS. There could be referrals more than one IAS or IFRS in the one section of the IFRS for SMEs. It can be argued that the numbered indexing of the full standards is somewhat inconvenient. For example the disclosure requirements for financial statements are entailed in first IAS 32 than IFRS 7 whereas the recognition and measurement treatments are included in IAS 39 (IASB, 2007b). So it is very inconvenient for a starter to understand the structure of the full set. Therefore the organization by topic is simpler and more user-friendly than the organization of the full set and the Board's decision to organize the IFRS for SMEs by topic is seems very appropriate.

5.19. THE BOARD'S PLAN FOR MAINTAINING (UPDATING) THE IFRS FOR SMES

The updating frequency of the IFRS for SMEs is another important issue that the Board has faced. Among the complexity of the standards it becomes harder to realize and fallow the amendments made. This effort needs consistent pursuit of the Board's updates

and a comprehensive understanding of the standards as a whole which is fairly inconvenient for the most of the SMEs. The respondents argue that SMEs are lack of this kind of accounting staff, who realizes, understands and applies the updates promptly (IASB, 2005).

On the other hand if the updates of the IFRS for SMEs come behind the updates of full standards, there would be a time lag and so inconsistency between those two standards (IASB, 2007a).

It can be argued that rather than the frequency of the updates, the application of these updates is important. The updates could be continuously amended, however the effective dates of these updates should be periodically organized. Therefore for this kind effort the local governments could take the charge and issue those updates on a timely manner by warning the SMEs frequently. The taxation system can be an example for this kind of practice since there are very often significant changes in the regulations and it is also important for SMEs to fallow those changes because they are legally binding.

Consequently the Board has decided to issue the updates on a periodical basis of two years (IASB, 2007a). However they also argue that there would be instances that immediate updates are necessary. In such a case the Board will consider the necessity for an update before the two year period and if it would considered as necessary early updates can be possible.

This kind of middle approach is appropriate since the fluctuation of the standards is tried to keep balanced, making it easier for SMEs to realize and apply the changes.

5.21 THE EFFECTIVENESS OF THE NEW IFRS FOR SMES DRAFT IN THE LIGHTS OF THE COMMENT LETTERS (IASB, 2005)

IFRS for SMEs is the second biggest and boldest project of the Board. In fact since its application is indirectly related with the full set of IFRS. From this aspect one can ask whether it is too early for a new project without the fully development and establishment of the full IFRS in the world. Although it has become mandatory for the publicly traded companies in the most of the developed and developing countries most of the standards cannot be understood and apply by the accounting departments of those firms.

According to an inquiry among the comment letters conducted by Reinhard Lackner (IASB, 2005) in Austria among the selected 90 SMEs roughly 70 % of the financial accounting departments of the SMEs have knowledge about the IFRS and IAS. This awareness levels falls 50 % in the financial controlling departments and even to 12 % in the cost accounting departments. Furthermore although there is a fair level of awareness in the accounting departments of the SMEs, roughly 40 % of the SMEs do not plan to implement IFRS in the near future.

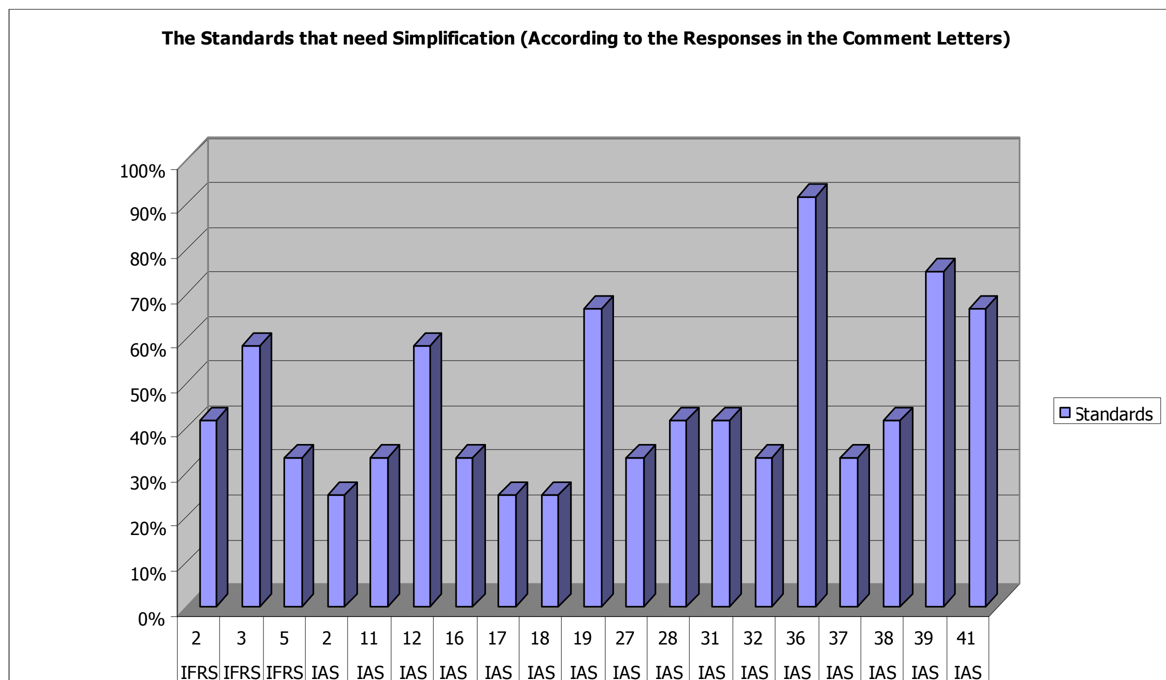
Among the current and prospective IFRS practitioner SMEs 39 % of them considers IFRS as a legal enforcement (IASB, 2005). 24 % of the SMEs conduct or will conduct IFRS for the intra-group reporting purposes (IASB, 2005). Finally only 7 % of the SMEs see the IFRS as a requirement of the new Basel II accords (IASB, 2005). This result is somewhat encouraging for both for us and for the IASB who want to draw a strong causality between capital needs and so the Basel II and accounting practices of the SMEs.

However as it has been described the previous sections there is a strong relationship between the quality of the financial information and the access of the credit in the new Basel II environment especially when the advanced capital requirement calculations are used by the banks. The SMEs with high quality financial information and

apply the rules of corporate governance would end up with higher credit ratings and consequently easier access to the capital provided by the banks. It can be argued that this effect of the Basel II environment have not been comprehensively understood by the SMEs yet.

The Simplifications Demands for the IFRSs and IAS in the Comment Letters

Graph-10: Demands for the simplification of the standards for the SMEs by commentators, Comment Letters (IASB, 2005).



The main aim of the IASB while initiating the IFRS for SMEs project was to create a understandable, consistent set of standards that have well-balanced according to the needs and capabilities of the SMEs (IASB, 2007a). The cost of the preparation of the financial information should not be exceeding by the benefit that is obtained from it. We have discussed these points in the earlier sections.

Simplifications are made through the consideration of the needs and capabilities of the SMEs on the full version of the IFRS. The comment letters (IASB, 2005) that were received by the IASB over the questionnaire on recognition and measurement was analyzed in order to find out the major expectations about the translation of the full version of the IFRS into the IFRS for SMEs through the cost and benefit filter of the SMEs. The respondents are the major authorities which are either preparer or user of the financial statements.

IAS 36 Impairment of Assets

According to the letters the most emphasized accounting standards that need simplification is the IAS 36. Roughly 90 % of the respondents are demanded simplification in IAS 16, especially for the impairment of the intangible assets (IASB, 2005).

Indeed IAS 36 is one of the most comprehensive standards that need so much managerial decision and external information. Determination of the useful lives of the assets, cash generating units, estimation of the future cash flows and recoverable amounts are very burdensome for the most of the SMEs if not impossible and impractical. For instance in the IAS 39, the recognition and measurement of the financial assets are done through the active markets which are the exactly the main sources of the financial instruments themselves (IASB, 2006b). Consequently the determination of the market price of a financial instrument is much easier than the prices of the intangible assets.

However there are only slight simplifications in the impairment of the assets. In the exposure draft it is still requires by the SMEs that for every year management should assess whether there has been any indication of the impairment of the goodwill which is an effort that requires sophisticated managerial skills and outside information (IASB, 2007b). For example determining an impairment loss over a low profile brand in the market would be very costly and not accurate. Furthermore in the next steps as is the IAS

36 the impairment losses should be determined by allocating goodwill to the components of the entity (IASB, 2007b).

It can be argued that the proposals made in the comment letters such as the determination of a finite lifetime no longer than 20 years and thus depreciating the intangible assets over that time would be more appropriate for most of the SMEs (IASB, 2005).

Furthermore the main principles of the IAS 36 still continue for the impairment test of the assets other than the goodwill. There is still very detailed emphasis on determining the fair value of the assets by making impairment tests.

Consequently for SMEs there is not much relief come from the new IFRS for SMEs in the principles of IAS 36 which is ironically the most wanted standard that is to be simplified.

IAS 39 Financial Instruments: Recognition and Measurement

Secondly the 75 % of the respondents demand simplification in the IAS 39 Financial Instruments; Measurement and Recognition (IASB, 2005). In the previous section as it has been described the simplifications over the classifications of the financial instruments abolishing the available for sale and held to maturity concept leaving that are measured at cost or amortized costs and the rest measured with fair value through profit or loss (IASB, 2007b).

Furthermore the hedge accounting became simpler than the IAS 39 by not requiring mid-term hedge effectiveness tests for the hedging instruments. Consequently it can be argued that although still there is complexity in the financial assets and liabilities section of the IFRS for SMEs draft the simplifications cannot be ignored.

IAS 41 Agriculture

Thirdly the 65 % of the respondents demand the cost method for all the agricultural products in the Draft (IASB, 2005). The Board has denied that since there are active markets for many biological products and most of the time their prices are determined by those markets, using directly cost method would be against the fair value concept of these assets (IASB, 2007a). The Board provides a more gradual approach to the cost method and it is probably more appropriate for the fair representation of the assets in the financial statements.

IAS 19 Employee Benefits

Fourthly again roughly 65 % of the respondents demand equal treatment of the defined benefit plans and defined contribution plans as the same (IASB, 2005). It is much easier to estimate the fixed payments in the defined contribution plan rather than the estimating the additional future liability that would arise from the loss of benefit investment. The Board argues that if all benefit plans considered as the defined contribution plan, there would be unrecognized liabilities of the business entities (IASB, 2007a). However it can be argued that considering the employment size and traditional employee benefits of the SMEs, the amounts of the possible unrecognized liabilities in the financial statements would be immaterial and the cost of preparing such financial information could exceed the benefit of it. It ca be said that the Board should make further considerations about this simplification demand.

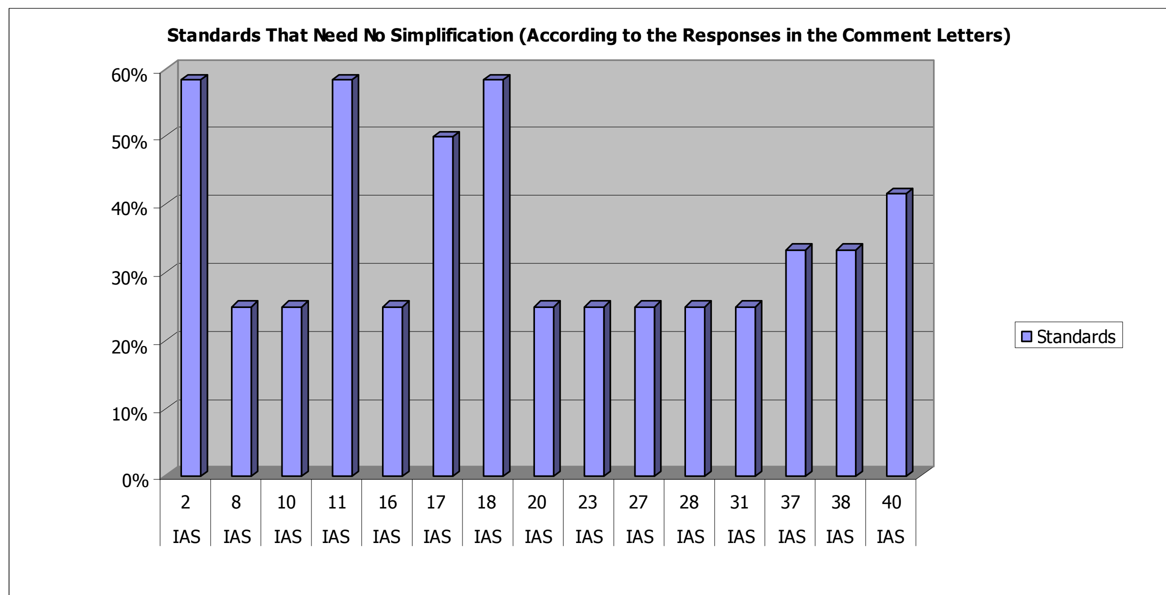
The other less demanded simplifications are the IFRS 3 which is more or less compromised with the limited simplification over the depreciation of the goodwill, and the IAS 12. Respondent argue that it would burdensome for many SMEs to calculate the deferred taxes and report them on their financial statements (IASB, 2005). As it has been emphasized in the previous section, due to the complex taxation regulations in the most of the business entities are required to report their prepaid and deferred taxes in their

financial statements. Consequently this simplification would be meaningless for most of the SMEs that operate in the countries where there are complex taxation regulations.

As a result the Board generally do not closely align with the simplification demands for the full IFRS and IAS. Especially this is the case in the IAS 36, IAS 41 and IAS 19. It can be argued that there could be more simplification amended for the SMEs. The technical expertise and managerial decision requirements of these standards are very demanding for the typical SMEs, especially in Turkey.

The Standards That Does Not Need Simplification

Graph-11: The standards that need no simplification, Comment Letters (IASB, 2005).



There is no strong consensus over the standards that can be applicable to SMEs without any modification. However there four standards come forward; IAS 2 the inventories, IAS 11 constructions contracts, IAS 17 accounting for lease and IAS 18 revenue.

IAS 2 Inventories

The section 12 of the Draft is constructed in align with the IAS 2 (IASB, 2007b). Although the standards can be seen as complex for some of the SMEs, generally one can argue that it is as simple as possible covering the main principles of the accounting for the inventories. Consequently in align with the respondent it can be argued that it is appropriate not to make any simplification in this standard for SMEs. Also the Board has noticed this factor and made no significant simplification in the IAS 2 (IASB, 2007a).

IAS 11 Construction Contracts

Another standard that the Board has worked in align with the respondents is the IAS 11, accounting for the construction contracts. There were some arguments that for the accounting the construction contract completed contract should be applicable (IASB, 2005). However as the Board has noted with the completed contract method significant variations occurs in the income statements of the business entities (IASB, 2007a). Also deferred tax provision accounting should also be considered when using the complete contract method because of the deferred income. Consequently it is acknowledged that the percentage completion method is more appropriate for the SMEs.

IAS 17 Leases

IAS 17 is the standard for accounting of the lease transactions. The main demand in the comment letters is to treat all lease transaction as the operating lease (IASB, 2005). Under the operating lease there is no requirement for the business entities to show the leased assets in their financial statements and depreciate them according to the useful life and value which are determined according to the lease contract. However as the Board has noted, treating as the operating lease where all risks and rewards of the ownership of the leased assets was transferred to the lessee would create unrecognized assets for the

business entities (IASB, 2007a). Besides in Turkey for example for the taxation purposes the operating lease is generally not allowed making such simplification meaningless for the SMEs. Consequently it can be said that it is appropriate not to consider the simplification for the finance leases in the Draft in align with the comment letters.

On the other hand since it cannot be described the leasing companies as SMEs due to the scale of the business, the lessor accounting for the lease transactions are excluded from the draft by the Board. This is consistent with the general structure of the SMEs.

IAS 18 Revenue

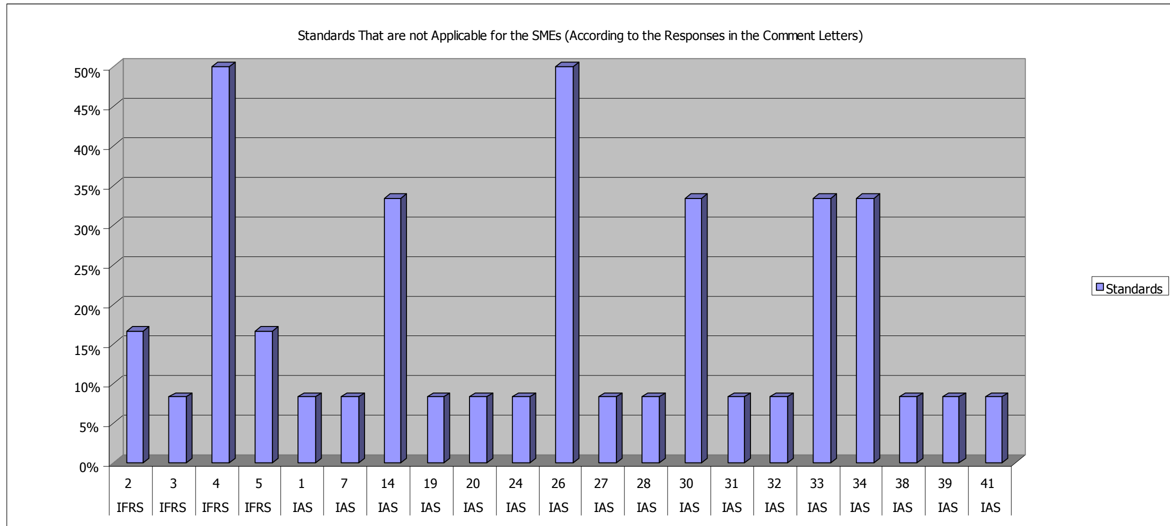
IAS 18 is the standard for the revenue recognition. Like in the IAS 11, there were arguments in some comment letters to employ completed contract method especially in the service contracts (IASB, 2005). Again for the same reason in the case of IAS 11, this method could reduce the fairness of the income statements and should not be applied.

IAS 40 Investment Property

IAS 40 accounting for the investment property is another mainly demanded standard that is not to be simplified (IASB, 2005). It is one of the least burdensome standards of the IAS and could be applicable for most of the SMEs. The standard contains enough flexibility by offering the fair value model and the cost model when the fair value cannot be determined reliable (IASB, 2006b). Thus as it is emphasized in the comment letters, there is no need to make any simplification in the standard. Nevertheless the Board has pushed the standard more flexible position in the Draft, requiring only the cost model in the draft and leaving reference for the fair value model to the IAS 40 (IASB, 2007a).

The Standards That are not Applicable for SMEs

Graph-12: The standards those are not applicable for SMEs, Comment Letters, (IASB, 2005).



IFRS 4 Insurance Contracts

According to the respondents there are some standards that are thought to be excluded from the Draft. Firstly IFRS 4 Insurance Contracts was considered to be excluded from the draft (IASB, 2007b). Like the banking sector there are no SMEs in the insurance sector because of the required scale of the insurance sector. Consequently the exclusion of the IFRS 4 from the Draft IFRS for SMEs is very normal.

IAS 14 Segment Reporting

Another standard that is thought to be excluded is the IAS 14 Segment Reporting and subsequently the IFRS 7 Operating Segments (IASB, 2005). As it has been emphasized the reasoning before, typical SMEs do not have different operating segments in distinctively different operating environments. Furthermore typical SMEs do not have

clearly separated operating units. As a result it can be argued that the exclusion of the standard from the Draft by the Board is appropriate and in line with the comment letters.

IAS 30 Disclosures in the Financial Statement of Banks and Similar Financial Institutions (Superseded by the IFRS 7 Financial Instruments: Disclosure by 1.1.2007)

Although the IAS 30 Disclosures in the financial Statements of Banks and Similar Financial Institutions was superseded by the IFRS 7, it is demanded for the exclusion from the drafts. Since the banks and similar financial institutions have necessarily large scales than typical SMEs it is very natural to exclude the disclosure requirements that are designed for the banks from the Draft by the Board. Consequently this argument can also be applicable for the related disclosure requirements for the IFRS 7.

IAS 33 Earnings per Share

Again since the IFRS for SMEs draft aims the SMEs that do not have public accountability (IASB, 2007b) the IAS 33 earnings per share becomes null for the targeted SMEs. It is therefore aligning with the comment letters the Board has excluded the standard from the Draft.

IAS 34 Interim Financial Reporting

IAS 34 is related with the interim financial reporting. The Board argues that interim financial reporting is not very common among the SMEs (IASB, 2007a). The respondents also think the same way with the Board so in the Draft this standard was excluded (IASB, 2005).

However it can be argued that the interim financial reporting will be practiced more frequently by the SMEs in the new capital environments. More frequent financial reporting

would certainly increase the quality and comparability of the financial information. Consequently the credit scores of the SMEs would possible increase with more frequent financial information. In such cases the SMEs would like comply with the IAS 34 as the section 37 of the IFRS for SMEs draft refers to it (IASB, 2007b).

In general the Board has tried to respond the demands from the commentators of the draft. However this effort would not be appreciated very much by the commentators especially for the simplifications that were considered but not adopted. In the section 26 of the draft IFRS for SMEs there are still too much emphasis on the outside and inside information related to the impairment of the assets that derive from the IAS 36 which was the most demanded standard for the simplification. The Board has been hesitant to apply the desired simplifications that were mentioned on the comment letters such as the impairment tests of the goodwill and other intangible assets.

On the other hand the Board tries to preserve the fair value accounting principles of the standards and apply them as much as possible to the draft. From this aspect the preservation of the relatively easier standards IAS 2, 11, 17 and 18 has certainly increased the overall quality of the draft.

The exclusion of the standards that are mainly targeted for the public or big scaled firms like insurance companies or banks, like IFRS 4 Insurance Contracts, IAS 14 Segment Reporting, IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions which was superseded by the IFRS 7 in 2007. These exclusions are made in order to answer the main targeted audience of the IFRS for SMEs; the SMEs.

5.22 THE EVALUATION OF THE NEW IFRS FOR SMES TO THE TURKISH SMES FROM THE TURKISH ACCOUNTING PRACTICE

Since from the beginning the main objective of this work has been to provide an idea about the ongoing efforts to establish new set of standards for SMEs and therefore the possible effects of the Draft to the Turkish SMEs cannot be ignored. In Turkey the IFRS and IAS are already obligatory for the public companies and regulated financial institutions mainly for the banks. Consequently it is the SMEs which will be affected from the prospective legal regulation with the new Turkish Trade Law proposal (2005) which includes obligation for all the business entities to report with the IFRS and IAS and the auditing of these financial statements. This affect will occur because of the major accounting differences between the tax based, historical cost oriented Turkish statutory accounting system and the fair value based, investor oriented accounting system of IFRS. Indeed the most of the SMEs in Turkey prepare their financial statements just for taxation regulations and classical loan applications from the banks.

In this section of the work it has been tried to explain briefly what would happen if the SMEs in Turkey move from the tax based statutory accounting system to more conservative and substance over form accounting system of the IFRS and IAS. Since the focus audience of this work is the SMEs, the SMEs balance-sheets as will be taken as the lead.

Secondly in this section it will be tried to examine the most material accounts that will affect from the possible accounting practice change. Indeed there are so many differences both the disclosure and recognition and measurement perspectives between the two practices. However in the case of a typical SME most of these differences would be very immaterial both by amount and by accounting effort. In this work due to the practical purposes only the material effects that would arise from a possible transformation between the two accounting practices will be focused.

In order to have an idea about the average weights and determine the material of the balance-sheet items of the SMEs, the data of the CBRT's sector research (2006) has been chosen. In the SME definition section it has been defined the samples of this research. CBRT uses the EU definition of the SMEs. Although this definition does not fit the economic scale of Turkish business entities and furthermore Turkish legal SME definition, in order to have an overall opinion

CBRT have consolidated the year 2005 balance-sheets of the chosen firms. The balance sheets were prepared according to the inflation accounting (CBRT, 2006). The sample size for the small firms is 2,280 and the medium-sized firms is 999.

Table 16: The consolidated balance –sheets (asset side) of the SMEs according to CBRT Sector Balances Sheets 2006 research (in 1,000 YTLs).

	Small			**Medium-Sized**		
ASSETS	**2005 (In Thousands)**	**Group (I-II) %**	**In Total Assets (%)**	**2005 (In Thousands)**	**Group (I-II) %**	**In Total Assets (%)**
I-Current Assets	**9,076,394**	**100.0**	**57.4**	**19,282,469**	**100.0**	**53.9**
A-Cash and Cash Equivalents	1,047,978	11.5	6.6	2,718,184	14.1	7.6
B-Marketable Securities	95,883	1.1	0.6	267,605	1.4	0.7
C-Trade Receivables	3,296,796	36.3	20.8	7,353,987	38.1	20.6
D-Other Receivables	485,576	5.3	3.1	753,556	3.9	2.1
E-Inventories	3,724,679	41.0	23.5	7,386,793	38.3	20.6
F-Contract Expenses Spread Through Years	100,103	1.1	0.6	100,344	0.5	0.3
G-Prepaid Expenses and Income Accruals	40,114	0.4	0.3	135,025	0.7	0.4
H-Other Current Assets	285,264	3.1	1.8	566,975	2.9	1.6
II-Fixed Assets	**6,742,542**	**100.0**	**42.6**	**16,500,500**	**100.0**	**46.1**
A-Trade Receivables	101,211	1.5	0.6	135,503	0.8	0.4
B-Other Receivables	89,670	1.3	0.6	248,474	1.5	0.7
C-Financial Fixed Assets	1,047,095	15.5	6.6	3,631,146	22.0	10.1
D-Tangible Fixed Assets	5,013,563	74.4	31.7	11,683,018	70.8	32.6
E-Intangible Fixed Assets	355,002	5.3	2.2	661,560	4.0	1.8
F-Special Diminishing Assets	6,980	0.1	0.0	16,347	0.1	0.0
G-Long-term Prepaid Expenses and Income Acc.	120,891	1.8	0.8	110,972	0.7	0.3
H-Other Fixed Assets	8,131	0.1	0.1	13,480	0.1	0.0
TOTAL ASSETS	**15,818,935**		**100.0**	**35,782,970**		**100.0**

Table 17: The consolidated balance –sheets (liability side) of the SMEs according to CBRT Sector Balances Sheets 2006 research (in 1,000 YTLs).

	Small			Medium-Sized		
LIABILITIES	**2005 (In Thousands**	**Group (I-II) %**	**In Total Liab. (%)**	**2005 (In Thousands**	**Group (I-II) %**	**In Total Liab. (%)**
I-CURRENT LIABILITIES	**7,032,599**	**100.0**	**44.5**	**13,619,084**	**100.0**	**38.1**
A-Loans	2,278,402	32.4	14.4	5,405,901	39.7	15.1
B-Trade Payables	2,679,628	38.1	16.9	5,379,080	39.5	15.0
C-Other Payables	885,338	12.6	5.6	919,881	6.8	2.6
D-Advances Received	701,520	10.0	4.4	922,069	6.8	2.6
E-Contract Revenues Spread Through Years	69,257	1.0	0.4	85,935	0.6	0.2
F-Other Liabilities and Taxes Payable	277,608	3.9	1.8	459,046	3.4	1.3
G-Debt and Expense Provisions	68,378	1.0	0.4	185,687	1.4	0.5
H-Accrued Revenues and Expense	45,984	0.7	0.3	141,857	1.0	0.4
I-Other Current Assets	26,483	0.4	0.2	119,628	0.9	0.3
II-Long-Term Liabilities	**1,680,459**	**100.0**	**10.6**	**4,207,428**	**100.0**	**11.8**
A-Loans	1,058,499	63.0	6.7	3,152,914	74.9	8.8
B-Trade Payables	107,152	6.4	0.7	273,439	6.5	0.8
C-Other Payables	234,035	13.9	1.5	306,659	7.3	0.9
D-Advances Received	203,660	12.1	1.3	140,983	3.4	0.4
E-Debt and Expense Provisions	66,871	4.0	0.4	318,713	7.6	0.9
F-Long-term Revenues and Expense Acc.	5,002	0.3	0.0	11,957	0.3	0.0
G-Other Long-Term Liabilities	5,241	0.3	0.0	2,763	0.1	0.0
III-EQUITY	**7,105,878**	**100.0**	**44.9**	**17,956,457**	**100.0**	**50.2**
A-Paid Capital	9,496,507	133.6	60.0	18,742,921	104.4	52.4
B-Capital Reserves	231,971	3.3	1.5	445,172	2.5	1.2
C-Profit Reserves	1,175,402	16.5	7.4	3,332,546	18.6	9.3
D-Retained Earnings	829,046	11.7	5.2	2,286,166	12.7	6.4
E-Retained (Losses)	(4,676,434)	(65.8)	(29.6)	(7,393,589)	(41.2)	(20.7)
F-Current Year Profit(Loss)	49,386	0.7	0.3	543,242	3.0	1.5
TOTAL LIABILITIES	**15,818,935**		**100.0**	**35,782,970**		**100.0**

5.22.1 Asset

As it can be seen from the consolidated balance-sheets, the major items of the SMEs in the asset side are; the trade receivables, inventories, and tangible fixed assets which have over 20 % weights.

Trade Receivables

One of the major deficits of the statutory accounting practice in Turkey is the accounting of the sales in credit. In general business entities make the payments after the invoices of the goods received. Furthermore although it changes according to the sector and the ability of the suppliers or customers due to their volume, the payment periods varies from 10 days to even 60 days. This practice is also stated in the invoices. Generally this is necessary for the convenience of the business transactions. However there are many small firms are funded with this payment delays which can be seen also from the consolidated-balance sheets. Roughly 20 % of the assets and 18 % of the liabilities consists of the trade receivables and payables balances.

However when it comes to the accounting of these payables it can be seen that there is no consideration for the time value of money (Selvi, Yakup, Yılmaz, Fatih, Sarıoğlu, Kerem, 2007). In other words, when a sale or purchase transaction occurs with the invoice that is payable for example 20 days after the transaction date, the invoice amount is debited as receivable and credited as sale (vice-versa in the purchase transaction). However within the sales amount there is the hidden time-value of the money for 20 days.

Consequently according to the IFRS the interest amount that was hidden to the invoice amount should be considered separately as a financial income and should not be recognized as income directly from the beginning. Rather considering the time value of the money the related amount should be recognized as the time passes.

The average receivable turnover rate for the SMEs in 2005 was 6 times (CBRT, 2006) which means 60 days. The weighted average interest rate in 2005 that arises from the bids of the government treasury discounted auctions was 16.3 % yearly effective (Undersecretariat of Treasury, 2007). If the daily rate is calculated this should be equal to 16.3 % as the compound rate by;

$1 + 0.163 = (1+ R*60/360)^{360/60}$

The R would be approximately 0.042 % and with that effective rate and if the total consolidated receivable balance of the small and medium-sized firms in 2005 is discounted, which is 8,607,455,000 YTL, with that effective rate;

$8,607,455,000 / (1+0,00042)^{60} = 8,393,560,000$ YTL is found as the discounted receivable amount and the difference is;

8,607,455,000 - = 8,393,560,000 = 213,894,000 YTL

This calculation means that there is approximately 213,894,000 YTL interest income hidden in the trade receivables balance of the SMEs in Turkey. This amount was also recognized as the sales revenue in the income statements which in fact did not accrued as income and therefore cannot be stated as income after the average 60 days passed. This consideration is also applicable for the trade payables in the liabilities section of the financial statements. SMEs do not separate the financial expense from the trade payables.

This practice is not the same when the sales transactions are made with the notes receivables. In such transactions discounting process is employed and the amounts are generally corrected in terms of the interest accruals. However in practice these kinds of transactions are only 18 % of the total amount of the trade receivables balance (CBRT, 2006).

Inventories

Another major balance-sheet item of the SMEs is the inventories. There are some crucial differences between the statutory accounting and the accounting practices of the

IAS 2. The major difference is in the subsequent measurement of the inventories. IAS 2 holds a conservative view by conducting the principle of accounting the inventories with the amount of the lowest of the net realizable value and cost (IASB, 2006b). On the other hand the statutory practices require the only the cost principle.

Secondly if the inventories are to be measured with their cost the IAS 2 does not permit the LIFO method (Last-in first-out) in measuring the cost while the statutory accounting permits this practice. Therefore because of the "LIFO layers" that consists of the items priced with early rates, significant increases in the sales profits could be seen in the income statements of the business entities. However it can be argued that since the LIFO method is not very widely used in the business entities this effect would be limited.

Thirdly in the purchase and the sales transactions in general the items does not booked debit or credit to the inventory accounts without the issuance or receive the invoices. However again considering the substance over form principle the IAS dictates the booking of the inventories and related purchase and sales accounts when all the risks and rewards of the ownership transfer. This nuance could create major differences in practice when there are long delays between the physical transfer of the goods and the issuance of the invoices. In general there are sales unrecognized revenues and expenses from the goods that were delivered but not invoiced or invoiced but not delivered.

Furthermore in many cases the unrecognized liability amounts can be found due to undelivered invoices of related period of the financial statements. For example the advertisement cost invoice of a good dated the last days of the financial statement period could be received after the financial statements are prepared. Consequently in the balance sheet and income statement there would be unrecognized liabilities and expenses related with this item if there is no booking of related provisions for the late-coming invoices.

Fixed Assets

Fixed assets are other major items in the balance-sheets of the SMEs. There are two main issues about the accounting of the fixed assets; firstly the recognition and measurement of the fixed assets. In the Turkish statutory accounting practice the fixed assets are recognized with their initial costs. This initial cost is recognized the main determinants of both the subsequent measurements and depreciation amounts. Also the IAS takes the initial investment for the fixed assets as the starting point. On the other hand IAS takes both the cost model and the fair value model for the subsequent measurement of the fixed assets. Consequently there would be gaps between the fair value of the assets and the initial acquisition costs. This gap especially widens in the case of lands when there are capital gains. Furthermore there is no periodical impairment test on the fixed assets considering the external and internal sources of the information. The proposed Draft for IFRS for SMEs states the similar factors when determining the indicators of impairment of a non-financial asset in the section 26 (IASB, 2007b);

External sources of information

a) *during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.*
b) *significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.*
c) *market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect materially the discount rate used in calculating an asset's value in use and decrease the asset's fair value less costs to sell.*
d) *the carrying amount of the net assets of the entity is more than its market capitalisation.*

Internal sources of information

e) evidence is available of obsolescence or physical damage of an asset.

f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. In this context economic performance includes operating results and cash flows.

Especially the market valuation of the fixed assets is ignored in the SMEs fixed assets accountings. Consequently during the disposals of the some assets there would be oversized profits due to the lack of fair value accounting of the fixed assets, especially in the case of land disposals.

This factor becomes very striking when the SMEs has given their fixed assets as collaterals to the banks for the loans. Significant value differences occur between the collateral amounts and the book value of these fixed assets.

Nevertheless at this point it can be appreciated that for a typical SME using such test and information sources would be costly and time consuming. Because of this reason the IAS 36 is the most demanded standard for the simplification when adapting to the new Draft IFRS for SMEs. Consequently if the Draft will enacted with this

Secondly in the statutory accounting practices the determination of the useful lives of the fixed assets is regulated by the Ministry of Finance in Turkey and this factor

constitutes the major difference of the statutory accounting from the IAS and IFRS practices (Akgül, 2004). In the IAS 16 the determination of the useful life of the assets depends on the external and internal information and managerial decision. The IAS 16 states the factors that should be considered when determining the useful life of asset (IASB, 2006b);

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

Financial Fixed Assets

The financial fixed assets, although not as significant as the previous items, is another significant item in the balance sheets of the SMEs. It consists of the investments in associates and subsidiaries and joint ventures, and granted long term financial loans. Although the last one is very rare in the SMEs the previous ones, especially joint ventures and associates could be found in some of the SMEs. The sections 13 and 14 of the Draft IFRS for SMEs are related with this balance-sheet item (IASB, 2007b).

The statutory accounting practice entails mainly the cost and fair value models for these kinds of investments. In the same manner the sections 13 and 14 of the Draft allows both the cost model and fair value model accounting for these investments (IASB, 2007b).

The difference is that when the fair value model of accounting employed according to the statutory accounting the goodwill should be depreciated over a limited time period which is not allowed both in the Draft and in IAS 36. Nevertheless it can be argued that considering the relatively low materiality of the item and low level of fair value accounting of the investments by the SMEs this difference would not lead any significant results in the financial statements of the SMEs.

5.22.2 Liabilities

The liability side is more evenly distributed than the asset side. Nevertheless the long-term outside financing is very weak compare to the short-term which indicates the long-term capital needs of the SMEs. The material items are; trade payables, loans, paid capital and the retained (losses).

Trade Payables

For the trade payables same comment could be made as in the case of the trade receivables. The related interest amounts within the deferred payments would be discounted and recognized according to financial income and expense recognition principles in the Draft.

Loans

The accounting of the bank loans in the statutory practice is roughly same with the major principles of the expense models in the IAS and the Draft IFRS for SMEs. Additionally the Draft permits the capitalization of the barrowing costs provided certain requirements by referring to the IAS 23. We argue that there would not be any material difference after the restatement of the financial statements of the SMEs according to the Draft.

Equity

The equity section is also an important part of the balance-sheets of the SMEs like any other business entities. And in this section the main item for the SMEs is the paid capital. Since there is no public issuance of the shares of other significant items in the equity section, the major difference would be in the disclosure requirements. Consequently it cannot be expected any material adjustment to this section after the initiation of the Draft standards for SMEs.

5.22.3 Income Statement

Another major financial statement that will be certainly affected from the accounting policy change is the income statement. Income statement in Turkish accounting practice is mainly used for the determination of the taxable income for the taxation authorities. Therefore the classification and presentation of the income statement of the statutory accounting is very different than the IFRS practices. However the classification and presentation changes would not affect the overall results of the SMEs.

On the other hand there will be some major changes both in the amount and classification of the some items. For example the classification of the hidden interest income in the credit sale revenues of the companies will be stated in the financial income item, separate from the sales revenue. Furthermore because the interest income cannot be realized fully before the maturity, the sales revenue will decreased. If the earlier example is considered 213,894,000 YTL amount will not be recognized as sales revenue in the income statement. Furthermore before the maturity comes this amount also will not be recognized in the financial income section (Selvi, Yakup, Yılmaz, Fatih, Sarıoğlu, Kerem, 2007). This unrecognized income effect will be offset by the recognition of the previous periods financial income from the credit sales, provided that the average sales amounts and collection maturity remain same between the periods. However the net sales items in

the income statements of the SMEs that constitutes the major part, will be declined depended on the amount of the credit sales and average maturity. This change will also have adverse affects on the turnover rates of the SMEs.

Table 18: The consolidated income statement of the SMEs according to CBRT Sector Balances Sheets 2006 research (in 1,000 YTLs).

	Small		Middle	
DESCRIPTION	2005	(%)	2005	(%)
A-GROSS SALES	13,977,227.2	103.3	38,324,770.1	105.0
B-SALES DISCOUNTS (-)	(442,590.2)	(3.3)	(1,815,983.9)	(5.0)
C-NET SALES	13,534,636.9	100.0	36,508,786.2	100.0
D-COST OF GOODS SOLD (-)	(11,551,823.9)	(85.4)	(31,414,508.7)	(86.0)
GROSS SALES INCOME/LOSS	1,982,813.0	14.6	5,094,277.5	14.0
E-OPERATING EXPENSES (-)	(1,652,252.5)	(12.2)	(3,967,478.4)	(10.9)
INCOME/(LOSS) FROM THE OPERATING ACTIVITIES	330,560.5	2.4	1,126,799.1	3.1
F-INCOME FROM OTHER OPERATING ACTIVITIES	464,905.9	3.4	1,706,647.4	4.7
G-LOSS FROM OTHER OPERATING ACTIVITIES (-)	(265,873.3)	(2.0)	(1,025,172.1)	(2.8)
H-FINANCIAL EXPENSE (-)	(352,146.5)	(2.6)	(980,786.0)	(2.7)
ORDINARY INCOME OR LOSS	177,446.6	1.3	827,488.4	2.3
I-EXTRAORDINARY REVENUE AND GAIN	132,541.5	1.0	348,625.3	1.0
J-EXTRAORDINARY EXPENSES AND LOSSES	(167,299.2)	(1.2)	(338,153.8)	(0.9)
K-ALLOWANCES FOR TAX AND OTHER LEGAL OBLIGATIONS OT HE CURRENT PERIOD. (-)	(93,303.4)	(0.7)	(294,718.0)	(0.8)
NET PROFIT OR LOSS OF THE CURRENT PERIOD	49,385.5	0.4	543,242.0	1.5

Also because of the changes in accounting of the inventories, the cost of goods sold items will be prone to significant changes. For example an accounting policy change from LIFO technique to the allowed FIFO technique would cause significant increases in the cost of goods sold items, if there are large LIFO layers, in other words old low priced inventories due to inflation effects. This factor on the short-run could cause significant income fluctuations in the income statements of the SMEs.

Besides because of the invoice dependent recognition of the transactions, there will be significant changes in recognition of the sales revenues, or cost of goods sold amounts when the IFRS principles that employed.

Another major item that will be affected from the change in the accounting practices is the mainly the depreciation expense items. Due to the changes in the recognition and measurement techniques and especially the impairment losses of the fixed asset there will be significant changes in the depreciation expense amounts in the income statements. This will eventually affect the current income or loss of the periods.

As a result there are many items in the financial statements of the SMEs that would be affected by a probable change from the statutory accounting practice to the IFRS for SMEs. However it can be argued that the main items, that will be affected, are the trade payables-receivables, inventories, and the fixed assets. The changes will affect the income statement items for example like the sales revenue, because of the separate classification of the interest income. Also the turnover rates will be affected because of the restatements of the inventories or cost of goods sold amounts.

Consequently the financial ratios of the SMEs could also be affected and inevitably this will lead the change of the risk perceptions of the creditors. Lower turnover ratios, net sales, and possible impairment amounts on the fixed assets could decrease the asset sizes and net incomes of the SMEs

On the other hand it can be argued that this transformation will increase the credibility of the financial statement of SMEs, because of the more fair representation of the IFRS principles than the statutory accounting principles that mainly aims to determine the taxable income. The fair, consistent and understandable financial statements, if verified with the external independence audit, can obviously decrease the risk of the capital that is lend to the SMEs. Consequently there would be significant changes in the cost of capital in favour of SMEs that make financial reporting under the principles of IFRS for SMEs.

5.23 THE ILLUSTRATIVE FINANCIAL STATEMENTS PREPARED UNDER THE APPLICATION OF THE DRAFT IFRS FOR SMES

In this section it has been tried to understand what will the financial statements of the SMEs look like when the SMEs prepare according to the draft IFRS for SMEs. While creating this section, mainly the Draft Implementation Guidance (IASB, 2007c) that has been provided with the draft IFRS for SMEs was used. Furthermore it has been tried to explain the critical points both in the notes and in the financial statements and provide an overall idea about the financial statement that are prepared under the draft IFRS for SMEs

Nevertheless it should be noted that neither these financial statements can cover all the aspects of the financial reporting of the SMEs nor they can response all the questions that would arise from the financial statement preparers. It would be more appropriate for such cases to refer to the full text of the draft IFRS for SMEs or the full IFRS and IAS.

In order to provide more detailed information for each financial statement note additional comments are added at the end of the note sections. The extracted paragraphs from the illustration in the guideline (IASB, 2007c) are written in italics. In some cases there are modifications to the illustrative example where necessary.

According to the draft IFRS for SMEs the financial statements of an entity shall include (IASB, 2007b):

(a) a balance sheet;

(b) an income statement;

(c) a statement of changes in equity showing either:

(i) all changes in equity; or

(ii) changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;

(d) a cash flow statement; and

(e) notes, comprising a summary of significant accounting policies and other explanatory information.

In the illustrative example all the required financial statement are presented except a separate statement of changes in equity. The Board has used the 3.16 paragraph of the draft and shown the changes in equity under the income statements (IASB, 2007b). This kind of preparation would be more suitable for the SMEs since they do not generally prepare separate statement of changes in equity. Furthermore there are not complex transactions in the equity sections of the most of the SMEs.

Secondly in the example the income statement there are two types of the income statements; one was prepared with the classification of the expenses by their functions and the other was prepared with the expense classification by their nature. Since the first one is closer to Turkish statutory accounting practice which is the current practice of the SMEs, it is more convenient for the SMEs in Turkey.

Thirdly the cash flow statement was prepared with the indirect method rather than the direct method. Since it is more convenient to prepare cash flow statements with the indirect method this option would certainly help SMEs to create their cash flow statements.

According to the board, also the notes that the financial statements are an essential part of the financial statement presentation (IASB, 2007b). Indeed they are basically the core part where the important accounting practices and details about the financial statement items can be found. Accounting practices is very vital in order to state that the financial statements comply with the draft IFRS for SMEs.

XYZ Group

Consolidated Balance Sheet as of 31 December 20X2

	Notes	20X2 YTL	20X1 YTL
ASSETS			
Current assets			
Cash	20	16,700	15,875
Trade and other receivables	14	485,548	463,862
Inventories	13	57,250	47,920
Financial assets at fair value through profit or loss	25	100,000	110,000
		659,498	**637,657**
Non-current assets			
Investment in associate	11	107,500	107,500
Property, plant and equipment	9	2,548,473	2,401,455
Intangible assets	10	850	2,550
Deferred tax assets	12	3,909	2,912
		2,660,732	2,514,417
Assets held for sale	15	1,603	—
		2,662,335	**2,514,417**
Total assets		**3,321,833**	**3,152,074**

	Notes	20X2	20X1
		YTL	YTL
LIABILITIES AND EQUITY			
Current liabilities			
Bank overdrafts	17	83,600	115,508
Trade payables		301,939	334,131
Current tax liabilities		271,648	190,316
Current portion of employee benefit obligations	18	6,181	5,943
Current portion of obligations under finance leases	19	21,461	19,884
		684,829	**665,782**
Non-current liabilities			
Bank loans	17	50,000	150,000
Long-term employee benefit obligations	18	4,442	3,887
Obligations under finance leases	19	23,163	44,624
		77,605	**198,511**
Liabilities directly associated with assets classified as held for sale	15	1,550	-
Total liabilities		**763,984**	**864,293**
		0	0
Equity			
Share capital	16	30,000	30,000
Retained earnings	4	2,527,849	2,257,781
		2,557,849	**2,287,781**
Total liabilities and equity		**3,321,833**	**3,152,074**

"**Comment:** In the illustrative financial statement example the balance sheet items were selected as the minimum amounts that should be disclosed in the face of balance-sheet (IASB, 2007c). In general as in the full version of the IFRS, the Board does not restrict the financials statement preparers in constructing the balance-sheet items and the sequence of them; whether the most liquid assets stated at the top or not."

XYZ Group

Consolidated statement of income and retained earnings for the year ended 31 December 20X2

(Alternative 1 – illustrating the classification of expenses by function)

	Notes	**20X2 YTL**	**20X1 YTL**
Revenue	5	6,863,545	5,808,653
Cost of sales		(5,178,530)	(4,422,575)
Gross profit		**1,685,015**	**1,386,078**
Other income		88,850	25,000
Distribution costs		(175,550)	(156,800)
Administrative expenses		(810,229)	(660,389)
Other expenses		(105,763)	(100,030)
Finance costs	6	(26,366)	(36,712)
Profit before tax	**7**	**655,957**	**457,147**
Income tax expense	8	(139,460)	(98,130)
Profit for the period		**516,497**	**359,017**
Retained earnings at start of year		2,161,352	1,998,764
Dividends (per share 20X2 5.00, 20X1 3.33)		(150,000)	(100,000)
Retained earnings at end of year		**2,527,849**	**2,257,781**

XYZ Group

Consolidated statement of income and retained earnings for the year ended 31 December 20X2

(Alternative 2 – illustrating the classification of expenses by nature)

	Notes	20X2 YTL	20X1 YTL
Revenue	**5**	**6,863,545**	**5,808,653**
Other income		88,850	25,000
Changes in inventories of finished goods and work in progress		3,310	(1,360)
Raw material and consumables used		(4,786,699)	(4,092,185)
Employee salaries and benefits		(936,142)	(879,900)
Depreciation and amortisation expense		(272,060)	(221,247)
Impairment of property, plant and equipment		(30,000)	-
Other expenses		(248,481)	(145,102)
Finance costs	6	(26,366)	(36,712)
Profit before tax	**7**	**655,957**	**457,147**
Income tax expense	8	(139,460)	(98,130)
Profit for the year		**516,497**	**359,017**
Retained earnings at start of year		2,161,352	1,998,764
Dividends (per share 20X2 5.00, 20X1 3.33)		(150,000)	(100,000)
Retained earnings at end of year		**2,527,849**	**2,257,781**

"**Comment**: The alternative 2 is closer and applicable to the format of the Turkish statutory accounting practice and consequently for the SMEs it would be more convenient that the alternative 1 in preparing their income statements."

"Furthermore as we have emphasized above the preparation of the cash flow statements by the indirect method is far easier that the direct method for the SMEs. Thus it would be advantageous for the SMEs in preparing the cash flow statements which is indeed an essential part of the financial statement package that gives valuable information for the outsiders about the cash generating ability of the business entities."

XYZ Group

Consolidated cash flow statement for the year ended (Indirect Method)

31 December 20X2

	Notes	20X2 YTL	20X1 YTL
Cash flows from operating activities			
Profit for the year		**385,306**	**267,588**
Adjustments for:			
Finance costs		26,366	36,712
Income tax expense		270,651	189,559
Depreciation of property, plant and equipment		270,360	219,547
Impairment loss		30,000	—
Amortisation of intangibles		1,700	1,700
Gain on disposal of property, plant and		(63,850)	—
Decrease (increase) in trade and other receivables		(11,686)	(52,628)
Decrease (increase) in inventories (20X2 includes CU131 of production supplies reclassified as assets held for sale)		(9,461)	(2,870)
Increase (decrease) in trade payables (20X2 includes CU1,550 reclassified as liabilities directly associated with assets classified as held for sale)		9,120	10,870
Increase in current and long-term employee benefits payable		793	193
Cash generated from operations		**909,299**	**670,671**
Interest paid	6	(26,366)	(36,712)
Income taxes		(190,316)	(172,426)
Net cash from operating activities		**692,617**	**461,533**
Cash flows from investing activities			
Proceeds from sale of equipment		100,000	—
Purchases of equipment		(485,000)	(435,000)
Purchase of the marketable securities		(110,000)	(95,000)
Proceeds from sale of marketables securities		100,000	90,000
Net cash used in investing activities		**(395,000)**	**(440,000)**
Cash flows from financing activities			
Payment of finance lease liabilities		(19,884)	(18,423)
Repayment of borrowings		(100,000)	—
Dividends paid		(150,000)	(100,000)
Net cash used in financing activities		**(269,884)**	**(118,423)**
Net increase (decrease) in cash and cash equivalents		**27,733**	**(96,890)**
Cash and cash equivalents at beginning of year		**(94,633)**	**(2,743)**
Cash and cash equivalents at end of year	**21**	**(66,900)**	**(99,633)**

XYZ Group

Accounting policies and explanatory notes to the financial statements for the year ended 31 December 20X2

1. General information

XYZ (Holdings) Limited (the Company) is a limited company incorporated in A Land. The address of its registered office and principal place of business is _________. XYZ Group consists of the Company and its wholly-owned subsidiary XYZ (Trading) Limited. Their principal activities are the manufacture and sale of candles.

"**Comment:** This section is where we can really understand the logic and technique of the financial statement preparation of the business entity and the concordance of the practices with the Draft IFRS for SMEs. Indeed by just looking at the accounting policies of the example a solid understanding of the standards could be obtained."

2. Basis of preparation and accounting policies

These consolidated financial statements have been prepared in accordance with the [draft] International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) issued by the International Accounting Standards Board (IASB). They are presented in the currency units YTL of the Turkish Republic.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and its wholly-owned subsidiary. All intragroup transactions, balances, income and expenses are eliminated.

Investments in associates

Investments in associates are accounted for at cost less any accumulated impairment losses. Dividend income from investments in associates is recognised when the shareholders' rights to receive payment have been established and is shown as other income.

Non-current assets held for sale

Non-current assets (and disposal groups) classified as held for sale are measured at the lower of the assets' previous carrying amount and fair value less costs to sell.

Revenue recognition

"**Comment:** The revenue recognition practice of IFRS for SMEs financial statement would likely to be one the practices that have most significant affects on the financials of the SMEs."

Revenue is measured at the fair value of the consideration received or receivable, net of discounts and sales-related taxes. Revenue from sales of goods is recognized when the goods are delivered and title has passed. Royalty revenue from licensing candle-making patents for use by others is recognised over the licence period.

Borrowing costs

All borrowing costs are recognised in profit or loss in the period in which they are incurred. Income taxes Income tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year.

Deferred tax is recognised on differences between the carrying amounts of assets and liabilities in the financial statements and their corresponding tax bases (temporary differences). Deferred tax liabilities are recognised for all taxable

temporary differences. Deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered. Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

Property, plant and equipment

Items of property plant and equipment are measured at cost less accumulated depreciation and any accumulated impairment losses. Depreciation is charged so as to allocate the cost of assets less their residual values over their estimated useful lives, using the straight-line method. The following rates are used for the depreciation of property, plant and equipment:

Buildings	2%
Fixtures and equipment	10% to 30%

Intangible assets

Intangible assets are purchased computer software that is stated at cost less accumulated depreciation and any accumulated impairment losses. It is amortised over its estimated life of five years using the straight-line method.

Impairment of non-current assets

At each balance sheet date, the carrying amounts of tangible and intangible assets and investments in associates are reviewed to determine whether there is any indication that those assets have suffered an impairment loss. If the fair value less

costs to sell of an asset (or group of assets) is estimated to be less than its carrying amount, the carrying amount of the asset (or group of assets) is reduced to its fair value less costs to sell. An impairment loss is recognised immediately in profit or loss. If an impairment loss subsequently reverses, the carrying amount of the asset (or group of assets) is increased to the revised estimate of its fair value less costs to sell, but not in excess of the amount that would have been determined had no impairment loss been recognised for the asset (group of assets) in prior years. A reversal of an impairment loss is recognised immediately in profit or loss.

Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

Assets held under finance leases are recognised as assets of the Group at their fair value at the inception of the lease. The corresponding liability to the lessor is included in the balance sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly to profit or loss. Assets held under finance leases are included in property, plant and equipment, and depreciation and impairment losses are recognised.

Rentals payable under operating leases are charged to profit or loss on a straight-line basis over the term of the relevant lease.

Inventories

Inventories are stated at the lower of cost and selling price less costs to complete and sell. Cost is calculated using the first-in, first-out (FIFO) method.

Trade and other receivables

"**Comment:** As it can be seen from the explanation after the SMEs measure their receivables with amortised cost using the effective interest method there would be major effects on the balance of receivables, finance income and sales revenue."

Trade and other receivables are measured at amortised cost using the effective interest method. At the end of each reporting period, the carrying amounts of trade and other receivables are reviewed to determine whether there is any objective evidence that the amounts are not recoverable. If so, an impairment loss is recognised immediately in profit or loss.

3. Key sources of estimation uncertainty

"Comment: In this section the management should provide the internal and external sources of the critical estimations in order to rationalize the accounting estimates on the financial statements. This is one of the parts that the managements of the SMEs would likely to suffer, because of the cost of providing the expertise and management skills in building estimates."

Long-service payment

In determining the liability for other long-term benefits (explained in note 18), management must make an estimate of salary increases over the following five years, the discount rate for the next five years to use in the present value calculation and the number of employees expected to leave before they receive the benefits. Note 18 provides details of the carrying amount of the obligation at the year-end.

4. Restriction on payment of dividend

Under the terms of the bank loan and bank overdraft agreements, dividends cannot be paid to the extent that they would reduce the balance of retained earnings below the sum of the outstanding balance of the bank loan and the bank overdraft.

5. Revenue

An analysis of the Group's revenue is as follows:

	20X2	**20X1**
	YTL	**YTL**
Sale of goods	6,743,545	5,688,653
Royalties – licensing of candle-making patents	120,000	120,000
	6,863,545	**5,808,653**

6. Finance Cost

	20X2	**20X1**
	YTL	**YTL**
Interest on bank loan and overdraft	(21,250)	(30,135)
Interest on finance leases	(5,116)	(6,577)
	(26,366)	**(36,712)**

7. Profit before tax

The following items have been recognised as expenses (income) in determining profit before tax:

	20X2	20X1
	YTL	YTL
Gain on disposal of property, plant and equipment	(63,850)	—
Depreciation of property, plant and equipment	270,360	219,547
Impairment of property, plant and equipment (included in impairment of property, plant and equipment/administrative expenses)	30,000	—
Amortisation of software (included in depreciation and amortisation/administrative expenses)	1,700	1,700
Employee benefits expense	936,142	879,900
Cost of inventories recognised as expense	4,783,389	4,093,545

8. Income tax expense

	20X2	20X1
	YTL	YTL
Current tax	140,457	98,887
Deferred tax (note 12)	(997)	(757)
	139,460	98,130

Domestic income tax is calculated at 20% (20X1: 20%) of the estimated assessable profit for the year.

The total income tax expense for the year can be reconciled to the accounting profit as follows:

	20X2	20X1
	YTL	YTL
Profit before tax	655,957	457,147
Tax at domestic rate of 20%	131,191	91,429

Tax effect of certain employee compensation expenses (CU20,670 in 20X2 and CU16,750 in 20X1) recognised in measuring profit before tax that are not tax-deductible	8,268	6,700
Tax Expense for the Year	**139,460**	**98,130**

9. Plant property equipment

	Land and buildings	**Fixtures and equipment**	**Total**
	YTL	**YTL**	**YTL**
Cost			
1 January 20X1	1,960,000	907,045	2,867,045
Additions	—	435,000	435,000
Disposals	—	(240,000)	(240,000)
At 31 December 20X1	**1,960,000**	**1,102,045**	**3,062,045**
Additions	–-	485,000	485,000
Disposals	–-	(241,000)	(241,000)
Reclassified as held for sale (note 15)	-	(1,550)	(1,550)
At 31 December 20X2	**1,960,000**	**1,344,495**	**3,304,495**

Accumulated Depreciation and Impairment:

	Land and buildings	**Fixtures and equipment**	**Total**
	YTL	**YTL**	**YTL**
1 January 20X1	360,000	321,043	681,043
Annual depreciation	30,000	189,547	219,547
Less accumulated depreciation on assets disposed of		(240,000)	(240,000)
At 31 December 20X1	**390,000**	**270,590**	**660,590**
Annual depreciation	30,000	240,360	270,360
Impairment	—	30,000	30,000
Less accumulated depreciation on assets disposed of	—	(204,850)	(204,850)
Less accumulated depreciation on assets reclassified as held for sale (note 15)		(78)	(78)
At 31 December 20X2	**420,000**	**336,022**	**756,022**

Carrying Amount

31 December 20X1	**1,570,000**	**831,455**	**2,401,455**
31 December 20X2	**1,540,000**	**1,008,473**	**2,548,473**

"Comment: The SMEs shall have to test the impairment of the assets for each reporting period which will obviously put burden on the financial reporting procedure of the SMEs that will report with the IFRS for SMEs."

During the period, the Group noticed a significant decline in the efficiency of two of its vehicles and so carried out a review of their fair values less costs to sell. The review led to the recognition of an impairment loss of 30,000 YTL.

The carrying amount of the Group's fixtures and equipment includes an amount of 40,000 YTL (20X1: 60,000 YTL) in respect of assets held under finance leases.

10. Intangible Assets

Software

Cost		**20X2** **YTL**
1 January 20X1		8,500
Additions	—	
Disposals	—	
At 31 December 20X1		**8,500**
Additions	—	
Disposals	—	
At 31 December 20X2		**8,500**
Accumulated depreciation and impairment		
1 January 20X1		**4,250**
Annual amortisation		1,700
At 31 December 20X1		**5,950**
Annual amortisation		1,700
At 31 December 20X2		**7,650**

Carrying amount	
31 December 20X1	2,550
31 December 20X2	**850**

11. Investment in associates

	20X2	**20X1**
	YTL	**YTL**
Cost of investment in associate	**107,500**	**107,500**

The Group owns 35 per cent of an associate whose shares are not publicly traded. Summarised financial information of the associate is set out below:

	20X2	**20X1**
	YTL	**YTL**
Total assets	559,509	589,423
Total liabilities	(167,128)	(156,312)
Net assets	**392,381**	**433,111**

	20X2	**20X1**
	YTL	**YTL**
Revenue	518,887	528,536
Profit for the year	**111,137**	**118,534**

12. Deferred Tax

Differences between amounts recognised in the income statement and amounts reported to tax authorities in connection with investments in the subsidiary and associate are insignificant.

The deferred tax asset is the tax effect of an expected future income tax benefit relating to the long-service benefit (note 18) that will not be tax deductible until the benefit is actually paid but has already been recognised as an expense in measuring the Group's profit for the year. The Group has recognised the full related deferred tax asset because, on the basis of past years and future expectations, management considers it

probable that taxable profits will be available against which the future income tax deduction can be utilised.

The following are the deferred tax liabilities (assets) recognised by the Group during the current and prior years:

	Software	Long service-benefit	Total
	YTL	**YTL**	**YTL**
At 1 January 20X1	1,700	(3,855)	(2,155)
Charge (credit) to profit or loss for the year	(680)	(77)	(757)
At 1 January 20X2	**1,020**	**(3,932)**	**(2,912)**
Charge (credit) to profit or loss for the year	(680)	(317)	(997)
At 31 December 20X2	**340**	**(4,249)**	**(3,909)**

The deferred tax asset for long-service benefits and the deferred tax liability for software relate to income taxes in the same jurisdiction, and the law allows net settlement. Therefore, they have been offset in the balance sheet as follows:

	20X2	20X1
	YTL	**YTL**
Deferred tax liability	340	1,020
Deferred tax asset	(4,249)	(3,932)
	(3,909)	**(2,912)**

13. Inventories

	20X2	20X1
	YTL	**YTL**
Raw materials	42,470	36,450
Work in progress	1,140	900
Finished goods	13,640	10,570
	57,250	**47,920**
Production supplies classified as part of a disposal group held for sale (note 15)	131	0
	57,381	**47,920**

14. Trade and other receivables

	20X2	20X1
	YTL	**YTL**
Trade debtors	428,788	418,384
Prepayments	56,760	45,478
	485,548	**463,862**

"**Comment:** As it is stated in the explanation of the accounting policies section, the receivables are reported with the amortized cost with effective interest method."

15. Assets held for sale

On 10 December 20X2, the directors resolved to dispose of one of the Group's recently acquired rolling machines for beeswax candles. Negotiations with several interested parties have taken place. The machine, along with related supplies purchased for use with the machine and the liability to the supplier of the machine, is expected to be sold within twelve months and so has been classified as a disposal group held for sale and presented separately in the balance sheet.

The proceeds of disposal are expected to exceed the net carrying amount of the relevant assets and liabilities and, accordingly, no impairment loss has been recognised on the assets classified as held for sale.

The major classes of assets and liabilities in the disposal group classified as held for sale are as follows:

	20X2
	YTL
Property, plant and equipment	1,472
Production supplies	131
	1,603
Payable associated with assets classified as held for sale	(1,550)
	53

16. Share capital

Balances as at 31 December 20X1 and 20X2 of 30,000 YTL comprise 30,000 ordinary shares with par value 1.00 YTL fully paid, issued and outstanding. An additional 70,000 shares are legally authorised but unissued.

17. Bank overdrafts and loans

	20X2	20X1
	YTL	YTL
Bank overdrafts	83,600	115,508
Bank loans—fully repayable in 20X4, prepayable without penalty	50,000	150,000
	133,600	**265,508**

The bank overdraft and loan are secured by a floating lien over the Group's assets.

18. Long-service benefit

The liability for employee benefit obligations relates to government mandated long-service payments. All full-time members of staff, excluding directors, are covered by the programme. A payment is made of 5 per cent of salary (as determined for the twelve months before the payment) at the end of each of five years of employment. The payment is made as part of the December payroll in the fifth year. The Group does not fund this obligation in advance. The accrual to be recognised at the year-end is determined on the basis of a present value calculation assuming a 3 per cent average annual salary increase, with employee turnover based on the Group's recent experience, discounted using the current market yield for high quality corporate bonds.

	YTL
At 1 January 20X2	9,830
Additional accrual during year	7,033
Payment made in year	-6,240
At 31 December 20X2	**10,623**

	20X2	20X1
	YTL	YTL
Current liability	6,181	5,943
Non-current liability	4,442	3,887
Total	**10,623**	**9,830**

19 Obligations under the finance lease

The Group holds one piece of specialised machinery with an estimated useful life of five years under a five-year finance lease. The future minimum lease payments at the end of the year, for each future year, are as follows:

	20X2	20X1
	YTL	YTL
In 20X2	n/a	25,000
In 20X3	25,000	25,000
In 20X4	25,000	25,000
	50,000	**75,000**

The obligation is analysed as:

	20X2	20X1
	YTL	YTL
Current	21,461	19,884
Non-Current	23,163	44,624
	44,624	**64,508**

20 Obligations under operating lease

	20X2	20X1
	YTL	YTL
Minimum lease payments under operating lease recognized as an expense during the year	26,100	26,100

At the balance sheet date, the Group has outstanding commitments under non-cancellable operating leases that fall due as follows:

	20X2	20X1
	YTL	YTL
In 20X2	n/a	26,100
In 20X3	13,050	13,050

Operating lease payments represent rentals payable by the Group for certain items of equipment. Leases are negotiated for an average period of three years, with fixed rentals over the same period.

21 Cash and cash equivalents

	20X2	20X1
	YTL	YTL
Cash and Cash Equivalents	16,700	15,875
Bank Overdrafts	(83,600)	(115,508)
	(66,900)	(99,633)

22 Contingent Liabilities

During 20X2, a customer of the Group instigated proceedings against XYZ (Trading) Limited for a fire caused by a faulty candle. The customer asserts that its total losses are 50,000 YTL and has claimed this amount from the company.

The Group's lawyers do not consider that the claim has merit, and they have recommended that it be contested. No provision has been recognised in these financial statements as the Group's management does not consider it probable that a loss will arise.

23 Event after the balance sheet date

On 25 January 20X3, there was a flood in one of the candle storage rooms. The cost of refurbishment is expected to be 36,000 YTL. The reimbursements from insurance are estimated to be 16,000 YTL.

24 Related party transactions

Transactions between the Company and its subsidiary, which is a related party, have been eliminated in consolidation. The Group sells goods to its associate (see note 11), which is a related party, as follows:

Sales of goods Amounts owed to the Group by the related party at year-end:

	20X2 YTL	20X1 YTL	20X2 YTL	20X1 YTL
Associate	10,000	8,000	800	400

The payments under the finance lease (see note 19) are personally guaranteed by a principal shareholder of the Company. No charge has been requested for this guarantee.

The remuneration of directors and other members of key management during the year were as follows:

	20X2 YTL	20X1 YTL
Salaries	190,500	169,300
Other short-term benefits	15,213	9,200
Post-employment benefits	44,205	29,760

25. Financial assets at fair value through profit or loss

This section has been added to the notes in order to show the accounting treatment of the financial assets at fair value through profit or loss.

The composition of the equity instruments is as fallows:

	20X2 YTL	20X1 YTL
Equity Shares of A Company	45,000	-
Equity Shares of B Company	55,000	-
Equity Shares of C Company	-	110,000
	100,000	**110,000**

The measurement of the equity instruments through fair value:

	Nominal Amounts	Market Price	Purchase Price	Profit/(Loss)
Equity Shares of A Company	1,000	45	42	3,000
Equity Shares of B Company	1,000	55	56	(1,000)
				2,000

26. Approval of financial statements

These financial statements were approved by the board of directors and authorised for issue on 10 March 20X3.

CONCLUSION

SMEs in the world economies are the major players that act behind the curtains. Thus their problems could affect the economies of the world far beyond their definitions. Their contributions to the world economies cannot be ignored and especially for the developing countries' economies there is still much more room for the SMEs to grow.

On the other hand the new capital environment of the Basel II which is major paradigmatic shift for the SMEs and the global business world is beginning to push SMEs in different status. However yet it is not very clear that how the SMEs will be affected by this new environment. But obviously since the main external capital suppliers of the SMEs are the banks, SMEs need to realign themselves according to this new parameters of the global capital environment.

Amid these dynamic changes certainly the IASB, premising single, understandable, enforceable accounting standards, cannot ignore this invisible but major player in its global project of setting globally acknowledged and applicable accounting standards. The IFRS for SMEs project has been initiated in order to establish cost-benefit balanced, globally recognized accounting standards for SMEs as a response to the new global capital environments.

Consequently it can be argued that the new draft IFRS for SMEs fills a major gap of the full IFRS and IAS in providing a cost-benefit balanced accounting practices for SMEs. However it is very crucial to establish the right balance between the fair representation and the benefit that the financial statement readers and the SMEs obtain from the financial statements. Otherwise the project would not meet its objectives.

There are certain areas in the IFRS for SMEs that could need more simplifications, provided that those simplifications are presented as allowed alternative treatments for the

full IFRS and IAS. In other words standards should provide a more room and several options for accounting treatments without spoiling the integrity of the standards. Consequently it should be admitted that this is very delicate effort and certainly needs careful considerations and consensus from different levels of the related parties.

When it is looked at from the perspective of the Turkey there are major differences between the principles of the IASB and Turkish statutory accounting practice. There have been major steps in adapting the IFRS and IAS to Turkish public companies and financial institutions and indeed these steps have been successful. However especially among the non-public companies the IFRSs are not widely accepted as a default financial reporting requirement.

At this point as it can be easily appreciated that the new Turkish Trade Law proposal would be the boldest step ever, if the IFRS and IAS will be obligatory for all the business entities. It is obvious that this act will bear very positive outcomes if this project is conducted by considering the capabilities of the Turkish business entities by providing the option of the IFRS for SMEs to the Turkish SMEs.

The affects of such transformation in Turkey could be somewhat difficult. However in the end Turkish SMEs would be producing financial statements that can be understood and acknowledged anywhere in the world. This factor obviously would strengthen the competitiveness of the Turkish SMEs in the world by decreasing the cost of capital, increasing their credit notes and by making them more interactive with the external markets. Consequently this would certainly push Turkish SMEs in realizing their potential and contributing more to the overall welfare and economic growth of Turkey.

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