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# THE NEXUS BETWEEN "BASEL II" AND "IFRS FOR SMEs"

# "BASEL II" VE "KOBİ'LER İÇİN UFRS" ARASINDAKİ BAĞLANTI

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***ABSTRACT***

*Banks rely heavily on SMEs (Small and Medium-Sized Entities) and Basel II Accord requires for SMEs transparent financial statements. On the other hand, IASB (International Accounting Standards Board) deals about SMEs for more transparent financial statements either. "Basel II" and "IFRS for SMEs" seem to fit each other. How and in which circumstances will this combination occur is the subject of this article.*

***Key Words:*** *IFRS, SMEs, IFRS for SMEs, Basel II*

***ÖZET***

*Bankalar daha çok KOBİ'lere (Küçük ve Orta Ölçekli İşlemeler) dayanmakta ve Basel II Uzlaşısı'da KOBİ'lerden şeffaf finansal tablolar istemektedir. Diğer taraftan Uluslararası Muhasebe Standartları Kurulu da KOBİ'lerin daha şeffaf finansal tablolara sahip olması için uğraşı vermektedir. "Basel II Uzlaşısı" ve "KOBİ'ler için UFRS" birbirlerini tamamladıkları anlaşılmaktadır. Bu birleşmenin nasıl ve hangi koşullarda sağlandığı bu makalenin konusudur.*

***Anahtar Kelimeler:*** *UFRS, KOBİ, KOBİ'ler için UFRS, BASEL II*

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## 1. Introduction

At first look it seems that Basel II Accord and IFRS for SMEs (International Financial Standards For Small and Medium-Sized Entities) has no direct relationship. One is a regulation of banking sector the other one is for establishing the transparency of financial statements. If it is analyzed deeper, it can be found that there exists a strong nexus between these two regulatory frameworks.

Basel II puts emphasis on a bank's internal controls and increase risk sensitivity by requiring minimum capital standards. A uniform, risk-weighted minimum capital-asset ratio of 8% is compulsory for all banks. In this circumstance banks must be careful by lending their resources to third parties. Firms must be rated before lending funds. Credit rates determine risk weight for the firm. Thus risk weight identifies the cost of credit. In lending credit procedure banks categorize the firms into two types: One is corporate firms, the other is SMEs (Small and Medium-Sized Entities). And SMEs are also categorized into two: Corporate SMEs and Retail SMEs. Consequently, this implies the fact that SMEs, which utilize the bank credits as their major sources of external financing, will also be affected in terms of risk management and internal control. Globally, it is known that SMEs have certain problems. Actually, the size is small for doing business smoothly. They try to add value to their business with limited resources and because of these limited resources they could hardly find the opportunity to improve their procedures and processes. The quality of management and accounting systems are very poor comparing with institutionalized firms.

According to Basel II Accord, banks have to rate SMEs by analyzing their quantitative and qualitative factors. Quantitative factors are derived from financial statements, which should be understandable and transparent enough. But de facto situation of SMEs is that their financial statements are prepared for tax purposes and do not reflect the real financial position of SME. Transparency is one of the major problems of a SME all over the world. And in rating procedure, qualitative factors are also very important. The quality of accountancy of the firm must be questioned. The accounting systems of most SMEs are in poor quality, which means untimely, inappropriate, irrelevant information.

In that picture, IFRS for SMEs framework is a valuable work, which suits Basel II criteria. IFRS for SMEs are for more transparent financial statements, which satisfy the needs of CRAs (Credit Rating Agencies) and SMEs. It will increase the level of accounting quality of SMEs, which will be searched by banks and CRAs, which are between banks and companies. In next section, Basel II and the effects on SMEs will be discussed in detail.

## 2. The Efects Of Basel II Accord On SMEs

Basel II Accord has been to refine risk-sensitive capital charges. Accord retains the general requirement for banks to hold capital equivalently at least 8% of their risk-weighted assets. Basel II requires the stability of banks in the complex and rapidly growing financial world by achieving through the combination of effective bank-level regulation, supervision and market discipline defined as three pillars that reinforce each other (Rochet, 2004:12).

Basel II Accord has four categories (20, 50, 100 and 150%) depending on credit rating. Retail claims are associated with a risk weight of 75%. CRAs will be authorized to attach risk weights to borrowers. It is analyzed by credit rating the ability of firms to meet their obligations in a timely manner. Credit exposure is shared by CRA and bank together. The consideration of the banking credit exposures to SMEs in terms of minimum capital requirements were among the elements that raised serious concerns among industry members and national authorities. European Union directive define SMEs as firms that annual sales are less than €50 million, employs less than 250 employees and has a size of balance sheet less than €43 million. SMEs represent the backbone of the economies of countries, constituting an important contribution to their Gross Domestic Product and to the sustainability of their employment levels. Some banks have also a large part of their loan portfolios devoted to finance SMEs. Thus, banks and authorities were concerned about an absolute increase in capital requirements, on those banks specialized in lending to SMEs. A risk-sensitive approach implies that credit financing to SMEs would probably require more capital than that to larger firms banking funding because of the probability of default (PD) of SME, which is usually much greater than that of a large firm. To estimate the risk of their client firms, banks need more information than before. SMEs that can show that they are stable can expect to benefit with lower interest rates and better access to loans. Riskier SMEs are likely to face higher interest rates and higher collateral requirements (Balci et al, 2008;167).

SMEs already encounter severe conditions such as changing markets, new technology, shrinking profitability and erratic, deficient and ambiguous cash flows. Various surveys show that most of the SMEs operate with incomplete financial records. Until Basel II, banks were extending the credits by taking the unrecorded data provided by the borrowers into consideration, but this data cannot be fed into the system and therefore will be useless after the implementation of the Accord, because of this underground economy. Credit rating agencies will rely on quantitative factors derived from financial statements. Surveys on SMEs admit that most financial statements of SMEs reflect a tax avoiding strategy rather than forward looking investment and maximizing earnings strategy. This goes in parallel with the secrecy that the SMEs tend to treat their business affairs and accounts. SMEs are so reluctant in disclosing their financial statements that they rather prefer to pay fines. In this regard, SMEs will face the cold fact that accounting records are indispensable for credit rating, which they need to acquire in order to get external financing. This affects the cost of this resource as well. For instance, two firms that are exactly identical except for the transparency and concordance of their accounting record will encounter different costs of capital in external financing. May be one of the firms might be ineligible for the credit (Balci et al, 2008;168).

**3. Credit Rating And SMEs**

Rating is an assessment of creditworthiness. There are two types of credit ratings: internal and external. Internal rating is assigned by bank that use basic or advance IRB approaches. External ratings are issued by CRAs. Common to both approaches is that the resulting rating will be used in credit exposure decision. The essential logic underlying their existence is to solve the problem of informative asymmetry between lenders and borrowers (Elkhoury, 2008). CRAs have relied on quantitative and qualitative assessment.

They derive software packages and enter the data of quantitative and qualitative assessment into them to get the score of their clients.

CRAs gather financial information from financials, quantify management qualifications, interpret past performances and process this information by considering future projects. The essential benefit of the credit rating is that the criterion set forward by the credit rating firm is minimally subjective and furthermore informative for the corresponding bank to calculate the required capital allocation. Credit rating firms evaluate firms as a whole.

Financial analysis is to evaluate cash generation capabilities. Financial data is used to extract information related to volatility, size, profitability, financial leverage, liquidity, growth and stocks. Credit rating firms explicitly declared that the rating process will involve a qualitative assessment of the target firm as well. Qualitative factors that will be examined are broadly categorized under industrial risks, ecological analysis, market position, management quality, operational aspects of business and qualitative aspects of accounting practices. Approximately 50% of the mid-sized and large banks in EU attach high or very high importance to a SMEs management quality as a rating input factor (DGEI-Directorate-General for Enterprise and Industry, 2005). Furthermore average weight of the qualitative data fed into the system that generates the rating has been approximately 30%-50%. Literature shows that in practice most methods rather work with more qualitative than quantitative analysis and rather simple methods to obtain a rating (Table 1).

**Table 1: Considered factors and their weights**

| Factor | Weight |
|---|---|
| Management and organization | 0.2 |
| Human resources | 0.15 |
| Corporate finance | 0.4 |
| Products and markets | 0.15 |
| Production and information technology | 0.05 |
| Facility locations and ecology | 0.05 |

**Source:** (Trueck et. al.; 2001)

Credit ratings provide a fair ground for comparison between firms. In return, having recognized their relative positioning within the market, firms will eventually develop risk management capacity that protects or at least acts as a buffer against adverse conditions or crises. This capacity will also stand as an early warning system. Meanwhile, the costs of overcoming crises and adverse situations will be significantly reduced. A proper risk management system will aid and comfort to reach targets through a stable path. Therefore credit rating should not be conceptualized as a certificate for admission of external resources but as a foundation for a risk management system, which is more than necessary in an emerging economy. Thus the dynamic relation of the three pillars of Basel II Accord flash backs as such; as the firms integrates risk management in strategic decision making processes as a sufficiently independent approach, risks are identified, consequences are calculated, required precautions are taken and further steps are evaluated by partitioning the problem into small manageable pieces and transferring the aggregated information forwards. Hence a uniform body of management practices would emerge and the firm will be further rewarded by higher ratings recursively. The entire thrust of the argument is that credit rating firms are actually expected to spread out an isomorphism throughout corporations in such a way that soon every single firm would develop the know-how to scale their own credit ratings. This idea explains the intended rationale behind rating. To sum up, credit rating involves key challenges. Most important one is the quality of the data that is fed into the system. The data determines the probabilities of interest and it can be well imagined that if the data itself is poor, the output will not be reliable (Balci et al, 2008;169).

**4. IFRS For SMEs And Transparency**

According to banks Basel II accord applications, credit lending depends on rating scores. Without a good rating score getting a cheap credit is impossible for SMEs. For a good rating score, SMEs must prepare transparent financial statements. Basel II accord requires also financials prepared according to International Financial Reporting Standards (IFRS). By the way, IASB is also trying to downsize the IFRS, for the benefit of SMEs. That means SMEs will find the opportunity to implement the IFRS rules for their financials, which will produce more transparent financial statements than before. That will facilitate to get perfect scores from Credit Rating Agencies (CRAs), which will result borrowing credit with a cheap price. Now, IFRSs for SMEs are in draft stage. Discussions are continuing. The items of the draft have the same importance. But some items increase the transparency of firms' financials and because of their importance these items deserve to have more attention than the others. In this section, we will highlight and examine these critical points that create transparent financials, which facilitate cheap credits for SMEs under Basel II framework.

As it is stated in preface section of the draft standard that one of its objectives of IASB is 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 world's capital markets and other users make economic decisions. IFRS for SMEs define **small and medium-sized entities** as entities that have no public accountability and that publish general purpose financial statements for external users. SMEs often produce financial statements only for the use of owner-managers, or for tax reporting or other non-securities regulatory filling purposes. It is intended to lessen the 'dual reporting burden' on SMEs by structuring tax reports as reconciliation from the profit or loss determined in accordance with the IFRS for SMEs and by other means. IFRS for SMEs also depend on concepts and pervasive principles like understandability, relevance, reliability, substance over form, prudence, completeness, comparability, timeliness, which identify the level of transparency in financial statements.

**Fair value** is an important measurement base that affects transparency. According to the IFRS for SMEs, **fair value** is the amount for which an asset could be exchanged, or a liability settled. After initial recognition, an entity measures financial assets and liabilities at fair value, which updates the historical costs of assets and liabilities and nearer them to actual values. For some non-financial assets that an entity initially recognized at historical cost, draft standard permits or requires subsequent measurement at fair value.

Standards force to use accrual basis of accounting to record any business transaction, which are without cash flow information, to get the actual picture of the entity. Standard does not require to **off-set** assets and liabilities, or income and expenses, unless required or permitted by the standard.

The application of the standard by SMEs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation of the financial position, financial performance and cash flows of SMEs. IFRS for SMEs state that compliance with the standards would be misleading in extremely rare circumstances. And standards permit to be departed because of a particular requirement to achieve a **fair presentation**. When management is aware in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. Disclosing the uncertainties related with going concern basis is another transparency dimension. **Consistency** of presentation, makes the accounting periods comparable, from which valuable information can be generated, and prevent from confusion which will hide some information from users. According to consistency basis, an entity shall retain the presentation and classification of items in the financial statements from one period to the next. When the presentation or classification of items in the financial statements is changed, an entity shall reclassify comparative amounts unless the reclassification is impracticable. IFRS for SMEs requires disclose **comparative information** in respect of the previous comparable period for all amounts reported in the financial statements, which means valuable narrative and descriptive information. **Immaterial items** have to be removed from financial statement according to standard, to get clear picture of an entity. Balance Sheet, Income Statement, Statement of Changes in Equity, Cash Flow Statement and Notes, comprising a summary of significant accounting policies and other explanatory information together is a set of statements, which standards requires from SMEs for a clear picture about an entity. An entity shall clearly identify each of the financial statements and the notes and distinguish them from other information in the same document according to standard. Entity shall display the information such as the name of the reporting entity, whether the financial statements cover the individual entity or a group of entities, the date of the end of the reporting period and the period covered by the financial statements, the presentation currency, and level of rounding.

Balance Sheet is divided according **line items** like cash, receivables etc. **Line items** are included to balance sheet when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position. This feature is important for transparency. Current/non-current distinction exists in IFRS for SMEs. The judgment on whether additional items are presented separately is based on an assessment of the nature and liquidity of assets; the function of assets within the entity; and the amounts, nature and timing of liabilities. Standard provides different treatment for the effects of corrections of errors and changes in accounting policies are presented as adjustment of prior periods rather than as part of profit or loss in the period in which they arise; revaluation surpluses some gains and losses arising on translating the financial statements of a foreign operation, and some changes in fair values of hedging instruments are reported directly in equity rather than as part of profit or loss, when they arises. An entity shall disclose separately profit or loss attributable to minority interest; and profit or loss attributable to equity holders of the parent, on the face of the income statement. Additional line items, headings and subtotals can be presented on the face of the income statement when such presentation is relevant to an understanding of the entity's financial performance. 'Extraordinary items' shall not be presented either on the face of the income statement or in the notes.

**Notes** contain information in addition to that presented on the face of the financial statements, which complete transparency. They provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements. Accounting policies, supporting information for items presented on the face of the financial statements, contingent liabilities and contingent assets, unrecognized contractual commitments, non-financial disclosures, proposed or declared dividends but not recognized as a distribution to equity holders are the items of notes. An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation **uncertainty** at the end of the reporting period, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. If an entity is subject to **externally imposed capital requirements**, it shall disclose the nature of those requirements and how they are managed, including whether the requirements have been complied with.

**Consolidated financial statements** is another dimension of transparency, that display the aggregated amounts for the parent entity and subsidiaries and reflect the whole financial picture of the group, that generate valuable information for users of these financial statements. The **consolidated financial statements** present financial information about the group as a single economic entity. IFRS for SMEs order the procedure about consolidation. Consolidated financial statements shall be prepared as of the same reporting date, using uniform accounting policies. An entity shall present minority interest in the consolidated balance sheet within equity, separately from the parent shareholders' equity, and in the profit or loss of the group separately in the income statement. This standard does not require **combined financial statements** to be prepared. IFRS for SMEs requires from management of entities to develop and apply an **accounting policy** that results in information that is relevant and reliable. An entity shall recognize the effect of a change in an **accounting estimate**. To the extent that a change in an accounting estimate gives rise to change in assets and liabilities, or relates to an item of equity, the entity shall recognize it by adjusting the carrying amount of the related asset, liability or equity item in the period of the change. An entity shall correct a **prior period error** retrospectively in the first financial statements authorized for issue after its discovery.

## 4. Conclusion

Certainly, there are too much specific topics related with IFRS for SMEs. Discussing every section of IFRS for SMEs in detail will exceed the limits of this article. Highlighting the general components of IFRS for SMEs regarding transparency, and the importance of them by focusing to Basel II Accord was the objective of this article.

Basel II Accord will change the climate of banking sector. And SMEs which are the popular but even the weakest category of the entity classification must give attention on this changing environment. They are weak in management, corporate culture, finance, manufacturing and planning the future. They have to be rated when they demand funds from financial institutions according to Basel II criteria. They must get perfect rates to supply cheap financing and to be competitive globally. And IASB launched an initiative to grant financials for SMEs, that more transparent and reliable is. SMEs must understand IFRS for SMEs for a better quality of accounting. If they increase the quality of their accountancy, their performance will be understood better.

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