August 2020

In brief

# Second comprehensive review of the *IFRS for SMEs* Standard

## What does alignment mean?

The second comprehensive review of the *IFRS for SMEs* Standard has raised many questions because of the potential effects on the accounting for SMEs that could arise following publication of the Request for Information by the International Accounting Standards Board (Board) in January 2020.

One subject of energetic debate is 'alignment with full IFRS Standards'—that is, whether, how and when to reflect changes to IFRS Standards in the *IFRS for SMEs* Standard.

In this article, Darrel Scott, member of the Board, provides additional context for discussions on this subject and shares his views on alignment.

## The two approaches

**Diagram 1— Two possible approaches to the second comprehensive review**

**Alignment approach** — Different views on whether to align the *IFRS for SMEs* Standard with IFRS Standards

**Two possible approaches**

**Proponents of simplified IFRS Standard approach**

- experience gained developing full IFRS Standards used efficiently
- consistent with expectation that *IFRS for SMEs* Standard is simplified IFRS Standards
- allows the specific requirements and characteristics of SMEs to be considered

**Alignment**

**Proponents of independent Standard approach**

- *IFRS for SMEs* Standard should be updated only for specific issues arising from the application of the Standard

Two approaches to alignment have emerged as clear frontrunners—the 'simplified IFRS Standard' approach and the 'independent Standard' approach. A common view is that these are mutually exclusive positions, but I prefer to think of them as the two ends of a continuum.

Adopting the simplified IFRS Standard approach would mean the *IFRS for SMEs* Standard is treated as a condensed version of full IFRS Standards. All recognition and measurement principles from full IFRS Standards would be reflected in the *IFRS for SMEs* Standard, albeit in a simplified or shorter version. Two companies with the same transactions and balances would have similar outcomes in their financial statements if one applied the *IFRS for SMEs* Standard and the other applied full IFRS Standards.

The independent Standard approach falls at the other end of the continuum and requires that the *IFRS for SMEs* Standard be viewed as an independent text. Applying this approach, requirements in the *IFRS for SMEs* Standard would originate only from direct input about the needs of users of SMEs' financial statements and preparers' resources, and without any reference to developments in full IFRS Standards. Any differences between the *IFRS for SMEs* Standard and full IFRS Standards would be expected to widen over time.

Thinking of the approaches as the two ends of a continuum makes it easier to view them as starting points instead of mutually exclusive positions. Further, the simplified IFRS Standard approach can be viewed as a 'top–down' approach, and the independent Standard approach as a 'bottom–up' approach.

## The continuum in practice

Using the above terminology, we can describe the Board's preferred approach as a top–down approach. The Board would start by considering the most important requirements of IFRS Standards and then eliminating those that are not relevant or less relevant to SMEs and the users of their financial statements.

The wide application of IFRS Standards around the world, together with the significant resource pool preparing, auditing, regulating and using financial statements based on IFRS Standards, means there is considerable data available. That data helps illustrate the effectiveness of IFRS Standards in practice, application and interpretation difficulties and any unintended financial reporting consequences. The data is also complemented by a body of academic research which relies to an extent on the public availability of market information including share prices. In considering whether and how to respond to this data, the Board examines feedback, engages with stakeholders and applies its deliberative processes for considering, on a point-by-point basis, whether IFRS Standards need to be amended either through annual improvements or a more significant review and potential replacement of a Standard. For new IFRS Standards and for some significant amendments, the post-implementation review further formalises and ensures a timely response to emerging issues.

Although the *IFRS for SMEs* Standard is also widely used, the resource pool is smaller and has less capacity for engagement with the Board. Less information is publicly available in this sector and there are fewer opportunities for tracking and understanding share prices—consequently, less research is available. The Board, therefore, does not have access to the same amount or quality of feedback, nor does it have the ability to test fully the application of the *IFRS for SMEs* Standard. In view of the Board's preference for evidence-based standard-setting, the most robust starting point for determining whether, how and when to amend the *IFRS for SMEs* Standard is changes to full IFRS Standards.

In contrast, a bottom–up approach would start with specific, albeit limited, feedback from stakeholders in SMEs, including their inputs into the Q&A process.[1] Using such an approach, the Board would build on that feedback by evaluating what other changes may be anticipated in the SME environment and by looking at gaps in the *IFRS for SMEs* Standard. A bottom–up approach would require taking a broader view, for example, considering developments in similar financial reporting standards (such as the UK guidance and EU Directives) and in local legislation.

1 The SME Implementation Group publishes Q&As in response to questions on the application of the *IFRS for SMEs* Standard.

## Approach to the review

The *IFRS for SMEs* Standard was originally drafted to provide a simplified, self-contained set of accounting principles based on full IFRS Standards. The Standard was developed to meet the needs of smaller, non-listed entities and contained modifications to reflect the needs of users of SMEs' financial statements and cost-benefit considerations. There was no stated or implied goal of either remaining consistent with IFRS Standards or of maintaining the *IFRS for SMEs* Standard as an entirely independent Standard. The Board needed, therefore, to consider the approach it wished to adopt as the first step in preparing to launch the second comprehensive review.

The Board agreed to use a top–down approach at the start of the review, as evidenced in the questions asked within the Request for Information. This approach reflects our majority (but not consensus) view that maintaining consistency with IFRS Standards through continued alignment is broadly positive.

After determining it would adopt a top–down approach to the review, the Board considered a comprehensive list of the new and amended IFRS Standards issued since the last comprehensive review or carried forward from the first comprehensive review of the *IFRS for SMEs* Standard. Each new or amended IFRS Standard was then assessed using three 'alignment principles'.

## Applying the top–down approach

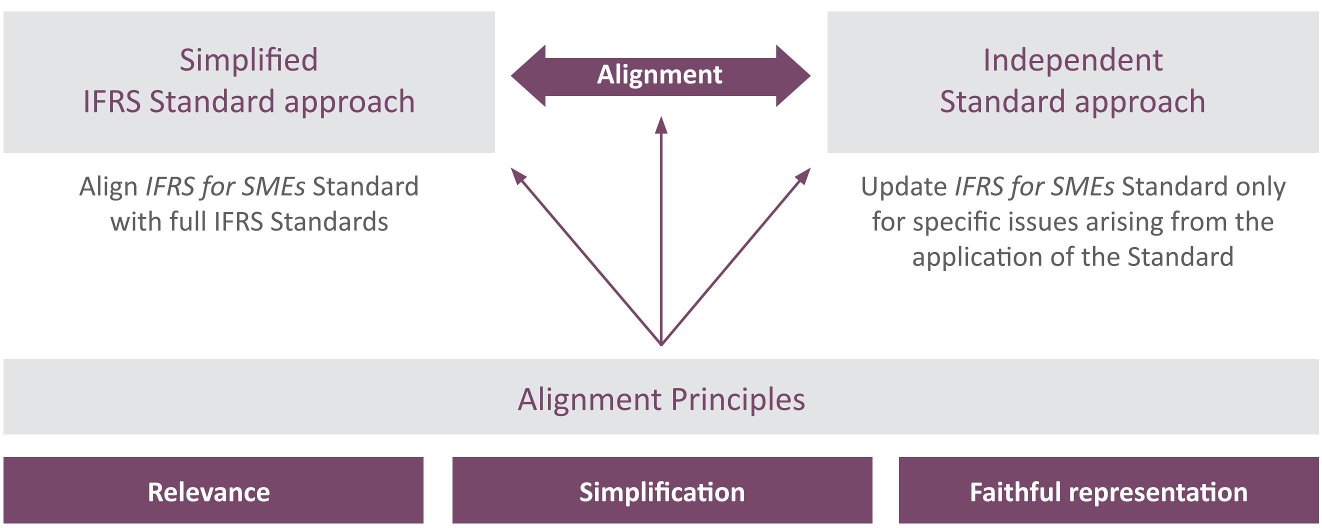
In line with the Board's proposed approach, each possible amendment to the *IFRS for SMEs* Standard starts as complete alignment of the recognition and measurement requirements with those in IFRS Standards, albeit expressed in a simplified way. We start with the intention of incorporating the substance of a new or amended IFRS Standard into the *IFRS for SMEs* Standard, and adapt that new or amended IFRS Standard by applying the three alignment principles in turn.

Our aim is to simplify and adapt a requirement originating from full IFRS Standards so it meets the needs of SMEs. In this way, the *IFRS for SMEs* Standard keeps its unique characteristics and remains suited to the companies in its scope, while retaining its link to full IFRS Standards. This approach provides the Board with a framework to move along the continuum, while requiring the Board to consider rigorously and justify any differences between full IFRS Standards and the *IFRS for SMEs* Standard. A natural consequence of this process is that we would expect that few, if any, proposed changes to the *IFRS for SMEs* Standard would be a word-for-word copy of changes made to full IFRS Standards.

## The alignment principles

As part of its top–down approach, the Board considers each new or amended IFRS Standard for alignment with the *IFRS for SMEs* Standard using three principles.

**Diagram 2—Alignment principles**



The first of the alignment principles is relevance—we examine whether a change to IFRS Standards is relevant to the financial statements of a typical SME and whether any additional information provided in an entity's financial statements in accordance with those amendments is useful. Where an amendment fails that test—for instance if it relates to transactions that are not prevalent in the SME sector—it will be rejected and not considered further. An amendment would also fail the relevance test if its main effect in full IFRS Standards was to provide extra information in financial statements that is judged unlikely to be of interest to the users of SMEs' financial statements.

A good example of the application of relevance principle in the Request for Information is the Board's discussion on excluding the expected credit loss model set out in IFRS 9 *Financial Instruments*. The Board concluded that because of the scope limitation in the *IFRS for SMEs* Standard, it is unlikely that including this requirement for SMEs would provide useful information.

The second alignment principle is simplicity, which requires that we consider whether a principle in full IFRS Standards can be applied in a simpler way.

A good example of how we applied the simplicity principle in the Request for Information is the Board's discussion of the definition of 'lease term' as set out in IFRS 16 *Leases*. That definition requires judgement and relies in part on expectations relating to uncertain future outcomes. The Board concluded that less judgement would be required if the *IFRS for SMEs* Standard referred instead to the non-cancellable period as set out in the lease arrangement.

Another example is the assessment of whether one company controls another—IFRS 10 *Consolidated Financial Statements* sets out a detailed process for making this assessment. The Board considered that while it would be useful for the *IFRS for SMEs* Standard to retain elements of this test, companies would find it much simpler to make the assessment if the Board retained a rebuttable presumption that control exists where an entity holds more than 50% of the voting rights.

The simplicity principle also assisted the Board with considering requirements such as the application of the undue cost or effort exemption and with reducing the number of categories for classifying financial assets.

The final principle relates to faithful representation—the Board considers whether, applying a simplified approach, the outcome would faithfully represent in words and numbers the activities of an SME in its financial statements.

In theory, if we apply the first and second principles, it should be quite hard to fail this third test. However, the third principle is arguably a safety net to ensure that the simplification needed to make the amendment is appropriate and does not, perhaps in concert with other simplifications, significantly reduce the usefulness of the financial statements.

## Costs and benefits

Although questions of cost and benefit were not discussed explicitly in the Request for Information, the alignment principles do take these considerations into account. The first step in applying the relevance principle is to consider whether a requirement imposes a workload on SMEs disproportionate to the value of the output to their stakeholders. The simplicity principle seeks to streamline requirements and thereby reduce or eliminate the cost of application. Additional information the Board receives on costs and benefits as part of the feedback on the Request for Information will of course be considered in the next stage of the review.

## Timing

Determining when to align the *IFRS for SMEs* Standard with a new or amended IFRS Standard is an essential step in the review.

Developing a Standard is a multi-step process that typically starts with a research phase. Even when an IFRS Standard is issued, a period of time elapses before the effective date so that jurisdictions have sufficient time to incorporate the new requirements and preparers have time to update their data and systems. Finally, a post-implementation review, where the Board hears feedback about how the new IFRS Standard is working in practice, will only commence after several years of post-implementation experience. The start of research to completion of a post-implementation review—the life cycle of a Standard, if you like—can last up to a decade or more.

If the *IFRS for SMEs* Standard is to be aligned in some sense with full IFRS Standards, we need to consider which stage of that life cycle is an appropriate trigger to begin reviewing the new or amended IFRS Standard for inclusion in the *IFRS for SMEs* Standard. The Board is explicitly seeking views on whether in each review cycle it should look at all new and amended IFRS Standards issued, only those where there has already been a period of application or on which the post-implementation review has been completed. This latter approach has the virtue of caution, but it builds in a significant time lag, and risks forgoing some of the benefits of alignment.

## Example—leasing

IFRS 16, the Standard on leasing, was issued in 2016 and was effective from 2019. It changed the model for lessees and, as such, was a possible candidate for inclusion in the *IFRS for SMEs* Standard. Applying the three alignment principles to IFRS 16 the Board noted that according to one report, leasing is the third most important source of finance for SMEs, with around 40% of SMEs using leases. As a result, IFRS 16 readily passed the relevance test.

Simplification was more challenging. In applying the second principle, the Board noted that the move to a single leasing model is itself a simplification, along with the short-term lease and low value asset exemptions. The Board acknowledged that this long-term simplification may come with some short-term pain on transition and is therefore considering other possible simplifications, as set out in the Request for Information. One such potential simplification is permitting the option to use a discount rate by reference to market yields on high-quality corporate bonds when the interest rate implicit in the lease and the lessee's incremental borrowing rate cannot be readily determined. Another potential simplification is changing the definition of the lease term so it refers to the non-cancellable period, instead of relying on the definition in IFRS 16. The definition in IFRS 16 states that the term is longer if the lessee has the option to use the asset longer than the non-cancellable period and is likely to take that option.

Finally, looking at faithful representation, the Board considered whether financial statements prepared using the simplified requirements would faithfully represent a company's assets and liabilities. Since this is a relatively new IFRS Standard, it might be expected that it sets out a model that would help provide a better representation of a lessee's underlying position.

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## Example—leasing

However, complications could arise if some of the requirements in the IFRS 16 model are simplified. For instance, effectively changing the definition of the lease term may make the Standard easier to apply but could also open the door to misleading representation if cancellation clauses are introduced or used as a way of reducing the amounts of assets and liabilities recognised on the balance sheet. The resulting financial statements would, arguably, not truly reflect the lessee's position with regard to future commitments, or at least would not reflect that position in the same way as applying IFRS 16 would.

For these reasons, the Board is asking in the Request for Information for feedback on the suggestion to reflect the IFRS 16 leasing model, with suitable simplifications, in the *IFRS for SMEs* Standard, and will be considering carefully the feedback on each of the possible simplifications.


The Request for Information is open for comment until **27 October 2020**. Responses to the Request for Information can be submitted in one of three ways:

1. by comment letter;
2. by comment letter using the optional response document; or
3. by responding to the survey.

Visit the 2019 Comprehensive Review of the *IFRS for SMEs* Standard project page on the IFRS Foundation's website to find out more about how to respond.

### To get in touch

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