



IFRS for Small and Medium-sized Entities (IFRS for SMEs)

Presented by:

SHABBIR YUNUS KHAIRULLAH

PARTNER

ERNST & YOUNG FORD RHODES SIDAT HYDER

 **ERNST & YOUNG**

Quality In Everything We Do

Contents

- ▶ IFRS for SMEs
- ▶ Transition to IFRS for SMEs
- ▶ Key differences between IFRS for SMEs and Accounting Standards for Medium Sized Entities published by ICAP
- ▶ Considerations before applying IFRS for SMEs
- ▶ Applicability in other countries
- ▶ Applicability in Pakistan



IFRS for SMEs

Background

- ▶ A discussion paper was published in **June 2004**
- ▶ Project was discussed with **Standards Advisory Council (SAC)** at seven SAC meetings
- ▶ Project was discussed at five annual meetings of the **World Accounting Standard-Setters** (2003 & 2004 to 2008)
- ▶ **Working Group** met four to five times to discuss the issues and provide advice to the International Accounting Standards Board (IASB)
- ▶ The Exposure Draft (ED) was published in **February 2007**
- ▶ The ED was **translated into five languages** to increase outreach

Background – Contd.

- ▶ A questionnaire on the ED was posted on the IASB's website in June 2007 and **field test reports** were required to be submitted by 30 November 2007. Field testers were asked to restate their most recent financial statements using the ED and respond to a questionnaire. Responses were received from 116 SMEs in 20 countries.
- ▶ The **IASB** discussed the Project in a total of 44 public meetings
- ▶ **Presentations** at 104 conferences and round tables in 40 countries, including 55 presentations after the ED was published.

Background – Contd.

- ▶ The IASB explained the ED and responded to questions in two public **webcasts** for which nearly 1,000 participants registered.
- ▶ The final standard was published in **July 2009**
- ▶ The standard is a result of a **five year project** to address the financial reporting needs of small and medium-sized entities

Quest for a name

- ▶ The standard was originally called **“IFRS for SMEs”** when it was issued in draft in June 2004
- ▶ However, as this did not precisely capture the intended audience of the standard, the name of the standard has changed several times during its evolution.
- ▶ At various stages, the standard was renamed **“IFRS for Private Entities”** and **“IFRS for Non-Publicly Accountable Entities”**
- ▶ Each name has been rejected for various reasons and eventually the standard was issued with its original name

Overview

- ▶ The standard consists of **35 chapters (230 pages)** addressing all the requirements for SMEs
- ▶ It is a **stand alone** document – no fall back to full IFRS (with one exception)
- ▶ Update process
 - ▶ Review after two years of financial statements have been published
 - ▶ Then **review every three years**
- ▶ May need interpretative guidance from the IFRIC between reviews

What is an SME?

- ▶ SMEs are defined as **entities that:**
 - ▶ **Do not have public accountability, and**
 - ▶ **Publish general purpose financial statements for external users**
- ▶ An entity has public accountability if:
 - ▶ Its debt or equity instruments are traded in a public market, or
 - ▶ It holds assets in a fiduciary capacity for a broad group of outsiders

Who can apply IFRS for SMEs?

- ▶ The definition of an SME explains which entities the standard applies to
- ▶ The **regulatory authorities in each jurisdiction** determine which entities can apply it
- ▶ A **publicly accountable entity cannot claim to comply with IFRS for SMEs** even if it is permitted or required to apply it in its jurisdiction.

Five types of simplifications

- ▶ IFRS for SMEs contains five types of simplifications of full IFRSs:
 - ▶ some **topics in IFRSs are omitted** because they are not relevant to typical SMEs
 - ▶ some accounting policy **options in full IFRSs are not allowed** because a more simplified method is available to SMEs
 - ▶ simplification of many of the recognition and measurement principles that are in full IFRSs
 - ▶ substantially **fewer disclosures**
 - ▶ **simplified redrafting**
- ▶ The effect of simplification process was to produce a standard of 230 pages compared with nearly 3,000 pages in the 2009 volume of full IFRS

Omitted topics

- ▶ IFRS for SMEs does not address the following topics that are covered in full IFRSs:
 - ▶ earnings per share
 - ▶ interim financial reporting
 - ▶ segment reporting
 - ▶ special accounting for assets held for sale
- ▶ It should be noted that **additional voluntary information**, if necessary, is not precluded, but is encouraged in the standard.

Concepts and pervasive principles

- ▶ Standard sets out the concepts and basic principles underlying the financial statements of SMEs
- ▶ Concepts are **derived from the IASB Framework**
- ▶ Addresses issues such as:
 - ▶ **Objective of the financial statements**
 - ▶ **Qualitative characteristics** of information in the financial statements (understandability, relevance, materiality, reliability, substance over form, prudence, etc.)
 - ▶ General recognition and measurement requirements

Complete set of financial statements

- ▶ Consolidated financial statements are the **primary set**
- ▶ **Complete set of financial statements** is similar to that required by IAS 1 *Presentation of Financial Statements (revised)* i.e. it comprises:
 - ▶ A statement of financial position
 - ▶ A statement of comprehensive income (or two statements – P&L and statement of comprehensive income)
 - ▶ A statement of changes in equity (including only owner changes)
 - ▶ A statement of cash flows (prepared using direct or indirect method)
 - ▶ Notes, including summary of significant accounting policies
- ▶ **Comparative information** must be provided
- ▶ **No requirement for an opening statement of financial position** (required where an accounting policy is applied retrospectively or there is a retrospective restatement of the financial statements)

Complete set of financial statements – Contd.

- ▶ The **presentation of a combined statement of comprehensive income and retained earnings is permitted**, if the only changes to equity during the period arise from:
 - ▶ Profit or loss
 - ▶ Payment of dividends
 - ▶ Correction of prior period errors
 - ▶ Changes in accounting policies
- ▶ Must make a **statement of compliance** with IFRS for SMEs
- ▶ The IFRS for SMEs includes a set of **illustrative financial statements and a presentation and disclosure checklist** to assist entities with preparing their financial statements.

Long-term assets

- ▶ **Property, plant and equipment (P,P and E)**
 - ▶ Measured at cost less accumulated depreciation and impairment losses
 - ▶ Revaluation option removed
 - ▶ Borrowing costs cannot be capitalised
 - ▶ Review of useful life, residual value and depreciation rate is required only if there is a significant change in the asset or how it is used
 - ▶ This section also applies to investment properties (not covered by “Investment Property” section) and to assets held for sale
 - ▶ Holding of assets for sale is an indicator of possible impairment

Long-term assets – Contd.

▶ **Investment properties (IP)**

- ▶ Cost model is not allowed
- ▶ Measured at fair value, unless the fair value cannot be measured reliably without “undue cost or effort”
- ▶ Otherwise, the IP is treated as P,P and E
- ▶ Remeasure to fair value at each reporting date with changes recognised in profit and loss account
- ▶ Unlike IAS 40, the IFRS for SMEs does not require disclosure of the fair values of IP measured on a cost basis and classified as P, P & E

Long-term assets - Contd.

- ▶ **Borrowing costs**

- ▶ Must all be expensed

- ▶ **Government grants**

- ▶ Must be recognised in profit or loss at fair value, when performance conditions are met
- ▶ If there are no performance conditions, recognise the grant immediately in profit or loss
- ▶ Other treatments of government grants in certain situations, including allowing grants relating to specific assets to be deducted from the carrying value of the asset are not available to SMEs.

Intangible assets

▶ Intangible assets

- ▶ Measured at cost less accumulated amortisation and impairment losses
- ▶ Revaluation model is not allowed
- ▶ All internally generated intangibles are expensed
- ▶ Finite useful life – 10 years if can't reliably estimate
- ▶ Residual value is assumed to be zero unless there is an active market or a committed third party

▶ Goodwill

- ▶ Amortised over useful economic life (cannot be indefinite)
- ▶ Finite useful life – 10 years if can't reliably estimate
- ▶ No compulsory annual impairment test – indicator approach
- ▶ Reversal of goodwill impairment is not permitted

Group accounts

- ▶ The **reporting dates** of parent and subsidiaries should be the same, unless impracticable – no guidance on what might be considered an acceptable difference in reporting dates
- ▶ **Exemption from preparing consolidated accounts:**
 - ▶ If parent is a subsidiary and the ultimate parent produces financial statements compliant with IFRS/IFRS for SMEs
 - ▶ If it has only one subsidiary acquired with the intention of disposal within one year
- ▶ **Business combinations** – acquisition costs are capitalised

Group accounts – Contd.

- ▶ **Investments in Associates and jointly controlled entities**
 - ▶ Consolidated accounts – the accounting policy choice is as under:
 - ▶ at cost
 - ▶ at fair value (if published price quotation is available)
 - ▶ using the equity method
- ▶ **Separate financial statements**
 - ▶ Separate financial statements – measured using the cost model (cost less impairment) or at fair value (with changes in fair value recognised in profit or loss)
 - ▶ The entity shall apply the same accounting policy for all investments in a single class (subsidiaries, associates or jointly controlled entities), but it can elect different policies for different classes.

Financial instruments - overview

- ▶ IFRS for SMEs includes **two sections** on Financial Instruments
 - ▶ **Section 11 “Basic financial instruments”**
 - ▶ Relevant to all entities
 - ▶ **Section 12 “Other financial instruments issues”**
 - ▶ More complex transactions – primarily hedge accounting
- ▶ **Accounting policy choice**
 - ▶ To apply the IFRS for SMEs; or
 - ▶ To apply IAS 39, and the disclosure requirements of the IFRS for SMEs

Basic financial instruments

▶ Examples

- ▶ Cash
- ▶ Demand and fixed-term deposits when the entity is the depositor, e.g. bank accounts
- ▶ Commercial paper and commercial bills held
- ▶ Accounts, notes and loans receivable and payable
- ▶ Bonds and similar debt instruments
- ▶ Investments in non-convertible preference shares and non-puttable ordinary and preference shares

Other financial instruments

▶ Examples

- ▶ Asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables
- ▶ Options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument
- ▶ Financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section 12.
- ▶ Commitments to make a loan to another entity.
- ▶ Commitments to receive a loan if the commitment can be net settled in cash.

Basic financial instruments

- ▶ **Initial recognition and measurement**
 - ▶ Transaction price including transaction costs (other than the instruments measured at fair value through profit or loss)
- ▶ **Subsequent measurement**
 - ▶ Amortised cost
 - ▶ Fair value through P&L (cost if no reliable FV measurement)
 - ▶ No “AFS equivalent”
- ▶ **Impairment of instruments measured at cost or amortised cost**
 - ▶ No restrictions on reversal
- ▶ **Derecognition**
 - ▶ Based on the exposure draft of IAS amendments (March 2009)
- ▶ **Disclosures**
 - ▶ Much simplified from full IFRS

Other financial instruments – issues

- ▶ Apart from obvious cross-references back to section 11, for those complex instruments that are within scope of section 12, this section deals only with hedge accounting and hedge accounting disclosures
 - ▶ **Very much simplified from IAS 39 equivalents (only four instances in which an SME can apply hedge accounting)**
 - ▶ **No 80-125% effectiveness test specified**
 - ▶ **Reduced documentation requirements**

Employee benefits

▶ **Defined benefit pension schemes**

- ▶ Projected unit credit method not required if undue cost or effort
- ▶ Actuarial valuation is not mandated nor required to be conducted annually if principal actuarial assumptions have not changed significantly
- ▶ Simplifications allowed, if projected unit credit method not used
- ▶ No corridor - Actuarial gains and losses are recognised in full, either through profit or loss or through other comprehensive income
- ▶ Past service costs are recognised in profit or loss as incurred

Employee benefits – Contd.

▶ **Share-based payments**

- ▶ Directors' judgement used to measure fair value of shares in equity-settled transactions if observable market prices are not available
- ▶ Schemes that give choice of equity or cash settlement are usually accounted for as cash-settled
- ▶ Guidance on accounting for group plans reduced

Income tax

- ▶ Drawn from **IAS 12 and the March 2009 ED** of proposed amendments
- ▶ Section covers:
 - ▶ Scope
 - ▶ Steps in accounting for income tax
 - ▶ Current tax (and withholding tax) – **discounting is prohibited**
 - ▶ **Deferred tax**
 - ▶ **Temporary difference approach retained (new, simpler definition of tax base)**
 - ▶ **Valuation allowance for DT assets**
 - ▶ **Tax uncertainties (use the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will review the amounts reported and will have full knowledge of all relevant information)**
 - ▶ Presentation and disclosures

Related party disclosures

- ▶ The **definition** of related parties and **disclosure requirements** are similar to those under full IFRS
- ▶ **Disclosure reliefs** from full IFRS are as follows:
 - ▶ Disclosure of key management personnel compensation in total only, and not by category or type of benefit
 - ▶ Full exemption from the disclosure of relationships and transactions with the state and other state-controlled entities, except that the parent-subsidary relationship is still required to be disclosed.

Specialised activities

- ▶ Provides guidance on
 - ▶ Agriculture (drawn from IAS 41)
 - ▶ Extractive industries (refers to PP&E, intangibles other than goodwill, and Provisions sections)
 - ▶ Service concession arrangements (drawn from, but much simplified, IFRIC 12)


Topics having no significant changes from full IFRS

- ▶ Accounting policies, estimates and errors
- ▶ Inventories
- ▶ Impairment of assets
- ▶ Leases
- ▶ Provisions and contingencies
- ▶ Liabilities and equity (except for the changes covered in the next slide)
- ▶ Revenue (IAS 18 and IAS 11 combined)
- ▶ Foreign currency translation
- ▶ Hyperinflation
- ▶ Events after the end of the reporting period

Issues addressed in IFRS for SMEs that are not covered in full IFRS

In IASB's judgment, the following issues are relevant to SMEs but are not addressed in full IFRS:

- ▶ combined financial statements (paragraphs 9.28-9.30)
- ▶ original issue of shares or other equity instruments (paragraph 22.7-22.10)
- ▶ sale of options, rights and warrants (paragraph 22.11)
- ▶ Capitalisation or bonus issues of shares and share splits (paragraph 22.12)



**KEY DIFFERENCES BETWEEN
IFRS FOR SMES AND
ACCOUNTING STANDARDS FOR
MEDIUM SIZED ENTITIES
PUBLISHED BY ICAP**

Main differences

▶ Structure

- ▶ The IFRS for SMEs (the IFRS) is a stand-alone document with no **fall back to full IFRS** with one exception relating to financial instruments. However, the MSE standard published by ICAP has fall back to full IFRS.

▶ Contents

- ▶ No mention of the **statement of comprehensive income** in the MSE standard
- ▶ **Borrowing costs** not allowed to be capitalised in the IFRS
- ▶ Property, Plant and Equipment and Intangible Assets not allowed to be carried at **revalued amounts** in the IFRS

Main differences – Contd.

- ▶ In the IFRS, all **research and development costs** are expensed as incurred. No capitalization is allowed for internally generated intangible assets.
- ▶ As per the IFRS, **intangible assets (including goodwill)** cannot have an indefinite life. If it is not possible to estimate useful life, amortise it over 10 years. Impairment test is required only if there are indicators of impairment.
- ▶ Under the IFRS, entities have a choice to account for **financial instruments** in accordance with IFRS for SMEs or to apply IAS 39. Under the IFRS, reversal in impairment (relating to Basic Financial Instruments) in subsequent periods is recognised in profit or loss immediately. Under the MSE standard, the recognition

Main differences – Contd.

and measurement principles are the same as in IAS 39. Reversal of impairment in AFS investment is not allowed through profit or loss.

- ▶ **Hedge accounting** is not addressed in the MSE standard. The IFRS allow hedge accounting for four types of risks.
- ▶ No mention of **functional currency** in the MSE standard
- ▶ As per MSE standard, if a defined benefit plan is funded, **actuarial valuation** is required atleast once in 3 years. However, as per the IFRS, use of independent actuary to perform actuarial valuation is not mandated nor is required to be conducted annually if principal actuarial assumptions have not changed significantly. Further, the

Main differences – Contd.

IFRS require the use of projected unit credit method only if the entity is able to use it without **undue cost or effort**. Otherwise, the entity is permitted to make the following simplifications in its calculations:

- ▶ Ignore estimated future salary increases (assume current salaries continue until current employees begin receiving benefits)
- ▶ Ignore future service of current employees (assume closure of plan for existing as well as any new employees)
- ▶ Ignore possible future in-service mortality (assume all current employees will receive the benefits)
- ▶ There are certain **sections in the IFRS which are not covered in the MSE standard** – such as, consolidated financial statements, investments in associates and joint ventures, investment property, share based payments, etc.



**TRANSITION TO IFRS FOR
SMEs**

Effective date of IFRS for SMEs

- ▶ The standard was issued on **9 July 2009** but it does not have an effective date of application.
- ▶ Therefore, the standard is considered immediately effective for any entity preparing its **financial statements on or after 9 July 2009** and wishing to apply this standard.
- ▶ However, caution is required and any such entity must consider the **requirements of regulators and users** in transitioning to the standard.

Transition to IFRS for SMEs

- ▶ Applies to all entities adopting IFRS for SMEs, irrespective of the GAAP they are departing from
- ▶ Transition rules are derived from IFRS 1, but simplified
- ▶ **Retrospective application is primarily required** with
 - ▶ Five exceptions (Same four as IFRS 1 plus discontinued operations)
 - ▶ Twelve exemptions (See next slide)
- ▶ Restatements to the opening position do not have to be made if they are impracticable
- ▶ An entity can only be a **first-time adopter once in its life**
- ▶ Reconciliations are required (same as IFRS 1)

Transition to IFRS for SMEs - exemptions

- ▶ Business combinations (effected before the date of transition to this IFRS)
- ▶ Share-based payment (equity instruments granted or liabilities settled before the date of transition)
- ▶ Fair value as deemed cost (PP&E, intangible or IP)
- ▶ Revaluation as deemed cost (PP&E, intangible or IP)
- ▶ Cumulative translation differences (identical to IFRS 1)
- ▶ Separate financial statements (identical to IFRS 1)
- ▶ Compound financial instruments (identical to IFRS 1)
- ▶ Service concession arrangements (for SCAs before the date of transition)
- ▶ Arrangements involving a lease (identical to IFRS 1)

Transition to IFRS for SMEs – exemptions

- ▶ Decommissioning liabilities included in the cost of PP&E (identical to IFRS 1)
- ▶ Extractive industries (identical to 2009 amendment to IFRS 1 regarding full cost accounting)
- ▶ Deferred tax
 - ▶ Not an exemption in IFRS 1
 - ▶ No recognition if “undue cost and effort”



**CONSIDERATIONS BEFORE
APPLYING IFRS FOR SMEs**

Key considerations

▶ Needs of their own specific users

- ▶ The standard concentrates on items such as short term cash flows, liquidity and balance sheet strength. Full IFRS at times provide too much information for the needs of an SME user.

▶ Impact of tax accounting

- ▶ The requirements surrounding the accounting for and disclosure of **uncertain tax positions**, in particular, may have far-reaching data gathering, documentation and support implications for an SME and could potentially affect its dealings with tax authorities.

Long term considerations

- ▶ **Becoming publicly accountable or possible listing of debt or equity instruments**
 - ▶ An entity with such plans would be precluded from using this standard in the future, as it would fail to meet the definition of an SME.
 - ▶ This would then force the entity into a second diversion to full IFRS.
- ▶ **Reporting to the Holding Company**
 - ▶ If an SME's holding company reports under full IFRS in order to facilitate the consolidation process in its parent company, not adopting this standard may avoid the need for dual reporting.

Long term considerations – Contd.

▶ **Research and Development costs**

- ▶ An entity with heavy research and development expenditure (such as a pharmaceutical company) must consider the fact that none of these costs will be allowed to be capitalised under the IFRS for SMEs.



**APPLICABILITY IN OTHER
COUNTRIES**

Applicability in other countries

- ▶ In its press release of 9 July 2009 the **American Institute of Certified Public Accountants (AICPA)** quoted its President and CEO Barry Melancon as saying “The AICPA welcomes the introduction of IFRS for small and medium entities as an alternative accounting and reporting option for private companies”.
- ▶ The **Accounting Standards Board (ASB) in the United Kingdom** stated in its July press release, “Since 2006, the ASB has been saying that it considers the IFRS for SMEs could play a significant role in the future reporting requirements for UK and Irish entities”. The ASB has since issued a Policy Proposal consultation paper seeking input as to whether this standard should be considered as an alternative to UK GAAP.
- ▶ On 14 August 2009, the **Accounting Practices Board of the South African Institute of Chartered Accountants** endorsed the standard for immediate use in South Africa.

An abstract graphic on a dark grey background. A bright yellow beam of light originates from a point on the left and extends diagonally upwards and to the right. To the left of this beam, a series of vertical white lines of varying lengths form a triangular shape that tapers towards the right, meeting the start of the yellow beam. The text 'APPLICABILITY IN PAKISTAN' is written in bold yellow capital letters in the lower right quadrant of the image.

APPLICABILITY IN PAKISTAN

Status of adoption in Pakistan

- ▶ A review of the IFRS for SMEs (standard) is currently being carried out by the **Accounting Standards Committee** of ICAP
- ▶ A sub-committee has been formed which is in the process of identifying practical difficulties in the transition from MSE Standards to the IFRS for SMEs
- ▶ **Sub-committee** comprises of following members:
 - ▶ Syed Iftikhar Anjum - Convener
 - ▶ Mohammad Almas
 - ▶ Naresh Kumar
 - ▶ Faisal Latif
 - ▶ Muddassar Mehmood
 - ▶ Shabbir Yunus

Status of adoption in Pakistan – Contd.

- ▶ The above Sub-committee has met once and as a result of preliminary discussions, it is being considered that for the purposes of applicability in Pakistan, the following approach be followed:
 - ▶ **Publicly accountable and economically significant entities – IFRS, as applicable in Pakistan**
 - ▶ **Medium sized entities – ICAP's MSE standards will be replaced by IFRS for SMEs**
 - ▶ **Small sized entities – ICAP's SSE standards**
- ▶ Once approved by the ICAP's Council, the standard will be sent to the SECP for necessary adoption and amendments in the Fifth Schedule to the Companies Ordinance, 1984.