

## Proposed financial reporting standards for small and medium-sized entities

### - comparability of financial statements and yet simpler accounting?

Many consider the Exposure Draft (ED) of an International Financial Reporting Standard (IFRS) for small and medium-sized entities (SMEs) as one of the most important current projects of the International Accounting Standards Board (IASB).

The potential for take-up of this standard is much higher than that of the full IFRS because of the vast number of SMEs in most countries.

An identical ED had been issued in Singapore. Currently, companies in Singapore are generally required to prepare their financial statements in accordance with the Singapore Financial Reporting Standards (SFRS). These are based on the IFRS, with a few minor differences.

There is an emerging view that the full-blown IFRS is designed for larger, listed companies. Other companies, many of these small and medium-sized, need something simpler that will meet the users' needs and at the same time justify the costs to the companies to produce their financial statements.

In this issue, we look at the ED on the IFRS for SMEs issued for comments by the IASB and the identical ED issued by the Singapore Council on Corporate Disclosure and Governance (CCDG). We hope that the discussion in this publication will set you thinking about whether the level of simplification that it offers in relation to accounting and disclosure, would be appropriate to the needs of preparers and end users.

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## Exposure Draft of the IFRS for SMEs

CCDG has issued an equivalent ED of an IFRS for SMEs in Singapore on 7 March 2007. The CCDG has invited comments on the ED by 1 September 2007.

We are carefully considering the proposals laid out in this ED, in order to provide comments to the CCDG. Please get in touch with your usual KPMG contacts if you would like to discuss your views about the exposure draft with us or would like us to consider your comments in our response.

## A. Proposed financial reporting standards for small and medium-sized entities

### Who can use the proposed standard for SMEs?

The ED proposes that SMEs be defined as entities that publish general purpose financial statements for external users, but do not otherwise have public accountability. An entity has public accountability and should use the full SFRS (or IFRS) if:

- it has issued debt or equity securities in a public market such as the Singapore Stock Exchange (SGX), or
- it holds assets in a fiduciary capacity for a broad group of outsiders (e.g. a bank or insurance company).

The ED has not used size limits to define the entities within its scope, although in deciding the content of the proposed IFRS for SMEs, the IASB focused on a typical entity with about 50 employees.

### What is the likelihood of the IFRS for SMEs being imposed or permitted in Singapore?

Quite likely. However, although the CCDG has issued the same ED in Singapore for comments, there is at present no timetable or official statement to the effect that the IFRS for SMEs will become effective in Singapore.

The IASB had stated that national regulators should decide which entities would be permitted or required to comply with the IFRS for SMEs in their jurisdictions. Given that currently all companies in Singapore (with limited exceptions) are already required to comply with the full IFRS, an important factor in CCDG's consideration of whether Singapore would adopt the IFRS for SMEs in Singapore would be the level of acceptance of the IFRS for SMEs internationally. However, the relative complexity of the draft standard may limit its usefulness internationally, particularly in developing economies.

### How were the proposals in the ED of IFRS for SMEs determined?

The draft standard is intended to be a stand-alone document, consisting of 38 topics. The draft standard was developed by extracting the fundamental concepts from the IASB Framework along with the principles and related mandatory guidance from IFRS. Thereafter, the IASB eliminated topics that are not generally relevant to SMEs and simplifies methods of recognition and measurement.

As a result, this has reduced the volume of accounting guidance by 85 percent when compared to the full IFRS. It is, however, still 250 pages long with a further 80 pages of guidance notes (including Illustrative Financial Statements and Disclosure Checklists).

Although the accounting principles are intended to be the same as the full IFRS, the draft standard contains significantly less guidance than the full IFRS. The ED largely omits the paragraphs in IFRS explaining the principles, worked examples, application guidance and the basis for conclusions. Therefore, even when the general principles in the proposal appear to be the same as the full IFRS, differences in application may result.

### What were the simplifications made in the ED of IFRS for SMEs?

There are a number of recognition and measurement simplifications proposed in the ED aimed at reducing the compliance costs of SMEs. We set out some examples below:

Simplifications proposed	Implications
<p data-bbox="341 555 901 589"><b>Financial assets and financial liabilities</b></p> <p data-bbox="341 589 901 795">There are only two categories of financial assets (amortised cost or fair value through profit or loss) rather than four. There is no need to deal with all of the “intent-driven” held-to-maturity rules or accounting “penalties”. There is also no need for an available-for-sale option.</p> <p data-bbox="341 929 901 1108">The principle for de-recognition of financial assets and financial liabilities have been simplified. The simplified principle does not rely on the complex ‘pass-through’ and ‘continuing involvement’ provisions in the full IFRS.</p> <p data-bbox="341 1131 901 1243">Hedge accounting has also been simplified. However, the ED allows hedge accounting only for limited risks and limited hedging instruments.</p>	<p data-bbox="901 589 1463 728">More financial instruments may be required to be measured at fair value. This is due to the more stringent criteria for financial instruments to be measured at amortised cost.</p> <p data-bbox="901 728 1463 907">Companies that want to have the option of recognising fair value differences in equity (available-for-sale category) would have to adopt the more complex IAS 39 <i>Financial Instruments: Recognition and Measurement</i> in its entirety.</p> <p data-bbox="901 929 1463 1131">The reason for simplification is because the complex provisions in the full IFRS relate to de-recognition transactions and hedging transactions in which SMEs are typically not engaged. This simplification could result in different accounting treatment from companies applying the full IFRS.</p>
<p data-bbox="341 1254 901 1288"><b>Impairment</b></p> <p data-bbox="341 1288 901 1400">For goodwill, the impairment test needs to be performed only if an indicator of impairment exists.</p> <p data-bbox="341 1489 901 1624">For non-financial assets other than goodwill, the impairment loss would be calculated by reference to fair value less costs to sell. The ED makes no reference to the concept of value in use.</p>	<p data-bbox="901 1288 1463 1467">This is likely to reduce the amount of work required in performing an impairment test, as the full IFRS requires an impairment test to be performed at least annually, even if no indicator of impairment exists.</p> <p data-bbox="901 1489 1463 1668">This could lead to more volatility in the income statement, as the fair value of certain assets may be more volatile than the value in use. This results in increased instances of impairment recognition.</p>
<p data-bbox="341 1680 901 1713"><b>Research and development costs</b></p> <p data-bbox="341 1713 901 1917">All research and development costs are expensed. Alternatively, SMEs would be permitted to apply the requirements set out in the full IFRS. That is, development costs incurred after the project is deemed to be commercially viable are to be capitalised.</p>	<p data-bbox="901 1713 1463 1848">SMEs need not devote resources to assess whether a project is commercially viable on an ongoing basis to comply with the accounting standards.</p>

Simplifications proposed (continued)	Implications
<p><b>Associates and joint ventures</b></p> <p>SMEs may account for their investments in associated entities and joint ventures at cost in the consolidated financial statements; rather than using the equity or proportionate consolidation methods.</p>	<p>The IASB offers this simplification to alleviate the difficulty SMEs face in obtaining the required information coupled with the need to conform accounting policies and reporting dates. However, significant reductions in compliance costs might not actually arise. This is because SMEs are required to disclose summarised financial information with information about an investor's ownership in its associates.</p>

**What were the simplifications considered but not adopted in the ED of IFRS for SMEs?**

A common reaction to the ED is that more should be done to simplify the IFRS for SMEs. This is so that small companies can reap more benefits of moving to the IFRS for SMEs. We set out below some of the simplifications considered by the IASB that were not adopted.

Simplifications proposed but not adopted	IASB's reasons for rejection
Not to require a cash flow statement	Preparing a cash flow statement is not a difficult, time-consuming or costly task. Users of SMEs' financial statements had indicated that the cash flow statement is useful.
Treat all leases as operating leases	Finance leases create obligations substantially equivalent to those arising when an asset is purchased on credit. Lenders consistently say that they do not want 'off balance sheet obligations'.
Completed contract method for long-term contracts	Completed contract method can produce a potentially misleading accounting result. The percentage of completion method provides information that users find more useful.
Non-recognition of share-based payment	Non-recognition is inconsistent with the definition of an expense. Users of financial statements generally hold the view that share-based payments to employees should be recognised as a remuneration expense.

Simplifications proposed but not adopted (continued)	IASB's reasons for rejection
Non-recognition of deferred tax	Deferred taxes are liabilities (or sometimes assets) that can result in large cash outflows (or inflows) of cash in the near future, and therefore, should be recognised.
No consolidated financial statements	Users find consolidated financial statements useful, as entities often enter into transactions with each other that are not necessarily structured or priced on an arm's length basis.
Amortisation of goodwill	An amortisation approach still requires assessment of impairment, so it is actually more complex. In addition, goodwill often has an indefinite life and thus amortising goodwill over an arbitrarily determined period would not faithfully represent economic reality.

**What are the key topics that were omitted in the ED of IFRS for SMEs?**

IFRS topics not relevant to a typical SME are omitted. However, these omissions have minimal effect in reducing the compliance cost of SMEs as:

- Some of the topics were already not required for non-publicly accountable entities in the full IFRS; such as interim reporting, earnings per share and segment reporting; and
- SMEs are still required to look to the full IFRS if they have transactions that were omitted in the ED of IFRS for SMEs, such as equity-settled share-based payment and lessor accounting for finance leases.

**Where full IFRS provide an accounting policy option, is the choice still available to SMEs?**

In its discussion, the IASB concluded that where full IFRS allows accounting policy options, the IFRS for SMEs should include only the simpler option. The other (more complex) option(s) should be available to SMEs by cross-reference to the full IFRS. For example, the cost model for property, plant and equipment is included in the ED, but the revaluation model is allowed by reference to the full IFRS.

This reduces the length of the IFRS for SMEs, but does not have any effect in reducing the compliance cost of SMEs.

**How should an SME account for a transaction where specific accounting guidance is not available in the IFRS for SMEs?**

The ED does not require a mandatory 'fallback' to full IFRS when transactions encountered are not dealt with in the IFRS for SMEs. Rather, the ED proposes a hierarchy that requires an SME to consider the applicability of the following sources of guidance in the following order:

- The requirements and guidance elsewhere in the IFRS for SMEs dealing with similar and related issues.
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles contained in the IFRS for SMEs.

**How will amendments be made to the IFRS for SMEs?**

The IASB proposes that updates to the IFRS for SMEs would only occur approximately once every two years. Each omnibus ED will consider any new or amended IFRS that has been adopted in the two previous years, as well as any issues specific to SMEs.

It is hoped that with this approach, SMEs would not have to acquire internal accounting resources or hire accounting advisers on an ongoing basis to cope with the constant changes in the full IFRS.

**Where do we go from here?**

The comment deadline on the IASB's ED is 1 October 2007. The deadline for the equivalent ED issued by the CCDG is 1 September 2007. The CCDG will consider all responses received in their response to the IASB. The debate over the drafting and content of the eventual standard is likely to continue for some time after this. Now is however the best time to influence it.

A final standard is expected to be issued in mid-2008, and is not expected to be effective before 1 January 2009.

## D. Developments in international standards and interpretations

### IASB's projects overview

Refer to *IFRS Briefing Sheet – Issue 65* for details.

This IFRS Briefing Sheet summarises the status of the current projects of the IASB. The project summaries set out a description of each project and the major areas of existing IFRSs that may be affected by the project. The latest estimates of the timing for completion are also noted.

Some of the key projects that are expected to be published in 2007 are:

Project overview	Timing
<p><b>Business combinations phase II: application of the purchase method (convergence with US GAAP)</b></p> <p>This project will introduce substantial change to the accounting for acquisitions. For example, if an acquirer owns less than 100 percent of the equity interests of an acquiree, then goodwill attributable to the non-controlling (minority) interest (NCI) would be recognised.</p>	<p>A final standard is expected in the third quarter of 2007.</p>
<p><b>Consolidation and minority interests (convergence with US GAAP)</b></p> <p>This project would affect how NCI are accounted for:</p> <ul style="list-style-type: none"> <li>• Losses would be allocated to NCI without limit</li> <li>• Changes in NCI that do not involve a change in control cannot be recognised in the income statement</li> <li>• A re-measurement of any remaining NCI in a former subsidiary to fair value upon loss of control would be required.</li> </ul>	<p>A final standard is expected in the third quarter of 2007.</p>
<p><b>Financial instruments puttable at fair value</b></p> <p>The following instruments (that are currently classified as a liability) would be classified as equity:</p> <ul style="list-style-type: none"> <li>• those that are puttable at fair value of a pro-rata share of the net assets of an entity</li> <li>• those that require an entity to deliver a pro-rata share of its net assets upon liquidation.</li> </ul>	<p>A final standard is expected in the third quarter of 2007.</p>
<p><b>Income taxes (convergence with US GAAP)</b></p> <p>Convergence issues considered include the definition of a tax base, removing the exceptions from the initial recognition of deferred taxes and accounting for uncertainties in income tax.</p>	<p>An ED is expected in the fourth quarter of 2007.</p>
<p><b>Joint ventures</b></p> <p>The main proposed change is that proportionate consolidation would not be allowed.</p>	<p>An ED is expected in the second quarter of 2007.</p>
<p><b>Share-based payment</b></p> <p>The main proposed change is that when an employee chooses not to continue making contributions to an employee share purchase plan, this should be accounted for as a cancellation, i.e. accelerated recognition of expenses, rather than a reversal of previous expenses recognised.</p>	<p>A final amendment is expected in the second quarter of 2007.</p>

### Revised standard IAS 23 *Borrowing Costs*

Refer to *IFRS Briefing Sheet – Issue 66* for details.

Effective: Annual periods from 1 January 2009

The main change is the removal of the option of immediately recognising all borrowing costs as an expense. The revised standard requires that an entity capitalises borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the total cost of that asset.

The equivalent standard is expected to be issued in Singapore shortly.

### Discussion Paper (DP) Preliminary Views on Insurance Contracts

Refer to *IFRS Briefing Sheet – Issue 68* for details.

The DP addresses insurance liabilities (an insurer's obligations under an insurance contract) and insurance assets (an insurer's rights under an insurance contract).

The IASB has invited comments on this DP by 16 November 2007. The IASB expects to publish an ED for this phase of the project by late 2008 and a final standard by late 2009.

### Meetings of the IASB – March, April and May 2007

Refer to *IFRS in Brief – Issues 34 to 36* for details.

The topics that were discussed in recent IASB meetings include:

- Financial statement presentation – Phase A focuses on the content of primary financial statements and comparative data (final amendments expected to be published in the second quarter of 2007).
- Business Combinations Phase II
- Annual improvement process (non-urgent, minor amendments to standards)
- Amendments to IAS 37 on provisions
- Proposals on earnings per share calculations
- Financial instruments puttable at fair value and obligations arising on liquidation
- Short-term convergence: Income taxes
- Short-term convergence: Joint ventures
- Conceptual framework for financial reporting

The KPMG International publications covered in this issue are:

- IFRS in Brief: Issues 34 to 36
- IFRS Briefing Sheet: Issues 65 to 68

This section provides a highlight, particularly the relevance of international developments in the local context, of our international publication – *IFRS in Brief* and *IFRS Briefing Sheet*. You can access the electronic version as follows:

IFRS in Brief:

[http://www.kpmg.com.sg/newsletters/ifrs\\_in\\_brief.html](http://www.kpmg.com.sg/newsletters/ifrs_in_brief.html)

IFRS Briefing Sheet:

[http://www.kpmg.com.sg/newsletters/ifrs\\_briefing\\_sht.html](http://www.kpmg.com.sg/newsletters/ifrs_briefing_sht.html)

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