IFRS

In July, the International Accounting Standards Board published the International Financial Reporting Standard for Small and Medium-sized Entities (known as IFRS for SMEs).

It is a standalone pronouncement of 230 pages that sits alongside the full set of IFRS now used in more than 100 nations. IFRS for SMEs is built on full IFRS foundations, but with simplifications that reflect how SMEs' financial statements are used and cost-benefit considerations.

It is intended for any entity that does not have public accountability, which means that its securities do not trade in public markets and it is not a financial institution (such as a bank or insurance company). Full IFRS are designed for entities with public accountability. IASB uses SME as the name for entities eligible to use the new standard; in other places, such entities are referred to as "private entities" or "non-publicly accountable entities."

IFRS for SMEs was more than five years in development, and the going was not always smooth. Though from the outset, some board members supported a standard that reflected significant simplifications from full IFRS, a majority did not. In fact, in June 2004, the board published a Discussion Paper in which its preliminary view was that there should be no changes for SMEs in the principles for recognizing and measuring assets, liabilities, income and expenses.

Another preliminary view was that if IFRS for SMEs did not specifically address an issue, an entity would be required to look to the full IFRS (a volume that, this year, is more than 2,800 pages long).

The mood swing within the board from 2003 to recently was palpable — from skepticism to acceptance to enthusiasm. The result is a standard that reflects significant simplifications based on two criteria — the needs of users of SMEs' financial statements and the technical and financial capabilities of small companies to produce them. There are many recognition and measurement simplifications, and there is no requirement for an entity using IFRS for SMEs to ever look to the full IFRS.

Why IFRS for SMEs?

IASB took on the project in response to an overwhelming demand from regulators, standard setters, small companies and auditors in developed and emerging economies across the globe. Their reasons fall into two broad and overlapping categories — public interest and the SMEs' self-interest.

Lenders, vendors, customers, rating agencies, venture capitalists and outside investors use financial statements to make credit, lending and in-

With the issuance of IFRS for SMEs, IASB has eased the complexity of financial statements for thousands of companies worldwide — as well as for those who use those financial statements to make credit, lending and investment decisions

INTERNATIONAL

For MOST Private Companies GOES LIVE

By Paul Pacter

vestment decisions. Often, those are cross-border decisions, so high-quality, comparable information — tailored to user needs — is important.

In most countries, all or most SMEs are required by law or government regulation to prepare and publish generally accepted accounting principles financial statements — and, in many jurisdictions, to have them audited. Americans are often surprised to learn this, because it is not the case in the United States. To illustrate, in the European Union there are approximately 21 million business entities (including corporations, partnerships, proprietorships and co-ops) of which, by law, around five million must publish GAAP financial statements.

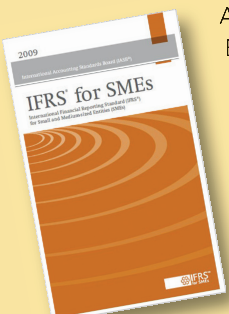
In contrast, in the U.S. there are around 20 million businesses, of which a relative handful — only about 25,000 — have a statutory requirement to prepare GAAP financial statements. (The EU is currently studying whether to scale back its statutory audit requirement.)

For example: in Hong Kong, a city of seven million people, all the nearly 700,000 registered companies must prepare audited financial statements. Such obligations by legislators and regulators are set with the goal of protecting the public interest by having good information available to capital providers and others.

There are now 117 jurisdictions that require listed companies to use full IFRS, with 80 of those either requiring or permitting unlisted companies to use full IFRS. Also, many national GAAPs for SMEs are slowly converging with full IFRS. As a result, SMEs are increasingly voicing their concerns that the full IFRS or national GAAPs based on full IFRS are burdensome, costly and unnecessary. (Indeed, consider the U.S. Financial Accounting Standards Board's newly released Codification at about 17,000 pages.)

Users of SMEs' financial statements say they are mainly interested in information about short-term cash flows, liquidity and solvency. They do not need the kinds of information that long-term equity investors in public capital markets look for, or the volume of disclosures that full IFRS require.

Additionally, many jurisdictions acknowledge shortcomings in the quality of implementation and enforcement where SMEs use full IFRS or local IFRS equivalents. These problems are borne out in the *Reports on the Observance of Standards and Codes* (ROSC) that have been produced by the World Bank for more than 80 jurisdictions. The quality of implementation is expected to significantly improve with IFRS for SMEs. The World Bank's ROSC initiative was established to assist member countries in strengthening their corporate governance frameworks.



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The reason SMEs are expected to benefit from IFRS for SMEs is simple: access to capital.

Small companies often run into problems not because of the quality of their products or services, but because they cannot get adequate working capital as well as capital for investment and growth. Lenders, vendors and other capital providers and rating agencies, in turn, ask for financial reports that are factual, understandable and complete and that reduce the information risk in their capital-allocation and pricing decisions.

Full IFRS Made Simple

Compared with full IFRS (and many national GAAPs), IFRS for SMEs is less complex in many ways. For one, the standard was written in clear, easily translatable language. It is organized topically into 35 sections. Among other areas that are less complex:

- *Topics not relevant for small companies are omitted.* Examples include earnings per share, interim financial reporting, segment reporting and special requirements for assets held for sale.
- *Where full IFRS allow accounting policy choices, IFRS for SMEs allow only the easier option.* For instance, all borrowing and research and development costs are expensed; there is no option to revalue property, plant and equipment or intangibles; a cost-depreciation model is used for investments in real estate unless fair value is readily available without undue cost or effort; and there's no fair value option for financial instruments.
- *Many of the principles for recognizing and measuring assets, liabilities, income and expenses in full IFRS have been simplified.* For example, goodwill is amortized, a cost model is used for associates and joint ventures (rather than equity method); there are no available-for-sale or held-to-maturity classes of financial assets and no "corridor approach" for actuarial gains and losses.
- *Substantially fewer disclosures are required* — roughly 10 percent of the number required by full IFRS.

The Exposure Draft that preceded IFRS for SMEs was field tested by 116 small entities from 20 countries. Of those, about 35 percent had 10 or fewer full-time employees and a further 35 percent had between 11 and 50 full-time employees. More than half of the entities had bank loans or significant overdrafts. A third had foreign operations.

Field test entities were asked to restate their most recent annual financial statements in accordance with the ED and identify problems they encountered; their reports led to important changes to the ED.

Transitioning to IFRS for SMEs

IFRS for SMEs was effective immediately when it was issued in July, and jurisdictions around the world have begun to consider whether to require or permit it, and for which entities.

In the United States, it is immediately available to private entities. In May 2008, the American Institute of Certified Public Accontants amended its rules to allow auditors to express an opinion on fairness of presentation using IFRS for SMEs (or full IFRS).

One of the 35 sections of the standard deals with first-time adoption of IFRS for SMEs. In the year of adoption, one prior year's data would be restated, but there are many optional exceptions to restatement plus a general impracticability exception.

IFRS for SMEs is available for free download from IASB's Web site: *http://go.iasb.org/IFRSforSMEs*. There are separate booklets of implementation guidance (illustrative financial statements and a presentation and disclosure checklist) and the basis for the board's conclusions. A Spanish translation is expected to be available by September, with other translations to follow.

The International Accounting Standards Committee Foundation (IASB's parent body) has an education team developing comprehensive training materials for IFRS for SMEs — one training module for each section of the standard. Each module will have the full text of the standard with commentary, examples of application, case studies and a quiz. The materials will be published in multiple languages (initially English by the end of this year) and posted on IASB's Web site for free download.

IASB intends to thoroughly review SMEs' experiences in applying IFRS for SMEs when two years of financial statements using the standard have been published by a broad range of entities and — based on that review — to propose amendments to address implementation issues. At that time, the board will also consider new and amended IFRS that have been adopted since IFRS for SMEs was issued. After that initial implementation review, the board expects to propose amendments to IFRS for SMEs by publishing a single omnibus Exposure Draft approximately once every three years.

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