

the future of SME accounting



Michael Kavanagh reveals why Irish SMEs must pay close attention to IASB's latest exposure draft.

■ In February, the International Accounting Standards Board (IASB) published what is arguably the most important accounting exposure draft (ED) in many years. But what is so important about an ED issued by the accounting standard setting body whose accounting standards (IAS and IFRS) are not used directly by the majority of SMEs in Ireland?

To put it bluntly the ED – a proposed IFRS for small and medium sized entities (IFRS for SMEs) – could potentially be the accounting standard used by entities ranging in size from the small souvenir shop selling its wares to tourists in scenic Cork to the large multi-million Euro turnover entity headquartered in Dublin with operations stretching from Donegal to Dingle. This is because:

- the ED is applicable for SMEs which do not have public accountability and therefore the scope includes very large as well as very small entities (see 'definition of SME' below)
- whether the accounting standard setter for the UK and Ireland (the ASB) deems the ED as being suitable for use in these jurisdictions will, potentially, be a key determinant of whether, and if so to what extent, the ASB standards will converge with IFRS in the future (discussed in more detail later)

- it is a matter for each EU member state to decide upon which accounting standards SMEs should follow. In that context, the ASB's deliberations on the suitability of the ED for use by SMEs is likely to be influential in Ireland's decision making process in this regard.

definition of SME

The proposed IFRS for SMEs defines SMEs as entities that:

- do not have public accountability
- publish general purpose financial statements for external users. Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

An entity has public accountability (and so should use full IFRSs) if:

- it has issued debt or equity securities in a public market
- it holds assets in a fiduciary capacity for a broad group of outsiders.

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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.

Therefore the title of the ED is somewhat confusing in that the scope of the proposed IFRS for SMEs is wider than just SMEs and would include much larger entities.

overview of the proposed standard

The ED itself is a condensed version of full IFRS which has been achieved by effectively omitting certain topics, reducing some accounting policy options available in full IFRS, simplification of the recognition and measurement principles contained in full IFRS and eliminating much of the explanatory text.

Through this process and methodology the IASB has managed to reduce over 2,200 pages contained in 37 standards and 22 interpretations to 300 pages (excluding the disclosure checklist and illustrative financial statements). This 85% reduction in volume was no mean feat and, while some commentators will undoubtedly have issues with various aspects of the document, the ED goes some way towards achieving the goal of a workable, self-contained set of accounting standards that could allow users to compare an SME's financial performance across international boundaries on a like for like basis.

Other useful aspects of the proposed IFRS for SMEs are that it is structured according to topics, rather than in IAS/IFRS

number sequence, which makes it more user friendly. It also includes a disclosure checklist and illustrative financial statements, both of which are particularly helpful.

topics omitted

The proposed IFRS for SMEs has completely omitted certain topics from the document on the basis that IASB deem them not relevant to typical SMEs. These include:

- general price-level adjusted reporting in a hyper-inflationary environment.
- equity-settled share-based payment
- determining the fair value of agricultural assets
- extractive industries
- interim reporting
- lessor accounting for finance leases
- earnings per share and segment reporting, which are not required disclosures for SMEs.

If an entity has such transactions then they need to refer to the relevant IFRS in full, which is cross-referenced in the ED. However, there is no mandatory fallback to full IFRSs, which is considered significant.

reduction of accounting policy options

Where full IFRSs provide an accounting policy choice, only the simpler option is in the proposed IFRS for SMEs. 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
- 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*).

While the proposed IFRS for SMEs only contains the simpler option, an entity is nevertheless permitted to use the other option by cross-reference to the relevant IFRS in full if it wishes to do so.

simplification of recognition and measurement principles

As well as significant disclosure reductions in the notes to the financial statements there are also significant recognition and measurement simplifications. Examples include:

- a simpler approach to financial instruments – there are two categories of financial assets rather than four and much more simplified hedge accounting tests etc
- goodwill impairment – an indicator approach rather than mandatory annual impairment calculations
- recognise all research and development costs as an 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)
- defined benefit plans – a principle approach rather than the detailed

- calculation and deferral rules of IAS 19 *Employee Benefits*. The 'corridor approach' is omitted
- share-based payment – the intrinsic value method is to be used
- finance leases – simplified measurement of lessees rights and obligations.

the convergence debate

The proposed IFRS for SMEs is of fundamental importance in the context of the ASB's convergence project and is, therefore, of particular relevance in an Irish context. To date, the ASB has consulted on its convergence strategy on three separate occasions (in 2004, 2005 and 2006). In summary, the tentative proposals put forward by the ASB in 2006 were that:

- all publicly quoted and other publicly accountable companies would be required to apply full IFRS, irrespective of turnover and whether they present group accounts or not
- the use of the ASB's Financial Reporting Standard for Smaller Entities (FRSSE), which enables small entities to take advantage of certain simplified requirements, would be extended beyond small companies to include medium-sized entities
- subsidiaries of parent entities that apply full IFRS would also be required to apply full IFRS in respect of measurement and recognition, but with reduced disclosure requirements (not yet defined)
- no definitive proposals were put forward regarding companies that do not fall within categories 1, 2 or 3 immediately above.

Alternatives that were identified, however, included:

- extending the application of the FRSSE further
- applying IFRS to more companies
- maintaining UK GAAP for affected entities
- some combination of these three alternatives.

Responses to the ASB's proposals broadly supported a two-tier approach, with the lower end of the spectrum potentially being based on IASB's SME project. In that context, the ASB stated that once IASB's proposals were published it would consider further whether the proposals are, in its judgement, suitable for the needs of its UK and Irish constituents.

As is clear from the foregoing, the proposed IFRS for SMEs is particularly important to Irish stakeholders and will require detailed consideration for the reasons outlined at the beginning of this article.

ASB consultation paper

Given the importance of the document, in April the ASB issued the proposed IFRS for SMEs in full as a consultation paper, together with an accompanying the ASB's invitation to comment (ITC) on the ED and the potential implications for UK and Irish entities. The ASB published this ITC for two reasons:

- to help inform its response to the IASB on the proposed IFRS for SMEs
- to receive further feedback from constituents as to how the ED might fit into the ASB's strategy for convergence of UK/Irish GAAP with IFRS.

To help constituents, the ITC provides a very helpful analysis of the significant differences between UK/Irish GAAP and the proposed IFRS for SMEs and an analysis of the significant differences between the ASB's existing Financial Reporting Standard for Smaller Entities (FRSSE) and the proposed IFRS for SMEs. It also makes reference to the significant differences between full IFRS and the IFRS for SMEs – as published in the Basis of Conclusions of the IASB's ED.

The ASB is of the opinion that there are three main implications that need to be considered by constituents, namely:

- what other role the proposed IFRS for SMEs may play within the ASB's convergence project i.e. is it suitable for a mid-tier of companies above the current range for the FRSSE but below those

- currently required to apply full IFRS?
- is the IFRS for SMEs an appropriate replacement for the FRSSE?
- if the IFRS for SMEs is to be considered a suitable basis for middle tier companies or as a replacement for the FRSSE, what changes should be made to the ASB version of the IFRS for SMEs in a UK/Irish context?

conclusion

The proposed IFRS for SMEs will form a key component to future discussions on convergence of ASB accounting standards to IFRS as well as being possibly mandatory for certain entities not currently subject to IFRS.

As the Irish Auditing and Accounting Supervisory Authority (IAASA) has a statutory role to act as a specialist source of advice to the minister on accounting matters, to co-operate with interested parties in developing accounting standards and is an observer at the ASB, we will be monitoring developments and contributing to the debate on this important topic. In that context, we would welcome stakeholders' views, which can be e-mailed to info@iaasa.ie.

The ASB consultation paper is available at www.frc.org.uk/asb. While the ASB's deadline for comments passed on 31 July, IASB is inviting comments on the ED until 1 October. You can view this online at www.iasb.ie.

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Any opinions expressed in this article are Michael's own.