1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

INTRODUCTION

The mission of the IFRS Foundation and the International Accounting Standards Board (IASB) is to develop International Financial Reporting Standards (IFRS) that bring transparency, accountability and efficiency to financial markets around the world. They seek to serve the public interest by fostering trust, growth and long-term stability in the global economy.

The driver for the convergence of historically dissimilar financial reporting standards has been mainly to facilitate the free flow of capital so that, for example, investors in the US would become more willing to finance business in, say, China or the Czech Republic. Access to financial statements which are written in the same "language" would help to eliminate a major impediment to investor confidence, sometimes referred to as "accounting risk," which adds to the more tangible risks of making such cross-border investments. Additionally, permission to list a company's equity or debt securities on an exchange has generally been conditional on making filings with national regulatory authorities. These regulators tend to insist either on conformity with local Generally Accepted Accounting Practice (GAAP) or on a formal reconciliation to local GAAP. These procedures are tedious and time-consuming, and the human resources and technical knowledge to carry them out are not always widely available, leading many would-be registrants to forgo the opportunity of broadening their investor bases and potentially lowering their costs of capital.

There were once scores of unique sets of financial reporting standards among the more developed nations ("national GAAP"). The year 2005 saw the beginning of a new era in the global conduct of business, and the fulfilment of a 30-year effort to create the financial reporting rules for a worldwide capital market. During that year's financial reporting cycle, the 27 European Union (EU) member states plus many other countries, including Australia, New Zealand and South Africa, adopted IFRS.

Since then, many countries, such as Argentina, Brazil, Korea, Canada, Mexico and Russia, have adopted IFRS. Indeed, at the time of writing, more than 130 countries now require or permit the use of IFRS. China has moved its national standards significantly towards IFRS. All other major economies, such as Japan and the United States, have either moved towards IFRS in recent years or established time lines for convergence or adoption in the near future.

2007 and 2008 proved to be watershed years for the growing acceptability of IFRS. In 2007, one of the most important developments was that the US Securities and Exchange Commission (SEC) dropped the reconciliation (to US GAAP) requirement, which had formerly applied to foreign private registrants. Since then, those reporting in a manner fully compliant with IFRS (i.e., without any exceptions to the complete set of standards imposed by IASB) have no longer been required to reconcile net income and shareholders' equity to the amounts which would have been presented under US GAAP. In effect, the SEC was acknowledging that IFRS was fully acceptable as a basis for accurate, transparent, meaningful financial reporting.

This easing of US registration requirements for foreign companies seeking to enjoy the benefits of listing their equity or debt securities in the US led understandably to a call by domestic companies to permit them also to choose freely between financial reporting under US GAAP and IFRS. By late 2008 the SEC appeared to have begun the process of acceptance, first for the largest companies in those industries having (worldwide) the preponderance of IFRS adopters, and later for all publicly held companies. However, a new SEC chair took office in 2009, expressing a concern that the move to IFRS, if it were to occur, should perhaps take place more slowly than had previously been indicated.

It had been highly probable that non-publicly held US entities would have remained restricted to US GAAP for the foreseeable future, both from habit and because no other set of standards would be viewed as being acceptable. However, the American Institute of Certified Public Accountants (AICPA), which oversees the private-sector auditing profession's standards in the US, amended its rules in 2008 to fully recognise IASB as an accounting standard-setting body (giving it equal status with the Financial Accounting Standards Board (FASB)), meaning that auditors and other service providers in the US could now issue opinions (or provide other levels of assurance, as specified under pertinent guidelines) which affirmed that IFRS-based financial statements conformed with "generally accepted accounting principles." This change, coupled with the promulgation by IASB of a long-sought standard providing simplified financial reporting rules for privately held entities (described later in this chapter), might be seen as increasing the likelihood that a more broadly-based move to IFRS will occur in the US over the coming years.

The historic 2002 Norwalk Agreement—embodied in a Memorandum of Understanding (MoU) between the US standard setter, FASB, and the IASB—called for "convergence" of the respective sets of standards, and indeed a number of revisions of either US GAAP or IFRS have already taken place to implement this commitment. The aim of the Boards was to complete the milestone projects of the MoU by the end of June 2011.

Despite this commitment by the Boards, certain projects such as financial instruments (impairment and hedge accounting), revenue recognition, leases and insurance contracts were deferred due to their complexity and the difficulty in reaching consensus views. The converged standard on revenue recognition, IFRS 15, was finally published in May 2014, although both Boards subsequently deferred its effective date to annual periods beginning on or after January 1, 2018. The standard on leasing, IFRS 16, was published in January 2016, bringing to completion the work of the Boards on the MoU projects. Details of these and other projects of the standard setters are included in a separate section in each relevant chapter of this book.

Despite the progress towards convergence described above, the SEC dealt a blow to hopes of future alignment in its strategic plan published in February 2014. The document states that the SEC "will consider, among other things, whether a single set of high-quality global accounting standards is achievable," which is a significant reduction in its previously expressed commitment to a single set of global standards. This leaves IFRS and US GAAP as the two comprehensive financial reporting frameworks in the world, with IFRS gaining more and more momentum.

The completed MoU with FASB (and with other international organisations and jurisdictional authorities) has been replaced by a MoU with the Accounting Standards Advisory Forum (ASAF). The ASAF is an advisory group to the IASB, which was set up in 2013. It consists of national standard setters and regional bodies with an interest in financial reporting. Its objective is to provide an advisory forum where members can constructively contribute towards the achievement of the IASB's goal of developing globally accepted high-quality accounting standards. FASB's involvement with the IASB is now through ASAF.

ORIGINS AND EARLY HISTORY OF THE IASB

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systematised form of accounting regulation developed in continental Europe in 1673. Here a requirement for an annual fair value statement of financial position was introduced by the government as a means of protecting the economy from bankruptcies. This form of accounting at the initiative of the state to control economic participants was copied by other states and later incorporated into the 1807 Napoleonic Commercial Code. This method of regulating the economy expanded rapidly throughout continental Europe, partly through Napoleon's efforts and partly through a willingness on the part of European regulators to borrow ideas from each other. This "code law" family of reporting practices was much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on business profits started to be introduced, mainly in the early twentieth century.

This model of accounting serves primarily as a means of moderating relationships between the individual entity and the state. It serves for tax assessment, and to limit dividend payments, and it is also a means of protecting the running of the economy by sanctioning individual businesses which are not financially sound or are run imprudently. While the model has been adapted for stock market reporting and group (consolidated) structures, this is not its main focus.

The other model did not appear until the nineteenth century and arose as a consequence of the industrial revolution. Industrialisation created the need for large concentrations of capital to undertake industrial projects (initially, canals and railways) and to spread risks between many investors. In this model, the financial report provided a means of monitoring the activities of large businesses in order to inform their (non-management) shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanction of the courts. This approach was rapidly adopted by the US as it, too, became industrialised. As the US developed the idea of groups of companies controlled from a single head office (towards the end of the nineteenth century), this philosophy of financial reporting began to become focused on consolidated accounts and the group, rather than the individual company. For differing reasons, neither the UK nor the US governments saw this reporting framework as appropriate for income tax purposes, and in this tradition, while the financial reports inform the assessment process, taxation retains a separate stream of law, which has had little influence on financial reporting.

This second model of financial reporting, sometimes referred to as the Anglo-Saxon financial reporting approach, can be characterised as focusing on the relationship between the business and the investor, and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (e.g., the SEC's mission is to protect the investor and ensure that the securities markets run efficiently), but the financial report is aimed principally at the investor, not the government.

Neither of the two approaches to financial reporting described above is particularly useful in an agricultural economy, or to one that consists entirely of microbusinesses, in the opinion of many observers. Nonetheless, as countries have developed economically (or as they were colonised by industrialised nations) they have tended to adopt variants of one or the other of the two models.

IFRS are an example of the second, capital market-oriented, system of financial reporting rules. The original international standard setter, the International Accounting Standards Committee (IASC), was formed in 1973, during a period of considerable change in accounting regulation. In the US, the FASB had just been created, in the UK the Accounting Standards Committee had recently been set up, the EU was working on the main plank of its own accounting harmonisation plan (the Fourth Directive), and both the UN and the Organisation for Economic Co-operation and Development (OECD) were shortly to create their own accounting committees. The IASC was launched in the wake of the 1972 World Accounting Congress (a five-yearly get-together of the international profession) after an informal meeting between representatives of the British profession (the Institute of Chartered Accountants in England and Wales—ICAEW) and the American profession (the American Institute of Certified Public Accountants—AICPA). A rapid set of negotiations resulted in the professional bodies of Canada, Australia, Mexico, Japan, France, Germany, the Netherlands and New Zealand being invited to join with the US and UK to form the international body. Due to pressure (coupled with a financial subsidy) from the UK, the IASC was established in London, where its successor, the IASB, remains today.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977 (at the next World Congress of Accountants), the IASC had to fight off attempts to make it a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

IASC's efforts entered a new phase in 1987, which led directly to its 2001 reorganisation, when the then-Secretary General, David Cairns, encouraged by the US SEC, negotiated an agreement with the International Organization of Securities Commissions (IOSCO). IOSCO was interested in identifying a common international "passport" whereby companies could be accepted for secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to endorse IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to a level of quality and comprehensiveness stipulated by IOSCO.

Historically, a major criticism of IFRS was that it essentially endorsed all the accounting methods then in wide use, effectively becoming a "lowest common denominator" set of standards. The trend in national GAAP had been to narrow the range of acceptable alternatives, although uniformity in accounting had not been anticipated as a near-term result. The IOSCO agreement energised IASC to improve existing standards by removing the many alternative treatments which were then permitted, thereby improving comparability across reporting entities. The IASC launched its Comparability and Improvements Project with the goal of developing a "core set of standards" that would satisfy IOSCO. These were complete by 1993, not without difficulties and spirited disagreements among the members, but then—to the great frustration of the IASC—the standards were not accepted by IOSCO. Rather than endorsing the standard-setting process of IASC, as was hoped for, IOSCO appeared to want to cherry-pick individual standards. Such a process could not realistically result in near-term endorsement of IFRS for cross-border securities registrations.

Ultimately, the collaboration was relaunched in 1995, with IASC under new leadership, and this began a further period of frenetic activity, where existing standards were again reviewed and revised, and new standards were created to fill perceived gaps in IFRS. This time the set of standards included, among others, IAS 39, on recognition and measurement of financial instruments, which was endorsed, at the very last moment and with great difficulty, as a compromise—and purportedly interim—standard.

At the same time, the IASC had undertaken an exercise to consider its future structure. In part, this was the result of pressure exerted by the US SEC and also by the US private sector standard setter, the FASB, both of which were seemingly concerned that IFRS were not being developed by "due process." While the various parties may have had their own agendas, in fact the IFRS were in need of strengthening, particularly in the way of reducing the range of diverse but accepted alternatives for similar transactions and events. The challenges presented to IASC would ultimately serve to make IFRS stronger.

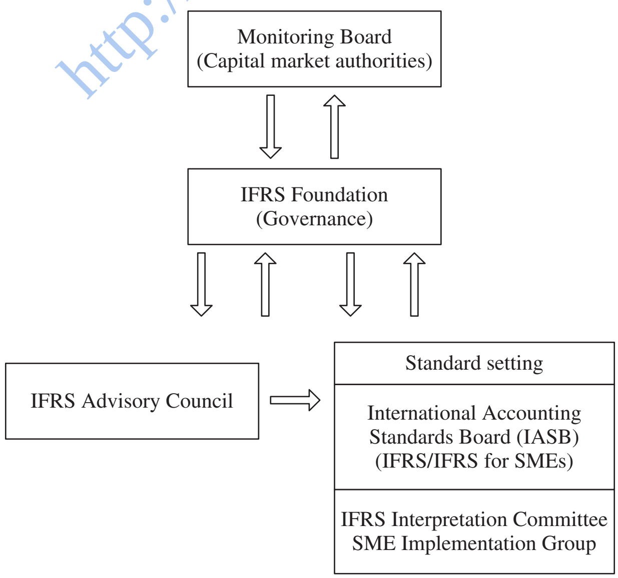
If IASC was to be the standard setter endorsed by the world's stock exchange regulators, it would need a structure which reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the twenty-five years since the IASC was formed, and standards were mostly being set by dedicated and independent national boards such as the FASB, and not by profession-dominated bodies like the AICPA. The choice, as restructuring became inevitable, was between a large, representative approach—much like the existing IASC structure, but possibly with national standard setters appointing representatives—or a small, professional body of experienced standard setters which worked independently of national interests.

The end of this phase of international standard setting, and the resolution of these issues, came about within a short period in 2000. In May of that year, IOSCO members voted to endorse IASC standards, albeit subject to a number of reservations (see discussion later in this chapter). This was a considerable step forward for the IASC, which itself was quickly exceeded by an announcement in June 2000 that the European Commission intended to adopt IFRS as the requirement for primary listings in all member states. This planned full endorsement by the European Union (EU) eclipsed the lukewarm IOSCO approval, and since then the EU has appeared to be the more influential body insofar as gaining acceptance for IFRS has been concerned. Indeed, the once-important IOSCO endorsement has become of little importance given subsequent developments, including the EU mandate and convergence efforts among several standard-setting bodies.

In July 2000, IASC members voted to abandon the organisation's former structure, which was based on professional bodies, and adopt a new structure: beginning in 2001, standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

THE CURRENT STRUCTURE

The formal structure put in place in 2000 has the IFRS Foundation, a Delaware corporation, as its keystone (this was previously known as the IASC Foundation). The Trustees of the IFRS Foundation have both the responsibility to raise funds needed to finance standard setting, and the responsibility of appointing members to the International Accounting Standards Board (IASB), the IFRS Interpretations Committee (IFRIC) and the IFRS Advisory Council (AC). The structure was amended to incorporate the IFRS Foundation Monitoring Board in 2009, renaming and incorporating the SME Implementation Group in 2010 as follows:



The Monitoring Board is responsible for ensuring that the Trustees of the IFRS Foundation discharge their duties as defined by the IFRS Foundation Constitution and for approving the appointment or reappointment of Trustees. The Monitoring Board consists of the Board and the Growth and Emerging Markets Committees of the International Organization of Securities Commissions (IOSCO), the European Commission (EC), the Financial Services Agency of Japan (JFSA), the US Securities and Exchange Commission (SEC), the Brazilian Securities Commission (CVM), the Financial Services Commission of Korea (FSC) and Ministry of Finance of the People's Republic of China (China MOF). The Basel Committee on Banking Supervision participates as an observer.

The IFRS Foundation is governed by trustees and reports to the Monitoring Board. The IFRS Foundation has fundraising responsibilities and oversees the standard-setting work, the IFRS structure and strategy. It is also responsible for a five-yearly formal, public review of the Constitution.

The IFRS Advisory Council is the formal advisory body to the IASB and the Trustees of the IFRS Foundation. Members consist of user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups.

The IASB is an independent body that is solely responsible for establishing International Financial Reporting Standards (IFRS), including the IFRS for SMEs. The IASB also approves new interpretations.

The IFRS Interpretations Committee (the Interpretations Committee) is a committee comprised partly of technical partners in audit firms but also includes preparers and users. The Interpretations Committee's function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different requirements. It also proposes modifications to standards to the IASB, in response to perceived operational difficulties or the need to improve consistency. The Interpretations Committee liaises with the US Emerging Issues Task Force and similar bodies and standard setters in order to preserve convergence at the level of interpretation.

Working relationships are set up with local standard setters who have adopted or converged with International Financial Reporting Standards (IFRS), or are in the process of adopting or converging with IFRS.

PROCESS OF IFRS STANDARD SETTING

The IASB has a formal due process, which is currently set out in the *IFRS Foundation Due Process Handbook* issued in February 2013 by the Due Process Oversight Committee (DPOC), and updated in June 2016 to include the final IFRS Taxonomy due process.

The DPOC is responsible for:

1. reviewing regularly, and in a timely manner, together with the IASB and the IFRS Foundation staff, the due process activities of the standard-setting activities of the IASB;
2. reviewing, and proposing updates to, the Due Process Handbook that relates to the development and review of Standards, Interpretations and the IFRS Taxonomy so as to ensure that the IASB procedures are best practice;
3. reviewing the composition of the IASB's consultative groups to ensure an appropriate balance of perspectives and monitoring the effectiveness of those groups;

4. responding to correspondence from third parties about due process matters, in collaboration with the Director for Trustee Activities and the technical staff;
5. monitoring the effectiveness of the IFRS Advisory Council ("Advisory Council"), the Interpretations Committee and other bodies of the IFRS Foundation relevant to its standard-setting activities; and
6. making recommendations to the Trustees about constitutional changes related to the composition of committees that are integral to due process, as appropriate.

As a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis.

The IASB's agenda is determined in various ways. Suggestions are made by the Trustees, the IFRS Advisory Council, liaison standard setters, the international accounting firms and others. These are debated by IASB and tentative conclusions are discussed with the various consultative bodies. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by IASB in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper, which is then debated at a subsequent meeting. In theory at least, there is an internal process where the staff proposes solutions, and IASB either accepts or rejects them. In practice, the process is more involved: sometimes (especially for projects such as financial instruments) individual Board members are delegated special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one matter or another.

The due process comprises six stages: (1) setting the agenda; (2) project planning; (3) developing and publishing a Discussion Paper; (4) developing and publishing an Exposure Draft; (5) developing and publishing the IFRS; and (6) procedures after an IFRS is issued. The process also includes discussion of Staff Papers outlining the principal issues and analysis of comments received on Discussion Papers and Exposure Drafts. A pre-ballot draft is normally subject to external review. A near final draft is also posted on the limited access website. If all outstanding matters are resolved, the final ballot is applied.

Final ballots on the standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB website and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where IASB takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. The Board may decide not to issue Discussion Papers or to reissue Discussion Papers and Exposure Drafts.

The IASB also has regular public meetings with the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF), among others. Special groups are set up from time to time. An example was the Financial Crisis Advisory Group, which was set up to consider how improvements in financial reporting could help enhance investor confidence in financial markets in the wake of the financial crisis of 2008. Formal working groups are established for certain major projects to provide additional practical input and expertise. Apart from these formal consultative processes, IASB also carries out field trials of some standards (examples of this include performance reporting and insurance), where volunteer preparers apply the proposed new standards. The IASB may also hold some form of public consultation during the process, such as roundtable discussions. The IASB engages closely with stakeholders around the world such as investors, analysts, regulators, business leaders, accounting standard setters and the accountancy profession.

The revised *IFRS Foundation Due Process Handbook* has an introduction section dealing with oversight, which identifies the responsibilities of the Due Process Oversight Committee. The work of the IASB is divided into development and maintenance projects. Developments are comprehensive projects such as major changes and new IFRS Standards. Maintenance consists of narrow scope amendments. A research programme is also described that should form the development base for comprehensive projects. Each phase of a major project should also include an effects analysis detailing the likely cost and benefits of the project.

CONVERGENCE: THE IASB AND FINANCIAL REPORTING IN THE US

Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASB until the 1990s. It was only then that FASB became interested in IASC, when IASC was beginning to work with IOSCO, a body in which the SEC has always had a powerful voice. In effect, both the SEC and FASB were starting to consider the international financial reporting arena, and IASC was also starting to take initiatives to encourage standard setters to meet together occasionally to debate technical issues of common interest.

IOSCO's efforts to create a single passport for secondary listings, and IASC's role as its standard setter, while intended to operate worldwide, would have the greatest practical significance for foreign issuers in terms of the US market. It was understood that if the SEC were to accept IFRS in place of US GAAP, there would be no need for a Form 20-F reconciliation, and access to the US capital markets by foreign registrants would be greatly simplified. The SEC has therefore been a key factor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987, and also observed that too many options for diverse accounting were available under IAS. SEC suggested that it would be more favourably inclined to consider acceptance of IAS (now IFRS) if some or all of these alternatives were reduced. Shortly after IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) to the effect that, to be acceptable, IFRS would need to satisfy the following three criteria:

1. It would need to establish a core set of standards that constituted a comprehensive basis of accounting;
2. The standards would need to be of high quality, and enable investors to analyse performance meaningfully both across time periods and among different companies; and
3. The standards would have to be rigorously interpreted and applied, as otherwise comparability and transparency could not be achieved.

IASC's plan was predicated on its completion of a core set of standards, which would then be handed over to IOSCO, which in turn would ask its members for an evaluation, after which IOSCO would issue its verdict as to acceptability. It was against this backdrop that the SEC issued a "concept release" in 2000 that solicited comments regarding the acceptability of the core set of standards, and whether there appeared to be a sufficiently robust compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, whether auditors would ensure this and whether stock exchange regulators would verify such compliance.

This last-named element remains beyond the control of IASB, and is within the domain of national compliance bodies or professional organisations in each jurisdiction. The IASC's Standards Interpretations Committee (SIC, which was later succeeded by IFRIC and thence the IFRS Interpretations Committee (the Interpretations Committee)) was formed to help ensure uniform interpretation, and the Interpretations Committee has taken a number of initiatives to establish liaison channels with stock exchange regulators and national interpretations bodies—but the predominant responsibilities remain in the hands of the auditors, the audit oversight bodies and the stock exchange oversight bodies.

The SEC's stance at the time was that it genuinely wanted to see IFRS used by foreign registrants, but that it preferred convergence (so that no reconciliation would be necessary) over the acceptance of IFRS as they were in 2000 without reconciliation. In the years since, the SEC has in many public pronouncements supported convergence and, as promised, waived reconciliations in 2007 for registrants fully complying with IFRS. Thus, for example, the SEC welcomed various proposed changes to US GAAP to converge with IFRS.

Relations between FASB and IASB have grown warmer since IASB was restructured, perhaps influenced by the growing awareness that IASB would assume a commanding position in the financial reporting standard-setting domain. The FASB had joined the IASB for informal meetings as long ago as the early 1990s, culminating in the creation of the G4+1 group of Anglophone standard setters (US, UK, Canada, Australia and New Zealand, with the IASC as an observer), in which FASB was an active participant. Perhaps the most significant event was the signing by IASB and FASB of the Norwalk Agreement in October 2002, which set out a programme for the convergence of their respective sets of financial reporting standards. The organisations' staffs subsequently worked together on a number of vital projects, including business combinations and revenue recognition and, later, supplemented by the 2006 and 2008 Memoranda of Understanding (MoU) between these bodies.

In June 2010, the Boards announced a modification to their convergence strategy, responding to concerns from some stakeholders regarding the volume of draft standards due for publication in close proximity. The strategy retained the June 2011 target date to complete those projects for which the need for improvement was the most urgent. In line with this strategy, the Boards completed the consolidation (including joint arrangements) and fair value measurement project before the June 2011 target date. The derecognition project was cancelled and only disclosure amendments were incorporated in the standard. Projects on financial instruments, leases, revenue and insurance contracts were extended to create significant time for reconsultation after comments were received.

With the end of the MoU with FASB, FASB has become a member of ASAF similarly to other standard setters. The remaining outstanding MoU projects were thus completed as IASB projects and not joint projects.

However, certain convergence problems remain, largely of the structural variety. FASB operates within a specific national legal framework, while IASB does not. Equally, both have what they term "inherited" GAAP (i.e., differences in approach that have a long history and are not easily resolved). FASB also has a tradition of issuing very detailed, prescriptive ("rules-based") standards that give bright-line accounting (and, consequently, audit) guidance, which are intended to make compliance control easier and remove uncertainties. Notwithstanding that detailed rules had been ardently sought by preparers and auditors alike for many decades, in the post-Enron world, after it became clear that some of these highly prescriptive rules had been abused, interest turned toward developing standards that would rely more on the expression of broad financial reporting objectives, with far less detailed instruction on how to achieve them ("principles-based" standards). This was seen as being superior to the US GAAP approach, which mandated an inevitably doomed effort to prescribe responses to every conceivable fact pattern to be confronted by preparers and auditors.

This exaggerated rules-based vs. principles-based dichotomy was invoked particularly following the frauds at US-based companies WorldCom and Enron, but before some of the more prominent European frauds, such as Parmalat (Italy) and Royal Ahold (the Netherlands), came to light, which would suggest that the use of neither US GAAP nor IFRS could protect against the perpetration of financial reporting frauds if auditors were derelict in the performance of their duties or even, on rare occasions, complicit in management's frauds. As an SEC study (which had been mandated by the Sarbanes-Oxley Act of 2002) into principles-based standards later observed, use of principles alone, without detailed guidance, reduces comparability. The litigious environment in the US also makes companies and auditors reluctant to step into areas where judgements have to be taken in uncertain conditions. The SEC's solution is "objectives-based" standards, which are both soundly based on principles and inclusive of practical guidance.

Events in the mid to late 2000s served to accelerate the pressure for full convergence between US GAAP and IFRS. In fact, the US SEC's decision in late 2007 to waive reconciliation requirements for foreign registrants complying with "full IFRS" was a clear indicator that the outright adoption of IFRS in the US could be on the horizon, and that the convergence process might be made essentially redundant if not actually irrelevant. The SEC subsequently granted qualifying US registrants (major players in industry segments, the majority of whose worldwide participants already report under IFRS) the limited right to begin reporting under IFRS in 2009.

In late 2008, the SEC proposed its so-called "roadmap" for a phased-in IFRS adoption, setting out four milestones. which, if met, could have led to wide-scale adoption beginning in 2014. However, under new leadership, which assumed office in 2009, the SEC has shown that it will act with less urgency on this issue, and achievement of the "milestones"—which include a number of subjective measures such as improvement in standards and level of IFRS training and awareness among US accountants and auditors—leaves room for later balking at making the final commitment to IFRS. Notwithstanding these impediments to progress, the authors believe that there is ultimately an inexorable move toward universal adoption of IFRS, and that the leading academic and public accounting (auditing) organisations must, and will, take the necessary steps to ensure that this can move forward. For example, in the US the principal organisation of academicians is actively working on standards for IFRS-based accounting curricula, and the main organisation representing independent accountants is producing Web-based materials and live conferences to educate practitioners about IFRS matters.

While the anticipated further actions by the SEC will only directly promote or require IFRS adoption by multinational and other larger, publicly held business entities, and later by even small, publicly held companies, in the longer run, even medium- and smaller-sized entities will probably opt for IFRS-based financial reporting. There are several reasons to predict this "trickle down" effect. First, because some involvement in international trade is increasingly a characteristic of all business operations, the need to communicate with customers, creditors and potential partners or investors will serve to motivate "one language" financial reporting. Secondly, the notion of reporting under "second-class GAAP" rather than under the standards employed by larger competitors will eventually prove to be unappealing. And thirdly, IASB's issuance of a one-document comprehensive standard on financial reporting by entities having no public reporting responsibilities (the IFRS for SMEs, discussed later in this chapter), coupled with formal recognition under US auditing standards that financial reporting rules established by IASB are a basis for an expression of an auditor's professional opinion, may actually find enthusiastic support among smaller US reporting entities and their professional services providers, even without immediate adoption among publicly held companies.

THE IASB AND EUROPE

Although France, Germany, the Netherlands and the UK were founding members of the predecessor organisation, the IASC, and have remained heavily involved with IASB, the European Commission (EC) as such has generally had a fitful relationship with the international standard setter. The EC did not participate in any way until 1990, when it finally became an observer at Board meetings. It had had its own regional programme of harmonisation since the 1960s and in effect only officially abandoned this in 1995 when, in a policy paper, it recommended to member states that they seek to align their rules for consolidated financial statements with IFRS. Notwithstanding this, the Commission gave IASB a great boost when it announced in June 2000 that it wanted to require all listed companies throughout the European Union (EU) to use IFRS beginning in 2005 as part of its initiative to build a single European financial market. This intention was made concrete with the approval of the IFRS Regulation in June 2002 by the European Council of Ministers (the supreme EU decision-making authority).

The EU decision was all the more welcome given that, to be effective in legal terms, IFRS have to be enshrined in EU statute law, creating a situation where the EU is in effect ratifying as laws the set of rules created by a small, self-appointed, private-sector body. This proved to be a delicate situation, which was revealed within a very short time to contain the seeds of unending disagreements, as politicians were being asked in effect to endorse something over which they had no control. They were soon being lobbied by corporate interests that had failed to effectively influence IASB directly, in order to achieve their objectives, which in some cases involved continued lack of transparency regarding certain types of transactions or economic effects, such as fair value changes affecting holdings of financial instruments. The process of obtaining EU endorsement of IFRS was at the cost of exposing IASB to political pressures in much the same way that the US FASB has at times been the target of congressional manipulations (e.g., over stock-based compensation accounting rules in the mid-1990s, the derailing of which arguably contributed to the practices that led to various backdating abuse allegations made in more recent years).

The EU created an elaborate machinery to mediate its relations with IASB. It preferred to work with another private-sector body, created for the purpose, the European Financial

Reporting Advisory Group (EFRAG), as the formal conduit for EU inputs to IASB. EFRAG was formed in 2001 by a collection of European representative organisations (for details see www.efrag.org), including the European Accounting Federation (FEE) and a European employer organisation (BUSINESSEUROPE). EFRAG in turn formed the small Technical Expert Group (TEG) that does the detailed work on IASB proposals. EFRAG consults widely within the EU, and particularly with national standard setters and the European Commission to canvass views on IASB proposals, and provides input to IASB. It responds formally to all Discussion Papers and Exposure Drafts.

At a second stage, when a final standard is issued, EFRAG is asked by the EC to provide a report on the standard. This report is to state whether the standard has the requisite quality and is in conformity with European company law directives. The EC then asks another entity, the Accounting Regulatory Committee (ARC), whether it wishes to endorse the standard. ARC consists of permanent representatives of the EU member state governments. It should normally only decline to endorse IFRS if it believes they are not in conformity with the overall framework of EU law and should not take a strategic or policy view. However, the European Parliament also has the right to comment independently, if it so wishes. If ARC does not endorse a standard, the EC may still ask the Council of Ministers to override that decision.

Experience has shown that the system suffers from a number of problems. First, although EFRAG is intended to enhance EU inputs to IASB, it may in fact isolate people from IASB, or at least increase the costs of making representations. For example, when IASB revealed its intention to issue a standard on stock options, it received nearly a hundred comment letters from US companies (who report under US GAAP, not IFRS), but only one from EFRAG, which in the early 2000s effectively represented about 90% of IASB's constituents. It is possible, however, that EFRAG is seen at IASB as being only a single respondent, and if so, that people who have made the effort to work through EFRAG feel underrepresented. In addition, EFRAG will inevitably present a distillation of views, so it is already filtering respondents' views before they reach IASB. The only recourse is for respondents to make representations not only to EFRAG but also directly to IASB.

However, resistance to the financial instruments standards, IAS 32 and IAS 39, put the system under specific strain. These standards were already in existence when the EC announced its decision to adopt IFRS for European listed companies, and they had each been exhaustively debated before enactment. European adoption again exposed these particular standards to strenuous debate.

The first task of EFRAG and ARC was to endorse the existing standards of IASB. They did this—but excluded IASs 32 and 39 on the grounds that they were being extensively revised as part of IASB's then-ongoing *Improvements Project*.

During the exposure period of the improvements proposals—which exceptionally included roundtable meetings with constituents—the European Banking Federation, under particular pressure from French banks, lobbied IASB to modify the standard to permit special accounting for macro-hedging. The IASB agreed to do this, even though that meant the issuance of another Exposure Draft and a further amendment to IAS 39 (which was finally issued in March 2004). The bankers did not like the terms of the amendment, and even as it was still under discussion, they appealed to the French president and persuaded him to intervene. He wrote to the EC in July 2003, saying that the financial instruments standards were likely to cause banks' reported earnings to be more volatile and would destabilise the

European economy, and thus that the proposed standard should not be approved. He also argued that the Commission did not have sufficient input to the standard-setting process.

This drive to alter the requirements of IAS 39 was intensified when the European Central Bank complained in February 2004 that the "fair value option," introduced to IAS 39 as an improvement in final form in December 2003, could be used by banks to manipulate their *prudential ratios* (the capital to asset ratios used to evaluate bank safety), and asked IASB to limit the circumstances in which the option could be used. IASB agreed to do this, although this meant issuing another Exposure Draft and a further amendment to IAS 39, which was not finalised until mid-2005. When IASB debated the issue, it took a pragmatic line that no compromise of principle was involved, and that it was reasonable that the principal bank regulator of the Board's largest constituent by far should be accommodated. The fact that the European Central Bank had not raised these issues at the original Exposure Draft stage was not discussed, nor was the legitimacy of a constituent deciding unilaterally it wanted to change a rule that had just been approved. The Accounting Standards Board of Japan lodged a formal protest, and many other constituents were not pleased at this development.

Ultimately, ARC approved IAS 32 and IAS 39, but a "carve-out" from IAS 39 was prescribed. Clearly the EU's involvement with IFRS is proving to be a mixed blessing for IASB, both exposing it to political pressures that are properly an issue for the Commission, not IASB, and putting its due process under stress. Some commentators speculated that the EU might even abandon IFRS, but this is not a realistic possibility, given the worldwide movement toward IFRS and the fact that the EU had already tried and rejected the regional standard-setting route.

A better observation is that this is merely part of a period of adjustment, with regulators and lobbyists both being uncertain as to how exactly the system does and should work, and both testing its limits, but with some *modus vivendi* evolving over time.

The EC decision to impose "carve-outs" has most recently had the result that the US SEC's historic decision to eliminate reconciliation to US GAAP for foreign private issuers has been restricted to those registrants that file financial statements that comply with "full IFRS" (which implies that those using "Euro-IFRS" and other national modifications of IFRS promulgated by the IASB will not be eligible for this benefit). Registrants using any deviation from pure IFRS, and those using any other national GAAP, will continue to be required to present a reconciliation to US GAAP. Over time, it can be assumed that this will add to the pressure to report under "full IFRS," and that even the EU may eventually line up behind full and complete adherence to officially promulgated IFRS. In November 2009 EFRAG decided to defer the endorsement of IFRS 9, although stating that in principle they agreed with the management approach adopted in the standard. EFRAG's deferral arose because of its belief that more time should be taken to consider the outcome of other sections of the financial instrument project and that the sections should be endorsed as a package. EFRAG published its final endorsement advice on IFRS 9 in September 2015, and the standard was finally endorsed for use in the EU in November 2016.

In June 2010 EFRAG issued a new *Strategy for European Proactive Financial Reporting Activities*. This strategy of proactive activities enhances EFRAG's role in influencing standard setting by early engagement with European constituents to provide effective and timely input to the IASB's work. This demonstrates that EFRAG is positively committed to the standard-setting process and it has duly become a member of ASAF.

APPENDIX A: CURRENT INTERNATIONAL FINANCIAL REPORTING STANDARDS (IAS/IFRS) AND INTERPRETATIONS (SIC/IFRIC)

IFRS 1	First-Time Adoption of IFRS
IFRS 2	Share-Based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments (effective for accounting periods commencing on or after January 1, 2018 and will supersede IAS 39 and IFRIC 9)
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interest in Other Entities
IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers (effective for accounting periods commencing on or after January 1, 2018 and will supersede IAS 11, IAS 18, IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31)
IFRS 16	Leases (effective for accounting periods commencing on or after January 1, 2019 and will supersede IAS 17, IFRIC 4, SIC 15 and SIC 27)
IFRS 17	Insurance Contracts (effective for accounting periods commencing on or after January 1, 2022 and will supersede IFRS 4, IFRIC 4 and SIC 15)
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts (replaced by IFRS 15)
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue (replaced by IFRS 15)
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related-Party Disclosure
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets

IAS 39 Financial Instruments: Recognition and Measurement (replaced by IFRS 9)
IAS 40 Investment Property
IAS 41 Agriculture
IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 4 Determining whether an Arrangement contains a Lease
IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6 Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment
IFRIC 7 Applying the Restatement Approach under IAS 29, *Financial Reporting in Hyperinflationary Economies*
IFRIC 9 Reassessment of Embedded Derivatives (replaced by IFRS 9)
IFRIC 10 Interim Financial Reporting and Impairment
IFRIC 12 Service Concession Arrangements
IFRIC 13 Customer Loyalty Programmes (replaced by IFRS 15)
IFRIC 14 IAS 19—*The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*
IFRIC 15 Agreements for the Construction of Real Estate (replaced by IFRS 15)
IFRIC 16 Hedges of a Net Investment in a Foreign Operation
IFRIC 17 Distributions of Non-cash Assets to Owners
IFRIC 18 Transfer of Assets from Customers (replaced by IFRS 15)
IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments
IFRIC 20 Stripping Costs in the Production Phase of a Surface Mine
IFRIC 21 Levies
IFRIC 22 Foreign Currency Transactions and Advance Consideration
IFRIC 23 Uncertainty over Income Tax Treatments
SIC 7 Introduction of the Euro
SIC 10 Government Assistance—No Specific Relation to Operating Activities
SIC 15 Operating Leases—Incentives
SIC 25 Income Taxes—Changes in the Tax Status of an Enterprise or its Shareholders
SIC 27 Evaluating the Substance of Transactions involving the Legal Form of a Lease
SIC 29 Disclosure—Service Concession Arrangements
SIC 31 Revenue—Barter Transactions Involving Advertising Services (replaced by IFRS 15)
SIC 32 Intangible Assets—Web Site Costs

APPENDIX B: PROJECTS COMPLETED SINCE PREVIOUS ISSUE (JULY 2017 TO JUNE 2018)

Project	**Issue date**	**Nature**	**Effective date**
Long-term Interests in Associates and Joint Ventures (amendments to IAS 28)	October 2017	To clarify that the exclusion in IFRS 9 applies only to interests a company accounts for using the equity method.	January 1, 2019

Project	Issue date	Nature	Effective date
Prepayment Features with Negative Compensation (amendments to IFRS 9)	October 2017	To allow the measurement of certain prepayable financial assets with so-called negative compensation at amortised cost.	January 1, 2019
Income Tax Consequences of Payments on Instruments classified as Equity (amendments to IAS 12)	December 2017	To clarify that a company accounts for all income tax consequences of dividends in the same way, regardless of how the tax arises.	January 1, 2019
Previously Held Interests in a Joint Operation (Amendments to IFRS 3 and IFRS 11)	December 2017	To clarify when joint operations would and would not be remeasured.	January 1, 2019
Plan Amendment, Curtailment or Settlement (amendments to IAS17)	February 2018	To clarify that, after a plan event, a company would use updated assumptions to measure current service cost and net interest for the remainder of the reporting period after the plan event.	January 1, 2019
Conceptual Framework for Financial Reporting	March 2018	To describe the objective of and concepts for general purpose financial reporting.	January 1, 2020

APPENDIX C: IFRS FOR SMEs

A long-standing debate among professional accountants, users and preparers—between those advocating some form of simplified financial reporting standards for smaller or non-publicly responsible entities (however they are defined), and those arguing that all reporting entities purporting to adhere to officially mandated accounting standards should do so with absolute faithfulness—was resolved on July 9, 2009 with the publication of the *International Financial Reporting Standard (IFRS) for Small and Medium-Sized Entities (IFRS for SMEs)*. Notwithstanding the name, it is actually intended as an optional, somewhat simplified and choice-limited comprehensive financial reporting standard for enterprises not having public accountability. Many of the recognition and measurement principles in full IFRS have been simplified, disclosures significantly reduced and topics not relevant to SMEs omitted from the IFRS for SMEs. The IASB carried out a comprehensive review of the *IFRS for SMEs* which it completed in May 2015 resulting in limited amendments to the standard. A complete revised version of the standard was issued in December 2015 and is effective from January 1, 2017. The IASB expects that revisions to the standard will be limited to once every three years.

A parallel debate on accounting for smaller entities raged in the UK, the US and in other national GAAP domains for decades. In the US, a number of embryonic proposals have been offered over at least the past 30 years, but no serious offering was forthcoming, largely because the idea of differential recognition or measurement standards for smaller entities was seen as conceptually unappealing, leaving the relatively trivial issue of differential disclosures as the focus of discussion. Apart from a limited number of disclosure topics, such as segment results and earnings per share, and some pension obligation details, this proved an unproductive line of inquiry, and no sweeping changes were ever adopted or even proposed.

In the UK, the story was different. A single, comprehensive standard, the *Financial Reporting Standard for Smaller Entities* (FRSSE), was successfully implemented more than 20 years ago, and then revised several times, employing a periodic updating strategy, which IASB has now emulated. Rather than impose different recognition or measurement concepts on smaller entities, the approach taken, in the main, was to slim down the standards, eliminate much of the background and illustrative materials, and in some cases narrow or eliminate the alternative methods that users of full UK GAAP could elect to apply, with some concomitant simplifications to informative disclosures. Since this was deemed to have been successful in the UK, IASB determined to emulate it, beginning with a Discussion Paper in 2004, and continuing via an early-2007 Exposure Draft to a final standard in mid-2009.

In August 2009, the UK Accounting Standards Board (ASB) issued a consultation paper to adopt *IFRS for SMEs* in the UK. Good support was received to adopt a standard based on the *IFRS for SMEs* as a second-tier standard. *FRSSE* was to be retained as an interim measure for a third-tier standard. The process culminated in the issue, in March 2013, of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, a standard based on the *IFRS for SMEs*, which applies to second-tier entities with effect from accounting periods commencing on or after January 1, 2015.

The enthusiasm and support that was shown for the *IFRS for SMEs* project from national accounting standard setters throughout the world stemmed mostly from the widely acknowledged complexity of the full body of IFRS, and from the different statutory requirements for financial reporting in many countries, which in many instances demand that audited financial statements, without any qualifications, be submitted to tax or other authorities. For example, in the European Union about 7,000 listed companies were implementing IFRS in 2005, but more than 5 million SMEs are required to prepare their financial statements in accordance with various national GAAP, resulting in lack of comparability across this sector of financial reporting entities. Reportedly, more than 50 different sets of standards govern private reporting in the 28 EU nations. EFRAG has not decided whether the *IFRS for SMEs* should be endorsed in Europe, although most countries have responded positively to such an implementation.

It had long been asserted, although often without solid evidence, that the complexity of the full body of IFRS (and, even more so, of full US GAAP) imposes a high and unwelcome cost on implementing and applying these standards, and that many or most external users of the resulting financial statements did not see value commensurate with the cost and effort associated with their preparation. Whether or not this is true, many now believe that the *IFRS for SMEs* will provide companies with an easier transition to full IFRS, thus serving to accomplish, in the longer term, a more thorough and broadly-based move towards universal reporting under a single set of financial reporting standards.

Opponents of a separate set of standards for SMEs believe that all entities should follow the same basic set of accounting principles for the preparation of general-purpose financial statements, whether that set of standards be IFRS or US GAAP. Some have noted that complexity in accounting is merely a symptom—the inevitable result of the ever-increasing complexity of transactional structures, such as the widespread use of "engineered" financial products. Based on observations of the difficulties faced by companies implementing and applying the full IFRS, others have concluded that the problem is not that SMEs need simpler accounting, but that all reporting entities would benefit from reporting requirements that are less complex and more principles based. Since this latter goal seemed to be perpetually unattainable, momentum ultimately shifted in favour of having a simplified stand-alone standard for either smaller or non-public companies. The *IFRS for SMEs*, available for use by non-publicly accountable entities of any size, is the solution that has been offered by IASB to this chronic problem.

Because the IASB lacks the power to require any company to use its standards, the adoption of the *IFRS for SMEs* is a matter for each country to decide. The issue must be resolved by a country's government legislators and regulators, or by an independent standard setter, or by a professional accountancy body. Each country needs to establish criteria to determine the eligibility of reporting entities seeking to qualify under the standard as a "small or medium-sized" entity.

The *IFRS for SMEs* is not immediately updated for any changes to full IFRS but, as noted above, the IASB issued amendments in the first half of 2015 and then anticipates updating the standard every three years thereafter.

Definition of SMEs

The *IFRS for SMEs* is intended for entities that do not have public accountability. An entity has public accountability—and therefore would not be permitted to use the *IFRS for SMEs*—if it meets either of the following conditions: (1) it has issued debt or equity securities in a public market; or (2) it holds assets in a fiduciary capacity, as one of its primary businesses, for a broad group of outsiders. The latter category of entity would include most banks, insurance companies, securities broker/dealers, pension funds, mutual funds and investment banks. The standard does not impose a size test in defining SMEs, notwithstanding its name.

The standard also states that it is intended for entities which publish financial statements for external users, as with IFRS and US GAAP. In other words, the standard is not intended to govern internal or managerial reporting, although there is nothing to prevent such reporting from fully conforming to such standards.

A subsidiary of an entity that employs full IFRS, or an entity that is part of a consolidated entity that reports in compliance with IFRS, may report, on a stand-alone basis, in accordance with the *IFRS for SMEs*, if the financial statements are so identified, and if the subsidiary does not have public accountability itself. If this is done, the standard must be fully complied with, which could mean that the subsidiary's stand-alone financial statements would differ from how they are presented within the parent's consolidated financial statements; for example, in the subsidiary's financial statements prepared in accordance with the *IFRS for SMEs*, borrowing costs incurred in connection with the construction of long-lived assets would be expensed as incurred, but those same borrowing costs would be capitalised in the consolidated financial statements, since IAS 23 as most recently revised no longer provides the option of immediate expensing. In the authors' view, this would not be optimal financial reporting, and the goals of consistency and comparability would be better served if the stand-alone financial statements of the subsidiary were also based on full IFRS.

IFRS for SMEs is a Complete, Self-Contained Set of Requirements

The *IFRS for SMEs* is a complete and comprehensive standard, and accordingly contains much or most of the vital guidance provided by full IFRS. For example, it defines the qualities that are needed for IFRS-compliant financial reporting (reliability, understandability, et al.), the elements of financial statements (assets, liabilities, et al.), the required minimum captions in the required full set of financial statements, the mandate for comparative reporting and so on. There is no need for an entity reporting under this standard to refer elsewhere (other than for guidance in IAS 39, discussed below), and indeed it would be improper to do so.

An entity having no public accountability, which elects to report in conformity with the *IFRS for SMEs*, must make an "explicit and unreserved" declaration to that effect in the notes to the financial statements. As with a representation that the financial statements comply with full IFRS, if this representation is made, the entity must comply fully with all relevant requirements in the standard(s).

Many options under full IFRS remain under the *IFRS for SMEs*. For example, a single statement of comprehensive income may be presented, with profit or loss being an intermediate step in the derivation of the period's comprehensive income or loss, or alternatively a separate statement of income can be displayed, with profit or loss (the "bottom line" in that statement) then being the opening item in the separate statement of comprehensive income. Likewise, most of the mandates under full IFRS, such as the requirement to consolidate special-purpose entities that are controlled by the reporting entity, also exist under the *IFRS for SMEs*.

Modifications of Full IFRS made in IFRS for SMEs

Compared to full IFRS, the aggregate length of the standard, in terms of number of words, has been reduced by more than 90%. This was achieved by removing topics deemed not to be generally relevant to SMEs, by eliminating certain choices of accounting treatments and by simplifying methods for recognition and measurement. These three sets of modifications to the content of full IFRS, which are discussed below, respond both to the perceived needs of users of SMEs' financial statements and to cost-benefit concerns. According to the IASB, the set of standards in the *IFRS for SMEs* will be suitable for a typical enterprise having 50 employees, and will also be valid for so-called micro-entities having only a single or a few employees. However, no size limits are stipulated in the standard, and thus even very large entities could conceivably elect to apply the *IFRS for SMEs*, assuming they have no public accountability as defined in the standard, and that no objections are raised by their various other stakeholders, such as lenders, customers, vendors or joint venture partners.

Omitted topics. Certain topics covered in the full IFRS were viewed as not being relevant to typical SMEs (e.g., rules pertaining to transactions that were thought to be unlikely to occur in an SME context), and have accordingly been omitted from the standard. This leaves open the question of whether SMEs could optionally seek expanded guidance in the full IFRS. Originally, when the Exposure Draft of the *IFRS for SMEs* was released, cross-references to the full IFRS were retained, so that SMEs would not be precluded from applying any of the financial reporting standards and methods found in IFRS, essentially making the *IFRS for SMEs* standard entirely optional on a component-by-component basis. However, in the final *IFRS for SMEs* standard all of these cross-references have been removed, with the exception of a reference to IAS 39, *Financial Instruments: Recognition and Measurement*, thus making the *IFRS for SMEs* a fully stand-alone document, not to be used in conjunction with the full IFRS. An entity that would qualify for use of the *IFRS for SMEs* must therefore make a decision to use full IFRS or the *IFRS for SMEs* exclusively.

Topics addressed in full IFRS, which are entirely omitted from the *IFRS for SMEs*, are as follows:

- Earnings per share;
- Interim reporting;
- Segment reporting;
- Special accounting for assets held for sale;
- Insurance (since, because of public accountability, such entities would be precluded from using *IFRS for SMEs* in any event).

Thus, for example, if a reporting entity concluded that its stakeholders wanted presentation of segment reporting information, and the entity's management wished to provide that to them, it would elect to prepare financial statements in conformity with the full set of IFRS, rather than under the *IFRS for SMEs*.

Only the simpler option included. Where full IFRS provide an accounting policy choice, generally only the simpler option is included in *IFRS for SMEs*. SMEs will not be permitted to employ the other option(s) provided by the full IFRS, as had been envisioned by the Exposure Draft that preceded the standard, as all cross-references to the full IFRS have been eliminated.

The simpler options selected for inclusion in *IFRS for SMEs* are as follows, with the excluded alternatives noted:

- For investment property, measurement is driven by circumstances rather than a choice between the cost and fair value models, both of which are permitted under IAS 40, *Investment Property*. Under the provisions of the *IFRS for SMEs*, if the fair value of investment property can be measured reliably without undue cost or effort, the fair value model must be used. Otherwise, the cost method is required.
- Use of the cost-amortisation-impairment model for intangible assets is required; the revaluation model set out in IAS 38, *Intangible Assets*, is not allowed.
- Immediate expensing of borrowing costs is required; the capitalisation model stipulated under revised IAS 23 is not deemed appropriate for SMEs.
- Jointly controlled entities cannot be accounted for under the proportionate consolidation method under the *IFRS for SMEs*, but can be under full IFRS as they presently exist. The *IFRS for SMEs* does permit the use of the fair value-through-earnings method as well as the equity method, and even the cost method can be used when it is not possible to obtain price or value data.
- Entities electing to employ the *IFRS for SMEs* are required to expense development costs as they are incurred, together with all research costs. Full IFRS necessitates making a distinction between research and development costs, with the former expensed and the latter capitalised and then amortised over an appropriate period receiving economic benefits.

It should be noted that the Exposure Draft that preceded the original version of the *IFRS for SMEs* would have required that the direct method for the presentation of operating cash flows be used, to the exclusion of the less desirable, but vastly more popular, indirect method. The final standard has retreated from this position and permits both methods, so it includes necessary guidance on application of the indirect method, which was absent from the draft.

All references to full IFRS found in the original draft of the standard have been eliminated, except for the reference to IAS 39, which may be used, optionally, by entities reporting under the *IFRS for SMEs*. The general expectation is that few reporting entities will opt to do this, since the enormous complexity of that standard was a primary impetus to the development of the streamlined *IFRS for SMEs*.

It is inevitable that some financial accounting or reporting situations will arise for which the *IFRS for SMEs* itself will not provide complete guidance. The standard provides a hierarchy, of sorts, of additional literature upon which reliance could be placed, in the absence of definitive rules contained in the *IFRS for SMEs*. First, the requirements and guidance that are set out for highly similar or closely related circumstances would be consulted within the *IFRS for SMEs*. Second, the *Concepts and Pervasive Principles* section (Section 1.2) of the standard would be consulted, in the hope that definitions, recognition criteria and measurement concepts (e.g., for assets, revenues) would provide the preparer with sufficient guidance to reason out a valid solution. Third and last, full IFRS is identified explicitly as a source of instruction. Although reference to US (or other) GAAP is not suggested as a tactic, since full IFRS permits preparers to consider the requirements of national GAAP, if based on a framework similar to full IFRS, this omission may not indicate exclusion as such.

Recognition and measurement simplifications. For the purposes of the *IFRS for SMEs*, IASB has made significant simplifications to the recognition and measurement principles included in full IFRS. Examples of the simplifications to the recognition and measurement principles found in full IFRS are as follows:

1. Financial instruments:

   a. *Classification of financial instruments*. Only two categories for financial assets (cost or amortised cost, and fair value through profit or loss) are provided, rather than the four found in full IFRS. Because the available-for-sale and held-to-maturity classifications under IAS 39 are not available, there will be no need to deal with all of the "intent-driven" held-to-maturity rules, or related "tainting" concerns, with no need for an option to recognise changes in value of available-for-sale securities in current profit or loss instead of as an item of other comprehensive income.

      (1) The *IFRS for SMEs* requires an amortised cost model for most debt instruments, using the effective interest rate as at initial recognition. The effective rate should consider all contractual terms, such as prepayment options. Investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably are to be measured at fair value with changes in value reported in current earnings. Most other basic financial instruments are to be reported at cost less any impairment recognised. Impairment or uncollectability must always be assessed, and, if identified, recognised immediately in profit or loss; recoveries to the extent of losses previously taken are also recognised in profit or loss.

(2) For more complex financial instruments (such as derivatives), fair value through profit or loss is generally the applicable measurement method, with cost less impairment being prescribed for those instruments (such as equity instruments lacking an objectively determinable fair value) for which fair value cannot be ascertained.

(3) Assets which would generally not meet the criteria as being basic financial instruments include (a) asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables; (b) options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument; (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in the standard; (d) commitments to make a loan to another entity; and (e) commitments to receive a loan if the commitment can be net settled in cash. Such instruments would include (a) an investment in another entity's equity instruments other than non-convertible preference shares and non-puttable ordinary and preference shares; (b) an interest rate swap, which returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument, which is capable of being cash settled and which, on settlement, could have positive or negative cash flow; (c) options and forward contracts, because returns to the holder are not fixed; (d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates; and (e) a loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change.

b. *Derecognition*. In general, the principle to be applied is that, if the transferor retains any significant risks or rewards of ownership, derecognition is not permitted, although if full control over the asset is transferred, derecognition is valid even if some very limited risks or rewards are retained. The complex "passthrough testing" and "control retention testing" of IAS 39 can thus be omitted, unless full IAS 39 is elected for by the reporting entity. For financial liabilities, derecognition is permitted only when the obligation is discharged, cancelled or expires.
c. *Simplified hedge accounting*. Much more simplified hedge accounting and less strict requirements for periodic recognition and measurement of hedge effectiveness are specified than those set out in IAS 39.
d. *Embedded derivatives*. No separate accounting for embedded derivatives is required.

2. *Goodwill impairment*: An indicator approach has been adopted to supersede the mandatory annual impairment calculations in IFRS 3, *Business Combinations*. Additionally, goodwill and other indefinite-lived assets are considered to have finite lives, thus reducing the difficulty of assessing impairment.
3. *All research and development costs are expensed* as incurred (IAS 38 requires capitalisation after commercial viability has been assessed).
4. The cost method or fair value through profit or loss of accounting for associates and joint ventures may be used (rather than the equity method or proportionate consolidation).

5. *Simplified accounting for deferred taxes*: The "temporary difference approach" for recognition of deferred taxes under IAS 12, *Income Taxes*, is allowed with a minor modification. Current and deferred taxes are required to be measured initially at the rate applicable to undistributed profits, with adjustment in subsequent periods if the profits are distributed.
6. *Less use of fair value for agriculture* (being required only if fair value is readily determinable without undue cost or effort).
7. *Share-based payment*: Equity-settled share-based payments should always be recognised as an expense and the expense should be measured on the basis of observable market prices, if available. When there is a choice of settlement, the entity should account for the transaction as a cash-settled transaction, except under certain circumstances.
8. *Finance leases*: A simplified measurement of a lessee's rights and obligations is prescribed.
9. *First-time adoption*: Less prior period data would have to be restated than under IFRS 1, *First-time Adoption of International Financial Reporting Standards*. An impracticability exemption has also been included.

Because the default measurement of financial instruments would be fair value through profit and loss under the *IFRS for SMEs*, some SMEs may actually be required to apply more fair value measurements than do entities reporting under full IFRS.

Disclosure Requirements under IFRS for SMEs

There are certain reductions in disclosure requirements under *IFRS for SMEs* compared to full IFRS, but these are relatively minor and alone would not drive a decision to adopt the standard. Furthermore, key stakeholders, such as banks, often prescribe supplemental disclosures (e.g., major contracts, compensation agreements), which exceed what is required under IFRS, and this would be likely to continue to be true under *IFRS for SMEs*.

Maintenance of the IFRS for SMEs

SMEs have expressed concerns not only over the complexity of IFRS, but also about the frequency of changes to standards. To respond to these issues, IASB intends to update *IFRS for SMEs* approximately once every three years via an "omnibus" standard, with the expectation that any new requirements would not have mandatory application dates sooner than one year from issuance. Users are thus assured of having a moderately stable platform of requirements.

SME Implementation Group

The mission of the SME Implementation Group (SMEIG) is to support the international adoption of the *IFRS for SMEs* and monitor its implementation. The SMEIG has two main responsibilities:

- Consider implementation questions raised by users of the *IFRS for SMEs* and develop proposed guidance in the form of questions and answers (Q&As), which are made publicly available. The Q&As are intended to be non-mandatory guidance.
- Consider, and make recommendations to the IASB on, the need to amend the *IFRS for SMEs*.

The SMEIG issued a series of Q&As up to 2012 based on the original version of the *IFRS for SMEs*. This activity ceased as the IASB began its consultation on amendments to the *IFRS for SMEs* and the Q&As issued up to that point have been incorporated into the revised *IFRS for SMEs* (and thus made mandatory) and/or the IFRS Foundation's educational material (remaining non-mandatory). Further Q&As are likely to be issued as the revised *IFRS for SMEs* comes into use. Comprehensive training material has been developed for SMEs by the IFRS Foundation.

Implications of the IFRS for SMEs

The *IFRS for SMEs* is a significant development, which appears to be having a real impact on the future accounting and auditing standards issued by organisations participating in the standard-setting process.

On March 6, 2007, the FASB and the AICPA announced that the newly established Private Company Financial Reporting Committee (PCFRC) will address the financial reporting needs of private companies and of the users of their financial statements. The primary objective of PCFRC will be to help the FASB determine whether and where there should be specific differences in prospective and existing accounting standards for private companies.

In many continental European countries, a close link exists between the statutory financial statements and the results reported for income tax purposes. The successful implementation of SME Standards will require breaking the traditional bond between the financial statements and the income tax return, and may well trigger a need to amend company laws.

Since it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards, differential accounting for SMEs will affect regulators such as the Public Company Accounting Oversight Board (PCAOB) and the SEC. The *IFRS for SMEs* may be a welcome relief for auditors as it will decrease the inherent risk that results from the numerous choices and wide-ranging judgement required by management when utilising the full version of IFRS. The ultimate success of the *IFRS for SMEs* will depend on the extent to which users, preparers and their auditors believe the standard meets their needs.

Application of the IFRS for SMEs

The application of the *IFRS for SMEs* is not covered in this publication. However, there is a detailed accounting manual available, which addresses the requirements, application and interpretation of the standard—*Applying IFRS for SMEs* (available from Wiley).