IFRS for SMEs

1. Who is it for?

IASB define an SME (in Section 1) in the following way
Small and medium-sized entities are 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) its debt or equity instruments are traded 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 (such as banks, insurance companies, and similar financial institutions).

Commentary
Some entities (such as schools and universities) hold assets in a fiduciary capacity but that is not the primary business of such entities.

IASB avoided using any measurement criteria (such as Revenue or number of employees). If national governments decide to include such criteria it will be necessary to ensure that there is no disagreement with the class of entity for which the *IFRS for SMEs* is intended

2. How many standards?

IFRS for SMEs is a single stand-alone document (except for one cross-reference to IAS 39) but it is divided into 35 Sections, as shown in Appendix A.

Commentary
The first eight sections are something like the equivalent of the Framework document and IAS 1; the remaining sections have titles that are similar to those used in full IFRS except that Financial instruments are divided into two sections: (‘Basic Financial Instruments’ and ‘Other Financial Instrument Issues’) and there is a Section called ‘Liabilities and Equity’.

3. How frequently will it be changed?

The IASB expects to undertake a thorough review when two years of financial statements using the IFRS have been published by a broad range of entities. After that initial review, the IASB expects to propose amendments to the IFRS for SMEs by publishing an omnibus exposure draft approximately once every three years.

4. Main differences with full IFRS

The remainder of this document summarises the main differences between IFRS for SMEs and full IFRS. If a particular subject area is not mentioned it may be presumed that IFRS for SMEs is either the same as, or is similar to, the corresponding subject in full IFRS.

5. Financial Statements

The financial statements required are broadly similar to full IFRS but there are exceptions and there are some cosmetic differences between the illustrations in IAS 1 and illustrations in the implementation guidance intended for IFRS for SMEs. The implementation guidance notes do state that the illustrations should not be treated as a template but if past experience is any guide, most companies will adopt the style in these guidance notes.

5.1 Statement of income and retained earnings

If the only changes to equity during the period are a result of profit or loss, payment of dividends, correction of prior-period errors or changes in accounting policy, a combined statement of income and retained earnings can be presented instead of both a statement of comprehensive income and a statement of changes in equity.

The new statement is called a ***'Statement of income and retained earnings'*** and replaces the separate statements of comprehensive income and changes in equity.

Illustration

At the start of a company's accounting year it had retained earnings of $150,000. During the year it earned a profit of $10,000 and paid dividends of $3,000. There were no other changes in equity during the year. The movement on retained earnings may be presented at the foot of the 'statement of income and retained earnings', as follows:

From Revenue to Income Tax expense	as IAS 1
Profit for the Year	10,000
Retained earnings at start of year	150,000
Dividends	(3,000)
Retained earnings at end of year	157,000

Commentary on 'other comprehensive income'

The section on Property, plant and equipment (Section 17) permits only the cost model and so revaluation gains and losses on property revaluations (the most common form of 'other comprehensive income') will not feature in IFRS for SMEs. Consequently, the only items to be reported as other comprehensive income will be related to:

- actuarial gains and losses on pension funds,
- hedging gains and losses on financial instruments, and
- gains and losses on translation of foreign investments.

All of these will be rare events in most companies for which IFRS for SMEs is appropriate.

5.2 Presentation in statement of financial position

The current/non-current distinction for assets and liabilities has been retained, as has the exception when items are presented in order of liquidity. But in the illustrations in the implementation guidance current assets are presented first followed by non-current (the

reverse of how they are presented in the IAS 1 illustration). The format in the implementation guidance is set out as follows:

ASSETS	
Current assets	xxx
Non-current assets	xxx
Total assets	xxx
LIABILITIES AND EQUITY	
Current liabilities	xxx
Non-current liabilities	xxx
Total liabilities	xxx
Equity	xxx
Total liabilities and equity	xxx

Commentary

Although the guidance notes state that the illustrative financial statements should not be regarded as a template appropriate for all entities, no doubt many entities will adopt the basis suggested. The reverse order (non-current first followed by current) is also permitted.

It is not necessary to distinguish between current and non-current providing items are set out in an approximate order of liquidity (ascending or descending), which is the basis commonly adopted by many banks.

5.3 Statement of cash flows

The choice between direct and indirect methods has been retained with one slight difference in presentation under the indirect method. The wording (Para 7.8) and the illustration suggest that if the indirect method is adopted, cash flows from operating activities should commence with '**profit for the period'** (in the IAS 7 format it starts with profit before tax). This means that adjustments will have to be made for non-cash finance costs and non-cash tax expense

Illustration

A company has profit before tax of $150,000 and a tax expense of $45,000. The amount of tax on profit paid during the year was $42,000, the difference between this and the tax expense of $45,000 relates only to changes in the liabilities for current and deferred tax. The tax expense relates solely to operating profits. The opening section of statement of cash flows will include the following:

Cash flows from operating activities	
Profit for the year	105,000
Adjustments for non-cash income and expenses:	
Non-cash income tax expense	3,000

A similar adjustment will be needed for non-cash finance costs. These two items are included in the first section headed **‘Adjustments for non-cash expenses’** (along with depreciation and similar items) and not in the section that deals with ‘**Changes in operating assets and liabilities’.**

The illustration also includes a separate heading following the ‘non-cash adjustments’ which is called ‘*Cash flow included in investing activities’*. This heading is used to disclose the adjustment needed to remove book gains or losses arising on disposal of equipment from the profit figure.

The end result of these refinements is that the first part of the statement of cash flows will be as follows if entities adopt the illustration as a template:

Cash flows from operating activities

Profit for the year	xxx
Adjustments for non-cash income and expenses:	
Non-cash finance costs	xxx
Non-cash income tax expense	xxx
Depreciation	xxx
Impairment loss	xxx
Amortisation of intangibles	xxx
Cash flow included in investing activities	
Gain on sale of equipment	(xxx)
Changes in operating assets and liabilities	
Increases/decreases as in IAS 7	

6. Non-current assets

6.1 Property, plant and equipment

The definition of Property, plant and equipment is the same as in IAS 16.

The revaluation model is **NOT** permitted.

The requirement in full IFRS to review remaining useful life, residual value and depreciation method at each reporting date is replaced by a requirement to review these estimates only if there is an indication that there has been a significant change since the last annual reporting date.

All borrowing costs must be treated as expenses and cannot be capitalised as part of the cost of property, plant and equipment.

There is no category of non-current assets held for sale; instead, any plan to dispose of an asset before its expected date is an indicator of impairment that triggers the calculation of recoverable amount to determine whether the asset is impaired.

6.2 Intangible assets other than goodwill

The most radical differences are concerned with:

- treating all research and development costs as an expense, and
- the amortisation of intangibles

6.21 Research and development

The requirement in full IFRS to capitalise development costs if certain criteria are satisfied has not been included; instead there is a requirement to treat all research and development costs as an expense. Rules regarding other items that cannot be treated as intangibles are similar to full IFRS.

6.22 Amortisation of intangibles

All intangibles are considered to have a finite useful life (the concept of indefinite life in full IFRS does not exist). The useful life should not exceed the period of any contract or other legal rights to the intangible asset, but may be shorter. In cases where it is impossible to make an estimate of useful life, the life is presumed to be 10 years.

6.23 Impairment of intangibles

The requirements for recognition of impairment losses are set out in Section 27 *Impairment of Assets* of the IFRS (see Section 10 in these notes below).

7. Investments in associated undertakings

The requirement in full IFRS to use the equity method is modified. Investors will have to adopt one of three policies, which are:

- the cost model
- the equity method
- the fair value model

7.1 The cost model

This option is only available if there is no published price for the investment. The investment will be subject to impairment testing in accordance with Section 27 *Impairment of Asset.* Any dividends received are recognised as income irrespective of whether they were paid out of the associate's profits before or after acquisition.

7.2 The fair value model

The transaction is initially recognised at transaction price, excluding transaction costs. At each reporting date the investment shall be measured at fair value with any changes in value being recognised in profit or loss. If the fair value cannot be determined reliably without undue cost or effort the cost model shall be used.

7.3 Equity method

The equity method is similar to that in full IFRS except for the way that the goodwill element in the carrying value is dealt with. This arises because of the new rules on amortisation of goodwill in Section 19 of the IFRS. Goodwill (positive or negative) on acquisition will have to be determined and subjected to the rules on amortisation in Section 19 (see Section 9.3 in these notes). The transaction price includes transaction costs when calculating goodwill

However, impairment losses are treated in a similar way to that required in full IFRS where it is the full carrying value (including goodwill) of the entire investment that is subject to impairment testing. The goodwill element is not tested separately.

8. Investment Property

There is NO CHOICE OF POLICY between the cost and fair value models; instead the fair value model must be adopted, except where the fair value cannot be determined without undue cost and effort. In cases where the fair value cannot be determined, investment property shall be treated as Property, plant and equipment

9. Business Combinations and Goodwill

IFRS for SMEs is based on the cost-allocation model in the earlier IFRS 3 (before it was revised). The revised IFRS 3 does not have a cost-allocation model. The most significant differences created by this relate to:

- transaction costs
- non-controlling interests
- measurement and amortisation of goodwill

9.1 Transaction costs

Transaction costs are included with the cost of the acquisition (and will, therefore, be included in the calculation of any goodwill arising).

9.2 Non-controlling interest

There is no choice to value non-controlling interest at acquisition at the fair value of their shares. Consequently, any goodwill reported will be the parent's share only. Non-controlling interest at acquisition will be based on a proportion of the fair value of net identifiable assets at acquisition.

9.3 Goodwill amortisation

After initial recognition goodwill is measured at cost less accumulated amortisation and any accumulated impairment losses. Goodwill is amortised over its useful life, which is presumed to be 10 years if the entity is unable to make a reliable estimate of the useful life.

10. Impairment of assets

The rules on impairment are said to relate to all assets, other than the following:

- deferred tax assets
- assets arising from employee benefits
- financial assets (Basic and Other)
- investment property measured at fair value
- biological assets

The reason why all of these are excluded is because other sections of the IFRS for SMEs establish impairment requirements for them.

Note that impairment of trade receivables is excluded from this section because it is included with the impairment of Basic Financial Assets. The main requirements in this section are divided between

- impairment of inventories,
- impairment of assets other than inventories, and
- special considerations in relation to goodwill

10.1 Impairment of inventories

Inventories must be tested for impairment at each reporting date. Reversals of impairment losses are permitted where the circumstances change

10.2 Impairment of assets other than inventories

It is only necessary to test for impairment if there are indications that an asset might be impaired. If there is no indication of impairment, it is not necessary to estimate the asset's recoverable amount.

10.3 Special considerations in relation to goodwill

Although goodwill must now be amortised (see 9.3 above) it must still be tested for impairment if there are indications that it might have been impaired. Since goodwill does not generate cash by itself it is the cash generating unit to which the goodwill has been allocated that is tested; in this respect the rules in IFRS for SMEs are similar to those in full IFRS.

11. Financial instruments

The requirements for financial instruments are in two sections, as follows:

- Section 11 Basic Financial Instruments
- Section 12 Other Financial Instrument Issues

Section 11 is relevant to all entities. Section 12 applies only to the more complex financial instruments. If an entity enters into only basic financial instrument transactions then Section 12 is not applicable. However, even entities with only basic financial instruments are required to consider the scope of Section 12 to ensure that they are exempt.

11.1 Choice of policy

Entities may choose to apply either:

- Both Sections 11 and 12 in full, or
- IAS 39 on recognition and measurement and Sections 11 and 12 on disclosure

Whichever of these two bases is adopted, it must be applied to all financial instruments.

11.2 Basic Financial Instruments - examples

Examples of basic financial instruments include the following:

- cash
- bank accounts (demand and fixed-term deposits)
- accounts, notes and loans receivable and payable
- bonds and similar debt instruments (where returns to the holder are fixed)
- 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

(Note that 'puttable' shares are those that can be sold back to the issuer at a pre-determined price.)

11.3 Basic Financial Instruments - measurement

Initial measurement is at the transaction price – including transaction costs except where the instrument is measured at fair value through profit or loss. Subsequent measurement depends on the type of instrument, as follows:

- Debt instruments are measured at amortised cost using the effective interest method
- Instruments classified as current assets or current liabilities (such as receivables and payables) are measured at the amount expected to be paid or received (this means net of impairment losses in the case of receivables) – see 11.4 below for extended credit sales
- Non-puttable non-convertible preference shares and non-puttable ordinary shares, if publically traded, or their fair value can be measured reliably, are carried at fair value with changes in value recognised in profit or loss.
- If there is no reliable basis for measuring shares at fair value they are be measured at cost less impairment.

11.4 Exception on receivables

One exception to valuing a receivable at the amount expected to be received is where the sale is on extended credit and therefore consists of a financing arrangement. In these cases the entity measures the financial asset at the present value of the future payments discounted at a market rate of interest for a similar debt instrument. This is a similar provision to that for what is usually called 'sales-aid leasing' in IAS 17.

11.5 Other Financial Instrument Issues

Examples of financial instrument that do not satisfy the conditions to be dealt with under Section 11 and are, therefore, covered by Section 12 include the following:

- options and forward contracts (because returns to the holder are not fixed)
- an interest rate swap that returns a cash flow that is positive or negative,
- a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow,
- investments in convertible debt (because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates)

Note that normal trading contracts to buy or sell tangible assets such as inventory or property, plant and equipment, are not financial instruments.

11.6 Measurement rules under Section 12

At the end of each reporting period, all financial instruments within the scope of Section 12 should be measured at fair value and changes in fair value recognised in profit or loss. In the following exceptional cases the instrument should be measured at cost less impairment:

- 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

11.7 Hedge Accounting

There are similarities with IAS 39 but the range of risks are not as broad and there is no requirement for a quantitative assessment of hedge effectiveness. Hedge accounting is permitted for the following risks:

- An interest rate risk of a debt instrument measured at amortised cost;
- A foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;
- A foreign exchange risk in a net investment in a foreign operation; or
- A price risk of a commodity

A hedging instrument:

- Is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract, or a commodity forward exchange contract.
- Involves a party external to the reporting entity.
- Has a notional amount equal to the designated amount of principal or notional amount of the hedged item.
- Has a specified maturity date no later than the maturity of the hedged item, the expected settlement of the commodity purchase or sale commitment, or the occurrence of the highly probable forecast transaction, and
- Has no pre-payment, early termination or extension features.

11.8 Disclosures

The disclosure requirements for financial instruments in Sections 11 and 12, particularly where only Section 11 applies, are far less onerous than those in full IFRS. These disclosure requirements are not listed in this information sheet.

12. Employee Benefits

The main differences to full IFRS are concerned with:

- a simplified option for measuring defined benefit obligations
- recognition of actuarial gains and losses

12.1 Defined benefit obligations

The **projected unit credit method** (as required by IAS 19) should be used to measure the entity's defined benefit obligation and the related expense, only if this can be done without undue cost or effort. If an entity is not able, without undue cost or effort, to use the projected unit credit method, the entity is permitted to ignore a number of future uncertainties when estimating the liability.

For this simplified basis the following are ignored:

- estimated future salary increases
- estimated future services of current employees
- estimated mortality rates of current employees before retirement

The IFRS does not require an independent actuary to perform a comprehensive actuarial valuation. Nor does it require that a comprehensive actuarial valuation is done annually. In periods between comprehensive actuarial valuations the defined benefit obligation can be measured by adjusting the prior period measurement to reflect changes in number of employees and salary levels

12.2 Recognition of actuarial gains and losses

The provision in IAS 19 for amortising gains and losses over expected remaining lives of employees is not available. Actuarial gains and losses must be expensed immediately. The entity has a choice between recognising them in profit or loss or in other comprehensive income.

13. Government Grants

Under IAS 20, Government grants are recognised in the statement of comprehensive income over the periods necessary to match them with the related costs that they are intended to compensate. Consequently, there are different rules depending on whether the grant relates to assets or to income.

This distinction between assets and income does not exist in IFRS for SMEs; instead, the recognition rules are as follows:

- A grant that does not impose specified future performance conditions on the recipient is recognised in income when the grant proceeds are receivable
- A grant that imposes specified future performance conditions on the recipient is recognised in income only when the performance conditions are met
- Grants received before the income recognition criteria are satisfied are recognised as a liability and released to income when all attached conditions have been met.

This suggests that if a grant related to assets is received and there are no future performance conditions attached to the grant, the amount should be recognised in income immediately.

14. Borrowing costs

All borrowing costs must be expensed. See Property, plant and equipment in Section 6 above. This is contrary to the provisions in IAS 23 to capitalise certain types of borrowing cost.

15. Share-based payment transactions

Transactions with employees are measured at the fair value of the instruments granted. Since these shares might be in an unquoted entity, a three-tier hierarchy is applied when measuring the fair value of the equity instruments. This hierarchy is as follows:

- Observable market prices
- Specific observable market data, such as a recent transaction in the entity's shares or a recent independent fair valuation of the entity.
- Use of a generally accepted valuation technique that uses market data

16. Inventories

Most provisions are similar to IAS 2 except that there is some change in terminology. For example, net realisable value is described by the term: *'selling price less costs to complete and sell'*. Accepted techniques for identifying the cost of inventory now include an item described as: *'Most recent purchase price'*. As noted in 10 above, inventory must be tested for impairment on an annual basis.

17. Equity

There are some minor cosmetic differences. Equity is defined in the same was as in the full IFRS Framework document but its component parts are specified, as follows:

- Investments by the owners of the entity;
- Plus additions to those investments earned through profitable operations and retained for use in the entity's operations;
- Less reductions to owner's investments as a result of unprofitable operations and distributions to owners.

Equity instruments are measured at the fair value of the consideration received or receivable, net of direct issue costs.

18 Deferred Tax

There is a minor cosmetic difference in relation to deferred tax assets.

In IFRS for SMEs a valuation allowance is recognised so that the net carrying amount of the deferred tax asset equals the highest amount that is more likely than not to be recovered. This will have the same effect as full IFRS where deferred tax asset is only recognised to the extent that it is probable that there will be sufficient future taxable profit to enable recovery of the deferred tax asset (although no separate allowance is required in full IFRS).

19. Foreign Exchange differences

The main difference relates to the gains and losses that arise when translating the financial statements of a foreign subsidiary. Such gains and losses must still be recognised in other comprehensive income and reported as a component of equity but the provisions in IAS 21 that allow such gains and losses to be recycled to profit or loss on disposal of the subsidiary do not apply. Reclassification to profit or loss is specifically prohibited.

DISCLAIMER

This document has been prepared to assist those who are reasonably familiar with full IFRS and who might be required to prepare financial statements under IFRS for SMEs. We do not claim that all substantial differences have been identified and explained but we do believe the document is sufficiently comprehensive to be a useful starting point for anyone who needs to understand IFRS for SMEs. Users who are required to prepare financial statements using IFRS for SMEs are advised to refer to the actual text of the standard for more information.

Appendix A – List of Sections in IFRS for SMEs

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7 Statement of Cash Flows
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11 Basic Financial Instruments
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32 Events after the end of the Reporting Period
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