February 2007

Basis for Conclusions
SMEs

BASIS FOR CONCLUSIONS ON EXPOSURE DRAFT

IFRS for Small and Medium-sized Entities

Comments to be received by 1 October 2007

International
Accounting Standards
Board®

Basis for Conclusions on Exposure Draft

INTERNATIONAL FINANCIAL REPORTING STANDARD FOR SMALL AND MEDIUM-SIZED ENTITIES

Comments to be received by 1 October 2007

This Basis for Conclusions accompanies the Exposure Draft of the proposed *International Financial Reporting Standard for Small and Medium-sized Entities* (see separate booklet). Comments on the draft standard and its accompanying documents should be sent in writing so as to be received by **1 October 2007**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

ISBN for this part: 978-1-905590-14-8

ISBN for complete publication (three parts): 978-1-905590-16-2

Additional copies of this publication may be obtained from:
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Basis for Conclusions on Draft *International Financial Reporting Standard for Small and Medium-sized Entities*

This Basis for Conclusions accompanies, but is not part of, the draft standard.

Background

BC1 In its transition report of December 2000 to the newly formed International Accounting Standards Board (IASB), the outgoing Board of the International Accounting Standards Committee said 'A demand exists for a special version of International Accounting Standards for Small Enterprises.'

BC2 Shortly after its inception in 2001, the IASB began a project to develop accounting standards suitable for small and medium-sized entities (SMEs). The Board set up a Working Group of experts to provide advice on the issues and alternatives and potential solutions.

BC3 In their 2002 annual report, the Trustees of the IASC Foundation, under which the IASB operates, wrote 'The Trustees also support efforts by the IASB to examine issues particular to emerging economies and to small and medium-sized entities.' In July 2005 the Trustees formalised their support by restating the objectives of the Foundation and the IASB as set out in the Foundation's Constitution. They added an objective that, in developing IFRSs, the IASB should take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies. Similarly, the Standards Advisory Council has consistently encouraged the Board to pursue the project.

BC4 At public meetings of the Board during the second half of 2003 and early 2004, the Board developed some preliminary and tentative views about the basic approach that it would follow in developing IASB accounting standards for SMEs. It tested that approach by applying it to several IFRSs.

Discussion Paper (June 2004)

BC5 In June 2004, the Board published a Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* setting out and inviting comments on the Board's approach. The Board received 120 responses.

BC6 The major issues set out in the Discussion Paper were:

(a) Should the IASB develop special financial reporting standards for SMEs?

(b) What should be the objectives of a set of financial reporting standards for SMEs?

(c) For which entities would IASB standards for SMEs be intended?

(d) If IASB standards for SMEs do not address a particular accounting recognition or measurement issue confronting an entity, how should that entity resolve the issue?

(e) May an entity using IASB standards for SMEs elect to follow a treatment permitted in an IFRS that differs from the treatment in the related IASB standard for SMEs?

(f) How should the Board approach the development of IASB standards for SMEs? To what extent should the foundation of SME standards be the concepts and principles and related mandatory guidance in IFRSs?

(g) If IASB standards for SMEs are built on the concepts and principles and related mandatory guidance in full IFRSs, what should be the basis for modifying those concepts and principles for SMEs?

(h) In what format should IASB standards for SMEs be published?

BC7 At its meetings later in 2004, the Board considered the issues raised by respondents to the Discussion Paper. In December 2004 and January 2005, the Board made some tentative decisions on the appropriate way forward for the project. The responses to the Discussion Paper showed a clear demand for an International Financial Reporting Standard for SMEs (IFRS for SMEs) and a preference, in many countries, to adopt the IFRS for SMEs rather than locally or regionally developed standards. The Board therefore decided to publish an exposure draft of an IFRS for SMEs as the next step.

Recognition and measurement questionnaire and public round tables

BC8 Most respondents to the Discussion Paper said that recognition and measurement simplifications were needed, but few specifics were proposed. And when some specifics were proposed, the commentators generally did not indicate the particular transactions or other events or conditions that create the recognition or measurement problem for SMEs under IFRSs or how that problem might be solved.

BC9 The IASB concluded that it needed further information to assess possible recognition and measurement simplifications. Consequently the Board decided to hold public round-table meetings with preparers and users of the financial statements of SMEs to discuss possible modifications of the recognition and measurement principles in IFRSs for use in an IFRS for SMEs. The Board instructed the staff to develop and publish a questionnaire as a tool to identify issues that should be discussed at those round-table meetings.

BC10 The questionnaire (published April 2005) asked two questions:

1 What are the areas for possible simplification of recognition and measurement principles for SMEs?

2 From your experience, please indicate which topics addressed in IFRSs might be omitted from SME standards because they are unlikely to occur in an SME context. If they occur, the standards would require the SME to determine its appropriate accounting policy by looking to the applicable IFRSs.

BC11 The Board received 101 responses to the questionnaire. Those responses were discussed with the Standards Advisory Council (June 2005), with the SME Working Group (June 2005), World Standard-Setters (September 2005) and at the public round tables held by the Board in October 2005. A total of 43 groups participated in the round-table discussions with the Board over a two-day period.

Board deliberations

BC12 The IASB's Working Group met in June 2005 and made a comprehensive set of recommendations to the Board regarding the recognition, measurement, presentation and disclosure requirements that should be included in an exposure draft of an IFRS for SMEs. Later in 2005, the

Board considered those recommendations and the views expressed in the responses to the Discussion Paper and the questionnaire, and at the round tables. During those deliberations, the Board made tentative decisions about the requirements to be included in the exposure draft.

BC13 On the basis of those tentative decisions, at the Board meeting in January 2006 the staff presented a preliminary draft of the exposure draft. The Working Group met in late January 2006 to review that draft and prepared a report of its recommendations for Board consideration. Board discussion of the draft began in February 2006 and continued through the remainder of 2006. Revised drafts of the exposure draft were prepared for each Board meeting from May onwards.

BC14 This Basis for Conclusions sets out the principal issues addressed by the Board, the alternatives considered, and the Board's reasons for accepting some alternatives and rejecting others.

Why global financial reporting standards for SMEs?

BC15 Global financial reporting standards, applied consistently, enhance the comparability of financial information. Accounting differences can obscure the comparisons that investors, lenders and others make. By resulting in the presentation of high quality comparable financial information, high quality global financial reporting standards 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.

BC16 The benefits of global financial reporting standards are not limited to entities whose securities are traded in public capital markets. In the Board's judgement, small and medium-sized entities—and those who use their financial statements—can benefit from a common set of accounting standards. SMEs' financial statements that are comparable from one country to the next are needed for the following reasons:

(a) Financial institutions make loans across borders and operate multinationally. 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 and in establishing terms and interest rates.

(b) Vendors want to evaluate the financial health of buyers in other countries before they sell goods or services on credit.

(c) Credit rating agencies try to develop ratings uniformly across borders. Similarly, banks and other institutions that operate across borders often develop ratings in a manner similar to credit rating agencies. Reported financial figures are crucial to the rating process.

(d) Many SMEs have overseas suppliers and use a supplier's financial statements to assess the prospects of a viable long-term business relationship.

(e) Venture capital firms provide funding to SMEs across borders.

(f) 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 have interests in other SMEs.

Should the IASB develop standards for SMEs?

BC17 In deciding to develop an IFRS for SMEs, the IASB was mindful of the following issues:

(a) Should financial reporting standards for SMEs be developed by others?

(b) Do national standard-setters support the IASB developing an IFRS for SMEs?

(c) Is developing an IFRS for SMEs consistent with the Board's mission?

(d) Existing IFRSs make some distinctions for SMEs.

Should others do it?

BC18 The Board considered whether financial reporting standards for SMEs would best be developed by others—either globally, country by country, or perhaps at a regional level—while the IASB focused its efforts primarily on standards for entities that participate in public capital markets. However, the Board noted that its mission, as set out in its Constitution (see paragraph BC21), is not restricted to standards for entities that participate in public capital markets. Focusing only on those entities is likely to result in standards or practices for other entities (including

SMEs) that may not address the needs of external users of financial statements, are not consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements* or standards, may lack comparability across national boundaries or within a country, and may not allow for an easy transition to full IFRSs for entities that wish to enter the public capital markets. For those reasons, the Board decided to undertake the project.

Do national standard-setters support an IASB initiative?

BC19 National accounting standard-setters throughout the world support the IASB's initiative. In September 2003 the IASB hosted a meeting of the world's national accounting standard-setters. In preparation for that meeting the Board surveyed them about standards for SMEs. With near-unanimity, the standard-setters that responded said that the IASB should develop global standards for SMEs.

BC20 The Board discussed the progress on its project on standards for SMEs at subsequent meetings of the world's national accounting standard-setters in 2004–2006. Standard-setters continued to support the Board's project.

An IFRS for SMEs is consistent with the IASB's mission

BC21 Developing a set of standards for SMEs is consistent with the IASB's mission. The principal objective of the IASB, as set out in its Constitution and in the *Preface to International Financial Reporting Standards*, is 'to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions'. 'Single set' means that all entities in similar circumstances globally should follow the same standards. The circumstances of SMEs can be different from those of larger, publicly accountable entities in several ways, including:

(a) the users of the entity's financial statements and their information needs;

(b) how the financial statements are used;

(c) the depth and breadth of accounting expertise available to the entity; and

(d) SMEs' ability to bear the costs of following the same standards as the larger, publicly accountable entities.

Existing IFRSs include some differences for non-public entities

BC22 IFRSs include several differences for entities whose securities are not publicly traded. For example:

(a) IFRS 8 *Operating Segments* requires disclosure of segment information only by entities whose debt or equity instruments are traded or registered for trading in a public market.

(b) IAS 27 *Consolidated and Separate Financial Statements* exempts some parent entities from preparing consolidated financial statements if their debt or equity instruments are not traded in a public market. Similar exemptions are in IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*.

(c) IAS 33 *Earnings per Share* requires presentation of earnings per share data only by entities whose ordinary shares or potential ordinary shares are publicly traded.

Different users' needs and cost-benefit considerations

BC23 The *Framework* (paragraph 12) states:

> The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

In establishing standards for the form and content of general purpose financial statements, the needs of users of financial statements are paramount.

BC24 Users of financial statements of SMEs may have less interest in some information in general purpose financial statements prepared in accordance with full IFRSs than users of financial statements of entities whose securities are listed for trading in public securities markets or that otherwise have public accountability. For example, users of financial statements of SMEs may have greater interest in short-term cash flows, liquidity, balance sheet strength and interest coverage, and in the historical trends of earnings and interest coverage, than they do in information that is intended to assist in making forecasts of an entity's long-term cash flows, earnings and value. However, users of financial statements of SMEs may need some information that is not ordinarily presented in the financial statements of listed entities. For example, as an alternative to the public capital markets, SMEs often obtain capital from shareholders, directors and suppliers, and shareholders and directors often pledge personal assets so that the SME can obtain bank financing.

BC25 In the Board's judgement, the nature and degree of the differences between full IFRSs and an IFRS for SMEs must be determined on the basis of users' needs and cost-benefit analyses. In practice, the benefits of applying accounting standards differ across reporting entities, depending primarily on the nature, number and information needs of the users of their financial statements. The related costs may not differ significantly. Therefore, consistently with the *Framework*, the Board believed that the cost-benefit trade-off should be assessed in relation to the information needs of the users of an entity's financial statements.

BC26 The Board faced a dilemma in deciding whether to develop an IFRS for SMEs. On the one hand, it believed that the same concepts of financial reporting are appropriate for all entities regardless of public accountability—particularly the concepts for recognising and measuring assets, liabilities, income and expenses. This suggested that a single set of accounting standards should be suitable for all entities, although it would not rule out disclosure differences based on users' needs and cost-benefit considerations. On the other hand, the Board acknowledged that differences in the types and needs of users of SMEs' financial statements, as well as limitations in, and the cost of, the accounting expertise available to SMEs, suggested that separate standards for SMEs are appropriate. Those separate standards could include constraints such as linkage back to the *Framework*, consistent definitions of elements of financial statements and focus on the needs of users of financial statements of SMEs. On balance, the Board concluded that the latter approach (separate standards) was appropriate.

Adoption of an IFRS for SMEs does not imply that full IFRSs are not appropriate for SMEs

BC27 The Board believes that the objective of financial statements as set out in the *Framework* is appropriate for SMEs as well as for entities required to apply full IFRSs. The objective of providing information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions is applicable without regard to the size of the reporting entity. Therefore, standards for general purpose financial statements of entities with public accountability would result in financial statements that meet the needs of users of financial statements of all entities, including those without public accountability. The Board is aware of research that shows that over 50 jurisdictions currently require or permit SMEs to use full IFRSs.

The objective of the proposed *IFRS for SMEs*

Why determination of taxable income and determination of distributable income are not specific objectives of the proposed *IFRS for SMEs*

BC28 IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities. General purpose financial statements are directed towards the common information needs of a wide range of users, for example, shareholders, creditors, employees and the public at large. General purpose financial statements are intended to meet the needs of users that are not in a position to demand reports tailored to their particular information needs. General purpose financial statements provide information about an entity's financial position, performance and cash flows.

BC29 Determining taxable income requires special purpose financial statements—ones designed to comply with the tax laws and regulations in a particular jurisdiction. Similarly, an entity's distributable income is defined by the laws and regulations of the country or other jurisdiction in which it is domiciled.

BC30 Tax authorities are also often important external users of the financial statements of SMEs. Almost invariably, tax authorities have the power to demand whatever information they need to meet their statutory tax assessment and collection obligations. Tax authorities often look to financial statements as the starting point for determining taxable income, and some have policies to minimise the adjustments to accounting profit or loss for the purpose of determining taxable income. Nonetheless, global accounting standards for SMEs cannot deal with tax reporting in individual jurisdictions. 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 a 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.

Why it is not the purpose of the proposed *IFRS for SMEs* to provide information to owner-managers to help them make management decisions

BC31 Owner-managers use SMEs' financial statements for many purposes. However, 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.) Nonetheless, general purpose financial statements will often also serve managers' needs by providing insights into the business's financial position, performance and cash flows.

BC32 SMEs often produce financial statements only for the use of owner-managers, or for tax reporting or other non-securities regulatory filing purposes. Financial statements produced solely for those purposes are not necessarily general purpose financial statements.

The entities for which the proposed *IFRS for SMEs* is intended and those for which it is not intended

BC33 One of the first issues confronting the Board was to describe the class of entities for which the proposed *IFRS for SMEs* would be intended. The Board recognised that, ultimately, decisions on which entities should use the *IFRS for SMEs* will rest with national regulatory authorities and standard-setters. However, a clear definition of the class of entity for which the *IFRS for SMEs* is intended is essential so that:

(a) the Board can decide on the standards that are appropriate for that class of entity, and

(b) national regulatory authorities, standard-setters, reporting entities and their auditors will be informed of the intended scope of applicability of the *IFRS for SMEs*.

In that way, jurisdictions will understand that there are some types of entities for which the proposed *IFRS for SMEs* is not intended.

BC34 In the Board's judgement, the proposed *IFRS for SMEs* is appropriate for an entity that does not have public accountability. An entity has public accountability (and therefore should use full IFRSs) if:

(a) it files, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or

(b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity.

Entities whose securities are traded in a public market have public accountability

BC35 Public securities markets, by their nature, bring together entities that seek capital and investors who are not involved in managing the entity and who are considering whether to provide capital, and at what price. Although those public investors often provide longer-term risk capital, they do not have the power to demand the financial information they might find useful for investment decision making. They must rely on general purpose financial statements. An entity's decision to enter a public capital market makes it publicly accountable—and it must provide the outside investors with financial information. Governments recognise this public accountability by establishing laws, regulations and regulatory agencies that deal with market regulation and disclosures to investors in public securities markets.

Financial institutions have public accountability

BC36 Similarly, banks, insurance companies, securities broker/dealers, pension funds, mutual funds and investment bankers stand ready to hold and manage financial resources entrusted to them by a broad group of clients, customers or members who are not involved in the management of the entities. Because such an entity acts in a public fiduciary capacity, it is publicly accountable. In most cases, these institutions are regulated by laws and government agencies.

SMEs that provide an essential public service

BC37 In the Discussion Paper, the Board's tentative view was that, in addition to the two conditions cited in paragraph BC34, an entity also has public accountability if it is a public utility or similar entity that provides an essential public service.

BC38 Most respondents to the Discussion Paper, and also the Working Group, pointed out that in many jurisdictions entities that provide public services can be very small—for example, refuse collection companies, water companies, local power generating or distribution companies, and local cable television companies. Respondents argued that the nature of the users of the financial statements, rather than the nature of the business activity, should determine whether full IFRSs should be required. The Board concurred.

SMEs that are economically significant in their home jurisdiction

BC39 In the Discussion Paper, the Board's tentative view was that, in addition to the two conditions cited in paragraph BC34, an entity also has public accountability if it is economically significant in its home country on the basis of criteria such as total assets, total income, number of employees, degree of market dominance and nature and extent of external borrowings.

BC40 Most respondents, and the Working Group, argued that economic significance does not automatically result in public accountability. Public accountability, as that term is used in paragraphs 1.1 and 1.2, refers to accountability to those present and potential resource providers and others external to the entity who make economic decisions but who are not in a position to demand reports tailored to meet their particular information needs. The Board concluded that economic significance may be more relevant to matters of political and societal accountability. Whether such accountability requires general purpose financial statements using full IFRSs is a matter best left to local jurisdictions to decide.

Approval by owners to use the proposed *IFRS for SMEs*

BC41 In the Discussion Paper, the Board's tentative view was that 100 per cent of the owners of a small or medium-sized entity must agree before the entity could use the proposed *IFRS for SMEs*. The objection of even one owner of an entity to the use of the *IFRS for SMEs* would be sufficient evidence of the need for that entity to prepare its financial statements on the basis of full IFRSs. Most respondents did not agree. In their view, an objection, or even a non-response, by one or a few shareholders does not make an entity publicly accountable. They thought that the two criteria of (a) publicly traded and (b) financial institution appropriately identify entities with public accountability. The Board found those arguments persuasive.

SMEs that are a subsidiary, associate or joint venture of an IFRS investor

BC42 In the Discussion Paper, the Board's tentative view was that if a subsidiary, joint venture or associate of an entity with public accountability prepares financial information in accordance with full IFRSs to meet the requirements of the parent, venturer or investor, it should be required to comply with full IFRSs, not the *IFRS for SMEs*, in its separate financial statements. In the Board's view, because the information in accordance with full IFRSs had been produced for other purposes, it would be more costly to prepare a second set of financial statements that comply with the *IFRS for SMEs*. Most respondents to the Discussion Paper did not agree. Many said that the IFRS data produced for consolidation or equity accounting purposes have a different materiality threshold from that necessary for the investee's own financial statements. Moreover, they said that the circumstances of the entity, rather than the circumstances of its parent or investor, should determine whether it has public accountability. Consequently, they argued, it would be costly and burdensome for the investee to have to apply full IFRSs in its own financial statements. The Board found those arguments persuasive. Therefore, SMEs should assess their eligibility to use the *IFRS for SMEs* on the basis of their own circumstances, even if they also submit financial information in accordance with full IFRSs to a parent, venturer or investor.

Quantified size criteria

BC43 The definition of SMEs does not include quantified size criteria for determining what is a small or medium-sized entity. The Board noted that its standards are used in over 100 countries. The Board concluded that it is not feasible to develop quantified size tests that would be applicable and long-lasting in all of those countries. This is consistent with the Board's general principle-based approach to standard-setting.

BC44 In deciding which entities should be required or permitted to use the *IFRS for SMEs*, jurisdictions may prescribe quantified size criteria. Similarly, a jurisdiction may decide that entities that are economically significant in that country should be required to use full IFRSs rather than the *IFRS for SMEs*.

Suitability of the proposed *IFRS for SMEs* for very small entities—the so-called 'micros'

BC45 In deciding on the content of the proposed *IFRS for SMEs*, the IASB focused on a typical entity with about 50 employees. The Board 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 explicitly addressed in the proposed *IFRS for SMEs*. The Board'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.

BC46 Some contend that an IFRS for SMEs that is designed to cover the typical transactions, events and conditions of SMEs with about 50 employees is not suitable for a very small 'micro' entity employing one, two or three people that is required, or elects, to publish general purpose financial statements for external users. The Board did not agree. 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 information 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.

BC47 Some who question whether the proposed *IFRS for SMEs* will be suitable for micros argue that many micro entities prepare financial statements solely to submit to income tax authorities for the purpose of determining taxable income. As explained more fully in paragraphs BC28–BC30, determining taxable income (and also determining legally distributable income) requires special purpose financial statements—ones designed to comply with tax laws and regulations in a particular jurisdiction.

BC48 Moreover, the Board noted that, in many countries, full IFRSs are required for all or most limited liability companies, including the micros. The Board also noted that many other countries permit the micros to use full IFRSs. As mentioned in paragraph BC27, well over 50 jurisdictions have decided that full IFRSs should be required or permitted for all entities, including 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 draft *IFRS for SMEs* is simple and straightforward. That guidance may cover some transactions or circumstances that micro SMEs do not typically encounter, but the Board did not believe that this imposes a burden on micro SMEs. The topical organisation of the proposed *IFRS for SMEs* will make it easy for micro SMEs to identify those aspects of the standard that are relevant to their circumstances.

BC49 Some favour a very simple and brief set of accounting requirements for micro SMEs—with broad principles of accrual basis accounting (some even suggest a cash basis or modified cash basis), specific recognition and measurement principles for only the most basic transactions, and requiring perhaps only a balance sheet and an income statement with limited note disclosures. The Board acknowledged that this approach might result in relatively low costs to SMEs in preparing financial statements. However, the Board concluded that the resulting statements would not meet the objective of decision-usefulness because they would not provide useful information about the entity's financial position, performance and changes in financial position that is useful to a wide range of users in making economic decisions. Moreover, the Board believed that financial statements prepared using such a simple and brief set of accounting requirements might not serve SMEs by improving their ability to obtain capital. Therefore, the Board concluded that it should not develop this type of IFRS for SMEs.

BC50 The IASB does not have the power to require any entity to use its standards. That is the responsibility of legislators and regulators. In some countries, the government has delegated that power to an independent standard-setter or to the professional accountancy body. They will have to decide which entities should be required or permitted to use, or perhaps prohibited from using, the *IFRS for SMEs*. The Board believes that the proposed *IFRS for SMEs* will be suitable for all entities that do not have public accountability, including micros.

The proposed *IFRS for SMEs* is not intended for small publicly-traded entities

BC51 Entities, large or small, whose debt or equity instruments are traded in public capital markets have chosen to seek capital from outside investors who are not involved in managing the business and who do not have the power to demand information that they might find useful. Full IFRSs have been designed to serve public capital markets by providing disclosures and guidance especially intended for investors and creditors in such markets. Some of those disclosures and some of that guidance is not included in the draft *IFRS for SMEs*. The Board concluded, therefore, that full IFRSs are appropriate for an entity with public accountability.

BC52 A jurisdiction that believes that the *IFRS for SMEs* is appropriate for small publicly traded entities in that jurisdiction could incorporate the requirements of the *IFRS for SMEs* into its national standards for small publicly-traded entities. In that case, however, the financial statements would be described as conforming to national GAAP. The draft IFRS for SMEs proposes to prohibit them from being described as conforming to the IFRS for SMEs.

'Small and medium-sized entities'

BC53 'Small and medium-sized entities' (SMEs) as used by the IASB is defined in Section 1 *Scope* of the draft *IFRS for SMEs*. Many jurisdictions have developed their own definitions of the term for a broad range of purposes including prescribing financial reporting obligations. Often those national or regional definitions include quantified criteria based on revenue, assets, employees or other factors. Frequently, the term is used to mean or to include very small entities without regard to whether they publish general purpose financial statements for external users.

BC54 The IASB considered whether to use another term, and used the term 'non-publicly accountable entity' (NPAE) for several months during 2005. Because the Board concluded that full IFRSs are necessary for entities with public accountability, the terms 'publicly accountable entity' and 'non-publicly accountable entity' had some appeal. However, constituents argued that this term is not widely recognised, whereas 'small and medium-sized entities' (SMEs) is universally recognised. Also, some said that 'non-publicly accountable entities' seemed to imply that the smaller entities were not accountable. Furthermore, in July 2005 the Trustees of the IASC Foundation restated the objectives of the Foundation and the IASB as set out in the Foundation's Constitution by adding objective (c), which uses the term 'small and medium-sized entities':

> The objectives of the IASC Foundation are:
>
> (a) to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

(b) to promote the use and rigorous application of those standards;

(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

(d) to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

For these reasons, the Board decided to use 'small and medium-sized entities'.

The users of SMEs' financial statements prepared using the proposed *IFRS for SMEs*

BC55 The proposed *IFRS for SMEs* is intended for non-publicly accountable entities that publish general purpose financial statements for external users. The main groups of external users include:

(a) banks that make loans to SMEs.

(b) vendors that sell to SMEs and use SMEs' financial statements to make credit and pricing decisions.

(c) credit rating agencies and others that use SMEs' financial statements to rate SMEs.

(d) customers of SMEs that use SMEs' financial statements to decide whether to do business.

(e) SMEs' shareholders that are not also managers of their SMEs.

The extent to which the proposed *IFRS for SMEs* should be a stand-alone document

BC56 As explained above, the proposed *IFRS for SMEs* is intended to be a stand-alone document for a typical small entity with about 50 employees. There will be occasions, however, when the *IFRS for SMEs* will require or permit entities to look to full IFRSs:

(a) When IFRSs provide an accounting policy option, the Board concluded that SMEs should have the same options. The simpler option is included in the draft *IFRS for SMEs* (see paragraphs BC108–BC115). The other option or options are permitted by cross-reference to IFRSs.

(b) The draft *IFRS for SMEs* omits some accounting topics that are addressed in full IFRSs, because the Board believes that typical SMEs are not likely to encounter such transactions (see paragraphs BC57–BC65). However, the draft has cross-references requiring SMEs that encounter such a transaction to look to a particular IFRS or to a section of one.

(c) The draft *IFRS for SMEs* states that if the standard does not address a transaction or other event or condition or provide a cross-reference back to another IFRS, an entity should select an accounting policy that results in relevant and reliable information. In making that judgement, an entity should consider, first, the requirements and guidance in the proposed *IFRS for SMEs* dealing with similar and related issues and, second, the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 *Concepts and Pervasive Principles* of the draft standard. If that does not provide guidance, the entity may look to the requirements and guidance in IFRSs, including Interpretations of IFRSs, dealing with similar and related issues.

Topics covered in IFRSs that are omitted from the draft *IFRS for SMEs*

BC57 Some hold the view that the *IFRS for SMEs* should be completely stand-alone—that an entity applying it should never have to look to full IFRSs. The Board concluded that, for that to be the case, the *IFRS for SMEs* would have to be significantly longer than the draft because it would have to address those transactions and circumstances that SMEs sometimes, although not typically, encounter. Paragraphs BC58–BC65 identify the topics that are not covered in the draft *IFRS for SMEs*, but for which it includes a cross-reference to the relevant IFRS that an entity would be required to apply if it encountered the transaction or situation.

Hyperinflation

BC58 Section 29 *Financial Reporting in Hyperinflationary Economies* would require SMEs whose functional currency is the currency of a hyperinflationary economy to apply IAS 29 *Financial Reporting in Hyperinflationary Economies* in preparing and presenting financial statements in accordance with the *IFRS for SMEs*. The draft *IFRS for SMEs* does not include requirements on reporting in hyperinflationary economies because it is uncommon for SMEs to have a hyperinflationary functional currency.

Equity-settled share-based payment

BC59 Section 25 *Share-based Payment* would require SMEs to apply IFRS 2 *Share-based Payment* in measuring equity-settled share-based payment transactions, and to make the relevant disclosures required by IFRS 2. The Board believes that it is uncommon for SMEs to enter into such transactions.

Agriculture

BC60 Section 35 *Specialised Industries* would require SMEs engaged in agricultural activities to apply the fair value model in paragraphs 10–29 of IAS 41 *Agriculture* to account for those biological assets whose fair value is readily determinable, and to make all related disclosures required by IAS 41. Although many entities that undertake agricultural activities are SMEs, typical SMEs are unlikely to undertake those activities.

Interim financial reporting

BC61 Section 37 *Interim Financial Reporting* would give SMEs that issue an interim financial report that is described as complying with the *IFRS for SMEs* a choice of applying either IAS 34 *Interim Financial Reporting* or all of the requirements of the proposed *IFRS for SMEs*. The Board concluded that most SMEs either would not issue interim financial reports or would issue interim financial reports that are not described as complying with the *IFRS for SMEs*.

Lessor accounting for finance leases

BC62 Section 19 *Leases* would require SMEs that are a lessor in a finance lease to apply paragraphs 36–46 of IAS 17 *Leases* and to make the related disclosures required by IAS 17. Many lessors in a finance lease are likely to be financial institutions that are publicly accountable and, thus, would not be eligible to use the proposed *IFRS for SMEs*.

Earnings per share

BC63 Section 34 *Earnings per Share* would not require SMEs to present amounts of earnings per share. However, if SMEs chose to disclose earnings per share, Section 34 would require them to follow the requirements of IAS 33 *Earnings per Share*.

Segment reporting

BC64 Section 31 *Segment Reporting* would not require SMEs to present segment information. However, if SMEs chose to disclose segment information, Section 31 would require them to follow the requirements of IFRS 8 *Operating Segments*.

Insurance

BC65 Because an insurer holds assets in a fiduciary capacity for a broad group of outsiders, it has public accountability and is therefore outside the definition of SMEs in paragraph 1.1. The proposed *IFRS for SMEs* is not intended for, and would not be available for use by, insurers.

Why the *Framework* and principles and mandatory guidance in existing IFRSs are the appropriate starting point for developing the proposed *IFRS for SMEs*

BC66 The draft *IFRS for SMEs* was developed by:

(a) extracting the fundamental concepts from the *Framework* and the principles and related mandatory guidance from IFRSs (including Interpretations), and

(b) considering the modifications that are appropriate in light of users' needs and cost-benefit considerations.

BC67 The Board judged that this approach is appropriate because the needs of users of financial statements of SMEs are similar in many ways to the needs of users of financial statements of publicly accountable entities. Therefore, full IFRSs are the logical starting point for developing an *IFRS for SMEs*.

BC68 The Board rejected the alternative 'fresh start' approach because that approach could have resulted in different objectives of financial reports, different qualitative characteristics of financial information, different definitions of the elements of financial statements, and different concepts of recognition and measurement. The Board concluded that a 'fresh start' approach would be costly and time-consuming and ultimately futile. This is because the Board is of the view that there is sufficient convergence of users' needs relative to the general purpose financial statements of entities with and without public accountability.

BC69 Several of the sections in the draft *IFRS for SMEs* relate to projects currently on the IASB's agenda. For several of those projects an exposure draft has been published. They include:

(a) Section 3 *Financial Statement Presentation* relates to the Exposure Draft of Proposed Amendments to IAS 1—*A Revised Presentation*.

(b) Section 18 *Business Combinations and Goodwill* relates to the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*.

(c) Section 20 *Provisions and Contingencies* relates to the Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(d) Section 24 *Borrowing Costs* relates to the Exposure Draft of Proposed Amendments to IAS 23 *Borrowing Costs*.

(e) Glossary definitions of liabilities and equity relate to the Exposure Draft of Proposed Amendments to IAS 32 and IAS 1—*Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*.

Because exposure drafts are proposals on which the IASB's due process is not yet complete, the starting point for developing the *IFRS for SMEs* is existing IFRSs that do not reflect the proposed changes under consideration.

Recognition and measurement simplifications

BC70 Paragraphs BC71–BC93 explain the significant simplifications that the Board proposes to the recognition and measurement principles in IFRSs, and the reasons for the proposals. The Board also discussed other recognition and measurement simplifications but decided not to adopt them (see paragraphs BC94–BC107).

Financial instruments

BC71 Many said that the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* are burdensome for SMEs. They cited as especially burdensome for SMEs the complexities of classifying financial instruments into four categories, the 'pass-through' and 'continuing involvement' tests for derecognition, and the detailed calculations required to qualify for hedge accounting. The Board agreed that simplifications of IAS 39 are appropriate for SMEs.

BC72 Much of the complexity in IAS 39 results from permitting entities to choose from a range of measurement attributes for financial instruments. Those choices reduce comparability and impose measurement complexity. The draft *IFRS for SMEs* enhances comparability and reduces complexity by defining a default measurement attribute and limiting the use of other measurement attributes.

BC73 Principal among the simplifications proposed in the draft *IFRS for SMEs* are the following:

(a) *Classification of financial instruments*. Financial instruments that meet specified criteria are measured at cost or amortised cost, and all others are measured at fair value through profit or loss. The available-for-sale and held-to-maturity classifications in IAS 39 are not available, thereby reducing the complexities associated with the two additional categories, including assessment of intentions, forecasts of cash flows, and accounting 'penalties' in some cases.

(b) *Derecognition*. The draft proposes a simple principle for derecognition. That principle does not rely on the 'pass-through' and 'continuing involvement' provisions that apply to derecognition under IAS 39. Those provisions are complex and relate to derecognition transactions in which SMEs are typically not engaged.

(c) *Hedge accounting*. The draft focuses on the types of hedging that SMEs are likely to do, specifically hedges of:

- interest rate risk of a debt instrument measured at amortised cost;
- foreign exchange risk or interest rate risk in a firm commitment or a highly probable forecast transaction;
- price risk of a commodity that it holds or in a firm commitment or a highly probable forecast transaction to purchase or sell a commodity; or
- foreign exchange risk in a net investment in a foreign operation.

BC74 With regard to hedge accounting, the draft *IFRS for SMEs* would require periodic recognition and measurement of hedge ineffectiveness, but under less strict conditions than those in IAS 39. In particular, ineffectiveness is recognised and measured at the end of the financial reporting period, and hedge accounting is discontinued prospectively starting from that point, for hedges that no longer meet the conditions for hedge accounting. IAS 39 would require discontinuation of hedge accounting prospectively starting at the date the conditions were no longer met—a requirement that SMEs often say they find burdensome.

BC75 As an alternative to simplified effectiveness testing, the Board considered an approach that is in the US standard SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* and is called the 'shortcut method'. Under such a method, the *IFRS for SMEs* would impose strict conditions on the designation of a hedging relationship with subsequent hedge effectiveness assumed without need for measuring ineffectiveness. The Board concluded that simplified effectiveness testing is preferable to the shortcut method for two principal reasons:

(a) Recognition of all hedge ineffectiveness in profit or loss is a basic principle of IAS 39. The shortcut method is inconsistent with that principle.

(b) To be able to assume that the possibility of hedge ineffectiveness is nil or insignificant, the key features of the hedging instrument and the hedged item, including the term, would have to match, and there could be no conditional terms. Consequently, hedge accounting would be prohibited if the hedging instrument is prepayable or puttable or has other early termination or extension features. Such a requirement would, in effect, make hedge accounting a practical impossibility for many, and perhaps most, SMEs.

BC76 Section 11 also differs from IAS 39 with respect to hedge accounting in the following ways:

(a) Hedge accounting cannot be achieved by using debt or equity instruments ('cash instruments') as hedging instruments. IAS 39 permits this for a hedge of a foreign currency risk. However, the same effect on profit or loss can be achieved by measuring the cash instrument at fair value, which Section 11 requires for some cash instruments and permits for others. SMEs typically sell the cash hedging instrument when the hedging relationship terminates.

(b) Hedge accounting cannot be achieved with an option-based hedging strategy. Because hedging with options involves incurring a cost, SMEs are more likely to use forward contracts as hedging instruments rather than options.

(c) Hedge accounting for portfolios is not permitted. Hedging portfolios adds considerable accounting complexity because of the need to remeasure all of the hedged items individually at fair value to ensure that the appropriate amounts are derecognised when the instrument is sold and to ensure that the amortisation is appropriate when an instrument is no longer being hedged.

The Board does not believe that these simplifications will affect SMEs adversely because these are not hedging strategies that are typical of SMEs.

BC77 Contracts to buy, sell, lease or insure a non-financial item such as a commodity, inventory, property, plant or equipment are accounted for as financial instruments within the scope of Section 11 if they could result in a loss to the buyer, seller, lessor, lessee or insured party as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates, or a default by one of the counterparties. Such contracts are accounted for as financial instruments because their terms include a financial risk component that alters the settlement amount of the contract that is unrelated to the purchase or sale of, or leasing or insuring, the non-financial item.

BC78 Section 11 proposes to give SMEs a choice of following Section 11 or IAS 39 in accounting for all of their financial instruments. The Board's reasons for proposing that choice in this case are as follows:

(a) Although Section 11 is a simpler approach to accounting for financial instruments than IAS 39, some of the simplifications involve eliminating options that are available to companies with public accountability under IAS 39, for instance:

   (i) available-for-sale classification and the available-for-sale option;

   (ii) held-to-maturity classification;

   (iii) a continuing involvement approach to derecognition (ie partial derecognition); and

   (iv) the use of hedge accounting for hedges other than the four specific types identified in paragraph BC73(c).

   In general, the draft *IFRS for SMEs* would permit SMEs to have the same accounting policy options as in full IFRSs.

(b) Because the proposed default category for financial instruments is fair value through profit and loss under the *IFRS for SMEs*, and cost or amortised cost is permitted only when specified conditions are met, some items measured at cost or amortised cost under IAS 39 because of their nature would be measured at fair value through profit or loss under the *IFRS for SMEs*. Some SMEs might find this added fair valuation burdensome.

(c) Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. Those entities generally believe that the available-for-sale classification of IAS 39 is appropriate to account for strategic investments. Under the draft *IFRS for SMEs*, however, these strategic investments would be accounted for at fair value through profit or loss.

(d) The derecognition provisions of the draft *IFRS for SMEs* would not result in derecognition for many securitisations and factoring transactions that SMEs may enter into, whereas IAS 39 would result in derecognition.

Goodwill impairment

BC79 In their responses to the recognition and measurement questionnaire and at the round-table meetings, many preparers and auditors of SMEs' financial statements said that the requirement in IFRS 3 *Business Combinations* for an annual calculation of the recoverable amount of goodwill is onerous for SMEs because of the expertise and cost involved. They proposed, as an alternative, that SMEs should be required to calculate the recoverable amount of goodwill only if impairment is indicated. They proposed, further, that the *IFRS for SMEs* should include a list of indicators of impairment of goodwill as guidance for SMEs. The Board agreed with those proposals. The draft *IFRS for SMEs* proposes an indicator approach and includes a list of indicators based on both internal and external sources of information.

BC80 Some respondents to the questionnaire and some of those who took part in the round-table discussions proposed requiring amortisation of goodwill over a specified maximum period. Proposals generally ranged from 10 to 20 years. They argued that amortisation is simpler than an impairment approach, even an impairment approach that is triggered by indicators. The Board did not agree with this proposal for three main reasons:

(a) An amortisation approach still requires assessment of impairment, so it is actually a more complex approach than an indicator-triggered assessment of impairment.

(b) Amortisation is the systematic allocation of the cost (or revalued amount) of an asset, less any residual value, to reflect the consumption over time of the future economic benefits embodied in that asset over its useful life. By its nature, goodwill often has an indefinite life. Thus, if there is no foreseeable limit on the period during which an entity expects to consume the future economic benefits embodied in an asset, amortisation of that asset over, for example, an arbitrarily determined maximum period would not faithfully represent economic reality.

(c) When the IASB was developing IFRS 3, and related amendments to IAS 38 *Intangible Assets*, most users of financial statements said they found little, if any, information content in the amortisation of goodwill over an arbitrary period of years.

Treat all research and development costs as expenses

BC81 IAS 38 requires all research costs to be charged to expense when incurred, but development costs incurred after the project is deemed to be commercially viable are to be capitalised. Many preparers and auditors of SMEs' financial statements said that SMEs do not have the resources to assess whether a project is commercially viable on an ongoing basis and, furthermore, capitalisation of only a portion of the development costs does not provide useful information. Bank lending officers told the Board that information about capitalised development costs is of little benefit to them, and that they disregard those costs in making lending decisions.

BC82 The Board accepted those views, and the draft *IFRS for SMEs* proposes an accounting policy choice (not available under IAS 38) for treating all research and development costs as expenses. Alternatively, SMEs would be permitted to apply the requirements of IAS 38 by cross-reference to that IFRS.

Cost method for associates and joint ventures

BC83 IAS 28 requires an entity to account for its investments in associates by the equity method. IAS 31 allows an entity to account for its investments in jointly controlled entities by either the equity method or proportionate consolidation. Many preparers of SMEs' financial statements questioned the usefulness of both of those accounting methods and told the Board that SMEs have particular difficulty in applying those methods because of inability to obtain the required information and the need to conform accounting policies and reporting dates. In their view, the cost method—which is permitted under IAS 28 and IAS 31 in accounting for investments in associates and joint ventures in the investor's separate financial statements—should also be permitted under the *IFRS for SMEs* in the investor's consolidated financial statements. Lenders generally indicated that information reported using the equity method and proportionate consolidation is of limited use to them because it is not useful in assessing either future cash flows or loan security. Fair values are more relevant for those purposes. Recognising the special problems of SMEs in applying the equity and proportionate consolidation methods, and also the relevance of fair values for lenders, the Board concluded that SMEs should be permitted to use either the cost method or fair value through profit or loss.

Income taxes—'timing differences plus' approach

BC84 In their responses to the questionnaire and at the round-table meetings, many preparers and auditors of SMEs' financial statements said that the temporary difference approach to accounting for income taxes in IAS 12 *Income Taxes* is difficult for SMEs to implement. They said that SMEs do not routinely prepare 'tax balance sheets' and generally do not track the tax bases of many assets. Some advocated a 'current taxes payable' method of accounting for income taxes, under which SMEs would not recognise deferred taxes.

BC85 The Board did not support the 'current taxes payable' approach for the reasons explained in paragraph BC102. However, while believing that the principle of recognising deferred tax assets and liabilities is appropriate for SMEs, the Board also concluded that implementation of that principle could be simplified for SMEs. Section 28 of the draft *IFRS for SMEs* uses the 'temporary difference approach' of IAS 12 for recognition of deferred taxes. However, it explains temporary differences in terms of 'timing differences', which many SMEs and their auditors indicated is not burdensome for SMEs, and adds requirements to recognise deferred taxes in several additional cases. With respect to the initial recognition of deferred taxes on the first-time adoption of the *IFRS for SMEs*, the draft proposes relief for SMEs if recognising the deferred taxes would involve undue cost or effort. Section 28 does not include an exception to recognition of deferred taxes on undistributed earnings of domestic subsidiaries, branches, associates and joint ventures because that exception is inconsistent with the simplified general principles in paragraphs 28.15 and 28.16.

Less fair value for agriculture

BC86 Some preparers and auditors of the financial statements of SMEs engaged in agricultural activities said that the 'fair value through profit or loss' model is burdensome for SMEs, particularly when applied to biological assets of those SMEs operating in inactive markets or developing countries. They said that the presumption in IAS 41 that fair value can be estimated for biological assets and agricultural produce is unrealistic with respect to biological assets of some SMEs. Some proposed that SMEs should be permitted or required to use a 'cost-depreciation-impairment' model for all such assets. The Board did not support this approach for the reasons explained in paragraph BC103. However, the Board concluded, both because of the measurement problems in inactive markets and developing countries and for cost-benefit reasons, that SMEs should be required to use the fair value through profit or loss model only when fair value is readily determinable without undue cost or effort. When that is not the case, the Board concluded that SMEs should follow the cost-depreciation-impairment model.

Employee benefits—defined benefit plans

BC87 The Board initially planned not to include in the proposed *IFRS for SMEs* any guidance on accounting for defined benefit plans, on the grounds that few SMEs have such plans. The *IFRS for SMEs* would have included a cross-reference to the requirements of IAS 19 *Employee Benefits* for those 'atypical' SMEs that had such plans. However, many people told the Board that in some countries the law requires SMEs to provide benefits to employees under terms that are equivalent to a defined benefit pension plan (eg long-service payments based on future salaries). They recommended that the *IFRS for SMEs* should include accounting requirements for such plans based on, but simplified from, those in IAS 19. The Board concurred.

BC88 One of the principal complexities of IAS 19 is recognition of actuarial gains and losses. Under IAS 19, an entity can:

(a) recognise actuarial gains and losses in full in profit or loss when they occur.

(b) recognise actuarial gains and losses in full directly in equity when they occur, but only if the entity presents those gains and losses in a statement titled 'statement of recognised income and expense' that does not include equity transactions with owners (ie not a traditional statement of changes in equity).

(c) amortise the excess of actuarial gains and losses over the greater of

    (i) 10 per cent of the present value of the defined benefit obligation at that date (before deducting plan assets) and

    (ii) 10 per cent of the fair value of any plan assets at that date

    (with those limits calculated and applied separately for each defined benefit plan) divided by the average remaining working life of the employees.

(d) recognise actuarial gains and losses in profit or loss using any systematic method that results in faster recognition than (c) above.

BC89 The draft *IFRS for SMEs* proposes to require method (a)—immediate recognition in profit or loss. Of the four methods identified in the preceding paragraph, this is the simplest method for SMEs to implement. Method (b) requires preparation of a financial statement that most SMEs do not normally prepare. Methods (c) and (d) require tracking of data over many years and annual calculations. Moreover, financial statement users generally have told the Board that they find immediate recognition (method (a)) provides the most understandable and useful information, in addition to simplicity.

BC90 Some preparers of SMEs' financial statements expressed support for recognising actuarial gains and losses directly in equity. That is not method (b). Nor is it what is now permitted by IAS 19 as a result of the amendments to IAS 19 issued in December 2004. Those amendments require the actuarial gains or losses to become part of equity only after they have been recognised in a statement of recognised income and expense. The Board did not favour introducing a new option in the proposed *IFRS for SMEs*—direct recognition in equity bypassing a statement of recognised income and expense.

Share-based payment

BC91 IFRS 2 provides relief for SMEs, and that relief is carried forward in the draft *IFRS for SMEs*. For equity-settled share-based payment transactions with employees, IFRS 2 generally requires measurement by reference to the fair value of the equity instruments granted. However, if the entity is unable to estimate reliably the fair value of the equity instruments granted at the measurement date, IFRS 2 provides for measurement of the equity instruments at their intrinsic value. In developing the draft *IFRS for SMEs*, the Board concluded that IFRS 2 provides appropriate simplifications for SMEs.

Leases

BC92 Paragraph 19.8 requires a lessee to measure rights and obligations under a finance lease at an amount equal to the fair value of the leased property. IAS 17 *Leases* requires an entity in the same circumstances to make two measurements—both the fair value of the leased property and the present value of the minimum lease payments—and to use the lower of the two. Thus Section 19 *Leases* retains the fundamental recognition principle in IAS 17 while simplifying the measurement.

Transition to the *IFRS for SMEs*

BC93 IFRS 1 *First-time Adoption of International Financial Reporting Standards* requires an entity's first IFRS financial statements to include at least one year of comparative information under IFRSs. Some preparers and auditors of SMEs' financial statements explained to the Board that a requirement to prepare restated prior period data in all cases would be burdensome for SMEs adopting the *IFRS for SMEs* for the first time. Thus, the draft *IFRS for SMEs* proposes an 'impracticability' exemption. Similarly, it provides an impracticability exemption with respect to some requirements for restating the opening balance sheet.

Simplifications considered but not adopted

BC94 In developing the draft *IFRS for SMEs*, the Board considered some recognition and measurement simplifications that it decided not to adopt. Some of those potential simplifications were identified in existing national accounting standards for SMEs. Some were proposed by the Board's constituents in their responses to the Discussion Paper or the recognition and measurement questionnaire in 2005. Those proposals, and the Board's reasons for rejecting them, are described in paragraphs BC95–BC107.

Not to require a cash flow statement

BC95 Some suggested that the Board should not require SMEs to prepare a cash flow statement. Some who held this view believed that preparing a cash flow statement is burdensome. Some contended that users of SMEs' financial statements do not find the cash flow statement useful.

BC96 The Board noted that if a comparative balance sheet (with amounts for the beginning and the end of the reporting period) and an income statement are available, preparing a cash flow statement is not a difficult, time-consuming or costly task. The accounting frameworks of most jurisdictions require broad groups of entities, including SMEs, to prepare a cash flow statement. Moreover, the great majority of lenders and other users of SMEs' financial statements who have communicated with the Board—including particularly lenders and short-term creditors—indicated that the cash flow statement is useful to them.

Treat all leases as operating leases

BC97 Under IAS 17, a lessee's rights and obligations under a lease are not recognised in the balance sheet if the lease is classified as an operating lease. Although lessees obtain rights and incur obligations under all leases, finance leases create obligations substantially equivalent to those arising when an asset is purchased on credit. Information about such assets and obligations is important for lending and other credit decisions. Lenders consistently say that they do not want 'off balance sheet obligations'.

Treat all employee benefit plans as defined contribution plans

BC98 As with leases, users of financial statements are concerned about 'off balance sheet obligations'. As noted in paragraph BC87, many jurisdictions require SMEs by law to provide benefits that are the equivalent of a defined benefit pension plan—for example, long-service benefits. Users of SMEs' financial statements consistently say that information about the funding status of such obligations is useful and important to them.

Completed contract method for long-term contracts

BC99 The completed contract method can produce a potentially misleading accounting result for a long-term contractor, with some years of large profits and other years of large losses. Many construction contractors are SMEs. The fluctuation between years of large profit and years of large losses may be magnified for SMEs because they tend to have fewer contracts than larger entities. Users of financial statements have told the Board that, for a long-term contractor, the percentage of completion method provides information that they find more useful than the completed contract method.

Fewer provisions

BC100 Provisions are liabilities of uncertain timing or amount. Despite the uncertainties, they are obligations that have met the liability recognition criteria. Users of SMEs' financial statements consistently say they want these obligations recognised in the balance sheet, with the measurement uncertainties explained.

Non-recognition of share-based payment

BC101 Non-recognition is inconsistent with the definitions of the elements of financial statements, especially an expense. Moreover, users of financial statements generally hold the view that share-based payments to employees should be recognised as remuneration expense because (a) they are intended as remuneration, (b) they involve giving something of value in exchange for services, and (c) the consumption of the employee services received is an expense. However, Section 25 *Share-based Payment* proposes to retain the provisions of IFRS 2 for simplified measurement for SMEs using the intrinsic value method.

Non-recognition of deferred taxes

BC102 Some respondents to the questionnaire and some of those who took part in the public round-table discussions supported the 'taxes payable method' of accounting for income taxes. Under that method, only income taxes currently payable or refundable are recognised; deferred taxes are not recognised. Many users of SMEs' financial statements disagree with the taxes payable method. They point out that deferred taxes are liabilities (or sometimes assets) that can result in large outflows (inflows) of cash in the near future and, therefore, should be recognised. Even those users of financial statements who do not agree that deferred tax liabilities or deferred tax assets should be recognised generally 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, but would be inconsistent with the principles for recognising assets and liabilities in the *Framework*. The Board concluded that making a fundamental departure from the recognition principles in IAS 12 *Income Taxes* while requiring disclosure of the information that users of SMEs' financial statements find useful is not justified on a cost-benefit basis. Moreover, the Board believes that deferred taxes satisfy the requirements for recognition as assets and liabilities and can be measured reliably.

Cost model for all agriculture

BC103 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. Moreover, managers of most SMEs that undertake agricultural activities say that they manage on the basis of market prices or other measures of current value rather than historical costs. Users also question the meaningfulness of allocated costs in this industry.

No consolidated financial statements

BC104 In many countries, SMEs are organised into two or more legal entities for tax or other legal reasons, even though they operate as one economic entity. Investors, lenders and other users of SMEs' financial statements say that they find information about the financial position, operating results and cash flows of the economic entity useful for their decisions. They say they cannot use the separate financial statements of the legal entities because those entities often enter into transactions with each other that are not necessarily structured or priced on an arm's length basis. In such circumstances, the amounts reported in the separate statements reflect internal transactions (eg sales between the legal entities) that are not transactions of the economic entity with other economic entities. Also, the entities are often jointly managed, and loans are cross-collateralised. In the Board's judgement, consolidated statements are essential for users when two entities operate as a single economic entity.

Recognition of foreign exchange gains and losses and revaluation increases in profit or loss

BC105 The draft *IFRS for SMEs* proposes that SMEs should recognise items of income or expense directly in equity in only two circumstances:

(a) Paragraph 11.37 provides that SMEs shall recognise changes in the fair value of some hedging instruments directly in equity.

(b) Paragraph 30.13 provides that, in consolidated financial statements, SMEs shall recognise directly in equity a foreign exchange difference (gain or loss) arising on a monetary item that forms part of the reporting entity's net investment in a foreign operation (subsidiary, associate or joint venture).

Additionally, SMEs that choose the revaluation model either for a class of property, plant and equipment (see paragraph 16.13) or for a class of intangible assets (see paragraph 17.23) would credit increases in the asset's carrying amount directly to equity as a revaluation surplus.

BC106 In developing the draft *IFRS for SMEs*, the Board considered whether to require SMEs to recognise the foreign exchange gains or losses and revaluation increases in profit or loss, rather than directly in equity. This would be consistent with the accounting for actuarial gains and losses on defined benefit plans proposed in Section 27 *Employee Benefits*. It would also be consistent with one of the two approaches proposed in the Exposure Draft of Proposed Amendments to IAS 1—*A Revised Presentation* (published March 2006). Under that approach, all components of income and expense recognised in a period would be presented in a single statement of recognised income and expense. Recognising foreign exchange gains or losses and revaluation increases in profit or loss would also be substantially consistent with the second proposed approach in that Exposure Draft. That approach would present all components of income and expense recognised in a period in two statements but would not permit any components of income and expense (ie non-owner changes in equity) to be presented in the statement of changes in equity. The Board concluded, however, that because the proposed amendments to IAS 1 are not final, the draft *IFRS for SMEs* should not reflect those proposals.

BC107 Because the Board has begun a comprehensive project on financial instruments as part of its convergence efforts with the US Financial Accounting Standards Board, the Board did not consider requiring SMEs to recognise changes in the fair value of all hedging instruments in profit or loss at this time.

All options in IFRSs should be available in the *IFRS for SMEs*. Jurisdictions can remove options

BC108 Full IFRSs include some accounting policy options (choices). Generally, for a given transaction, event or condition, one of the options is simpler to implement than the other(s). The Board considered whether the *IFRS for SMEs* should eliminate all accounting policy options and, therefore, require all SMEs to follow a single accounting policy for a given transaction, event or condition. The benefits of doing so would be simplification of the *IFRS for SMEs* and greater comparability of the resulting financial information among SMEs using the *IFRS for SMEs*. Although the Board found those benefits appealing, it concluded that prohibiting SMEs from using an accounting policy option that is available to entities using full IFRSs could hinder comparability between SMEs and entities applying full IFRSs.

BC109 The Board recognised that most SMEs are likely to prefer the simpler option in full IFRSs. Therefore, the Board concluded that when full IFRSs allow accounting policy options, the *IFRS for SMEs* should include only the simpler option, and the other (more complex) option(s) should be available to SMEs by cross-reference to the full IFRS. This policy has been implemented in the circumstances described in paragraphs BC110–BC115.

Investment property

BC110 The draft *IFRS for SMEs* provides guidance for the cost-depreciation-impairment model of accounting for investment property. The fair value through profit or loss model would be permitted by cross-reference to IAS 40.

Property, plant and equipment

BC111 The draft *IFRS for SMEs* provides guidance for the cost-depreciation-impairment model of accounting for property, plant and equipment. The revaluation model would be permitted by cross-reference to IAS 16.

Intangible assets

BC112 The draft *IFRS for SMEs* provides guidance for the cost-depreciation-impairment model of accounting for intangible assets. The revaluation model would be permitted by cross-reference to IAS 38.

Borrowing cost

BC113 The draft *IFRS for SMEs* provides guidance for the expense model of accounting for borrowing cost. The capitalisation model would be permitted by cross-reference to IAS 23 *Borrowing Costs*.

Presenting operating cash flows

BC114 The draft *IFRS for SMEs* provides guidance for the indirect method of presenting cash flows from operations. The direct method would be permitted by cross-reference to IAS 7 *Cash Flow Statements*. The direct method is not more difficult for an SME than the indirect method. However, although professional financial analysts generally favour the direct method, the majority of bank lenders and other users of financial statements of SMEs expressed a preference for the indirect method for SMEs. They said that the indirect method provides insights into SMEs' accrual accounting. For that reason, the draft *IFRS for SMEs* provides for the indirect method.

Accounting for government grants

BC115 The draft *IFRS for SMEs* provides guidance for one method of accounting for government grants (essentially the model in IAS 41 *Agriculture*). SMEs would be permitted to use the other methods permitted by IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* by cross-reference to IAS 20.

Optional reversion to full IFRSs by an entity using the *IFRS for SMEs*

BC116 The Board considered whether an entity using the proposed *IFRS for SMEs* should be allowed to choose to apply a recognition or measurement principle permitted in a full IFRS that differs from the principle required by the related section of the draft *IFRS for SMEs*.

BC117 Some proposed that the *IFRS for SMEs* should, in effect, contain 'optional simplifications of IFRSs'. Within this group, there were two schools of thought:

(a) One school would permit SMEs to revert to full IFRSs principle by principle, while otherwise continuing to use the *IFRS for SMEs*.

(b) The second school would permit SMEs to revert to full IFRSs in their entirety, standard by standard but not principle by principle, while otherwise continuing to use the *IFRS for SMEs*. Those who hold this view believe that the recognition and measurement principles in a full IFRS are so interrelated that they should be regarded as an integrated package.

BC118 The alternative view is that an entity should be required to choose only either the complete set of IFRSs or the complete *IFRS for SMEs*. The Board is of that view. Allowing SMEs optionally to revert to full IFRSs either principle by principle or standard by standard, while continuing to follow the IFRS for SMEs for other transactions and circumstances, would result in significant non-comparability. Undesirably, SMEs would have almost an infinite array of combinations of accounting policies from which to choose. As explained in paragraphs BC108–BC115, the draft *IFRS for SMEs* includes some accounting policy options—those that exist in full IFRSs.

Disclosure simplifications

BC119 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:

(a) Some disclosures are not included because they relate to topics covered in IFRSs that are omitted from the draft *IFRS for SMEs* (see paragraphs BC57–BC65).

(b) Some disclosures are not included because they relate to recognition and measurement principles in full IFRSs that have been replaced by simplifications proposed in the draft IFRS (see paragraphs BC70–BC93).

(c) Some disclosures are not included because they relate to options that are not included in the draft *IFRS for SMEs* but are available to SMEs by explicit cross-reference to the full IFRS (see paragraphs BC108–BC115).

(d) Some disclosures are not included on the basis of users' needs or cost-benefit considerations (see paragraphs BC25, BC26 and BC120).

BC120 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 Board was guided by the following broad principles:

(a) 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.

(b) 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.

(c) Information on measurement uncertainties is important for SMEs.

(d) Information about an entity's accounting policy choices is important for SMEs.

(e) Disaggregations of amounts reported on the face of SMEs' financial statements are important for an understanding of those statements.

(f) 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.

Why a separate volume rather than added sections in each IFRS

BC121 The Board saw merit in two approaches—publishing the *IFRS for SMEs* in a separate volume and publishing a separate section in each individual IFRS (including Interpretations). The principal advantages of the separate volume are:

(a) ease of use for those seeking to apply the *IFRS for SMEs*. If the *IFRS for SMEs* addresses the transactions, events and conditions typically encountered by SMEs with around 50 employees, much of the material in full IFRSs would not normally have application for SMEs.

(b) the *IFRS for SMEs* can be drafted in a simplified language without the details that are needed in full IFRSs.

BC122 The advantages of including the requirements for SMEs as a separate section of each IFRS (including Interpretations) include:

(a) the modifications or exemptions are highlighted.

(b) to the extent that SMEs must look to full IFRSs, putting both the requirements for SMEs and the related full standards in one place is more user-friendly.

(c) it would reduce the likelihood that, in drafting IASB standards for SMEs, an unintended difference will arise between an IFRS and the related requirements in the *IFRS for SMEs*.

BC123 Respondents to the Discussion Paper generally favoured the separate volume approach. On balance the Board agreed for the reasons outlined in paragraph BC121.

Why organisation by topic

BC124 The Board saw merit both in numbering the requirements for SMEs similarly to full IFRSs and in topical organisation. Using the same numbering system as full IFRSs would enable a user to link back to the full IFRS to seek further guidance on an accounting question. Topical organisation, on the other hand, would make the IFRS for SMEs more like a reference manual, which is likely to be the way that people would use it, and thus it would be more user-friendly. Indexing could minimise the benefits of one of those approaches over the other. Providing the IFRS for SMEs in electronic form could also minimise the benefits of one approach over the other. Most respondents to the Discussion Paper favoured organisation by topic. On balance the Board found the benefits of a topically organised reference manual persuasive.

The Board's plan for maintaining (updating) the *IFRS for SMEs*

BC125 In the Discussion Paper, the Board expressed a tentative view that, 'once the initial set of IASB Standards for SMEs is in place, concurrently with each exposure draft of an IFRS and each draft Interpretation, and most likely as part of those documents, the Board will propose the related IASB Standard or Interpretation for SMEs. The effective dates of the new or revised IASB Standards for SMEs would probably be the same as the effective date of the new or revised IFRSs (including Interpretations).' In general, respondents to the Discussion Paper did not agree with this approach. They explained that because SMEs do not have internal accounting resources or the ability to hire accounting advisers on an ongoing basis, the IFRS for SMEs should be updated only periodically, perhaps only once each two or three years. They also noted that not every new IFRS or Interpretation or amendment to an IFRS (including Interpretations) will affect the IFRS for SMEs. On the basis of users' needs or cost-benefit considerations, some of those changes may be relevant only for full IFRSs. Furthermore, there may be some changes to the IFRS for SMEs that are appropriate even if full IFRSs are not changed.

BC126 The principal benefits of considering changes to the IFRS for SMEs at the same time as each new IFRS is proposed or each amendment to an existing IFRS is proposed are consistency of consideration both by the Board and respondents, avoiding a time lag between when changes affect full IFRSs and when similar changes affect the IFRS for SMEs, and avoiding potentially differing standards in full IFRSs and the IFRS for SMEs.

BC127 On balance, the Board found the arguments set out in paragraph BC125 for periodic, rather than contemporaneous, updating of the IFRS for SMEs generally persuasive. However, the Board also concluded that there might be matters for which amendment of the IFRS for SMEs will be necessary more frequently than once in several years. Paragraph 16 of the Preface to the draft *IFRS for SMEs* explains the Board's plan for maintaining the *IFRS for SMEs*.

Alternative view on the proposed *International Financial Reporting Standard for Small and Medium-sized Entities*

AV1 One Board member voted against the publication of the Exposure Draft of the proposed *International Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)*. That Board member's alternative view is set out below.

AV2 The Board member believes that the proposed *IFRS for SMEs* is neither necessary nor desirable. It is unnecessary because the vast majority of accounting policy decisions of an SME are straightforward and extensive reference to IFRSs will not be required and, when required, not burdensome.

AV3 It is undesirable because the proposed IFRS would produce non-comparable information. SMEs will not be comparable with each other and will not be comparable with publicly accountable entities. That result is inconsistent with the IASB *Framework* and the Concepts and Pervasive Principles of the proposed IFRS.

AV4 Non-comparability will result because the proposed IFRS would allow SMEs, as a result of paragraph 10.3, to ignore the requirements of other IFRSs even when the specific accounting issue is addressed in those IFRSs. If an entity is satisfied with the result of applying paragraph 10.3(a) and (b) there is never a requirement to look to full IFRSs. Thus, identical transactions can be accounted for differently by different SMEs and differently from publicly accountable entities. If the Board finds it necessary to develop educational materials to assist SMEs in applying IFRSs, that would certainly be appropriate. However, this Board member believes that in all circumstances IFRSs should ultimately be the source of accounting guidance for all entities.

AV5 This Board member does not believe that the Board has demonstrated the need to make modifications to recognition and measurement requirements in IFRSs for application by SMEs on the basis of either cost-benefit analysis or user needs. Alternatively, the Board member would much more extensively modify the disclosure requirements to meet special user needs. That modification might well create disclosures not required at present, such as information about economic dependency, although many of the presentation and disclosure requirements proposed in the Exposure Draft seem unnecessary.

AV6 This Board member also believes that the Exposure Draft is inconsistent with the Constitution of the International Accounting Standards Committee Foundation and the *Preface to International Financial Reporting Standards*. Those documents set out an objective of a single set of accounting standards taking account of the special needs of small and medium-sized entities and emerging economies. The Board member accepts that objective but does not believe it implies separate sets of standards for entities in differing circumstances as indicated in paragraph BC21. The conclusion of that paragraph suggests that many sets of accounting standards would be appropriate depending on different circumstances.