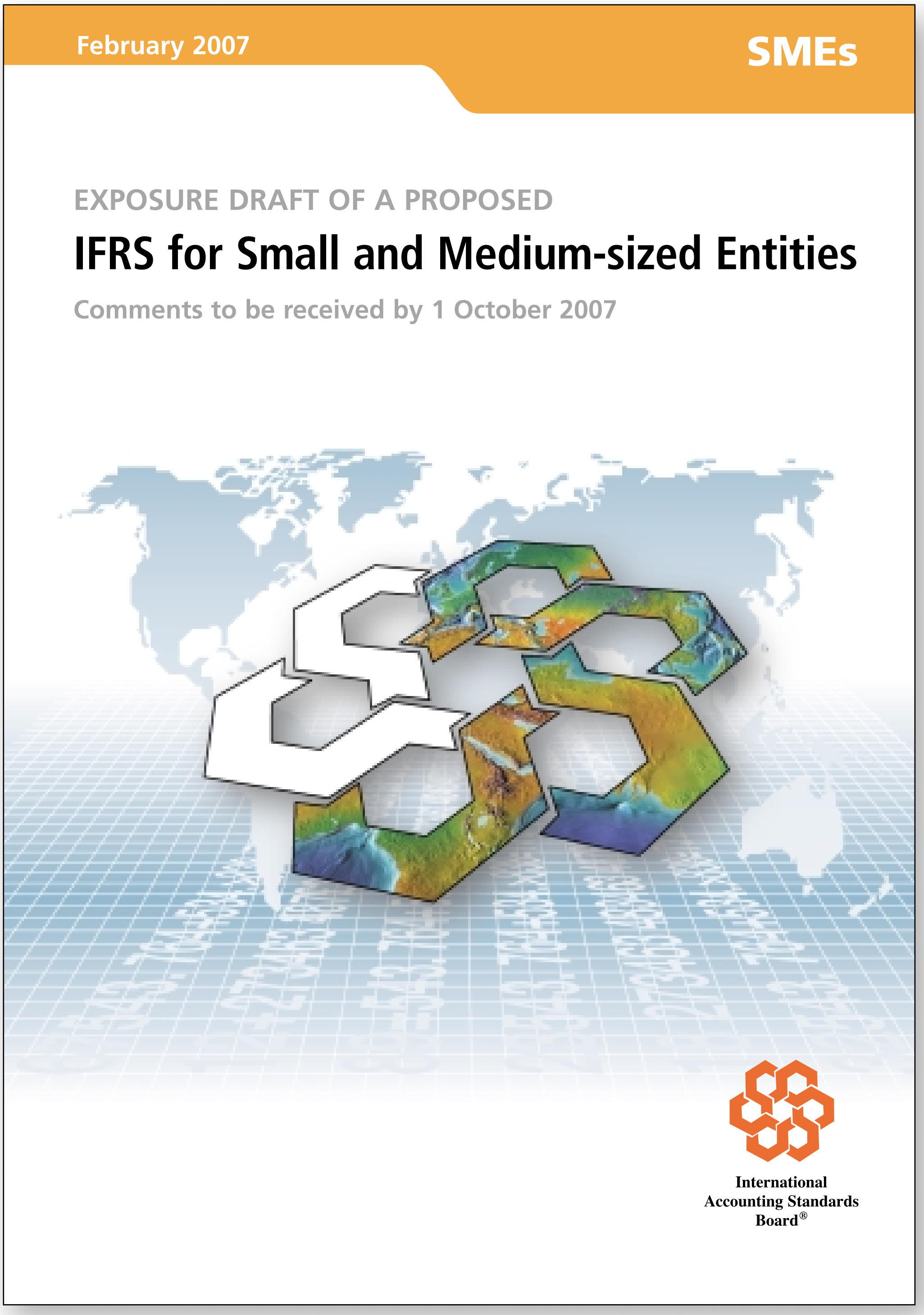
A Staff Overview


February 2007

SMEs

EXPOSURE DRAFT OF A PROPOSED

IFRS for Small and Medium-sized Entities

Comments to be received by 1 October 2007

International Accounting Standards Board®

This overview of the IASB's exposure draft of a proposed International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) was prepared by Paul Pacter, IASB Director of Standards for SMEs. It is intended as a high level introduction to the exposure draft. It has not been approved by the International Accounting Standards Board. Nor is it intended to serve as the basis for commenting on the exposure draft.

International Financial Reporting Standard
for
Small and Medium-sized Entities

A Staff Overview of the Exposure Draft

This overview of the IASB's exposure draft of a proposed International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) was prepared by Paul Pacter, IASB Director of Standards for SMEs. It is intended as a high level introduction to the exposure draft. It has not been approved by the International Accounting Standards Board (IASB). Nor is it intended to serve as the basis for commenting on the exposure draft.

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INTERNATIONAL FINANCIAL REPORTING STANDARD FOR SMALL AND MEDIUM-SIZED ENTITIES

An Overview of the Exposure Draft

In February 2007 the International Accounting Standards Board (IASB) published for public comment an exposure draft of an International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). The aim of the proposed standard is to provide a simplified, self-contained set of accounting principles that are appropriate for smaller, non-listed companies and are based on full International Financial Reporting Standards (IFRSs), developed primarily for listed companies.

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. As a result, the exposure draft offers a workable, self-contained set of accounting standards that would allow investors for the first time to compare SMEs' financial performance across international boundaries on a like for like basis.

Why are global financial reporting standards for SMEs needed?

High quality global financial reporting standards enhance the comparability of financial information. They improve the efficiency of allocation and the pricing of capital. This benefits not only those who provide debt or equity capital but also those entities that seek capital, because it reduces their compliance costs and removes uncertainties that affect their cost of capital. Global standards also improve consistency in audit quality and facilitate education and training.

The benefits of global financial reporting standards are not limited to entities whose securities are traded in public capital markets. SMEs—and those who use their financial statements—can also benefit from a common set of accounting standards. For example:

- Financial institutions make loans to SMEs, often across borders. In most jurisdictions, over half of all SMEs, including the very small ones, have bank loans. Bankers rely on financial statements in making lending decisions, in establishing terms and interest rates and in monitoring loans.
- Vendors want to evaluate the financial health of buyers before they sell goods or services on credit. This is especially true when the buyer is a small or medium-sized entity.
- Credit rating agencies try to develop ratings uniformly across borders. Similarly, banks and other institutions often develop ratings in the same way as credit rating agencies. Reported financial figures are crucial to the rating process.

- Many businesses have overseas suppliers and use a supplier's financial statements to assess the prospects of a viable long-term business relationship. The supplier is often a small or medium-sized entity.
- Venture capital firms provide funding to SMEs across borders.
- Global, regional and national development institutions, both public and private sector, provide financial assistance to entities in developing countries around the world. They rely on financial statements to make financing decisions and to assess financial results.
- Many SMEs have outside investors who are not involved in the day-to-day management of the entity. Global accounting standards for general purpose financial statements and the resulting comparability are especially important when those outside investors are located in a different jurisdiction from the entity and when they also have interests in other SMEs.

The benefits of the IASB's proposed IFRS for SMEs go beyond comparability. It is likely to improve the quality of financial reporting by SMEs in many jurisdictions because, often, the standards that SMEs are currently following may not have been designed with decision-usefulness as the overriding objective. The proposed IFRS for SMEs is designed to produce general purpose financial statements that are useful for economic decision-making by a broad range of resource providers to SMEs, such as non-manager owners, lenders, vendors and other creditors, customers and employees. Another benefit will be to reduce the financial reporting burden on SMEs in those jurisdictions where, at the moment, standards designed for reporting by participants in public capital markets have been pushed down to SMEs.

What are the IASB's goals in undertaking this project?

- To provide a simplified, self-contained set of standards that are appropriate for smaller, non-listed companies but still based on full IFRSs.
- To make modifications based on users' needs and cost-benefit considerations.
- To remove choices for accounting treatment, eliminate topics that are not generally relevant to SMEs, and simplify recognition and measurement.
- To enable investors, lenders and others to compare SMEs' financial performance, financial condition and cash flows while, at the same time, reducing the burden of preparing SMEs' financial statements.
- To provide emerging economies with an internationally recognised basis for financial reporting, helping to raise the quality of financial reporting in many countries while offering entities a clear path to upgrade to compliance with full IFRSs.
- To ensure that the IFRS for SMEs results in general purpose financial statements on which an auditor can give an opinion as to fair presentation (or true and fair view) of financial position, performance and cash flows.

- To redraft and simplify the language using plain English where possible to help SMEs in preparing their financial reports.
- To develop a standard that will be suitable for, and easily applied by, even the smallest of SMEs—the so-called micro-sized entities with just a few employees.

How does the IASB define SMEs?

The proposed 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 debt or equity securities in a public market; or
- it holds assets in a fiduciary capacity for a broad group of outsiders. Examples of such an entity include a bank, an insurance company, a securities broker/dealer, a pension fund, a mutual fund and an investment bank.

Does that mean that the proposed IFRS for SMEs is intended for any entity that does not have public accountability—regardless of size?

Yes—but with the following qualification. The proposed IFRS for SMEs is designed to produce general purpose financial statements that present an entity's financial position, results of operations and cash flows. If those financial statements are audited, an auditor would be able to express an opinion as to whether they present fairly (or give a true and fair view of) the entity's financial position, results of operations, and cash flows.

It is a matter for each jurisdiction to decide which entities without public accountability should be required to produce general purpose financial statements. In some jurisdictions, all limited liability companies are required to publish general purpose financial statements—often tens of thousands, if not millions, of companies. In other jurisdictions, such a requirement is not imposed on very small entities, or small entities can opt out. That's not a decision for the IASB. It is a public interest issue that must be addressed by legislators and regulators jurisdiction by jurisdiction.

Where an entity that does not have public accountability is required to prepare general purpose financial statements, or chooses to do so, the proposed IFRS for SMEs is appropriate—perhaps even ideal, because it has been tailored to the needs of such a company.

Is the proposed IFRS for SMEs suitable for micro-sized SMEs—those with, say, fewer than 10 employees?

Most definitely—for those SMEs that are required, or choose, to prepare general purpose financial statements for external users. External users such as lenders, vendors, customers, rating agencies and employees need specific types of information but are not in a position to demand reports tailored to meet their particular needs. They must rely on general purpose financial statements. This is as true for micros as it is for larger SMEs. Financial statements prepared using the proposed IFRS for SMEs are intended to meet those needs.

In deciding on the content of the proposed IFRS for SMEs, the IASB focused on a typical entity with about 50 employees. The IASB used the 50-employee guideline not as a quantified size test for defining SMEs but, rather, to help it decide the kinds of transactions, events and conditions that should be addressed in the IFRS for SMEs. The IASB's goal in doing so was to make the IFRS for SMEs a stand-alone document for such typical SMEs, and also for entities smaller than 50 employees.

Today, in well over 50 jurisdictions around the world, full IFRSs are required or permitted for all or most limited liability companies, including the micros. If full IFRSs have been judged suitable for all entities, then the proposed IFRS for SMEs will surely also be suitable. The guidance in the proposed IFRS for SMEs is simple and straightforward. That guidance may cover some transactions or circumstances that micro SMEs do not typically encounter, but the IASB did not believe that this imposes a burden on those entities. The topical organisation of the proposed IFRS for SMEs will make it easy for micro SMEs to identify those aspects of the IFRS that are relevant to their circumstances.

Is a 250-page IFRS for SMEs still too much for SMEs in developing economies?

That would depend on why a small or medium-sized entity in a developing country is preparing financial statements—to whom is it reporting, and why. The proposed IFRS for SMEs is not too much for financial statements intended for lending, investing and donor funding decisions. If financial statements are for reporting to development institutions, it would depend on what they require. Many now require full IFRSs or full national accounting standards, so the proposed IFRS for SMEs would be a substantial reduction in the reporting burden.

Did the IASB consider developing a very brief—say 20-page—standard for the micros, particularly in developing countries?

No. Such a standard would necessarily be limited to broad principles of accrual basis accounting (some even suggest a cash basis or modified cash basis) and specific recognition and measurement principles for only the most basic transactions, requiring perhaps only a balance sheet and an income statement with limited note disclosures. While this approach might result in relatively low costs to SMEs in preparing financial statements, the resulting statements would not meet the objective of decision-usefulness. Such statements would not provide adequate information about the entity's financial position, performance and cash flows that is useful to a wide range of users in making economic decisions. Moreover, financial statements prepared using such a simple and brief set of accounting requirements might not serve the entity by improving its ability to obtain capital.

Would small listed companies be eligible to use the proposed IFRS for SMEs?

No, they would not be eligible to use the proposed IFRS for SMEs. Listed companies, large or small, have elected to seek capital from a broad group of 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.

Should large unlisted companies use full IFRSs rather than the proposed IFRS for SMEs?

That is a public policy decision that each jurisdiction must make. Size alone is not part of the IASB's definition of public accountability. But a jurisdiction certainly could adopt a policy that entities over a certain size (perhaps in terms of revenue, assets or number of employees) should publish financial statements that conform to full IFRSs rather than the proposed IFRS for SMEs.

Some SMEs prepare financial statements primarily for the tax authorities, rather than for investment and credit decision making. Will the proposed IFRS for SMEs be suitable for them?

The proposed IFRS for SMEs is designed to produce general purpose financial statements intended to meet the needs of investors, lenders, creditors, rating agencies, employees, customers and others outside the business.

Determining taxable income requires special purpose financial statements—ones designed to comply with the tax laws and regulations in a particular jurisdiction. But profit or loss determined in conformity with the proposed IFRS for SMEs can serve as the starting point for determining taxable income in a given jurisdiction by means of a reconciliation that is easily developed at national level. A similar reconciliation can be developed to adjust profit or loss as measured by the proposed IFRS for SMEs to distributable income under national laws or regulations.

Is it the purpose of the proposed IFRS for SMEs to provide information to owner-managers to help them run their business?

It is not the purpose of the proposed IFRS for SMEs to provide information to owner-managers to help them make management decisions. Managers can obtain whatever information they need to run their business. (The same is true for full IFRSs.) But general purpose financial statements will often also serve managers' needs by providing insights into the business's financial position, performance and cash flows.

Will SMEs be required to look to full IFRSs for guidance?

No. The IASB has designed the proposed IFRS for SMEs as a stand-alone document for typical SMEs with about 50 employees. It therefore covers the kinds of transactions and other events and conditions that companies of that size are likely to encounter. There is no mandatory fallback to full IFRSs.

What if SMEs cannot find the answer to an accounting question directly in the proposed IFRS for SMEs?

SMEs should select an accounting policy that results in relevant and reliable information. In making that judgement, they should consider, first, the requirements and guidance in the proposed IFRS for SMEs dealing with similar and related issues. In other words, they should try to analogise from the guidance given in the proposed IFRS for SMEs for similar transactions. If that does not yield an answer, they should consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income and expenses and the pervasive principles that are set out in Section 2 *Concepts and Pervasive Principles* of the proposed IFRS for SMEs.

SMEs may choose to look to the requirements and guidance in IFRSs, including Interpretations, dealing with similar and related issues, though that is not a requirement.

Are the principles in the proposed IFRS for SMEs the same as those in full IFRSs?

No, not always the same. Nor as detailed. The first step in developing the proposed IFRS for SMEs was to extract 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. The next step was to make appropriate modifications in the light of users' needs and cost-benefit considerations. Modifications included eliminating topics that are not generally relevant to SMEs, removing choices for accounting treatment, simplifying methods for recognition and measurement, deleting the many disclosures in full IFRSs that are designed for public capital markets, and redrafting into plain English to enhance clarity.

Which topics in full IFRSs are omitted from the proposed IFRS for SMEs?

The following topics in full IFRSs are not relevant to typical SMEs and are therefore omitted from the proposed IFRS for SMEs, with cross-references to the relevant IFRS if needed:

- General price-level adjusted reporting in a hyperinflationary environment.
- Equity-settled share-based payment (the computational details are in IFRS 2 *Share-based Payment*).
- Determining the fair value of agricultural assets (look to IAS 41 *Agriculture*, but the exposure draft 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 (finance lessors are likely to be financial institutions that would not be eligible to use the proposed IFRS for SMEs).
- Recoverable amount of goodwill (SMEs would test goodwill for impairment much less frequently than under IAS 38 *Intangible Assets*, but if required to perform such a test would look to the calculation guidance in IAS 38).
- Earnings per share and segment reporting, which are not required disclosures for SMEs.
- Insurance contracts (insurers would not be eligible to use the proposed IFRS for SMEs).

Which options from full IFRSs are retained, and which are not included?

Where full IFRSs provide an accounting policy choice, only the simpler option is in the proposed IFRS for SMEs. SMEs are permitted to use the other option by cross-reference to the relevant IFRS. The simpler options selected are:

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

In adopting the IFRS for SMEs, an individual jurisdiction could decide not to allow the option that is cross-referenced to the full IFRS. For example, a jurisdiction in which reliable measures of the fair value of property, plant and equipment are difficult to obtain could allow only the cost-depreciation-impairment model and prohibit the revaluation model. SMEs would still be able to assert compliance with the IFRS for SMEs.

What are some examples of accounting recognition and measurement simplifications in the proposed IFRS for SMEs?

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 category, 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.
- recognise all research and development costs as expense (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*.

What was the basis for keeping or dropping disclosures?

The disclosure requirements in the proposed IFRS for SMEs are substantially reduced when compared with the disclosure requirements in full IFRSs. The reasons for the reductions are of four principal types:

- some disclosures are not included because they relate to topics covered in IFRSs that are omitted from the proposed IFRS for SMEs.
- some disclosures are not included because they relate to recognition and measurement principles in full IFRSs that have been replaced by simplifications in the proposed IFRS for SMEs.
- some disclosures are not included because they relate to options that are not included in the proposed IFRS for SMEs.
- some disclosures are not included on the basis of users' needs or cost-benefit considerations.

Assessing disclosures on the basis of users' needs was not easy, because users of financial statements tend to favour more, rather than fewer, disclosures. The IASB was guided by the following broad principles:

- Users of the financial statements of SMEs are particularly interested in information about short-term cash flows and about obligations, commitments or contingencies, whether or not recognised as liabilities. Disclosures in full IFRSs that provide this sort of information are necessary for SMEs as well.
- Users of the financial statements of SMEs are particularly interested in information about liquidity and solvency. Disclosures in full IFRSs that provide this sort of information are necessary for SMEs as well.
- Information on measurement uncertainties is important for SMEs.
- Information about an entity's accounting policy choices is important for SMEs.
- Disaggregations of amounts reported on the face of SMEs' financial statements are important for an understanding of those statements.
- Some disclosures in full IFRSs are more relevant to investment decisions in public capital markets than to the transactions and other events and conditions encountered by typical SMEs with around 50 employees.

Accompanying the exposure draft is implementation guidance including a checklist of all of the proposed disclosure requirements. We encourage everyone, and particularly users of SMEs' financial statements, to review this checklist and, in their comments to the IASB about the exposure draft, to indicate any of the proposed disclosures that should not be required for SMEs, and why. We would also like respondents to indicate disclosures that are not proposed but that should be required for SMEs, and why.

Which modifications of IFRSs were considered by the IASB but rejected?

There were quite a few. Here are the main modifications that the IASB considered but rejected, and its reasons.

- Drop the cash flow statement. Lenders to SMEs and other users consistently say that information about cash flows is critical to them. Moreover, it is easy to prepare.

- All leases operating. Information about leased assets and obligations is important for lending and other credit decisions. Lenders consistently say that they do not want off balance sheet obligations.
- All pension plans defined contribution. Users of SMEs' financial statements find information about the funding status of pension obligations useful and important to them.
- Completed contract method for all long-term contracts. This could produce a potentially misleading accounting result for a long-term contractor, with some years of large profits and other years of large losses.
- Fewer provisions. Provisions are obligations that meet the liability recognition criteria. Users want these obligations recognised in the balance sheet, with the measurement uncertainties explained.
- Non-recognition of share-based payment. Share-based payments to employees should be recognised as remuneration expense because (a) it is intended as remuneration, (b) it involves giving something of value in exchange for services and (c) the consumption of the employee services received is an expense.
- Non-recognition of deferred taxes. Deferred taxes are liabilities (or sometimes assets) that can result in large outflows (inflows) of cash in the near future. Most of those who support non-recognition want the amounts, causes and other information disclosed in the notes. Note disclosure would entail the same tracking and computation effort for SMEs as would recognition.
- Cost model for all agriculture. Not only is fair value generally regarded as a more relevant measure in this industry, quoted prices are often readily available, markets are active, and measuring cost is actually more burdensome and arbitrary because of the extensive allocations required.
- No consolidation. The separate financial statements of a parent and its subsidiary(ies) are not useful because those entities often enter into transactions with each other that are not on an arm's length basis. Consolidated statements are essential for users when two entities operate as a single economic entity.
- Derivatives at cost. This is the same as non-recognition. Real gains and losses are inappropriately ignored until settlement. And real assets and liabilities end up off the balance sheet.
- Amortisation of goodwill over a specified maximum period, say 10 or 20 years. An amortisation approach still requires assessment of impairment, so it is actually a more complex approach than an indicator-triggered assessment of impairment that is in the exposure draft. By its nature, goodwill often has an indefinite life. An amortisation approach ignores this. Also, most users of financial statements say they found little, if any, information content in the amortisation of goodwill over an arbitrary period of years.

How is the exposure draft organised?

The exposure draft has been published in three documents:

- the draft IFRS for SMEs (254 pages), This includes an invitation to comment setting out questions on which the IASB invites comments, plus a glossary of terms
- implementation guidance, consisting of illustrative financial statements and a disclosure checklist (80 pages)
- The Basis for Conclusions setting out the issues considered by the IASB and the reasons for its decisions (48 pages).

The draft IFRS for SMEs is organised topically, rather than in IAS/IFRS number sequence. This will make it user-friendly. It contains 38 sections. The table of contents is shown in Figure 1.

Figure 1
Contents of the proposed IFRS for SMEs

...continued

Will there be accounting computer software based on the proposed IFRS for SMEs?

The IASB itself does not develop computer software. However, at least five software developers have indicated a strong interest in developing software tailored to applying the proposed IFRS for SMEs. Some have already started development.

Incidentally, XBRL International is working on an XBRL taxonomy for the proposed IFRS for SMEs.

After the IFRS for SMEs is issued, will the IASB provide additional guidance materials or training?

The IASC Foundation, under which the IASB operates, has an education initiative that produces educational materials and organises conferences relating to IFRSs. The education work plan envisages developing guidance materials for the IFRS for SMEs as well as organising seminars and workshops. In addition, the IASC Foundation can provide assistance to professional organisations and others who are developing materials and training for the IFRS for SMEs.

What are the next steps in the project?

- The deadline for commenting on the exposure draft is 1 October 2007.
- During the exposure period the IASB will conduct round-table meetings with SMEs, small firms of auditors, and others to discuss the proposals. Also, the IASB will field test the proposals by encouraging SMEs to apply the exposure draft and tell us about any problems they encountered.
- The standard is expected to be issued in the second half of 2008.
- It would be effective according to decisions in each jurisdiction that adopts the IFRS for SMEs.

Where can I obtain the exposure draft?

Electronic copies can be downloaded without charge from the IASB's Website. Go to www.iasb.org. Then click on 'Open to Comment'.

Printed copies may be purchased for £18 from the IASC Foundation publications department online (www.iasb.org) or by phone (+44 (0)20 7332 2730).

How do I send my comments?

The IASB prefers respondents to send their comment letters electronically (Word or PDF format) via the IASB's Website—www.iasb.org, and then click 'Open to Comment'. Then follow the link for more information and click on 'Comment Letters'. Your comments will be posted on the Website.

If I send comments, will they be considered?

Absolutely, yes, provided they arrive by the deadline for comments (1 October 2007). We are actively seeking the views of all interested parties. Every IASB member receives copies of all comment letters. Moreover, the staff prepare analyses of the points raised in all of the letters and present those analyses at public meetings of the IASB. The IASB considers each recommendation and decides a course of action. The recommendations and reasoning of those who comment on the exposure draft are considered on their merits, not on the basis of a head count.

We especially want to hear from small and medium-sized businesses, small and medium-sized auditing firms whose clients are primarily SMEs, and banks and others who make loans or extend credit to SMEs.

We invite comments on any aspect of the exposure draft. We would particularly welcome answers to the 11 questions set out in the Invitation to Comment at the front of the exposure draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording. If, for example, you believe that further simplifications are needed for SMEs, be specific—which simplifications, and why.

