by Ellen M. Heffes

Should U.S. Private Companies Use IFRS for SMEs?

by Paul Pacter

The International Accounting Standards Board (IASB) has released an exposure draft (ED) to adopt a simplified, self-contained International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). IFRS for SMEs is less than 15 percent of the size of full IFRS (currently around 2,700 pages).

This substantial reduction was achieved by removing choices for accounting treatments, eliminating topics and detailed implementation guidance that are not generally relevant to SMEs, simplifying methods for recognition and measurement, substantial disclosure reductions and "plain English' redrafting.

Since full IFRS were designed to meet the needs of equity investors in companies in public capital markets, they cover a wide range of issues, contain a sizeable amount of implementation guidance and include disclosures appropriate for public companies.

Users of the financial statements of SMEs (or private companies in the U.S.) don't have those needs, but, rather are more focused on shorter-term cash flows, liquidity and solvency issues, such as: *If I make a loan, will the interest and principal be paid? If I extend credit, will my invoice be paid?*

Also, the full standards impose a burden on SME preparers — a burden that has been growing as IFRS become more detailed and more countries begin to use them. Thus, in developing the proposed IFRS for SMEs, IASB's twin goals were to meet user needs while balancing costs and benefits from a preparer perspective.

In most countries, many or even all entities have a statutory obligation to prepare financial statements that conform to a required set of generally accepted accounting principles (GAAP). Often, an audit is required by law (with tiny companies often exempted). Those statutory financial statements are normally filed with a government agency or put on a website and thus are available to creditors, suppliers, employees, governments and others.

In Europe, where there are over 20 million business enterprises, more than 5 million SMEs have a statutory audit and reporting obligation. Virtually every European country has developed its own simplified national GAAP for SMEs — some countries have two or even three levels of SME GAAP. The same is true in Asia and elsewhere across the globe.

This begs the question: Why shouldn't SMEs just use existing national GAAP in each country? Consider the following:

1. Lack of comparability in global markets. The world's business markets are integrated, even for small companies. In most jurisdictions, half to three-quarters of all SMEs, including the very small ones, have bank loans. Banks operate across borders and rely on financial statements in making lending decisions, establishing terms and interest rates and monitoring loans.

Banks want data they can understand and compare. Companies buy and sell goods and services across borders. Vendors want to evaluate the financial health of buyers before they sell goods or services on credit, and this is especially true when the buyer is an SME. Buyers use a supplier's financial statements to assess the prospects of a viable long-term business relationship.

Credit rating agencies try to develop ratings uniformly across borders. Development institutions, such as the World Bank, International Monetary Fund (IMF) and regional development banks, use financial statements for resource allocation decisions. Accounting differences reduce understandability, obscure comparisons and lead to sub-optimal decisions.

There doesn't appear to be any reason why private companies in the U.S. couldn't use IFRS for SMEs.

2. Information quality. The accounting standards for SMEs in many countries have not been developed with the needs of lenders, vendors and other external users in mind. This has harmed small companies' access to capital or, at a minimum, raised the cost of capital, particularly in small and developing countries. In jurisdictions that require small companies to use full IFRS, the quality of implementation often is problematic.

3. Burden. As IFRS have gained greater acceptance around the world, many countries have adopted them or have developed national GAAP based on IFRS. Today, IFRS are required for listed companies in over 80 countries and permitted for listed firms in another 25 countries. As for unlisted (private) companies, 20 countries require full IFRS for all and another 14 countries require them for some.

Many other countries that do not require IFRS directly are increasingly converging their national standards with IFRS, which means that, de facto, IFRS are being "pushed down" to private companies, which often don't have the expertise or ability to bear the costs of complying.

4. Other shortcomings. Many countries lack country-specific textbooks, guidance, training materials and software for implementing national standards. This diminishes comparability even within a country, as different requirements are interpreted differently. National standards mean that country-specific

auditing methodologies are needed. Developing national standards is costly.

Companies that Can Use IFRS for SMEs

Decisions on which entities should use IFRS for SMEs rest with national regulatory authorities and standard-setters. However, IASB has clearly stated that IFRS for SMEs is intended for an entity with no public accountability that is preparing general-purpose financial statements.

An entity has public accountability (and therefore should use full IFRS) if either its debt or equity securities are publicly traded, or it is a financial institution such as a bank, insurance company, securities broker/dealer, pension fund or mutual fund. Within the very large and broad group of remaining entities, each jurisdiction will have to decide which entities should be required or permitted to use IFRS for SMEs.

General-purpose financial statements that comply with IFRS for SMEs would enable an auditor to express an opinion on whether those statements present fairly (or present a true and fair view of) financial position, operating results and cash flows.

IFRS for SMEs is intended to be a stand-alone document. When deciding on its content, IASB focused on a typical entity with about 50 employees — not as a quantified size test for defining SMEs but, rather, to help it decide the kinds of transactions and other events and conditions that companies of that size will likely encounter.

Organization of the ED

The exposure draft (ED) is issued in three documents: The draft IFRS for SMEs itself, implementation guidance (consisting of illustrative financial statements and a disclosure checklist) and the basis for the IASB's conclusions. IFRS for SMEs is organized topically, and it has 38 sections and a glossary.

The proposed IFRS for SMEs reflects five broad types of modifications:

1. Topics omitted. Some topics in full IFRS are omitted because they are not relevant to a typical SME. These include hyperinflation, equity-settled share-based payment, extractive industries, interim reporting, lessor accounting finance leases, recoverable amount of goodwill, earnings per share, segment reporting and insurance contracts.

2. Simpler choice. Where full IFRS provide an accounting policy choice, only the simpler option is in IFRS for SMEs. An SME is permitted to use the other option by cross-reference to the relevant IFRS. Examples include historical cost-depreciation models for investment property and property, plant and equipment and intangibles; expensing all borrowing costs; the indirect method for reporting operating cash flows; and one method for all government grants.

3. Recognition and measurement simplifications. Some principles in full IFRS for recognizing and measuring assets, liabilities, income and expenses have been simplified (see the box above.)

4. Reduced disclosures. Over three-quarters of the disclosures in full IFRS have been eliminated.

5. Plain English. IFRS principles have been rewritten for clarity and ease of translation.

Examples of Recognition and Measurement Simplifications Under IFRS

- Financial instruments:
  - Two categories of financial assets rather than four. This eliminates the complex and intent-driven classifications.
  - A clear and simple principle for derecognition — if the transferor has any significant continuing involvement, do not derecognize.
  - Much-simplified hedge accounting.
- Goodwill impairment — an indicator approach rather than mandatory annual impairment calculations.
- Expense all R&D.
- The cost method for associates and joint ventures (rather than the equity method or proportionate consolidation).
- Fair value for agriculture only if "readily determinable without undue cost or effort."
- Complex "corridor approach" for defined-benefit plans omitted.
- Share-based payment — intrinsic value method.
- Finance leases — simplified measurement of lessee's rights and obligations.
- First-time adoption — less [amount of] prior period data would have to be restated.

Next Steps

The comment deadline on the ED was October 1 — although an extension to November 30 was proposed (no decision was made by press time). During the exposure period, IASB has been conducting roundtable meetings with SMEs and small audit firms. IASB has organized field tests of the proposals in the ED with approximately 100 small companies — with FEI helping in the U.S.

A final standard is expected by the end of 2008 and would be effective according to decisions in each jurisdiction that adopts IFRS for SMEs.

Most American accountants are surprised to learn that millions of SMEs around the world have statutory reporting and audit obligations. That's because the situation in the U.S. is so different — there are roughly 5 million limited-liability corporations and roughly 15 million more partnerships, proprietorships and other forms of ownership.

By law, only a relative handful of those are required by law to publish U.S. GAAP financial statements, audited or unaudited — generally the 15,000 SEC registrants plus a few other regulated entities. Sometimes, lenders or contracts impose such requirements. But for the vast majority of American private companies, there is no requirement to prepare U.S. GAAP statements.

So, could private companies in the U.S. use IFRS for SMEs? There does not appear to be any reason why not — provided that the basis of presentation note clearly explains that the statements conform to IFRS for SMEs. If audited, the auditor would report on conformity with the IFRS for SMEs.

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