2 The point of view of ...

Gil Rosenstock and Shlomi Shuv

... on IFRS for SMEs – Hierarchy to establishing accounting policy (1 of 3)

In July 2009, the IASB published the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs).

This article is the first of three on how an entity shall apply, in practice, an accounting treatment in a situation where the IFRS for SMEs does not address the specific transaction or event.

The IFRS for SMEs is intended to be a stand-alone document, where concise guidance can be found to deal with accounting issues or many typical SMEs. Thus, the IFRS for SMEs does not have any mandatory requirement to look to full IFRSs, although it does include one option for an entity to choose to follow full IFRS, which is the option to use IAS 39 Financial Instruments: Recognition and Measurement.

Hierarchy to establishing accounting policy

When the IFRS for SMEs does not specifically address a transaction, other event or condition, an entity's management shall use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable.

In making that judgment, management shall refer to, and consider the applicability of, the following sources:

(a) the requirements and guidance in the IFRS for SMEs dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in the IFRS for SMEs

Management may also consider the requirements and guidance in full IFRSs dealing with similar and related issues.

Following are a number of cases, for which the IFRS for SMEs does not describe a specific accounting treatment, and the proposed accounting solutions for those cases, in the authors' view, based on the hierarchy as established in the IFRS for SMEs.

- Transfer of a property to, or from, investment property
- Classification of gains from sale of assets held for rental
- Accounting-policy choice for the recognition of actuarial gains and losses

Transfer of a property to, or from, investment property

IAS 40 Investment Property requires an entity to transfer a property to, or from, investment property when, and only when, there is a change in use.

The IFRS for SMEs requires an entity to transfer a property to, or from, investment property only when the property first meets, or ceases to meet, the definition of investment property.

In light of the fact that the definition of Investment Property includes characteristics related to the reporting entity's intentions ("Property held to earn rentals or for capital appreciation or both"), the transfer dates required by the IFRS for SMEs may occur before the transfer dates required by IAS 40.

In the authors' view, in this case an entity shall not turn to full IFRSs to determine the date of a transfer to, or from, investment property. This is because wherever there is a specific guidance in the IFRS for SMEs addressing a transaction, other event or condition, the entity is required to follow the specific guidance, rather than applying the hierarchy and turning to full IFRSs.

Thus, for example, for a transfer from investment property to owner-occupied property (Property, Plant and Equipment), IAS 40 requires an actual commencement of owner-occupation. On the other hand, in the authors' view, under the IFRS for SMEs an entity shall transfer the property from investment property to owner-occupied property at the date when it assigns the property to its own use, even though it has yet to begin actually using the property.

In another example, for a transfer from inventories to investment property, IAS 40 requires an actual commencement of an operating lease to another party. In contrast, in the authors' view, under the IFRS for SMEs an entity shall transfer the property from inventories to investment property at the date when the entity assigns the property to be leased to another party, even though the leasing period has yet to begin, and the other party has yet to be found.

Classification of gains from sale of assets held for rental

IAS 16 Property, Plant and Equipment prohibits classification as revenue of gains arising from derecognition of items of property, plant and equipment. However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets shall be recognised as revenue.

The IFRS for SMEs prohibits an entity from classifying a gain on the derecognition of an item of property, plant and equipment as revenue. However, no guidance exists in the IFRS for SMEs regarding an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others.

In the authors' view, an entity shall not turn to full IFRSs to transfer the aforementioned assets to inventories, and subsequently classify the proceeds from their sale as revenue. Even though such a transfer better reflects the actual operations of those entities, SMEs are prohibited from straying from the unequivocal instruction in the IFRS for SMEs, according to which it is not permitted to classify a gain on the derecognition of an item of property, plant and equipment as revenue, including the implications on the Statement of Cash Flows.

Accounting-policy choice for the recognition of actuarial gains and losses

IAS 19 Employee Benefits currently allows an accounting-policy choice for the recognition of actuarial gains and losses, as follows:

- Immediate recognition in profit or loss
- Recognition in other comprehensive income and immediate recognition in retained earnings
- Using the corridor approach
- Using the accelerated corridor approach[5]

Under the IFRS for SMEs, an entity is required to recognise all actuarial gains and losses in the period in which they occur, while choosing an accounting policy to either recognise all actuarial gains and losses in profit or loss, or to recognise all actuarial gains and losses in other comprehensive income. Neither the corridor approach nor the accelerated corridor approach is permitted.

In respect of the option where actuarial gains and losses are recognised in other comprehensive income, the IFRS for SMEs does not specifically state that those gains and losses are to be recognised immediately in retained earnings.

Thus, in the authors' view, an entity is not required to turn to full IFRSs for the immediate recognition in retained earnings, but rather is allowed to choose as its accounting policy either one of the following options, and apply it consistently:

- Immediate recognition in retained earnings
- Immediate recognition in reserve with no recognition in retained earnings

This article will continue in the next two editions, where further aspects of IFRS for SMEs will be covered.

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[5] The corridor approach has recently been eliminated for annual periods beginning on or after 1 January 2013.

2 The point of view of ...

Gil Rosenstock and Shlomi Shuv

... on IFRS for SMEs – Hierarchy to establishing accounting policy (2 of 3)

This is the second article in a series of three on the application of the IFRS for SMEs.

In the first article, we introduced the concept of hierarchy of sources that preparers should use, when faced with lack of explicit directions in the IFRS for SMEs. We have also listed and proposed a solution for three such cases: (i) Transfer of a property to, or from, investment property, (ii) Classification of gains from sale of assets held for rental and (iii) Accounting-policy choice for the recognition of actuarial gains and losses.

In this article, we will further cover the following cases:

- Offsetting a financial asset and a financial liability in the statement of financial position
- Quantitative threshold in relation to substantial modification of the terms of a financial liability
- Date of documenting hedging relationship
- Exceptions to the recognition and measurement principles used to account for business combinations
- Classifying and designating assets acquired and liabilities assumed in a business combination

Offsetting a financial asset and a financial liability in the statement of financial position

IAS 32 states that a financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

There is no mention in the IFRS for SMEs of the issue of offsetting a financial asset and a financial liability in the statement of financial position. It should be noted that the Concepts and Pervasive Principles of the IFRS for SMEs include an unequivocal instruction, according to which an entity shall not offset assets and liabilities in the statement of financial position unless required or permitted by the IFRS for SMEs.

Based on the hierarchy to establishing accounting policy [see first article of this series in issue 9 September 2011], an entity shall not turn to full IFRS for guidance for offsetting a financial asset and a financial liability. This is because wherever there is a specific guidance in the Concepts and Pervasive Principles of the IFRS for SMEs, the entity is required to follow the specific guidance, rather than turning to full IFRS, which is lower in the hierarchy.

This would lead to the conclusion that an entity shall not offset a financial asset and a financial liability in the statement of financial position under any circumstances. However, in the authors' view, that conclusion was not the intention of the IFRS for SMEs.

Quantitative threshold in relation to substantial modification of the terms of a financial liability

The principles for the derecognition of a financial liability set out in IAS 39[2] and in the IFRS for SMEs are basically the same. However, the IFRS for SMEs does not mention a quantitative threshold in relation to substantial modification of the terms of an existing financial liability.

It is worth noting that the application guidance to IAS 39[2] adopts the ten percent threshold test, whereby the terms are substantially different if the discounted present value of the cash flows under the new terms (including any fees), discounted using the original effective interest rate, is at least ten percent different from the discounted present value of the remaining cash flows of the original financial liability.

Based on the hierarchy to establishing accounting policy, in the absence of a specific quantitative threshold in the IFRS for SMEs, an entity is allowed, but is not required, to turn to full IFRS for adoption of the ten percent threshold test. However, in the authors' view, an entity is allowed to adopt another quantitative threshold and apply it consistently.

Date of documenting hedging relationship

IAS 39[2] states that a hedging relationship qualifies for hedge accounting if, among other conditions, at the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation includes, among other things, identification of the hedging instrument, the hedged item and the nature of the risk being hedged.

Similarly, the IFRS for SMEs states that to qualify for hedge accounting, an entity shall designate and document the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified. However, the IFRS for SMEs does not specify whether the formal designation and documentation shall occur at the inception of the hedge.

[2] In these instances IFRS 9 will not bring significant changes to the current letter of IAS 39.

Based on the hierarchy to establishing accounting policy, in spite of the absence of a specific date in the IFRS for SMEs for the formal designation and documentation of a hedging relationship, in the authors' view, due to the nature and substance of hedge accounting, an entity is required to apply the same requirement in full IFRS, and designate the hedging relationship at the inception of the hedge to be eligible for hedge accounting.

Exceptions to the recognition and measurement principles used to account for business combinations

IFRS 3 provides for some limited exceptions to the recognition and measurement principles, whereby, as of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. Those include, among other things, recognising and measuring deferred tax assets or liabilities, liabilities related to the acquiree's employee benefit arrangements, indemnification assets, reacquired rights and replacement of an acquiree's share-based payment awards.

The IFRS for SMEs states that the acquirer in a business combination shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets and liabilities and a provision for contingent liabilities that satisfy the recognition criteria at their fair values at that date. The IFRS for SMEs does not provide any exceptions to the rule of "acquisition-date fair value".

Based on the hierarchy to establishing accounting policy, in the absence of any exceptions in the IFRS for SMEs, an entity shall not turn to full IFRS for recognising and measuring assets or liabilities other than at acquisition-date fair value. SMEs are prohibited from straying from the unequivocal instruction in the IFRS for SMEs, according to which assets and liabilities shall be measured at acquisition-date fair value. The entity is required to follow the specific guidance, rather than turning to full IFRS, which is lower in the hierarchy. However, in the authors' view, that conclusion was not the intention of the IFRS for SMEs.

Classifying and designating assets acquired and liabilities assumed in a business combination

IFRS 3 states that at the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.

IFRS 3 provides an exception to the principle (the other exception is not relevant to SMEs), according to which an entity shall classify a lease contract as either an operating lease or a finance lease on the basis of the contractual terms and other factors at the inception of the contract, rather than at the acquisition date.

No guidance exists in the IFRS for SMEs regarding the classification or designation of the identifiable assets acquired and liabilities assumed in a business combination. In light of the fact that the acquirer shall recognise the acquiree's identifiable assets and liabilities at the acquisition date, in the authors' view, the entity shall classify or designate them on the basis of the contractual terms and other conditions, as they exist at the acquisition date.

Furthermore, in the absence of both the rule and the exception to the rule regarding a classification of a lease contract as either an operating lease or a finance lease, in the authors' view, an entity shall turn to the guidance in IFRS 3, according to which such a classification shall be made on the basis of the contractual terms and other conditions as they exist at the acquisition date.

It should be noted that classifying leases as either finance leases or operating leases is applicable only under the current version of IAS 17 Leases. However, the Exposure Draft Leases, published in August 2010, proposes that lessees and lessors should apply a right-of-use model in accounting for all leases, without the need to distinguish between finance leases and operating leases. Assuming the Exposure Draft will be finalised, it remains to be seen whether the leasing revolution will find its way to the IFRS for SMEs.

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2 The point of view of ...

Gil Rosenstock and Shlomi Shuv

... on IFRS for SMEs – Hierarchy to establishing accounting policy (3 of 3)

This is the third and last article in a series on the application of IFRS for SMEs in practice.

In the first two articles we introduced the concept of hierarchy of sources that preparers should use when faced with lack of explicit directions in the IFRS for SMEs. We also listed and proposed a solution for eight such cases:

» Transfer of a property to, or from, investment property
» Classification of gains from sale of assets held for rental
» Accounting-policy choice for the recognition of actuarial gains and losses
» Offsetting a financial asset and a financial liability in the statement of financial position
» Quantitative threshold in relation to substantial modification of the terms of a financial liability
» Date of documenting hedging relationship
» Exceptions to the recognition and measurement principles used to account for business combinations
» Classifying and designating assets acquired and liabilities assumed in a business combination

In this article, we will further cover the following cases:

» Measuring non-controlling interests in an acquiree
» Reverse acquisitions
» The requirement for the difference between the reporting date of a subsidiary and that of a parent to be no more than three months
» Fair-value measurement for associates with published price quotations

Measuring non-controlling interests in an acquiree

For each business combination, IFRS 3 allows an entity to choose one of two alternatives for measuring a non-controlling interest in an acquiree which is a present ownership interest and entitles holders to a proportionate share of the entity's net assets in the event of liquidation:

(a) at fair value; or
(b) as the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

Since goodwill is defined in IFRS 3 as a residual value, entities that choose to measure non-controlling interest at fair value recognise in effect the part of goodwill attributable to the non-controlling interest in their consolidated financial statements. Consequently, under this choice, goodwill is not measured at the excess of the cost of the business combination over the acquirer's interest in the recognised amounts of the identifiable net assets of the acquiree.

There is no specific guidance in the IFRS for SMEs for measuring non-controlling interests in an acquiree. Based on the hierarchy to establishing accounting policy [see first article of this series in issue 9 September 2011], an entity shall turn to the requirements and guidance in the IFRS for SMEs dealing with similar and related issues.

In the authors' view, an entity shall turn to the guidance in the IFRS for SMEs for measuring goodwill. The IFRS for SMEs states that, at the acquisition date, the acquirer shall measure goodwill at the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Therefore, in order for the goodwill to be measured as stated in the IFRS for SMEs, in the authors' view, SMEs are not allowed to measure non-controlling interests in an acquiree at fair value, but rather at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. Measuring non-controlling interests in an acquiree at fair value would in effect cause the goodwill recognised in the consolidated financial statements to include the part of goodwill attributed to non-controlling interest, which is not permitted under the IFRS for SMEs.

Reverse acquisitions

A reverse acquisition most commonly occurs in practice when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. Both IFRS 3 and the IFRS for SMEs include detailed guidance for identifying the acquirer in a business combination. The acquirer is defined as the combining entity that obtains control of the other combining entities or businesses.

However, only IFRS 3 provides additional guidance for accounting for reverse acquisitions, including requirements for measuring the consideration transferred, measuring non-controlling interest in the accounting acquiree (the legal acquirer), disclosing earnings per share and preparing consolidated financial statements.

There is no guidance in the IFRS for SMEs as to how to account for reverse acquisitions.

Where there is no specific guidance in the IFRS for SMEs for accounting for a certain transaction, the hierarchy for establishing accounting policy requires an entity to turn to, among other sources, the Concepts and Pervasive Principles section of the IFRS for SMEs.

The Concepts and Pervasive Principles section of the IFRS for SMEs states that transactions should be accounted for and presented in accordance with their substance and not merely their legal form. Therefore, in the authors' view, SMEs shall apply the same guidance for reverse acquisitions as set out in IFRS 3, since the legal acquiree in a reverse acquisition is the combining entity that obtains control of the legal acquirer.

The requirement for the difference between the reporting date of a subsidiary and that of a parent to be no more than three months

IAS 27 includes guidance for a situation where the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a date different from that of the parent's financial statements.

IAS 27 states that when the date of financial statements of a subsidiary used to prepare consolidated financial statements is different to that of the parent, the difference between the reporting date of the subsidiary and that of the parent shall be no more than three months. In addition, IAS 27 states that the length of the reporting periods and any difference between the reporting dates shall be the same from period to period.

Those requirements are not included in the IFRS for SMEs. This standard states only that the financial statements of the parent and its subsidiaries used in the preparation of consolidated financial statements shall be prepared as of the same reporting date unless it is impracticable to do so.

Where the issue not addressed in the IFRS for SMEs cannot be settled by turning to the guidance in the IFRS for SMEs dealing with similar and related issues or the Concepts and Pervasive Principles in the IFRS for SMEs, the hierarchy to establishing accounting policy allows, but does not require, management to consider the requirements in full IFRSs dealing with similar and related issues.

It should be noted that the Basis for Conclusions on the IFRS for SMEs specifies the main changes from the principles proposed in the exposure draft. One of the changes is the elimination of the requirement, when applying the equity method, of a maximum three-month difference between the reporting date of the associate or jointly controlled entity and that of the investor.

The Basis for Conclusions refers only to applying the equity method, and does not mention the requirements as to the reporting date of a subsidiary when a parent prepares consolidated financial statements.

Based on the hierarchy to establishing accounting policy, in the absence of a specific guidance in the IFRS for SMEs in respect of the reporting date of a subsidiary and the length of its reporting periods, in the authors' view, an entity is not required to turn to full IFRSs, but rather is allowed to consolidate a subsidiary where the difference between the reporting date of the subsidiary and that of the parent is more than three months, provided that adjustments are made for the effects of significant transactions that occur between those two reporting dates.

Furthermore, in the authors' view, the length of the reporting periods and any difference between the reporting dates are not required to be the same from period to period.[2]

Fair-value measurement for associates with published price quotations

The IFRS for SMEs allows an investor to account for all of its investments in associates using one of the following:

(a) the cost model;

(b) the equity method; or

(c) the fair value model.

For an investor that chooses to use the cost model, the IFRS for SMEs requires that investments in associates for which there is a published price quotation be measured using the fair value model.

It is important to note that the Basis for Conclusions on the IFRS for SMEs states that contrary to IAS 28 (which requires investments in associates to be measured using only the equity method and does not make an accounting measurement distinction when associates happen to have a published price quotation) SMEs are required to account for any investment in an associate for which there is a published price quotation using the fair value model.

However, the requirements in the IFRS for SMEs for an investor that uses the equity method do not include any guidance for accounting for associates for which there is a published price quotation.

Furthermore, the IFRS for SMEs requires an investor in an associate to disclose the fair value of investments in associates accounted for using the equity method for which there are published price quotations. If the "requirement" inferred by the Basis for Conclusions was in fact a requirement of the standard, this disclosure requirement would be unnecessary.

In light of the fact that the Basis for Conclusions accompanies, but is not part of, the IFRS for SMEs, in the authors' view an investor is allowed to account for its investments in associates using the equity method, even for associates for which there are published price quotations and would disclose the fair value of these investments in the notes to the financial statements.

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[2] On this matter there are widely diverging opinions: others point out that advocating a difference with IAS 27 is weakly defensible a stance and do believe that consistency from period to period should be required. It is also worth pointing out that neither the IFRS for SMEs nor IAS 27 require that audited annual financial statements have to be used. A parent could use management accounts of a subsidiary for consolidation, and it would be up to the auditor of the parent, based on their assessment of risk and materiality, to determine what audit procedures would be necessary.