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Simplified financial reporting – IASB provides relief for SMEs

On 9 July 2009, the International Accounting Standards Board (IASB) issued the *IFRS for Small and Medium-sized Entities (IFRS for SMEs)*. This Standard provides an alternative framework that can be applied by eligible entities in place of the full set of International Financial Reporting Standards (IFRSs) in issue.

The *IFRS for SMEs* is a self-contained Standard, incorporating accounting principles that are based on full IFRSs but that have been simplified to suit the entities within its scope (known as SMEs). By removing some accounting treatments permitted under full IFRSs, eliminating topics and disclosure requirements that are not generally relevant to SMEs, and simplifying requirements for recognition and measurement, the *IFRS for SMEs* reduces the volume of accounting requirements applicable to SMEs by more than 90 per cent when compared with the full set of IFRSs.

Where financial statements are prepared using the Standard, the basis of presentation note (and, where applicable, the auditor's report) would refer to compliance with the IFRS for SMEs. Many SMEs may find that this internationally recognised 'cachet' for their financial statements will improve their access to capital.

The IASB has not set an effective date for the Standard because the decision as to whether to adopt the *IFRS for SMEs* (and also, therefore, the timing for adoption) is a matter for each jurisdiction.

The complete *IFRS for SMEs* (together with basis for conclusions, illustrative financial statements, and presentation and disclosure checklist) can be downloaded free from http://go.iasb.org/IFRSforSMEs

Who is eligible to use the *IFRS for SMEs*?

The *IFRS for SMEs* is intended by the IASB for use by entities that have no public accountability and that are required, or choose, to publish general purpose financial statements for external users. Essentially, an entity is considered to have public accountability if its debt or equity instruments are publicly traded, or if it is a financial institution or other entity that, as part of its primary business, holds and manages financial resources entrusted to it by clients.

Ultimately, the decision regarding which entities should use the *IFRS for SMEs* rests with national regulatory authorities and standard-setters – and those bodies will often specify more detailed eligibility criteria, including quantified criteria based on revenue, assets etc. However, because it would conflict with the IASB's intentions, even if the law or regulation in an entity's jurisdiction permits or requires the *IFRS for SMEs* to be used in the preparation of financial statements for small listed companies or small financial institutions – such financial statements cannot be described as conforming to the *IFRS for SMEs*.

A subsidiary that is part of a consolidated group that uses full IFRSs is not prohibited from using the *IFRS for SMEs* in its individual financial statements, provided that the subsidiary itself does not have public accountability. If the subsidiary opts to use the *IFRS for SMEs*, it must follow that Standard in its entirety – it cannot pick and choose between the requirements of the *IFRS for SMEs* and those of full IFRSs.

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Key features of the *IFRS for SMEs*

The *IFRS for SMEs* is a self-contained set of accounting principles that are based on full IFRSs, but that have been simplified to the extent suitable for SMEs. The Standard has been organised by topic to make it more like a reference manual – intended by the IASB to be more user-friendly for SME preparers and users of SME financial statements.

The *IFRS for SMEs* and full IFRSs are separate and distinct frameworks. Entities that are eligible to apply the *IFRS for SMEs*, and that choose to do so, must apply that Standard in full (i.e. they are not permitted to 'mix and match' the requirements of the *IFRS for SMEs* and full IFRSs).

The *IFRS for SMEs* includes requirements for the development and application of accounting policies in the absence of specific guidance on a particular subject. In particular, an entity may, but is not required to, consider the requirements and guidance in full IFRSs dealing with similar and related issues.

The following are the key simplifications made:

- some topics in IFRSs are omitted because they are not relevant to typical SMEs;
- some accounting policy treatments in full IFRSs are not allowed because a simplified method is available to SMEs;
- simplification of many of the recognition and measurement principles that are in full IFRSs;
- substantially fewer disclosures; and
- simplified language and explanations throughout.

The result of these simplifications is that the *IFRS for SMEs* is roughly 10 per cent the size of full IFRSs.

Topics that have been omitted from the *IFRS for SMEs*

The *IFRS for SMEs* does not address the following topics that are dealt with in full IFRSs, because these topics are not generally relevant to SMEs:

- earnings per share;
- interim financial reporting;
- segment reporting;
- insurance (because entities that issue insurance contracts will not be eligible to use the *IFRS for SMEs*); and
- assets held for sale.

Accounting treatments disallowed under the *IFRS for SMEs*

The *IFRS for SMEs* does not allow the following accounting treatments that are available under full IFRSs (generally because a simplified method is available to SMEs):

- the revaluation model for property, plant and equipment and intangible assets;
- proportionate consolidation for investments in jointly-controlled entities;
- for investment property, measurement is driven by circumstances rather than allowing an accounting policy choice between the cost and fair value models. Under the *IFRS for SMEs*, if an entity can measure the fair value of an item of investment property reliably without undue cost or effort, it must use fair value. Otherwise cost is applied;
- various options for government grants permitted by IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*;
- capitalisation of borrowing costs;
- capitalisation of development costs; and
- deferral of actuarial gains and losses of defined benefit pension plans.

Regarding financial instruments, the Standard drops the 'available-for-sale' and 'held-to-maturity' categories of IAS 39, has no fair value option, and has simplified hedge accounting and derecognition requirements. However, there is a fallback that allows entities to choose to apply IAS 39 in its entirety instead of the financial instrument requirements in the *IFRS for SMEs*. This is the only fallback option to full IFRSs in the *IFRS for SMEs*. It is expected that most SMEs will not choose to apply IAS 39 due to the additional complexity.

Recognition and measurement simplifications

The *IFRS for SMEs* makes numerous simplifications to the recognition and measurement requirements in full IFRSs. For example:

- goodwill and other indefinite-life intangibles are amortised (over their useful lives, but if useful life cannot be reliably estimated, then use 10 years);
- a simplified calculation is allowed if measurement of defined benefit pension plan obligations using the projected unit credit method involves undue cost or effort;
- the cost model is permitted for investments in associates and joint ventures; and
- there are no special accounting requirements for assets held for sale.

The Appendix to this newsletter provides details of the most significant of these simplifications.

Reductions in disclosure requirements

The disclosure requirements in the *IFRS for SMEs* are substantially reduced when compared with those in full IFRSs. Disclosures required by full IFRSs have been omitted from the *IFRS for SMEs* for two principal reasons, i.e. either:

- they relate to topics or accounting policy options in full IFRSs that are omitted from the *IFRS for SMEs*, or they relate to recognition and measurement principles in full IFRSs that have been replaced by simplifications in the *IFRS for SMEs*; or

- they are not considered appropriate based on users' needs and/or cost-benefit considerations. For example, 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.

Effective date and transition

The effective date of the *IFRS for SMEs* will be determined in each jurisdiction that adopts it.

The Standard contains a section on transition which contains all of the exemptions in IFRS 1 *First-time Adoption of International Financial Reporting Standards* – with additional simplifications in relation to comparative information. IFRS 1 requires an entity's first IFRS financial statements to include at least one year of comparative information under IFRSs. The *IFRS for SMEs* provides some relief from this by including an 'impracticability' exemption. Similarly, it provides an impracticability exemption with respect to restating the opening statement of financial position.

Additional guidance material

To accompany the Standard, the IASB has produced implementation guidance consisting of illustrative financial statements and a presentation and disclosure checklist.

Appendix

IFRS for SMEs recognition and measurement simplifications

The main simplifications to the recognition and measurement principles in full IFRSs are:

- **Financial instruments**
  - Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss. This avoids the inherent complexities of classifying financial instruments into four categories, such as assessing management's intentions and dealing with 'tainting provisions'.
  - The IFRS establishes a simple principle for derecognition. The 'pass-through' and 'continuing involvement' tests in full IFRSs are dropped.
  - Hedge accounting requirements, including the detailed calculations, are simplified and tailored for SMEs.
- **Goodwill and other indefinite-life intangible assets** are always considered to have finite lives. Therefore, such assets are amortised over their estimated useful lives. If the useful life cannot be estimated, then the assets are amortised over 10 years. An impairment test is performed only if there is an indication of impairment (full IFRSs would require the test at least annually).
- **Investments in associates and joint ventures** can be measured at cost unless there is a published price quotation (when fair value must be used).
- All **research and development costs**, and **borrowing costs**, must be expensed.
- Residual value, useful life and depreciation method for items of **property, plant and equipment**, and amortisation period/method for **intangible assets**, only need to be reviewed if there is an indication they may have changed since the most recent annual reporting date (full IFRSs requires an annual review).
- **Defined benefit plans**
  - All past service cost must be recognised immediately in profit or loss.
  - All actuarial gains and losses must be recognised immediately either in profit of loss or other comprehensive income.
  - An entity is only required to use the projected unit credit method to measure its defined benefit obligation and the related expense if it is possible to do so without undue cost or effort.
- Requirements for **income tax** follow the approach set out in the Board's exposure draft *Income Tax*, published in March 2009, which proposes a replacement for IAS 12 *Income Taxes*.
- There is no separate **held-for-sale** classification. Instead, holding an asset (or group of assets) for sale is an impairment indicator.
- **Exchange differences recognised initially in other comprehensive income** are not reclassified to profit or loss on disposal of the related investment. This eliminates the need for tracking such exchange gains or losses after initial recognition.
- The fair value through profit or loss model is required for **biological assets** only when fair value is readily determinable without undue cost or effort. Otherwise, SMEs follow the cost-depreciation-impairment model.
- The directors' best estimate of the fair value of an **equity-settled share-based payment** is used to measure the expense if observable market prices are not available.

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