Paul Pacter considers the benefits of IFRS for SMEs

standards and SMEs: who, what, when and why?

In most countries, many or even all companies are required by law to prepare financial statements that conform to a specified set of accounting principles. Those statutory financial statements are filed with a government agency or otherwise made available to creditors, suppliers, employees, government and others. The great majority of those entities are small or medium-sized.

To put the numbers in perspective, consider Europe. Over five million European companies are required by law to prepare financial statements. That figure greatly overshadows the 8,000 listed companies that were required to adopt IFRS in 2005 in the European Union. Similar statutory reporting requirements exist in Asia and the Americas, though not in the US.

Is one set of accounting standards suitable for all entities, regardless of size? There is widespread agreement around the world that the answer is *no*. User needs and preparer capabilities justify simplified standards for SMEs.

The IASB agrees, and for the past three years has been working on a project to develop an IFRS for SMEs. This article explains the IASB's project in question and answer format.

One important point: this is being written in early October 2006, and the IASB SME exposure draft has not yet been issued. Therefore, descriptions of its potential contents are subject to change.

Q1. What is the benefit of using the IFRS for SMEs?

Good accounting and disclosure give investors confidence to provide capital. By reducing risk, the cost of capital is also reduced.

The IFRS for SMEs takes into account the needs of the users of SME financial statements, the capabilities of SMEs, and the relative costs and benefits of accounting and disclosure alternatives.

Q2. What is the IASB's definition of SME?

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

- it has issued 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.

In short, entities without public accountability (SMEs) are unquoted companies that are not financial institutions.

Q3. But this definition could include entities ranging from very large unlisted companies down to micro-sized companies?

Yes, companies in that broad range could all be eligible to use the IFRS for SMEs. However, in deciding on the content of its SME standards, the IASB is focusing on a typical SME with about 50 employees. The IASB has not specified a quantified 'size test'. Each jurisdiction will have to develop detailed guidelines on which entities are eligible to use the IFRS for SMEs. Jurisdictions may decide to add a quantified size test.

Q4. Can standards designed for a company of about 50 employees also be suitable for a one or two or three person company – the so-called 'micros'?

In dozens of countries around the world today, full IFRS are required for all or most limited liability companies, including the micros (you will find a list at www.iasplus.com), and dozens of additional countries permit the micros to use full IFRS. If full IFRS are suitable for all, surely simplified standards will also be suitable. The IASB does not have the power to require any company to use its standards. That is the responsibility of legislators and regulators in government and, in some countries, an independent standard setter or a professional accountancy body. They will have to decide which entities should be required, permitted, or perhaps prohibited to use the IFRS for SMEs.

Q5. Who does the IASB view as the users of SME financial statements prepared using the IFRS for SMEs?

The IASB is developing standards for SMEs that publish general purpose financial statements for external users, including:

- non-manager owners (such as outside investors and family members)
- existing and potential lenders and creditors, and
- credit rating agencies.

Incidentally, an IASB staff study found that in the European Union, depending on the country, between 40% and 80% of SMEs have bank loans outstanding, so there are many external bank users.

Q6. What about tax authorities as users of an SME's financial statements?
Global SME accounting standards cannot directly deal with tax reporting or measuring distributable income, which are based on laws and regulations unique to each jurisdiction. But those matters can be addressed by reconciliations that are easily developed at national level.

Q7. Aren't SMEs' owner-managers themselves the primary users?
Certainly, owner-managers use the SME's financial statements for many reasons. However, it is not the purpose of the IFRS for SMEs to provide information to owner-managers to help them make management decisions. Managers can get whatever information they need to run their business. (The same is true for full IFRS.) Nonetheless, general purpose financial statements will often serve managers' needs as well by providing insights into the business' financial position, performance and cash flows.

Q8. Is the IASB starting 'from scratch' in developing the SME standards?
No. The IFRS for SMEs is being built on the concepts and principles in full IFRS, with appropriate modifications for SMEs. Those modifications are based on user needs and cost-benefit considerations.

Q9. What kind of modifications?
There are three broad types.

- IFRS topics not relevant to a typical SME are omitted, with cross-references to the IFRS if needed.
- Where full IFRS provide an accounting policy choice, only the simpler option is in the IFRS for SMEs. An SME is permitted to use the other option by cross-reference to the relevant IFRS.
- Recognition and measurement simplifications.

Q10. What are some examples of material in IFRS deemed not relevant to typical SME that has been omitted from the IFRS for SMEs?

- General price-level adjusted reporting in a hyperinflationary environment.
- Equity-settled share-based payment (the computational details are in IFRS 2, *Share-based Payment*).
- Agriculture (look to IAS 41, *Agriculture*, but we have also reduced the use of fair value through profit and 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 finance leases (finance lessors are likely to be financial institutions who would be ineligible to use the IFRS for SMEs anyway).
- Recoverable amount of goodwill (SMEs would test goodwill for impairment much less frequently than under IAS 38, *Intangible Assets*, but if an SME must do such a test it would look to the calculation guidance in IAS 38).

Q11. What are examples of the 'simpler options' in IFRS that have been retained in the SME standard and options that are not included?

- Cost-depreciation model for investment property (the revaluation model is permitted by cross-reference to IAS 16, *Property, Plant and Equipment*).
- Cost-amortisation model for PP&E and intangibles (again, the revaluation model is allowed by cross-reference).
- Expense all borrowing cost (capitalisation is allowed by reference to IAS 23, *Borrowing Cost*).

- Indirect method for reporting operating cash flows (the direct method is allowed by reference to IAS 7, *Cash Flow Statement*).
- One method for all grants (or an SME can look to the smorgasbord of alternatives in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*).

The IASB decided to leave the complex options in by cross-reference so that an SME would have the same accounting policy choices that are available to listed companies. However, in adopting the IFRS for SMEs, an individual jurisdiction could decide not to allow the option that is cross-referenced to the full IFRS.

Q12. Has the IASB really made simplifications of the recognition and measurement principles in IFRS?

Yes, here are some examples:

- Financial instruments

• Two categories of financial assets rather than four. This means 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.

• Embedded derivatives not separated out.

• 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 are avoided.

• Much simplified hedge accounting.

- Goodwill impairment – an indicator approach rather than mandatory annual impairment calculations.
- Expense all R&D (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 fair value is 'readily available'.
- Defined benefit plans – a principle approach rather than the detailed calculation and deferral rules of IAS 19, *Employee Benefits*.
- Share-based payment – intrinsic value method.
- First-time adoption – less prior period data would have to be restated than under IFRS 2, *First-time Adoption of IFRS.*
- Component depreciation not required (IAS 16 requires it).

Q13. If there are cross-references back to full IFRS, does that mean SMEs will be required to use two sets of standards – both the 'big book' and the 'SME book'?

For a typical small entity with about 50 employees, the IFRS for SMEs is intended to be a fully stand-alone document. Occasionally, however, the IFRS for SMEs will require an SME to look to full IFRS:

- if it elects to use a complex option that is cross-referenced in the IFRS for SMEs
- if it encounters one of the kinds of atypical transactions that have been omitted from the IFRS for SMEs
- 'when all else fails'. If the IFRS for SMEs does not address a transaction, event or condition, or provide an explicit cross-reference back to an IFRS, an SME should select an accounting policy that results in relevant and reliable information. In making that selection, an SME should consider, first, whether the appropriate accounting can be determined by analogising from the principles in the IFRS for SMEs. If that does not provide guidance, the SME must consult the full text of IFRS. This 'fallback' is in the nature of a 'safety net' that the Board expects to be invoked in only limited circumstances.

Q14. Why not allow small listed companies to use the IFRS for SMEs?

Listed companies, large or small, have elected to seek capital from outside investors who are not involved in managing the business and who do not have the clout to demand information that they might want. Full IFRS have been designed to serve public capital markets.

Q15. So where are we now ("now" being early October 2006)?

- The Board has been reviewing drafts of the exposure draft throughout 2006. The ED is nearly ready for a vote by the Board.
- About 220 pages. Full IFRS bound volume is now 2,400 pages.
- Organised by topic.
- 40 sections.
- Developed by considering needs of a company with about 50 employees.
- Model financial statements.
- Disclosure checklist.
- Draft ED was posted on the IASB's public website in August 2006 to give people an idea of the direction the Board is taking, stimulate early thinking and allay concerns.
- The IASB will likely publish translations of the ED in Spanish and French. A first!

Q16. Will the IASB be updating the IFRS for SMEs every time it issues a new IFRS or an amendment to an existing IAS or IFRS?

The short answer to that question is an emphatic no. We know that SMEs are worried about frequent updating of IFRS for SMEs. The Board has decided to update the IFRS for SMEs every two years via an 'omnibus' exposure draft.

Q17. Finally, what are the next steps?

Here are our tentative dates:

- exposure draft – Q4 2006
- six month comment period
- field tests and/or visits to SMEs? Roundtables?
- final standard – late 2007
- effective – 2008 or 2009.

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