

A proposed IFRS for small and medium-sized entities

Introduction

The International Accounting Standards Board (IASB) has issued for comment an exposure draft of an International Financial Reporting Standard (IFRS) aimed specifically at meeting the needs of (and to be used only by) small and medium-sized entities (the IFRS for SMEs).

With IFRS applying equally to all sizes of entity and containing few concessions, the intention is to reduce the burden on SMEs who want to use IFRS. The IASB's approach to the development of the draft IFRS for SMEs has been to extract the fundamental concepts from the IASB's Framework and the principles and related mandatory guidance from full IFRS and then consider the modifications appropriate in the light of the needs of users of financial statements together with cost-benefit considerations.

Some countries have cited the burden of adoption of full IFRS on smaller companies as one of the main reasons for maintaining their local GAAP. The IASB therefore envisage that the publication of the IFRS for SMEs may also greatly facilitate wider adoption of IFRS.

To further facilitate ease of use, the draft standard is organised by topic rather than being in financial standard order with each topic being presented in a separately numbered section.

Scope

The IASB defines SMEs as entities that do not have public accountability and that publish general purpose financial statements for external users. An entity is considered to have public accountability if:

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

While the IASB considers that the IFRS for SMEs would be suitable for even the smallest of entities, the decision as to which type of entities will be permitted to use it will be left for national regulatory authorities and standard-setters. This will ensure that application will take full account of local market requirements.

Entities complying with the IFRS for SMEs will be required to make an explicit and unreserved statement of compliance within the notes to the accounts.



Major differences with 'full' IFRS

Topics omitted from the IFRS for SMEs

The IASB have taken the view that for the IFRS for SMEs to be a truly stand alone document it would need to be substantially longer than the current 370 pages. This is because it would need to address the types of transactions and circumstances that SMEs might, but do not typically, come across. The following topics are therefore not covered in the IFRS for SMEs although there is a cross reference to the relevant IFRS that would need to be applied were the entity to come across the transaction or situation.

- **Hyperinflation** – It is uncommon for an SME to have a hyperinflationary reporting currency, therefore reference is made to IAS 29 'Financial reporting in hyperinflationary economies'.
- **Equity-settled share-based payments** – The IASB consider that it is rare for SMEs to enter into this type of arrangement, accordingly where such transactions do exist reference will be required to the full measurement and disclosure requirements of IFRS 2 'Share-based payment'.
- **Agriculture** – The IFRS for SMEs requires that SMEs involved in agricultural activities should use the fair value model set out in IAS 41 'Agriculture' to account for those biological assets where fair value is readily determinable.
- **Interim financial reporting** – In the rare circumstances where an SME decides to issue an interim report and states that it complies with the IFRS for SMEs they will be allowed a choice between complying with IAS 34 'Interim financial reporting' or the full requirements of the IFRS for SMEs.
- **Lessor accounting for finance leases** – Many of the lessors in a finance lease are likely to be financial institutions that are publicly accountable and therefore would be unable to apply the IFRS for SMEs. Where an SME is lessor in a finance lease and is eligible to use the IFRS for SMEs they would need to have reference to the relevant paragraphs of IAS 17 'Leases'.
- **Earnings per share** – Should an SME wish to disclose earnings per share they would need to apply the full requirements of IAS 33 'Earnings per share'.
- **Segment reporting** – Should an SME choose to disclose segmental information they would be required to comply with the requirements of IFRS 8 'Operating segments'.
- **Insurance** – An insurer holds assets in a fiduciary capacity for a broad group of outsiders and therefore has public accountability and would not be able to use the IFRS for SMEs.

Recognition and measurement simplifications

- **Financial instruments** – The IASB have agreed that some simplifications of the requirements of IAS 39 'Financial instruments: recognition and measurement' would be appropriate for SMEs. SMEs will however also be permitted to adopt IAS 39 in its entirety should they wish to do so. Much of the complexity in IAS 39 arises because of the choice of measurement bases available to entities and the main simplifications offered by the IFRS for SMEs are:
 - **Classification of financial instruments** – Financial instruments meeting certain criteria are required to be measured at cost or amortised cost, and all others will need to be measured at fair value through profit and loss. The available-for-sale and held-to-maturity classifications in IAS 39 are not available in the IFRS for SMEs.
 - **Derecognition** – The exposure draft contains a simple principle for derecognition thus avoiding the complexities associated with the 'pass through' and 'continuing involvement' provisions in IAS 39.
 - **Hedge accounting** – The exposure draft concentrates on the types of hedge accounting SMEs are most likely to be involved in, namely:
 - 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.
 - Foreign exchange risk in a net investment in a foreign operation.

With regard to hedge accounting, periodic recognition and measurement of hedge ineffectiveness will be required but under less strict conditions than those in IAS 39.

- **Goodwill impairment** – The draft IFRS for SMEs proposes an approach based on indicators of impairment rather than the mandatory annual review required by IFRS 3 'Business combinations'.
- **Research and development costs** – The IFRS for SMEs contains a choice of accounting treatment whereby an SME can either expense all research and development costs or apply the requirements of IAS 38 'Intangible assets' whereby research costs are expensed and development costs capitalised once the project is deemed commercially viable.

- **Associates and joint ventures** – The IASB has taken account of the concerns of SMEs as to the difficulties they encounter in applying the equity and proportionate consolidation methods of accounting and SMEs will be permitted to use either the cost method or fair value through profit and loss in accounting for associates and joint ventures.
- **Income taxes** – While the IFRS for SMEs uses the temporary differences approach of IAS 12 'Income taxes' the explanatory text is written by reference to 'timing differences' which it is considered SMEs will find easier to understand. There are then specific requirements to recognise deferred tax in certain additional circumstances.
- **Employee benefits** – defined benefit plans – The IASB had originally planned not to include any guidance on this subject in the IFRS for SMEs on the grounds that they believed that few SMEs have defined benefit arrangements. However, in a number of countries the law requires SMEs to provide benefits that are similar in nature to defined benefit pensions. The IFRS for SMEs therefore contains requirements based on IAS 19 'Employee benefits' albeit with a number of simplifications including the requirement for all actuarial gains and losses to be recognised immediately in profit or loss.

Simplifications considered but not adopted

In developing the draft IFRS for SMEs, the IASB considered some recognition and measurement simplifications suggested by interested parties that it decided not to adopt. These, together with the IASB's reason for rejecting them are considered below.

- **Consolidated accounts** – Investors, lenders and other users of SME's financial statements indicated that they found information about a group in its entirety useful in their decision making processes. This is because in their view, the financial statements of individual entities within those groups were less useful because of the effect of inter-group transactions which might not always be on an arms length basis.
- **Cash flow statement** – It had been suggested to the IASB that SMEs should not be required to produce a cash flow statement. The IASB has however taken the view that the production of a cash flow statement is neither difficult nor that onerous. In addition, the great majority of lenders and users of SME's financial statements had indicated that they found cash flow statements to be useful to them.

- **Leases** – the possibility of treating all leases as operating leases was considered and discounted on the grounds that lenders were concerned as to the possibility of off balance sheet obligations.
- **Employee benefit plans** – for similar reasons to those cited for leases, the IASB did not consider that it would be appropriate to treat all employee benefit plans as defined contribution as the users of financial statements needed to understand funding obligations associated with defined benefit type arrangements.
- **Long-term contracts** – the IASB has retained the requirement for use of the percentage of completion method of profit recognition rather than, as suggested by some, the simpler, completed contract method. The latter was considered to give rise to a risk of potentially significant distortion of reported results.

Implementation

The comment period for the exposure draft expires on 1 October 2007.

Keeping the IFRS for SMEs up to date

The IASB is proposing that they will issue an omnibus exposure draft of proposed amendments to the IFRS for SMEs approximately every other year. In developing the exposure draft they will take into account both new and amended IFRS issued in the previous two years as well as specific issues brought to the attention of the IASB regarding possible amendments to the IFRS for SMEs.

Implementation guidance

Illustrative financial statements

The implementation guidance to the IFRS for SMEs contains a set of illustrative financial statements showing how the presentation and disclosure requirements might be met by a typical small or medium-sized entity.

Disclosure checklist

A disclosure checklist is also presented within the implementation guidance and summarises the disclosures required from each section of the IFRS for SMEs. The disclosure checklist does not include the additional disclosures required where a 'full' IFRS is applied in respect of any particular area.

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