IFRS FOR SME’S

SECTION 1 - SMALL AND MEDIUM SIZE ENTERPRISES
SCOPE OF SECTION 1

- Describes the characteristics of SMEs and which type of entities may apply IFRS for SMEs
OBJECTIVE OF CPD FOR SECTION 1

• Understand what is IFRS for SMEs:
  • Why was it developed
  • The purpose of the framework
  • Who can apply IFRS for SMEs - IFRS for SMEs requirements and Co. act requirements
1.1: INTRODUCTION TO IFRS FOR SMES

- In **July 2009** the International Accounting Standards Board (IASB) published the International Financial Reporting Standard (IFRS) for Small and Medium-sized Entities (SMEs).
- **Why?** SMEs are estimated to represent well over 95 per cent of all companies in both developed and developing countries.
- **Difference?** The standard was developed to reduce the complexities and burden associated with applying IFRS whilst fulfilling the needs of the users of SME Financial Statements. (type of business and users)
1.2: A GLOBAL FINANCIAL REPORTING STANDARD FOR SMES

- Mainly for comparability
  - Comparability in terms the manner in which events, transactions and conditions are accounted for by different entities for the different users

- Users:
  - Lenders to multinationals
  - Vendors/suppliers who want to assess financial health of foreign customers/suppliers
  - Rating agencies use info to determine ratings
  - Outside investors of an entity who are involved in day to day
  - Venture capital entities that provide lending
1.3: NEEDS OF USERS OF FINANCIAL STATEMENTS OF SMES

- Owner managed therefore much fewer users of financial statements and **NO PUBLIC ACCOUNTABILITY**
- Main users as discussed above:
  - Lenders to assess liquidity
  - Vendors to make credit and pricing decisions.
  - Customers to decide whether to do business
  - Credit rating agencies to rate SMEs
  - Non managerial shareholders to assess management of the enterprise
  - Short term cash flow
  - **ACTION POINT- PAST EVALUATION INSTEAD OF FORWARD LOOKING INFO (NON-INVESTMENT)**
1.4: COST BENEFIT ANALYSIS OF INFORMATION PRESENTED

- Full IFRS= costly
- Information reported is dependent on the needs of users
- If SMEs users would benefit from full IFRS, a cost vs benefit analysis should be performed to assess the suitability.
1.5: ENTITIES THAT MAY USE IFRS FOR SMES

- (a) Do not have public accountability, and [Refer: paragraph 1.3]

AND

- (b) Publish general purpose financial statements for external users.
WHAT IS PUBLIC ACCOUNTABILITY?

- (a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) regardless of the size of the entity, or

- (b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. Most banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks would meet this second criterion (s.1.3).
WHAT ARE GENERAL PURPOSE FINANCIAL STATEMENTS?

- General purpose financial statements are those financial statements that are aimed to provide general financial information to a wide variety of users who are not in a position to demand reports tailored to meet their specific needs.
- The users include shareholders, creditors and employees
IN SUMMARY

The entity **DOES** publish general purpose financial statements.

The entity **DOES NOT** not have debt or equity traded in a public market **AND** neither is it in the process of doing so.

The entity **DOES NOT** hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary business.

If all these requirements are met, IFRS for SMEs can be applied as $1.2 is met. $\sqrt{ }$
EXAMPLE 1

Can the following entity apply IFRS for SMEs?

- Fashion Retailers is an unlisted company primarily involved in the clothing retail industry. Fashion Retailers intends expanding its operations and issues listed bonds on the Bond Exchange of South Africa (BESA).
SOLUTION

• Applying the definition of public accountability above, as Fashion Retailers has issued bonds on the Bond Exchange of South Africa, the bonds are traded in a public market. This means fashion retailers does have public accountability. Fashion Retailers would therefore be required to provide more extensive financial information to its users and would be required to apply full IFRS and not IFRS for SMEs.
1.6: APPLYING IFRS FOR SMES IN SOUTH AFRICA - CO ACT REQUIREMENTS

- Types of companies
  - Profit (Financial gain)
  - Non-profit (non financial gain, public benefit, 3 or more persons)
  - State-owned companies
    - state-owned enterprise or municipality, SOC Ltd
  - Private companies
    - (MOI) prohibits the offering of securities to the public and transferring equity
    - Min 1 member, “propriety limited = (Pty) Ltd
  - Personal liability companies
    - Meets requirements of Private co
    - MOI states members are liable in personal capacity, Incorporated Inc
  - Public Companies - Equity can be raised from a public offering and shares can be transferred
    - 1 or more persons
    - Listed - JSE requirement to use full IFRS
    - Unlisted - Can use IFRS for SMEs
• IFRS and IFRS for SME’s are permitted
• All entities apart from **public companies**, **state-owned companies** and **certain non-profit companies** are allowed to apply the IFRS for SMEs.
• See table below for co. act requirements
<table>
<thead>
<tr>
<th>Company</th>
<th>Financial Reporting Standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>State owned companies</td>
<td>Full IFRS, but in the case of any conflict with any requirements in terms of the Public Finance Management Act, or other applicable national legislation, the latter prevails</td>
</tr>
<tr>
<td>Public companies listed on an exchange</td>
<td>Full IFRS, but in the case of any conflict with the applicable listing requirements of the relevant exchange, the latter prevails</td>
</tr>
<tr>
<td>Public companies not listed on an exchange</td>
<td>Full IFRS or IFRS for SMEs¹</td>
</tr>
<tr>
<td>Profit companies, other than state owned or public companies, whose public interest score for the particular financial year is at least 350.</td>
<td>Full IFRS or IFRS for SMEs¹</td>
</tr>
<tr>
<td>Profit companies, other than state owned or public companies: (a) whose public interest score for the particular financial year is at least 100 but less than 350; or (b) whose public interest score for the particular financial year is less than 100, and whose statements are independently compiled.</td>
<td>Full IFRS or IFRS for SMEs¹ or SA GAAP²</td>
</tr>
<tr>
<td>Profit companies, other than state owned or public companies, whose public interest score for the particular financial year is less than 100, and whose statements are internally compiled.</td>
<td>There is no prescribed Financial Reporting Standard</td>
</tr>
</tbody>
</table>

² SA GAAP stands for South African Generally Accepted Accounting Principles.
### Non-profit companies that are required in terms of regulation 28 (2)(b) to have their annual financial statements audited

- IFRS, but in the case of any conflict with any requirements in terms of the Public Finance Management Act, or other applicable national legislation, the latter prevails.

### Non-profit companies, other than those contemplated in the first row above, whose public interest score for the particular financial year is at least 350.

- Full IFRS or IFRS for SMEs¹

### Non-profit companies, other than those contemplated in the first row above—

- (a) whose public interest score for the particular financial year is at least 100, but less than 350; or
- (b) whose public interest score for the particular financial year is less than 100, and whose financial statements are independently compiled.

- Full IFRS or IFRS for SMEs¹ or SA GAAP²

### Non-profit companies, other than those contemplated in the first row above, whose public interest score for the particular financial year is less than 100, and whose financial statements are internally compiled.

- There is no prescribed Financial Reporting Standard – it is determined by the company.
PI SCORES

• What is a PI score? A score used to determine what financial reporting framework can be used
• The Public Interest Score is calculated as:
  • 1 point for each employee or the average number of employees throughout the year.
  • 1 point per million rand of third party liability. This is the money owed in terms of loans, debentures, and other financing.
  • 1 point for each million rand of turnover during the financial year. If the turnover is half a million rand, score ½ point.
  • 1 point for every individual who, at the end of the year, is known to have a direct or indirect beneficial interest in the company. This will include shareholders, beneficiaries of a trust where a trust is a shareholder and other stakeholders.
1.9: SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

• Judgement in establishing if an entity has public accountability or not should be disclosed under significant estimates and judgements.
CONCEPTS AND PERVERSIVE PRINCIPLES

SECTION 2
S 2.1: SCOPE

• **Objective** of financial statements of small and medium-sized entities (SMEs)
• qualities that make the information in the financial statements of SMEs **useful (Qualitative characteristics)**
• concepts and basic principles underlying the financial statements of SMEs
OBJECTIVES FROM CPD

- **To understand the objective** of financial statements of small and medium-sized entities (SMEs).
- To understand and apply the qualitative characteristics of IFRS for SMEs.
  - Fundamental and
  - Enhancing
- To understand concepts and basic principles underlying the financial statements of SMEs
- To be able to recognise and apply the definitions and recognition criteria of the elements of the financial statement.
GENERAL INFORMATION: WHAT IS A CONCEPTUAL FRAMEWORK?

• The rationale being that a conceptual framework will form a theoretical basis for determining how transactions should be measured and communicated to the users in the financial statements.

• A conceptual framework from an IASB perspective is a frame of reference for the evaluation of existing IFRS and the development of new standards.

• A well-developed conceptual framework should assist the IASB in developing a global set of financial reporting standards which produces financial statements that are relevant, reliable and comparable to users regardless of where an entity is operating.

• In summary the conceptual framework addresses the underlying information presented in general purpose financial statements. The objective of this is to facilitate the consistent and logical formulation of IFRS standards.
The objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

Financial statements also show the results of the stewardship of management—the accountability of management for the resources entrusted to it.
INFORMATION NEEDS OF USERS

• Information that is useful to users includes:
  • information about the resources of the entity
  • claims against the entity
  • how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources as well as the results of the stewardship of management
Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. There are 2 types of qualitative characteristics:

- Fundamental
- Enhancing
2.3.1: FUNDAMENTAL QUALITATIVE CHARACTERISTICS

- Primary characteristics
  - Relevance
    - Information is relevant if it is capable of affecting the economic decisions of users
  - Reliability
    - Information is reliable when it is free from *material error* and *bias* and represents that which it either purports to represent or could reasonably be expected to represent.
2.3.1: ENHANCING QUALITATIVE CHARACTERISTICS

- **Understandability (s2.4)**
  - Classifying, characterising and presenting information clearly and concisely makes it understandable.
  - F/Ss to be prepared on the assumption that users have a reasonable knowledge of business and economics.

- **Materiality (s2.6)**
  - Information is material if its omission will lead to the users of the financial statements making a different decision.

- **Substance over form (s2.8)**
  - Transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form.

- **Prudence (s2.9)**
  - Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

- **Completeness (s2.10)**
  - To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

- **Comparability (s2.11)**
  - Entity through time to identify trends – Change in accounting policy needs to be disclosed.
  - Compare the financial statements of different entities.

- **Timeliness (s2.12)**
  - Timeliness involves providing the information within the decision time frame. Balance-relevance and reliability.

- **Balance between cost and benefit (s.2.14&s2.13)**
  - The benefits derived from information should exceed the cost of providing it.
In November 2015, the owners of a clothing business collectively decided to purchase an industrial pressing iron to be used in the Hyde Park store. The pressing iron was purchased from an overseas supplier the entity a flexible repayment option. The supplier agreement allowed the entity either to pay for the pressing iron upfront at a price of R7 500, where ownership would be passed immediately. The second option was the entity could settle the supplier on 1 November 2016 at a price of R 12 000, where ownership would be passed only when payment has been made. The entity chose the second payment option and used the pressing iron in the store since 1 November 2015.

The owners insist that the pressing iron should be recognized as an asset at an amount of R 12 000 on 1 November 2016 only.

Assuming the iron meets the asset definition, discuss the appropriateness of recognizing the asset at R12 000 and not at R7 500. Your answer should make reference to the enhancing qualitative characteristic “substance over form” in terms of section 2- concepts and pervasive principles.
• Since the supplier allowed Royal Addicted to pay 12 months later, the difference between the R 12 000 and the R 7 500 in substance reflects interest expense. The difference should not be recorded as part of the cost of the asset.
2.4: ELEMENTS OF THE FINANCIAL STATEMENTS

• Financial statements portray the financial effects of transactions, conditions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are called the ‘elements’ of financial statements.
FINANCIAL POSITION

• The financial position of an entity is the relationship of its assets, liabilities and **equity** as of a specific date as presented in the **statement of financial position**. These are defined as follows:

• The elements that are directly related to the measurement of financial position, which is shown in the **statement of financial position**
  • Assets
  • Liabilities
  • Equity
An asset is a **resource controlled** by the entity as a result of **past events** and from which **future economic benefits** are expected to flow to the entity.

- **Resource** - An item of value that has the ability to generate future economic benefits.
- **Control** - The ability to obtain future economic benefits and to restrict others from obtaining the future economic benefits. This does not necessarily mean ownership.
- **Future economic benefits** - The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity
A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

- **Present obligation**
  - **Legal obligation** - A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement.
  - **Constructive obligation** - A constructive obligation is an obligation that derives from an entity's actions when: by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities;
    and as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

- **Outflow of future economic benefits**
  - The settlement of a present obligation usually involves the payment of cash, the transfer of other assets, the provision of services, the replacement of that obligation with another obligation or the conversion of the obligation to equity.
Equity is the residual interest in the assets of the entity after deducting all its liabilities.
FINANCIAL PERFORMANCE

- **Performance** is the relationship of the income and expenses of an entity during a reporting period. **Total comprehensive income** and **profit or loss** is frequently used as measures of performance or as the basis for other measures, such as return on investment or earnings per share. Income and expenses are defined as follows:

  - *(a)* **Income** is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity investors.
    - Revenue
    - Gains

  - *(b)* **Expenses** are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity investors.
    - Expenses
    - Losses
RECOGNITION CRITERIA

(a) It is probable that any future economic benefit associated with the item will flow to or from the entity,
   • Assessments of the probability attaching to the flow of future economic benefits are made on the basis of the evidence relating to conditions at the end of the reporting period available when the financial statements are prepared.

and

(b) The item has a cost or value that can be measured reliably.
   • The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability.
   • A reliable estimate can also be made, this does not mean the recognition criteria have no been met
EXAMPLE 2- ASSET DEFINITION

Medical-Experts (Pty) Ltd is a private healthcare provider which operates a state-of-the-art cardiology unit. During the current year, the board of directors of the hospital has authorised the lease of a 3D printer to be used in the cardiology unit for 5 years. 3D printing is the process of making a three dimensional object by using a computer to control the process of depositing layers of material such that a 3D model of any shape or form can be produced. The images below provide illustrations of various 3D printers used in the medical profession.

Cardiologists in the unit intend to use the printer to print 3 dimensional models of patients’ hearts. These will be used as the basis of preparing for heart surgeries. The software designed for the 3D printer allows the cardiologist to design a unique on-screen model of the patient’s heart by using medical-image data such as X-rays and various other scans. The on-screen model is then printed in the form of a 3 dimensional model. The anatomy of each patient’s heart is unique and is thus captured in the 3D model that gets printed.

Cardiologists will be able to plan the best procedure and the best surgery unique to that patient. The team believes that preparing for surgeries by reference to a model of the patient’s actual heart will minimize errors in judgment and reduce operating time. Upon discussions held with cardiology units in other hospitals, cardiologists have indicated that many complex procedures that can now be practiced and performed at a successful rate.

The board of directors authorised the lease of the printer for use in the cardiology unit, but because it can create 3D replicas of other organs and systems, medical staff from other units will also have access to the machine. It is therefore considered an important asset to the hospital both in terms of its nature and the value attributable to it. The terms of the lease agreement do however restrict the use of the printer by any other third parties. The useful life of the printer is considered to be 5 years.
EXAMPLE 2-ASSET DEFINITION

• Discuss how the hospital should account for the 3D printer in the accounting records from a conceptual point of view.
In deciding upon the correct accounting treatment of the 3D printer, of consideration is whether it meets the definition and recognition criteria of an asset. According to section 2.15 (a) of IFRS for SME’s, an asset is defined as:

A resource - the 3D printer is a hospital resource given the number of benefits it has both within the cardiology unit and other units in the hospital.

Controlled by the entity - section 2.19 of IFRS for SME’s states that in determining the existence of an asset, right of ownership is not essential. Thus even though the printer is held on a lease, if the entity controls the benefits that are expected to flow to the entity, the printer can be regarded as an asset. The hospital can restrict its use by third parties by applying the terms of the contract. Also the term of the lease of 5 years is the same as its useful life. Thus the hospital will obtain the majority of the benefits of the machine. As such the hospital can be seen to control the printer.

As a result of past event of entering into the lease agreement.

From which future economic benefits are expected to flow to the entity - section 2.17 of IFRS for SME’s states that the economic benefit of an asset if its potential to contribute directly or indirectly to the flow of cash to the entity. Use of the machine will result in planning of the best procedure, minimization of errors, and success of complex operations, all of which can be expected to contribute directly and indirectly to an increase in the number of patients seeking medical care which will ultimately increase the cash flow to the unit. The reduction in operating cost would also reduce costs.

Section 2.27 of IFRS for SME’s states that an entity can only recognise an item as an asset if it meets the following recognition criteria:

It is probable that any future economic benefit associated with the item will flow to the entity- in this regard there is no evidence to suggest that the printer will not be able to be used for its intended use. It is reasonable to assume that is its probable that future economic benefits will flow to the entity as the printer has been used successfully in other hospitals.

It has a cost that can be measured reliably- a fair value/reliable measure would be included in the terms of the contract.

Based on the above, the 3D printer must be accounted for as an asset.
2.8: MEASUREMENT OF ASSETS, LIABILITIES, INCOME AND EXPENSES (2.33 & 2.34)

- Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expenses in its financial statements.

- Most common:
  - historical cost
    - the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition
  - fair value
    - Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
UNDERLYING PRINCIPLES
PERVASIVE RECOGNITION AND MEASUREMENT PRINCIPLES

• The requirements for recognising and measuring assets, liabilities, income and expenses in this Standard are based on pervasive principles that are derived from full IFRS. In the absence of a requirement in this Standard that applies specifically to a transaction or other event or condition, paragraph 10.4 provides guidance for making a judgement and paragraph 10.5 establishes a hierarchy for an entity to follow in deciding on the appropriate accounting policy in the circumstances.
HIERARCHY FOR AN ENTITY TO FOLLOW IN DECIDING ON THE APPROPRIATE ACCOUNTING POLICY

- Develop an accounting policy that is relevant and reliable
- Look for guidance in standards dealing with similar and related issues in IFRS for SMEs
- Use the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 Concepts and Pervasive Principles
- Consider the requirements and guidance in full IFRS dealing with similar and related issues.
On the accrual basis, items are recognised as assets, liabilities, equity, income or expenses when they satisfy the definitions and recognition criteria for those items.

Only statement of cash flow is recognized on the cash flow basis.
2.8.1: INITIAL MEASUREMENT (2.46)

- At initial recognition, an entity shall measure assets and liabilities at historical cost unless this IFRS requires initial measurement on another basis such as fair value.
2.9: OFFSETTING (S2.52)

- An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by this IFRS.
- (a) Measuring assets net of valuation allowances—for example, allowances for inventory obsolescence and allowances for uncollectible receivables—is not offsetting.
- (b) If an entity’s normal operating activities do not include buying and selling non-current assets, including investments and operating assets, then the entity reports gains and losses on disposal of such assets by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses.