

IFRS for SMEs

Supplement to IFRS outlook

Background

The International Accounting Standards Board (IASB) has issued its International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). This standard is the culmination of a five year project to address the financial reporting needs of small and medium-sized entities.

The IASB published the Exposure Draft (ED) of an IFRS for SMEs in February 2007 and began its redeliberations in May 2008. As a result, there have been changes to a significant number of the proposals originally contained in the ED. Perhaps the most fundamental change is that the IFRS for SMEs is now a stand-alone standard, with no fall back to full IFRS. The impact of this and other key requirements is outlined below.

Overview of IFRS for SMEs

The standard consists of 230 pages of text, arranged into 35 chapters that cover all of the recognition, measurement, presentation and disclosure requirements for SMEs. There is no cross reference to other IFRS (with one exception relating to financial instruments discussed below). This underscores the fact that IFRS for SMEs is viewed by the standard setter as independent from full IFRS.

On adoption of IFRS for SMEs, an entity must apply the provisions contained in Section 35, which deals with the transition to IFRS for SMEs. This requirement applies to all entities adopting IFRS for SMEs, irrespective of whether they are migrating from a national GAAP or full IFRS. Furthermore, if an entity were to apply IFRS for SMEs and subsequently wished to change to full IFRS, it would be required to apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

IFRS for SMEs is based on the fundamental principles of full IFRS, but in many cases, it has been simplified to make the accounting requirements less complex and to reduce the cost and effort required to produce the financial statements. To achieve this, the IASB has removed a number of the accounting options available under full IFRS and attempted to simplify accounting for SMEs in certain areas. Details of these changes are described in Table 1 and Table 2.



Scope of the standard

The standard is intended for use by SMEs. SMEs are defined in the standard as small and medium-sized entities that do not have public accountability and which also publish general-purpose financial statements for external users. An entity has public accountability if its debt or equity instruments are traded in a public market, or it holds assets in a fiduciary capacity for a broad group of outsiders.

Whilst this definition is necessary for an understanding of the entities to which IFRS for SMEs is applicable, the preface to the standard indicates that the decision as to which entities are required or permitted to apply the standard will lie with the regulatory and legislative authorities in each jurisdiction. However, if a publicly accountable entity uses the standard, it may not claim that the financial statements conform to IFRS for SMEs even if its application is permitted or required in that jurisdiction, as the entity would not meet the definition of an SME.

Concepts and pervasive principles

As the IFRS for SMEs is a stand-alone standard, it includes a section on the concepts and pervasive principles that underlie the financial statements of SMEs. The IASB considered that the overall principles of IFRS should apply to all entities and, hence, the concepts included in this standard are derived from the IASB Framework. These concepts address issues including the objective of financial statements for SMEs, the qualitative characteristics of information contained in those financial statements, and general recognition and measurement principles.

Complete set of financial statements

A complete set of financial statements of an entity reporting under the IFRS for SMEs is similar to that required by full IFRS. It requires:

- ▶ A statement of financial position
- ▶ Either a single statement of comprehensive income, or a separate income statement and a separate statement of comprehensive income
- ▶ A statement of changes in equity
- ▶ A statement of cash flows
- ▶ Notes including a summary of significant accounting policies.

Comparative information in respect of the previous comparable period must be included, although an opening statement of financial position is not needed in the instances described by IAS 1 *Presentation of Financial Statements*.

The IFRS for SMEs includes a set of illustrative financial statements and a presentation and disclosure checklist to assist entities with preparing their financial statements.



Table 1 - Key areas where options in full IFRS have been removed

- ▶ **Jointly controlled entities** can be accounted for using the cost model, the equity method or the fair value model. There is no option to use proportionate consolidation.
- ▶ **Investment properties** must be measured at fair value unless fair value cannot be measured reliably without undue cost or effort, in which case it is accounted for as property, plant and equipment. There is no accounting policy option to use the cost model.
- ▶ **Property, plant and equipment** must be measured at cost less any accumulated depreciation and accumulated impairment losses. There is no option to revalue PP&E assets.
- ▶ **Intangible assets** must be measured at cost less accumulated amortisation and accumulated impairment losses. They cannot be revalued.
- ▶ **Employee benefits** - actuarial gains and losses must be recognised in full either through profit or loss or through other comprehensive income. The corridor approach is not an option for SMEs.

Table 2 - Key areas where the accounting for SMEs has been amended

- ▶ **Intangible assets** - all research and development costs are expensed as incurred. There is no capitalisation of internally generated intangible assets, which is considerably more restrictive than full IFRS. All intangible assets must have a finite useful life. If this can't be estimated reliably then a useful life of 10 years is assumed. The residual value of an intangible asset is assumed to be zero unless there is a third party commitment to purchase the asset or it has an active market.
- ▶ **Business combinations** - acquisition costs are capitalised. Goodwill is amortised over its useful life. As with other intangible assets, if this can't be estimated reliably then a useful life of 10 years is assumed. Goodwill is tested for impairment only where there are indicators of impairment.
- ▶ **Financial instruments** - entities have a choice to account for financial instruments in accordance with IFRS for SMEs or to apply the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* to all financial instruments. Under IFRS for SMEs, there are only two categories of financial instrument. Basic financial instruments (such as non-derivative debt instruments) are measured at amortised cost, whilst other financial instruments (such as derivatives or equity instruments) are measured at fair value with all changes in the fair value being recognised in profit or loss. The derecognition rules have been simplified so that financial assets can only be derecognised where the entity has transferred substantially all of the risks and rewards or has transferred control of the asset to another party. The hedging rules have also been simplified to restrict the instances in which SMEs can apply hedge accounting, and to reduce the criteria in order to apply hedge accounting.
- ▶ **Borrowing costs** - all borrowing costs must be expensed as incurred and cannot be capitalised in relation to qualifying assets.
- ▶ **Government grants** - all government grants must be recognised in profit or loss either immediately if there are no performance conditions, or at the point such performance conditions are met. Grants relating to specific assets cannot be deducted from the carrying value of that asset.
- ▶ **Share-based payments** - the fair value of shares in equity-settled share-based payment transactions can be measured using the directors' best estimate of fair value if observable market prices are not available. Where share-based payments give either the entity or the counterparty a choice of settlement in cash or equity instruments, they are generally accounted for as cash-settled.
- ▶ **Deferred tax** - the accounting for income taxes differs significantly from the current requirements of full IFRS and contains many of the concepts from the Exposure Draft on income taxes issued in March this year that is currently being deliberated. IFRS for SMEs provides guidance on accounting for recognition and measurement of uncertain tax positions, brings in concepts of valuation allowances to offset deferred tax assets, and introduces a new definition of tax base which should be based on sale at the end of the period. The temporary difference approach (requiring recognition of deferred tax on all temporary differences with some exceptions) is retained from full IFRS. Since the income taxes section is largely based on requirements not yet within full IFRS, entities may find the requirements complex to apply in many situations and this may lead to interpretative issues.

Transition

IFRS for SMEs has transition rules that apply equally to all entities on first-time adoption of the standard. The transition rules are based on the requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards* but, in certain cases, the standard has been designed to make the transition rules simpler to apply.

Under the transition rules, restatements to the opening statement of financial position do not need to be made if it is impracticable for the entity to do so. In some cases this may relieve the need for restatement, although the ability to meet the impracticability hurdle may prove difficult. For example, due to the fact that certain information was never needed for the purposes of reporting under previous GAAP, such information about past transactions may now no longer be available.

The standard clarifies that an entity can only be a first-time adopter of IFRS for SMEs once. Therefore if an entity stops applying this standard and then chooses to adopt it again in a later period, it would have to apply all the requirements of IFRS for SMEs fully retrospectively.

Updates to IFRS for SMEs

The IASB intends to review the application of the standard and make necessary amendments to the standard as required. This review is expected to take place when two years of financial statements have been published by a range of entities. Taking into account the due process required to issue amendments, it may in practice result in a first amendment only being issued in four to five years. Following this initial review of the standard, amendments would then be published for comment every three years. These amendments are expected to be based on amendments to full IFRS and other issues that become known.

The question arises as to how issues will be addressed in the interim period between these amendment cycles. While this standard has not been allocated an IFRS number, it is still being published as part of IFRS. Hence, it would appear logical that the International Financial Reporting Interpretations Committee (IFRIC) could be approached to provide any interpretative guidance that users may require.

Impact

The publication of a simplified form of IFRS for private entities has been long awaited by national standard setters and small and medium-sized entities that have been required to apply full IFRS in the past. Application of this standard is expected to reduce the compliance costs for many smaller entities and help make the financial statements of such entities less complex.

As the standard is very much principles based, interpretation issues are likely to arise, which will require a globally consistent resolution. In order to ensure this standard achieves international consistency and comparability of financial reporting, it is important that interpretations are not developed that are specific to particular jurisdictions.

IFRS for SMEs includes a number of references to requirements not having to be applied if they require undue cost or effort to determine. This is likely to require significant judgment by preparers of financial statements to ensure consistent and high quality application of the standard.

Entities wishing to apply this standard will need to consider the legislative requirements in their jurisdiction to determine whether and when they are permitted to apply the standard. They will also need to consider whether changes are required to information systems and financial statements processes as in some cases the requirements may be significantly different to those currently applied under either full IFRS or national GAAP. As the IFRS for SMEs is a complete standard, any entity wishing to apply it will also need to consider the impact of not applying full IFRS, particularly as there is no short-cut approach if the entity later decides to adopt full IFRS.

Ernst & Young will be producing a more detailed publication later this year on the differences between this standard and full IFRS.

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