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Deloitte global IFRS leadership team

IFRS global office

Global IFRS leader
Ken Wild
kwild@deloitte.co.uk

IFRS centres of excellence

Americas
D. J. Gannon
iasplusamericas@deloitte.com

Asia-Pacific

Hong Kong
Stephen Taylor
iasplus@deloitte.com.hk

Melbourne
Bruce Porter
iasplus@deloitte.com.au

Europe-Africa

Johannesburg
Graeme Berry
iasplus@deloitte.co.za

Copenhagen
Jan Peter Larsen
dk_iasplus@deloitte.dk

London
Veronica Poole
iasplus@deloitte.co.uk

Paris
Laurence Rivat
iasplus@deloitte.fr

IASB offers IFRS relief for SMEs

On 15 February 2007, the International Accounting Standards Board (IASB) released an Exposure Draft (ED) for an **IFRS for Small and Medium Sized Entities** (SMEs) that could be applied by eligible SMEs instead of the full suite of International Financial Reporting Standards (IFRSs) in issue.

The aim of the proposed standard is to provide a simplified, self-contained set of accounting principles that are appropriate for smaller, non-listed entities and that are based on full IFRSs. By removing choices for accounting treatment, eliminating topics that are not generally relevant to SMEs, and simplifying methods for recognition and measurement, the resulting draft standard reduces the volume of accounting guidance applicable to SMEs by more than 85 per cent when compared with the full set of IFRSs.

Adoption of the IFRS for SMEs will be a matter for each country to decide, as will the criteria to determine eligibility. The Board intends the IFRS for SMEs to be self-contained for a typical SME with about 50 employees. Where a transaction or event is not addressed in the IFRS for SMEs, there is no mandatory fallback to full IFRSs.

The IASB has requested comments on the proposals by 1 October 2007.

Definition of an SME

The IFRS for SMEs is intended for an entity with no public accountability. An entity has public accountability (and therefore should use full IFRSs) if:

- it has issued, or is in the process of issuing, debt or equity securities in a public market; or
- 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 bank.

Note that, under the proposals, small listed companies would not be eligible to use the IFRS for SMEs. The Board has concluded that listed companies, large or small, share the characteristic that they have elected to seek capital from outside investors who are not involved in managing the business and who do not have the power to demand information that they might want. Full IFRSs have been designed to serve public capital markets.

Based on concepts and principles in full IFRSs

The draft IFRS for SMEs was developed by extracting the fundamental concepts from the IASB's **Framework for the Preparation and Presentation of Financial Statements** and the principles and related mandatory guidance from IFRSs, with appropriate modifications in the light of users' needs and cost-benefit considerations.

Modifications of IFRSs

The modifications made to full IFRSs in order to develop the IFRS for SMEs are of three broad types, which are summarised below.

Topics omitted

IFRS topics not relevant to a typical SME are omitted from the ED, with cross-references to full IFRSs if needed. These are:

- general price-level adjusted reporting in a hyperinflationary environment (look to IAS 29 **Financial Reporting in Hyperinflationary Economies**);
- equity-settled share-based payment (look to IFRS 2 **Share-based Payment**);
- determining fair value of agricultural assets (look to IAS 41 **Agriculture**, but the Board also proposes to reduce the use of fair value through profit or loss for agricultural SMEs);
- extractive industries (look to IFRS 6 **Exploration for and Evaluation of Mineral Resources**);
- interim reporting (look to IAS 34 **Interim Financial Reporting**);
- lessor accounting for finance leases (look to IAS 17 **Leases**. Finance lessors are likely to be financial institutions who would be ineligible to use the IFRS for SMEs in any case);
- recoverable amount of goodwill (SMEs would test goodwill for impairment much less frequently than under IAS 38 **Intangible Assets**, but if an SME is required to perform such a test it would look to the calculation guidance in IAS 38); and
- earnings per share and segment reporting (which are not required for SMEs), and insurance contracts (insurers would not be eligible to use the IFRS for SMEs).

Only the simpler option included

For a number of those occasions where full IFRSs provide an accounting policy choice, only the simpler option is included in the IFRS for SMEs. However, SMEs would be permitted to use the other option by cross-reference to the relevant IFRS. The simpler options included in the ED are:

- cost-depreciation-impairment model for investment property (fair value through profit or loss would be permitted by reference to IAS 40 **Investment Property**);
- cost-depreciation/amortisation-impairment model for property, plant and equipment and intangibles (the revaluation model would be allowed by references to IAS 16 **Property, Plant and Equipment** and IAS 38);
- borrowing costs to be expensed (capitalisation would be allowed by reference to IAS 23 **Borrowing Costs**);
- indirect method for reporting operating cash flows (the direct method would be allowed by reference to IAS 7 **Cash Flow Statements**); and
- one method for all grants (or an SME could use any of the alternatives in IAS 20 **Government Grants and Disclosure of Government Assistance**).

Note that, in adopting the IFRS for SMEs, an individual jurisdiction could decide not to allow the option that is cross-referenced to full IFRSs.

Recognition and measurement simplifications

The following are some examples of the recognition and measurement simplifications permitted under the IFRS for SMEs:

- Financial instruments:
  - Two categories of financial assets rather than four. This means that there would be no need to deal with all of the "intent-driven" held-to-maturity rules or related "tainting", no need for an available-for-sale option, and many other simplifications.
  - A clear and simple principle for derecognition – if the transferor has any significant continuing involvement, do not derecognise. The complex "pass-through testing" and "control retention testing" of IAS 39 **Financial Instruments: Recognition and Measurement** are avoided.
  - Much simplified hedge accounting.
- Goodwill impairment – an indicator approach rather than mandatory annual impairment calculations.
- Expense all research and development costs (IAS 38 would require capitalisation after commercial viability has been assessed).
- The cost method for associates and joint ventures (rather than the equity method or proportionate consolidation).
- Less fair value for agriculture – only if "readily determinable without undue cost or effort".
- Defined benefit plans – a principle approach rather than the detailed calculation and deferral rules of IAS 19 **Employee Benefits**. Complex 'corridor approach' omitted.
- Share-based payment – intrinsic value method.

- Finance leases – simplified measurement of lessee's rights and obligations.
- First-time adoption – less prior period data would have to be restated than under IFRS 1 First-time Adoption of International Financial Reporting Standards.

Fall-back to full IFRSs?

One key issue that has been debated in the development of the ED is whether, in circumstances where an event or transaction is not addressed in the IFRS for SMEs, entities would be required to revert to the requirements of full IFRSs i.e. whether there is a 'mandatory fallback' to full IFRSs. Under the proposals, such a fallback would not be required. In the absence of guidance in the IFRS for SMEs, the proposed hierarchy is that entities should refer to:

(a) the requirements and guidance in the IFRS for SMEs dealing with similar and related issues (and, therefore, determine an appropriate treatment by analogy); and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 of the IFRS for SMEs, entitled Concepts and Pervasive Principles.

The ED suggests that management may also consider the requirements and guidance in full IFRSs dealing with similar and related issues and, where additional guidance is needed, the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the IFRSs.

In reaching its conclusions on this issue, the Board's reasons included the following:

- SMEs are likely, in most cases, to conclude that they can find answers using (a) and (b) above, so a 'mandatory fallback' will not normally be invoked;
- requiring SMEs to look to full IFRSs imposes two sets of standards with some recognition and measurement differences on a single entity; and
- requiring a mandatory fallback creates a potential conflict between auditors – who are likely to be aware of the provisions of full IFRSs – and SME managers – who are responsible for preparing the financial statements and may have done so based solely on the IFRS for SMEs.

Additional guidance material

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

Next steps

- Comment deadline on the Exposure Draft is 1 October 2007.
- During the exposure period, the Board will conduct round-table meetings with SMEs and audit firms serving the SME sector to discuss the proposals. The Board will also conduct field tests and/or visits of the proposals in the ED.
- Final Standard is expected in mid-2008.
- It would be effective based on decisions in each jurisdiction that adopts the IFRS for SMEs.

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