IFRS for Small and Medium-sized Entities (SMEs)

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What is IFRS for SMEs?

The July 2009 release of International Financial Reporting Standards (IFRS) for Small and Medium-sized Entities (SMEs) is a major event in the adoption of international standards by U.S. companies. Since the AICPA's May 2008 recognition of the International Accounting Standards Board (IASB) as a standard-setting body, IFRS for SMEs automatically becomes an acceptable basis for accounting in the United States.

Prior to the release of IFRS for SMEs, professionals studying the U.S. adoption of IFRS generally concluded that public companies would lead the way in the U.S. adoption. However, since the SEC has made it clear other problems are more pressing right now, it is quite possible that private companies, not public ones, will lead the U.S. adoption of international standards.

The IASB intended IFRS for SMEs to be the acceptable standard that most companies would use. The standards setters envisioned that companies with ***public accountability*** would use full IFRS and all other for-profit entities would use IFRS for SMEs. The IASB defined public accountability to mean public companies and those holding assets in a fiduciary capacity for outsiders such as banks, credit unions, insurance companies, broker dealers and mutual funds. They defined SMEs as everyone else. Thus, their definition of "small and medium-sized entities" has little to do with size. A huge closely held company might fall under IFRS for SMEs while a small public company might be subject to full IFRS.

The IASB estimates that 95% of the world's for-profit entities would use IFRS for SMEs. The IASB acknowledged that legislatures and standard-setting bodies of each jurisdiction would make the decision about which entities would use each of the two IFRS standards. No international standards yet exist for not-for-profit entities.

What You Need To Know

The good news is that IFRS for SMEs is relatively short. Presented on an odd-sized 6″x 9¾″ paper with a tiny 8.5-point font, the full text runs only 231 pages[1]. This compares to some 2,500 pages for full IFRS and 25,000 pages for U.S. GAAP. IFRS for SMEs is not some severely scaled-down standard designed for third world countries, but a comprehensive principles-based standard.

Other good news is that most of the standards discussed in IFRS for SMEs will seem familiar and common sense to U.S. accountants. There will be few unfamiliar terms[2]. These are among the key provisions:

> **Inventory Valuation** – Inventory under IFRS is valued at lower of cost or selling price less cost to sell (net realizable value). While similar to the "lower of cost or market" used in U.S. GAAP, this is a harder analysis to perform due to the added requirement of estimating selling costs.
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> **Fair Value Accounting for Property, Plant and Equipment (PP&E)**, which is one of the major differences between full IFRS and U.S. GAAP, is not an option under IFRS for SMEs. Using historical cost is the only option. However, this is not the same historical cost methodology used by U.S. GAAP where accountants routinely ignore residual value and employ depreciable lives that sometimes represent merely half of economic reality. Under IFRS historical cost, companies adjust both useful lives and residual value as circumstances change.
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> While it will take most accountants well under an hour to understand the principles of IFRS historical cost accounting for PP&E, the amount of work to implement this standard may be considerable.
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> **Revenue Recognition** for SMEs closely resembles full IFRS, which consists of relatively few principles-based standards. Unlike rule-based U.S. GAAP, IFRS expects accountants to apply and interpret revenue recognition principles to their own company's situation.

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[1] Get the .pdf version from IASB.org. You will be able to read this standard best on a portrait mode monitor at a 150% magnification.

[2] Among these are ***biological assets*** and ***venturer***. ***Biological assets*** are the living products such as livestock, crops and timber of a company engaged in agriculture. A ***venturer*** is a company involved in a joint venture.

Financial Statement Presentation – IFRS for SMEs specifies the following basic financial statements:

- Statement of Financial Position
- Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flows

The standard also provides companies an alternative that allows them to show profit and loss on a separate statement from comprehensive income. In addition, when a company's only changes in equity are to retained earnings and dividends, they may combine the Statement of Changes in Equity with the Income Statement.

The current IFRS standards specify what must appear on financial statements, but not how companies must present them. Current IFRS will have little affect on US financial statement presentation. However, the current FASB/IASB's financial statement formatting joint project could completely remake financial statements as accountants worldwide know them today.

While not well known, despite a prominent article in the November 2008 ***Journal of Accountancy***, this joint project would remake all of the basic financial statements used in the United States today. The project has been controversial, particularly in view that the Statement of Financial Position would no longer reflect a balanced "Assets = Liabilities and Equity" format.

Like the changes to accounting for PP&E, understanding the potential changes to financial statements is likely to be easy when compared to the work involved in implementing the changes. The proposed changes to financial statement formatting are not minor and may require completely different financial reporting software than you are currently using. Thus, companies should only undertake new information technology projects with a full knowledge of these potential financial reporting changes.

Footnotes – IFRS for SMEs specifies Financial Statement footnotes must be in a systematic order and that companies must cross-reference them to the financial statements. This is a common-sense enhancement to financial statement readability.

Plan for the Future

Professionals who follow accounting standards generally agree that the United States will adopt IFRS. The only real issue is when. There also seems to be a consensus that the time accountants spend understanding the new standards will only be a small fraction of the work involved in the conversion effort. Most people estimate that IFRS conversion will involve an effort whose magnitude will rival implementation of Sarbanes-Oxley. Some estimates have been much higher.

Lessons learned from implementations in the United Kingdom tell us that most companies:

- Under-estimated the amount of work involved in converting to IFRS
- Started their conversion projects to late and
- Failed to involve other departments, particularly IT early enough in the process.

While we do not yet know when companies in the United States will convert, we know that it is not too soon to begin thinking about the conversion process in our own companies.

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