



Talking SMEs

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Talking SMEs is the Ernst & Young publication that considers topical issues on the *IFRS for SMEs*



In this issue...

Which entities can apply IFRS for SMEs?

Whilst the standard defines an SME, some entities will need to apply judgment to determine whether they are within the scope of the standard. We look at the definition in more detail and some of the factors to consider in determining the scope.

Tax compliance and tax accounting

In the first edition of *Talking SMEs*, we highlighted that *IFRS for SMEs* may have an impact on both tax compliance and tax accounting for many SMEs. In this edition, we explore in more detail some of the challenges that entities may face when applying the tax section of the standard.

IASB developments

We give an overview of developments at the International Accounting Standards Board (IASB) as they relate to *IFRS for SMEs*.

Which entities can apply IFRS for SMEs?

The *IFRS for SMEs* standard defines an SME and provides guidance regarding the entities to which the standard applies. Whilst for many entities this definition provides a clear answer as to whether the standard can be applied, for some entities, significant judgment is required to determine whether the entity is within the scope of the standard. In this article, we look at the definition in greater depth as well as some of the factors that entities need to consider to determine the scope of the standard.

Some jurisdictions may further define what an SME is, but it is important to note that such changes can only restrict the current scope (and not extend it to non-SMEs). Such restrictions may assist the determination of whether an entity is within the scope or not.

Does an entity have public accountability?

The definition of 'public accountability', given in the *Glossary to IFRS for SMEs* (shown in Box 1), begins with a broad

definition of 'accountability' followed by specific criteria to determine whether an entity has 'public accountability'.

In applying this, entities need to address the following key factors:

- a) Are its debt or equity instruments traded in a public market?
- b) Does the entity hold assets in a fiduciary capacity? Is there a broad group of outsiders? Is this part of the entity's primary business?

Each of these questions is explored in more detail below.

Are its debt or equity instruments traded in a public market?

In most cases, the answer to this question will be straightforward. However, as the term 'public market' is not defined, in some cases, judgment will be required to determine whether a public market exists. Generally, the term 'traded in a public market' is associated with being listed on a formalised exchange that brings together buyers and sellers of the entity's debt or equity instruments to transact at a price on an arm's length basis.

Box 1: Definition of 'public accountability'

Accountability to those existing and potential resource providers, and others external to the entity, who make economic decisions, but are not in a position to demand reports tailored to meet their particular information needs. An entity has public accountability if:

- 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)

or

- b) It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.



However, situations may exist where the acquisition or disposal of such instruments takes place in a non-formalised secondary market or in an over-the-counter transaction. For example, where an entity itself (or through an agent) acquires, redeems or issues such instruments as and when demand exists.

Entities may need to consider the following:

- ▶ Are there any restrictions placed on who may transact in these instruments? The greater the restrictions, the less likely that a public market exists.
- ▶ Who are the parties to the transaction? Trading in a public market is usually between two unrelated counterparties. If the entity (or its agent) is one of these counterparties, it is less likely that a public market exists.
- ▶ Is the price of these transactions a pre-determined fixed price? Generally, if the instrument is traded at a pre-determined price, it is less likely that a public market exists.

Does the entity hold assets in a fiduciary capacity?

Entities need to consider whether they hold and manage financial resources entrusted to them by persons or organisations who are not involved in the management of the entity. The standard gives a number of examples of financial

institutions that typically hold assets in a fiduciary capacity. This is further supported by paragraph BC 59 of the *Basis for Conclusions*, which states "... a primary business of banks, insurance companies, securities brokers/dealers, pension funds, mutual funds and investment banks is to hold and manage financial resources entrusted to them ..." While it may appear that this would scope out all financial institutions, there may be examples where these institutions do not hold assets in a fiduciary capacity.

Module 1 of the International Accounting Standards Committee Foundation's (IASCF) training material for *IFRS for SMEs* includes an example of a bank whose only business is to earn interest on money lent to customers (including the general public). In this example, the entity obtains all of its funds directly from its owner-managers, and does not take deposits from customers. Therefore, although it is a bank, it does not hold assets in a fiduciary capacity and, as such, it is not publicly accountable. The training material also notes that "banks typically have public accountability because of their deposit taking activities rather than their lending activities". Whilst the IASCF training materials are not authoritative, they indicate that the IASB did not intend to exclude all financial institutions (only those that meet the definition of publicly accountable).

Part (b) of the definition states that insurance companies are usually publicly accountable. As *IFRS for SMEs* does not include any guidance on how to account for insurance contracts, the IASB appears to have considered that all insurers would be scoped out of the standard. If this is the case, then the definition may well extend from holding assets to having fiduciary obligations to third parties.

Is there a broad group of outsiders?

The definition of 'public accountability' includes the requirement that entities hold assets in a fiduciary capacity for a broad group of outsiders. Again, this term is not defined, and is open to different interpretations. Paragraph BC59 of the *Basis for Conclusions* provides some guidance and states that this is "... a broad group of clients, customers or members who are not involved in the management of the entities ...".

The implication is that entities that hold assets in a fiduciary capacity for a small group of outsiders may not be publicly accountable. This may be particularly pertinent to special purpose entities (SPEs) that are created by an entity or group. For example, under the definition, a closed investment fund that has only three investors may not be a 'broad' group.

Management will need to apply judgment to the facts and circumstances of each reporting entity to determine whether the entity holds assets in a fiduciary capacity to such a 'broad group of outsiders'.



Is this part of the entity's primary business?

The final part of the definition of 'public accountability' is that the entity must hold assets in a fiduciary capacity as one of its primary businesses. The standard is clear that some entities, such as travel and real estate agents, may hold assets in a fiduciary capacity for reasons that are incidental to its main business. This does not make them publicly accountable. What is unclear in the standard is what constitutes a 'primary business'. Can an entity have multiple primary businesses? What benchmarks (such as assets, turnover, or profit) would be used to conclude whether a business is primary or not? Judgment may be required to determine the point at which holding assets becomes a 'primary' business. For some entities, such as solicitors, holding assets for clients may occur in many transactions and may be an integral part of the service they offer, but it is unclear whether this would be considered part of the primary business, therefore making the entity publicly accountable.

Conclusion

For most entities that wish to apply *IFRS for SMEs*, it will be obvious as to whether they meet the scoping requirements. However, there is a lack of clarity as to the boundaries of the scope. For those entities that fall within this grey area, determining whether or not they have public accountability, and therefore whether they are permitted to use *IFRS for SMEs*, will require significant judgment to apply the definitions to a particular set of facts and circumstances. Until adoption of the standard becomes more widespread, it remains to be seen what practice will develop.

Tax compliance and tax accounting

In the first edition of *Talking SMEs*, we highlighted that this standard may have an impact on both tax compliance and tax accounting for many entities. Firstly, entities will need to consider whether the tax authorities will accept *IFRS for SMEs* as the starting point for determining taxable income for tax compliance purposes. If not, this may require the maintenance of a separate set of books and records, based on statutory accounting or local GAAP, as required by the tax authorities. In many respects, the tax accounting requirements of *IFRS for SMEs* are more complex than tax accounting under full IFRS - an outcome that is counter-intuitive considering that one of the key objectives of *IFRS for SMEs* was to reduce complexity for smaller entities. In the following section, we explore some of the challenges that entities may face when applying the tax section of the standard.

General principles

IFRS for SMEs contains comprehensive rules on accounting for tax that must be applied by all entities adopting the standard. Whilst, in general, *IFRS for SMEs* has simplified accounting for SMEs, in the case of tax, some of the requirements are very complex and may require significant time and resources to implement.

The standard requires a temporary difference approach, whereby tax is accounted for on differences between the carrying amount of assets and liabilities in the balance sheet and the value attributed to them for tax purposes.



Under full IFRS, IAS 12 *Income Taxes* also uses a temporary difference approach. However, in developing *IFRS for SMEs*, the IASB based the tax section on the proposals contained in the March 2009 Exposure Draft (ED) *Income Tax*. In October 2009, the Board decided not to proceed with the ED in its current form and is now considering limited amendments to IAS 12.

This leaves entities adopting *IFRS for SMEs* in an unusual position as the tax section of the standard contains requirements that have not been previously applied under full IFRS. This may cause a number of application issues for SMEs. The IASB intends to review *IFRS for SMEs* on a regular basis, but it is unclear whether this will include changes to the tax requirements of the standard.

Definition of the tax basis

The *Glossary to IFRS for SMEs* defines the tax basis as "the measurement, under applicable substantively enacted tax law, of an asset, liability or equity instrument". As such, the tax basis of an asset is determined by the tax consequences of selling it for its carrying amount at the reporting date and the tax basis of a liability is determined by the tax consequences of settling it for its carrying amount at the reporting date. Therefore, the manner in which the entity expects to recover the asset (or settle the liability), such as through use, is not reflected in the tax basis of the asset. In many cases, the tax basis will be based on hypothetical calculations as most assets and liabilities will not be sold or settled at the reporting date. As a result, the actual tax consequences may be very different in practice.

Recognition of deferred tax assets and liabilities

IFRS for SMEs requires entities to recognise deferred tax for all temporary differences that are expected to increase or reduce taxable profit in the future, with two exceptions:

1. Foreign subsidiaries, branches, associates and joint ventures

No deferred tax is recognised for temporary differences associated with unremitted earnings from foreign subsidiaries, branches, associates and joint ventures, where the investment is permanent in nature, unless the temporary difference will reverse in the foreseeable future.

This exception has been restricted to 'foreign' investments. This means that, where an entity has investments in

domestic entities, deferred tax will need to be recognised on the associated temporary differences. For some entities this may require significant work to calculate and track the deferred taxes.

2. Goodwill

No deferred tax is recognised for temporary differences associated with the initial recognition of goodwill.

These are the only exceptions to recognising deferred tax for SMEs. Under IAS 12, there is an additional exception for items that create temporary differences on initial recognition. Although this has been conceptually difficult to justify, it has resolved a practical issue for those applying full IFRS. This is illustrated in Example 1 below.

Example 1

An entity purchases a building for use as a head office for CU1,000. The entity expects to use the building for 25 years and depreciates it at 4% per annum. The tax rate is 30% and the depreciation is not tax-deductible. On disposal there would be no tax due on any capital gain.

On initial recognition, temporary differences will amount to CU1,000 (tax basis is nil).

The difficulty arises in how to recognise the deferred tax liability on recognition of the asset. The standard provides no guidance. Entities essentially have two choices, either to:

1. Recognise a tax expense of CU300 on acquisition of the building. Recognition of an immediate expense is not particularly meaningful as the entity is recognising a loss, simply by purchasing a non-deductible asset.
2. Gross up the cost of the asset to the nominal amount of CU1,300 that would be paid for a fully deductible asset. However, this may also be undesirable as it makes the financial statements less transparent and raises potential impairment issues.

In the absence of any further guidance in the standard, SMEs will need to develop an accounting policy for these types of transactions.



The accounting requirements in *IFRS for SMEs* apply to both current and deferred taxes, as an uncertain tax position could affect both.

Measurement of deferred tax assets

An SME recognises a deferred tax asset for all temporary differences that are expected to reduce taxable profit in the future, as a total amount. The entity then recognises a valuation allowance against deferred tax assets. Therefore, the net carrying amount equals the highest amount that is more likely than not to be recovered based on current or future taxable profit. The net carrying amount of the deferred tax asset is then reviewed at each reporting date and the valuation allowance is adjusted to reflect the current assessment of future taxable profits. This is likely to require increased documentation to track each deferred tax asset and its related valuation allowance. The entries required to account for the deferred tax asset and the valuation allowance are shown in Example 2.

Uncertain tax positions

Uncertain tax positions (UTPs) are items for which the tax treatment is unclear, or there is a dispute between the reporting entity and the relevant tax authority. These scenarios generally occur where there is uncertainty as to the meaning of the law, or the applicability of the law to a particular transaction, or both.

IFRS for SMEs contains explicit guidance on accounting for UTPs. For most entities this will be a completely new requirement, whether they are transitioning from full IFRS or from a national GAAP. SMEs must measure current and deferred tax assets and liabilities using a probability-weighted average amount of all possible outcomes, assuming that the tax authorities will review the amounts reported and have full knowledge of all relevant information. Changes in this amount must be based on new information, rather than a different interpretation of previously available information.

Example 2

An entity has a deferred tax asset of CU100 arising from previous losses that have been carried forward. Based on reviews of future profits, the entity has determined that it is more likely than not that only CU40 of the asset will be offset against future profits and recovered. Therefore, the entity needs to recognise a valuation allowance of CU60. The entries are as follows:

Dr deferred tax asset	100	
Cr deferred tax – profit or loss		100
Dr deferred tax – profit or loss	60	
Cr valuation allowance		60



The standard does not include any probability threshold for the recognition of UTPs, implying that entities need to review and measure all UTPs.

The accounting requirements in *IFRS for SMEs* apply to both current and deferred taxes, as an uncertain tax position could affect both. For example, where an entity has claimed a deduction for an item that is subject to uncertainty in its tax return, the uncertainty will affect both the measurement of current tax and the tax basis of the item, and hence, also the deferred tax.

It is likely to require increased time, cost and effort for SMEs to identify, document and measure UTPs. For entities that trade internationally, this could impact their dealings with tax authorities worldwide.

For more information about the accounting for UTPs, see our recent publication, *Searching for clarity in uncertain tax positions*, which can be found at www.ey.com/ifrs.

Next steps

Due to the complexities in applying the tax section of the standard, entities will need to allow sufficient time and resources to understand the tax accounting changes, and related potential impacts to other areas, such as tax compliance, before adopting *IFRS for SMEs*. Entities will also need to consider whether changes will be required to information systems and financial statement processes to ensure

that all information is captured on a timely basis. The standard will have an impact across an entity's tax life cycle, including planning, provisioning, compliance and accounting. Therefore, early planning is vital to ensure issues are dealt with as they arise in the adoption process.

IASB developments

Training modules

The IASCF is developing training modules on each of the 35 sections of *IFRS for SMEs*. To date, 17 of the modules are available for download on the IASB website and the remainder are expected to be published later this year.

These modules can be obtained at www.iasb.org/IFRS+for+SMEs/Training+material.htm

SME implementation group

The Trustees of the IASCF have approved the formation of an SME implementation group (SMEIG). The purpose of the group will be to support the international adoption of *IFRS for SMEs* and monitor its implementation.

The group will have two main responsibilities:

- ▶ To consider implementation questions raised by users and publish implementation guidance in the form of questions and answers, where appropriate

- ▶ To make recommendations to the IASB to amend *IFRS for SMEs* for implementation issues and new and amended IFRS standards that have been issued since the *IFRS for SMEs*.

The IASCF Trustees are now seeking nominations for the SMEIG. Applications are invited by 30 April 2010.

Updates on the IASCF activities on the *IFRS for SMEs* standard can be obtained at www.iasb.org/IFRS+for+SMEs/IFRS+for+SMEs.htm.

Ernst & Young publications

IFRS for SMEs - Comparison with IFRS

This publication (to be published in the near future) provides a high-level comparison of the *IFRS for SMEs* standard to the full IFRS standards. An appraisal of the similarities and key differences between the frameworks is provided. In particular, this guide considers the scope, recognition and measurement of the different sections in the *IFRS for SMEs* standard.

For this, and other IFRS publications issued by Ernst & Young, visit our website at www.ey.com/ifrs.

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