

P&A accounting alert

IASB publishes IFRS for SMEs

Introduction

The IASB has published the *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs).

The IFRS for SMEs is designed to meet the financial reporting needs of entities that (a) do not have public accountability and (b) publish general purpose financial statements for external users.

The term Small and Medium-sized Entities (SMEs) is not associated with any size criteria in the Standard

In the Philippines, IFRS for SMEs will replace Philippine Accounting Standards 101, *Financial Reporting Standards for Non-publicly Accountable Entities*. The effective date of implementation in the Philippines is yet to be announced by our local standard setters.

Background to the IFRS for SMEs

The IASB's full IFRSs were designed to meet the needs of equity investors and other users of financial statements in public capital markets, and therefore cover a wide range of issues, as well as containing a sizeable amount of implementation guidance and disclosures appropriate for public companies.

Users of the financial statements of SMEs do not have the same needs, but, rather are more focused on assessing shorter-term cash flows, liquidity and solvency. In addition, many SMEs have observed that full IFRSs impose a burden on them, and that this burden has grown as IFRSs have become more detailed and more countries have begun to use them.

The IASB has therefore developed the IFRS for SMEs with the twin goals of meeting user needs while balancing costs and benefits from a preparer perspective. The Standard has essentially been designed to work as a standalone document, with no mandatory cross references to full IFRS. Where full IFRS permits a number of possible accounting options for a particular transaction, the Standard presents SMEs with a simplified version of the full requirements and reduces the number of options available to them.

Authority of the IFRS for SMEs

The decisions as to which entities are required or permitted to use the IFRS for SMEs will rest with legislative and regulatory authorities and standard-setters in individual jurisdictions.

The IFRS for SMEs does not itself deal with this question. It does contain a clear definition of the class of entity for which the IFRS for SMEs is intended (see below). This definition is essential in order that (a) the IASB can decide on the accounting and disclosure requirements that are appropriate for that class of entity and (b) the legislative and regulatory authorities, standard-setters, reporting entities and their auditors will be informed of the intended scope of applicability of the Standard.

Definition of Small and Medium-sized Entities

The IFRS for SMEs is a separate standard intended to apply to the general purpose financial statements of entities that in many countries are referred to by a variety of terms, including SMEs, private entities, and non-publicly accountable entities.

The IFRS for SMEs therefore includes the following definition of small and medium-sized entities to clarify its scope.

Entities that:

- "(a) do not have public accountability; and
- (b) publish general purpose financial statements for external users.

An entity has public accountability if:

- (a) it files, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; or
- (b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks."

Entities holding assets in a fiduciary capacity for reasons incidental to a primary business are not however considered to be publicly accountable. The IFRS for SMEs gives a number of examples of where this may be the case.

Components of financial statements

A complete set of financial statements prepared under the IFRS for SMEs includes

- a statement of financial position as at the reporting date
- either (i) a single statement of comprehensive income or (ii) a separate income statement and a separate statement of comprehensive income
- a statement of changes in equity for the reporting period
- a statement of cash flows for the reporting period (this can be presented using either the direct method or indirect method)
- notes, comprising a summary of significant accounting policies and other explanatory information

Comparative information is in general required in respect of the previous comparable period for all amounts presented.

As a simplification in comparison to full IFRS, where the only changes to equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy, the entity may present a single statement of income and retained earnings in place of a separate statement of comprehensive income and a statement of changes in equity.

General recognition and measurement principles

The requirements contained in the IFRS for SMEs for recognizing and measuring assets, liabilities, income and expenses are based on pervasive principles that are derived from the *IASB Framework for the Preparation and Presentation of Financial Statements* and from full IFRSs.

Where the IFRS for SMEs does not contain a requirement which applies specifically to a transaction or other event or condition, the Standard requires that management applies judgement in developing an accounting policy that results in information that is relevant and reliable.

In making such a judgement, a hierarchy is provided, with management being advised to refer to and consider the applicability of the following sources in descending order:

- (a) the requirements and guidance in the IFRS for SMEs dealing with similar and related issues, and
- (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in the section in the IFRS for SMEs on 'Concepts and Pervasive Principles'.

In making the judgement, management may also consider the requirements and guidance in full IFRSs dealing with similar and related issues, but this is not mandatory.

Specific areas of recognition and measurement guidance

The following paragraphs set out some particular areas of interest, where the requirements in the IFRS for SMEs diverge from those of full IFRSs. The issues listed are by no means exhaustive, and reference should be made to the text of the Standard itself for a proper understanding of all the potential differences that may arise.

Financial instruments

In seeking to meet user needs while balancing costs and benefits from a preparer perspective, the IFRS for SMEs divides its requirements on financial instruments into two sections, one dealing with basic financial instruments and the other with more complex financial instruments and transactions.

The Standard gives entities a choice between applying the provisions of these sections in full, or the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* (an entity might wish to apply IAS 39's recognition and measurement provisions because it holds complex financial instruments or because it is willing to deal with the additional complexity of IAS 39 in order to be able to take advantage of the less restrictive requirements on hedge accounting in that Standard). Where an entity does choose to adopt the recognition and measurement provisions of IAS 39, however, it still makes the disclosures for financial instruments that are required by the IFRS for SMEs rather than those in IFRS 7 *Financial Instruments: Disclosures*.

Basic financial instruments

The IFRS for SMEs requires an amortized cost or cost less impairment model for all basic financial instruments except for investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably (such instruments are measured at fair value with changes in their fair value recognized in profit or loss).

Examples of items that will normally be treated as basic financial instruments are cash, bank accounts, loans and trade receivables and payables, bonds and similar debt instruments.

More complex financial instruments and transactions

Financial instruments which do not meet the criteria set out in the IFRS for SMEs for treatment as basic financial instruments are initially measured at their fair value, which will normally be the transaction price. Examples of these more complex financial instruments include asset backed securities, options, futures contracts, forward contracts, interest rate swaps and financial instruments that qualify as hedging instruments.

In general, such instruments are then subsequently measured at fair value at the end of each reporting period, with changes in their fair value being recognized in profit or loss. (Equivalents of IAS 39's Available-for-sale and Held-to-maturity classifications are not included in the Standard).

Equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that (if exercised) will result in delivery of such instruments, shall be measured at cost less impairment.

In addition, the section dealing with more complex financial instruments and transactions sets out the conditions which must be met for hedge accounting to be used and how such accounting is to be applied. The guidance contained is a simplified but more restrictive version of that in IAS 39.

Investments in associates and in jointly controlled entities

The IFRS for SMEs contains an accounting policy election in respect of both investments in associates and investments in jointly controlled entities (JCEs). This applies to the accounting in consolidated financial statements and in the financial statements of an investor that is not a parent but that has an investment in one or more associates and/or JCEs.

Under the accounting policy election for investments in associates, an investor shall account for all such investments under either:

- the cost model (cost less any accumulated impairments losses);
- the equity model (initial recognition at the transaction price, with subsequent adjustments to reflect the investor's share of the profit or loss and other comprehensive income of the associate); or
- the fair value model.

A similar accounting policy election applies to investments in JCEs. The Standard does not permit the use of proportionate consolidation.

The cost model should not be applied to investments in associates or JCEs for which there is a published price quotation (the fair value model must be used where this is the case).

Investment property

The requirements on accounting for investment property differ from those which apply under full IFRS.

Under the IFRS for SMEs, investment property whose fair value can be measured reliably without undue cost or effort on an ongoing basis is accounted for at fair value, with changes in fair value being accounted for through profit or loss. (It is not possible to elect to use the cost-depreciation-impairment model for such property, as is the case under IAS 40 *Investment Property*.) All other investment property is accounted for as property, plant and equipment using the cost-depreciation-impairment model.

Property, plant and equipment

Items of property, plant and equipment are measured using the cost - depreciation - impairment model. There is no option to use a revaluation model.

Intangible assets other than goodwill

Internally developed intangible assets

The IFRS for SMEs requires an entity to recognize expenditure incurred internally on an intangible item, including all expenditure for both research and development activities, as an expense when it is incurred unless it forms part of the cost of another asset that meets the recognition criteria in this IFRS.

Other intangible assets

The criteria for recognition as assets are always considered satisfied for intangible assets that are separately acquired. Intangibles acquired in a business combination are normally recognized as assets because it is assumed that their fair value can be measured with sufficient reliability.

Measurement after recognition

The IFRS for SMEs requires intangible assets to be measured at cost less accumulated amortization and accumulated impairment losses.

For the purpose of the Standard, all intangible assets are considered to have a finite useful life. Where an entity is unable to make a reliable estimate of the useful life of an intangible asset, the life is presumed to be ten years.

Business combinations and goodwill

The IFRS for SMEs requires the acquirer to allocate the cost of a business combination at the acquisition date, by recognizing the acquiree's identifiable assets and liabilities and a provision for those contingent liabilities that satisfy the recognition criteria in the Standard at their fair values at that date.

Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities so recognized shall be accounted for as goodwill or so-called 'negative goodwill'.

After initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less accumulated amortization and accumulated impairment losses. Where an entity is unable to make a reliable estimate of the useful life of goodwill, the life is presumed to be ten years. The requirement to amortize goodwill is an important simplification compared to the requirements in full IFRS, as it eliminates the need for a detailed annual impairment test. An impairment test is only needed where there is an indicator of impairment.

Where so-called 'negative goodwill' is identified, the identification and measurement of the acquiree's assets, liabilities and contingent liabilities and the measurement of the cost of the combination is first of all reassessed. After this reassessment, any remaining 'negative goodwill' is recognized immediately in profit or loss.

Impairment of goodwill

Where goodwill cannot be allocated to individual cash-generating units (or groups of cash-generating units) on a non-arbitrary basis, then for the purposes of testing goodwill a reporting entity tests impairment by determining the recoverable amount of either:

- (a) the acquired entity in its entirety, if the goodwill relates to an acquired entity that has not been integrated, (integrated means the acquired business has been restructured or dissolved into the reporting entity or other subsidiaries) or
- (b) the entire group of entities, excluding any entities that have not been integrated, if the goodwill relates to an entity that has been integrated.

This treatment allows goodwill to be allocated and tested for impairment at a higher level than that required by full IFRS.

Borrowing costs

Under the IFRS for SMEs, an entity recognizes all borrowing costs as an expense in profit or loss in the period in which they are incurred. Capitalization is not permitted.

Share-based payment

The requirements for the recognition and measurement of share-based payment are based on those contained in IFRS 2 *Share-based Payment*. The IFRS for SMEs does however provide simplified guidance on measuring the fair value of share options and other forms of share-based payment.

Measurement hierarchy

The IFRS for SMEs uses the following three-tier measurement hierarchy for measuring the fair value of share options:

- (a) If an observable market price is available for the equity instruments granted, that price shall be used.
- (b) If an observable market price is not available, the fair value of share options granted shall be measured using entity specific observable market data such as for a recent transaction in the share options.

- (c) If an observable market price is not available and obtaining a reliable measurement of fair value under (d) is impracticable, an entity shall indirectly measure the fair value of share options using an option pricing model. The inputs for the model should use market data to the greatest extent possible. A similar hierarchy applies to the measurement of shares and share appreciation rights.

Post-employment benefits: defined benefit plans

Determination of cost for the period

There is no ability to use IAS 19 *Employee Benefits*' 'corridor' approach (under which actuarial gains and losses may be deferred in the Statement of Financial Position) under the IFRS for SMEs. Instead, any change in an entity's defined benefit liability during the period is recognized as the cost of its defined benefit plans for the period.

Allocation of actuarial gains and losses

The IFRS for SMEs gives entities an accounting policy election in respect of the allocation of their actuarial gains and losses. Under this election, an entity shall either

- (a) recognize all actuarial gains and losses in profit or loss, or
- (b) recognize all actuarial gains and losses in other comprehensive income

Actuarial valuation model

If an entity is able, without undue cost or effort, to use the projected unit credit method (which is the method required by IAS 19) to measure its defined benefit obligation and the related expense, it shall do so.

Where an entity is unable to do so without undue cost or effort, however, it is permitted to make the following simplifications in measuring its defined benefit obligation with respect to current employees. It may:

- ignore estimated future salary increases;
- ignore future service of current employees; and
- ignore possible in-service-mortality of current employees between the reporting date and the date employees are expected to begin receiving post-employment benefits. However, mortality after service (i.e., life expectancy) will still need to be considered.

The IFRS for SMEs does not require an independent actuary to be engaged to perform the actuarial valuation, nor does it require a comprehensive actuarial valuation to be performed annually. If the principal actuarial assumptions have not changed significantly during the periods between actuarial valuations, the defined benefit obligation can be measured by adjusting the prior period measurement for changes in employee demographics such as number of employees and salary levels.

Specialized activities

The IFRS for SMEs contains a section dealing with various specialized activities including agriculture, extractive industries and service concession arrangements. In relation to agricultural activity, the Standard requires fair value to be used for biological assets where fair value is readily determinable without undue cost or effort. All other biological assets are accounted for at cost.

Transition to the IFRS for SMEs

The default position under the IFRS for SMEs is that an entity shall, in its opening statement of financial position as of its date of transition (being the beginning of the earliest period for which the entity presents full comparative information):

- recognize all assets and liabilities whose recognition is required by the IFRS for SMEs;
- not recognize items as assets or liabilities if the IFRS for SMEs does not permit such recognition;
- reclassify items that it recognized under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity
- under the IFRS for SMEs; and,
- apply the IFRS for SMEs in measuring all recognized assets and liabilities.

The accounting policies that an entity uses in its opening statement of financial position may differ from those that it used for the same date using its previous financial reporting framework. The resulting adjustments arise from transactions, other events or conditions before the date of transition to the IFRS for SMEs and are recognized directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to the Standard.

The IFRS for SMEs does however contain certain exemptions and simplifications which apply only to a first-time adopter of the IFRS for SMEs. (An entity is a first-time adopter where it prepares its annual financial statements in accordance with the IFRS for SMEs for the first time, regardless of whether its previous accounting framework was full IFRSs or another set of accounting standards.)

Areas where retrospective application is prohibited

On first-time adoption of the IFRS for SMEs, an entity shall not retrospectively change the accounting that it followed under its previous financial reporting framework for any of the following transactions:

- derecognition of financial assets and financial liabilities
- hedge accounting
- accounting estimates
- discontinued operations
- measuring non-controlling interests

Optional exemptions

An entity may use one or more of a number of exemptions in preparing its first financial statements that conform with the IFRS for SMEs. These exemptions are similar to those contained in IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Disclosure on first-time adoption

In order to explain the process of transition, the IFRS for SMEs contains requirements for a first-time adopter to disclose a number of reconciliations to its most recent financial statements prepared under its previous financial reporting framework.

If it is impracticable for an entity to restate the opening statement of financial position at the date of transition in accordance with the requirements of the IFRS for SMEs, the entity shall apply the procedures for preparing financial statements at the date of transition in the earliest period for which it is practicable to do so, and shall identify the data presented for prior periods that are not comparable with the data that conforms to the IFRS for SMEs.

Illustrative financial statements and disclosure checklist

The disclosures required by the IFRS for SMEs are listed in a presentation and disclosure checklist that accompanies the Standard, together with illustrative financial statements.

Maintenance

The IASB expects to undertake a thorough review of the IFRS for SMEs after two years of financial statements have been published by a broad range of entities using the Standard. The IASB expects that it will then propose amendments to address the implementation issues identified in that review. It will also address issues arising from new and amended IFRSs that are published in the intervening period.

After this initial implementation review, the IASB expects to propose amendments to the Standard by publishing an omnibus exposure draft approximately once every three years.

Upcoming Seminar

P&A will conduct seminars for the implementation of IFRS for SMEs on September 2009. Exact date and location will be announced later.

This Accounting Alert is not a comprehensive analysis of the subject matters covered and is not intended to provide accounting or other advice to specific entity. All relevant facts and circumstances, including the full text of the pertinent standards, need to be considered to arrive at decisions that relate to matters addressed in this Accounting Alert.

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