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SLFRS for SMEs

Beyond hurdles of financial reporting

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9 May 2012

A Presentation to practitioners and preparers of financial statements on SLFRS for SMEs on 9th May 2012

Who Is the Standard Aimed At?

Millions of companies (over 99%)!

- The 52 largest stock ex changes in the world together have about 45,000 listed companies
- Europe has roughly 28 million private sector enterprises (SMEs)
- USA has about 20 million
- UK: 4.7 million (99.6% under 100 employees)
- Hong Kong: 750,000
- Brazil: 6 million Malaysia: 1.8 million
- Sri Lanka: 50,000+ but only 311+ listed

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Agenda

- **Introduction and business case for SLFRS for SMEs**
- **Which entities are eligible to use SLFRS for SMEs**
- **Detail requirements in SLFRS for SMEs**
- **Differences between SLFRS for SMEs and full SLAS**
- **How to tackle transition from SLAS**
- **Discussion**

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Introduction and Business case for SLFRS for SMEs

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Why do we need SLRFS for SMEs?

- **High quality globally accepted financial reporting standard – carefully applied – benefit many stakeholders:**
  - Information is understandable
  - Reduce compliance costs
  - Owners/ Capital providers have confidence
  - Remove uncertainties that affect their cost of capital
- **Improve consistency in audit quality**

Why Would an SME Want to Adopt It?

- **SLFRS for SMEs is a completely stand alone SLFRS**
- **Tailored for SMEs**
  - User needs for information about cashflows, liquidity, and solvency
  - Costs and SME capabilities
- **Much smaller**
  - 295 pages vs 1200+ in full SLASs
- **Simplifications** from full SLASs

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Good Financial Reporting Made Simple.

- Some topics in SLFRSs omitted if irrelevant to private entities
- Where SLFRSs have options, include only simpler option
- Recognition and measurement simplifications
- Reduced disclosures
- Simplified drafting

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Disclosure Simplifications

Big reduction in disclosures:

- Full SLFRSs – more than **3,000** items in the disclosure checklist
- SLFRS for SMEs – roughly **300** disclosures

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IFRS for SME is used by the whole world
74 jurisdictions… and counting

Which entities are eligible to use SLFRS for SMEs?

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Who Is Eligible to Use It?

- Any entity that does not have public accountability.
  - **securities not publicly traded**
  - **not a financial institution**

  ... and is required or chooses to produce General Purpose Financial Statements (GPFS)

- Size is no barrier
- Listed companies may not use, no matter how small

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Details of SLFRS for SMEs

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Section by section highlights

35 sections of the *SLFRS for SMEs*

- These are selective highlights
- This presentation does not cover all sections and what is covered are not complete summaries

Section 1 Small and medium entities

- Defines SME :
  Small and medium-sized entities are entities that:
  (a) do not have public accountability, and
  (b) publish general purpose financial statements for external users.

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Section 1 Small and medium entities

An entity has **public accountability** if:

(a) its debt (debentures) or equity (shares) are traded in a public market or it is in the process of trading (getting a listing)

(b) it holds assets in a fiduciary capacity as one of its primary businesses.

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Section 1 Small and medium- sized entities

- Following are not SMEs under SLAAS Act
  - Banks
  - Insurance companies
  - Companies carrying on leasing business
  - Factoring companies
  - Finance companies
  - Unit trusts
  - Fund management companies
  - Stock brokers or stock dealers
  - Stock exchange
  - Listed companies
  - Public corporations engaged in the sale of goods or in the provision of services

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Section 2 Concepts and principles

- **Basic measurement concepts**
- Measurement at initial recognition
  - measure assets and liabilities at historical cost unless SLFRS for SMEs requires another basis

Section2 Concepts and principles

- **Basic measurement concepts**
- Subsequent measurement
  - **Financial assets and financial liabilities**
    - basic **financial assets and basic financial liabilities:**
      - at amortised cost less impairment
      - except for quoted investments at fair value with changes in fair value recognised in profit or loss (publicly traded or whose fair value can otherwise be measured reliably),

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Section 2 Concepts and principles

- **Basic measurement concepts**
- Subsequent measurement
  - **Non-financial assets**
    - PPE at the lower of depreciated cost and recoverable amount.
    - Inventories at the lower of cost and selling price less costs to complete and sell.
    - Impairment loss relating to non-financial assets that are in use or held for sale.
    - In some cases, if readily determinable with undue cost and effort, FV can be used.

Section 2 Concepts and principles

- **Basic measurement concepts**
- Subsequent measurement
  - **Liabilities other than financial liabilities**
    - Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.

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Section 3 Financial statement presentation

- **Complete set of financial statements:**
  - Statement of financial position
  - Either single statement of comprehensive income, or two statements: Income statement and statement of comprehensive income
  - Statement of changes in equity
  - Statement of cash flows
  - Notes

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Section 3 Financial statement presentation

Single ***Statement of Comprehensive Income***:
- Revenue
- Expenses:
  - Finance costs
  - P&L from associates / JVs
  - Tax expense
  - Discontinued operations
- **Profit or loss**
- Items of Other Comprehensive Income
- **Total comprehensive income**

Two statements:

Income Statement:
- **Bottom line is profit or loss (as at left)**

Statement of Comprehensive Income:
- Begins with profit or loss
- Items of OCI
- **Bottom line is Total Comprehensive Income**

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Illustrative P&L (Statement of comprehensive income and retained earnings)

	Notes	20X2	20X1
		CU	CU
Revenue	5	6,863,545	5,808,653
Cost of sales		(5,178,530)	(4,422,575)
Gross profit		1,685,015	1,386,078
Other income	6	88,850	25,000
Distribution costs		(175,550)	(156,800)
Administrative expenses		(810,230)	(660,389)
Other expenses		(106,763)	(100,030)
Finance costs	7	(26,366)	(36,712)
Profit before tax	8	654,956	457,147
Income tax expense	9	(270,250)	(189,559)
Profit for the year		384,706	267,588
Retained earnings at start of year		2,171,353	2,003,765
Dividends		(150,000)	(100,000)
Retained earnings at end of year		2,406,059	2,171,353

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Section 3 Financial statement presentation

- Can present only an income statement (no statement of comprehensive income) if no items of other comprehensive income (OCI)
- The only OCI items under SLFRS for SMEs are:
  1. Some foreign exchange gains and losses
  2. Some changes in fair values of hedging instruments
  3. Some actuarial gains and losses

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Section 3 Financial statement presentation

- If the only changes to equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy, the entity may present a **single statement of income and retained earnings** in place of the *statement of comprehensive income and statement of changes in equity*

Section 3 Financial statement presentation

- If an entity has no items of other comprehensive income in any of the periods for which financial statements are presented, it may present only an income statement, or it may present a statement of comprehensive income in which the 'bottom line' is labelled 'profit or loss'.

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Section 4 Statement of financial position

- May still be called "balance sheet"
- Current/non-current split is not required if entity concludes liquidity approach is better
- Some minimum line items
- And some items that may be in the statement or in the notes
- But sequencing, format, and titles are not mandated

Illustrative BS (Statement of financial position)

	Notes	20X2 CU	20X1 CU
ASSETS			
Current assets			
Cash		28,700	22,075
Trade and other receivables	10	585,548	573,862
Inventories	11	57,381	47,920
		671,629	643,857
Non-current assets			
Investment in associate	12	107,500	107,500
Property, plant and equipment	13	2,549,945	2,401,455
Intangible assets	14	850	2,550
Deferred tax asset	15	4,609	2,912
		2,662,204	2,514,417
Total assets		3,334,233	3,158,274
LIABILITIES AND EQUITY			
Current liabilities			
Bank overdraft	16	83,600	115,507
Trade payables	17	431,480	420,520
Interest payable	7	2,000	1,200
Current tax liability		271,647	190,316
Provision for warranty obligations	18	4,200	5,040
Current portion of employee benefit obligations	19	4,944	4,754
Current portion of obligations under finance leases	20	21,461	19,884
		819,332	757,221

	Notes	20X2 CU	20X1 CU
Non-current liabilities			
Bank loan	16	50,000	150,000
Long-term employee benefit obligations	19	5,679	5,076
Obligations under finance leases	20	23,163	44,624
		78,842	199,700
Total liabilities		898,174	956,921
Equity			
Share capital	22	30,000	30,000
Retained earnings	4	2,406,059	2,171,353
		2,436,059	2,201,353
Total liabilities and equity		3,334,233	3,158,274

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Section 5 Income Statement and Statement of Comprehensive Income

- If an SME presents consolidated financial statements:
  - Bottom line (Profit or Loss in the income statement and Total Comprehensive Income in the statement of comprehensive income) is <u>before</u> allocating those amounts to non-controlling interest and owners of the parent

Section 6 Statement of Changes in Equity

- Can omit if no owner investments or withdrawals other than dividends
- Shows all changes to equity including
  - Total comprehensive income
  - Owners investments and withdrawals
  - Dividends
  - Treasury share transactions

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Section 9 Consolidation

- Consolidation is required when parent-subsidiary relationship except:
  - Sub was acquired with intent to dispose within one year
  - Parent itself is a sub and its parent or ultimate parent uses full SLFRSs or *SLFRS for SMEs*
- Basis of consolidation: control
  - Consolidate all controlled SPEs

Section 10 Accounting policies

- If *SLFRS for SMEs* addresses an issue, must follow *SLFRS for SMEs*
- If *SLFRS for SMEs* does not address an issue:
  - Choose policy that results in most relevant and reliable information
  - Try to analogise from requirements in the *SLFRS for SMEs*
  - Or use concepts/pervasive principles in Sec 2
  - May look to guidance in full SLFRSs — but not required

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Section 10 Accounting policies

- **Change in accounting policy:**
  - If mandated, follow the transition guidance as mandated
  - If voluntary, retrospective
- **Change in accounting estimate:**
  - Prospective
- **Correction of prior period error:**
  - Restate prior periods if practicable

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Section 11 Basic financial instruments

- **Scope of Sec 11 includes:**
  - Cash
  - Fixed deposits and Demand deposits (savings a/c)
  - Accounts receivable and Accounts payable
  - Loans from banks
  - Investments in shares
  - Debentures

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Section 11 Basic financial instruments

- **Accounting for basic financial instruments:**

  Initial measurement
  - Most basic financial instruments measured initially at the transaction price (including transaction costs)
  - E.g: Financial assets
    - For goods sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that entity, which is normally the invoice price.
    - For a cash purchase of another entity's ordinary shares, the investment is recognised at the amount of cash paid to acquire the shares.

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Section 11 Basic financial instruments

- **Accounting for basic financial instruments:**
  - E.g
    - For a long-term loan made to another entity, a receivable is recognised at the present value of cash receivable (including interest payments and repayment of principal) from that entity.

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Section 11 Basic financial instruments

- **Accounting for basic financial instruments:**
  - E.g: Financial liabilities
    - For goods purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier, which is normally the invoice price.
    - For a loan received from a bank, a payable is recognised initially at the present value of cash payable to the bank (eg including interest payments and repayment of principal).

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Section 11 Basic financial instruments

- **Accounting for basic financial instruments:**

  Subsequent measurement
  - Shares: if quoted – fair value (e.g market value in Stock Exchange)
  - At the year-end assess whether there is objective evidence of impairment of any financial assets that are measured at cost or amortised cost.
  - If there is objective evidence of impairment, the entity shall recognise an impairment loss in profit or loss immediately

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Section 11 Basic financial instruments

- **Accounting for basic financial instruments:**

  Subsequent measurement
  - E.g. (Accounting for impairment)
    - Shares: take individually and assess if impaired
    - If significant debtors assess individually
    - Other financial assets for impairment either individually or grouped on the basis of similar credit risk characteristics

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Section 11 Basic financial instruments

- Option to follow LKAS 39 instead of sections 11 and 12
  - Even if LKAS 39 is followed, make Section 11 and 12 disclosures (not SLFRS 7 disclosures)

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Section 12 Complex financial instruments

- **Financial instruments not covered by Section 11 are at fair value through profit or loss.** This includes:
  - Investments in convertible and puttable ordinary and preference shares
  - Options, forwards, swaps, and other derivatives
  - Financial assets that would otherwise be in Section 11 but that have "exotic" provisions that could cause gain/loss to the holder or issuer
- Hedge accounting

Section 13 Inventories

- At cost, which may be
  - Specific identification for specialised items
  - FIFO or weighted average for others
- Impairment (write down to estimated selling price less costs to complete and sell)

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Section 14 Associates

- Option to use:
  - Cost model (except if published quotation then must use Fair Value through P&L)
  - Equity method
  - Fair value through profit or loss (if impracticable, then use cost)

Cost and FV models are not allowed by LKAS 28.

Section 15 Joint ventures

- Option to use:
  - Cost model (except if published quotation then must use Fair Value through P&L)
  - Equity method
  - Fair value through profit or loss (if impracticable, then use cost)
- Proportionate consolidation is prohibited

Cost and FV models are not allowed by LKAS 31.
Proportionate consol is allowed by LKAS 31.

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Section 16 Investment property

- If fair value can be measured reliably without undue cost or effort, use Fair Value through P&L
- Otherwise, must treat investment property as property, plant and equipment using Section 17

LKAS 40 is pure accounting policy choice – either depreciation model or fair value through P&L.

Section 17 Property, plant & equipment

- Historical cost – depreciation – impairment model only. No revaluation model.

LKAS 16 allows revaluation of PP&E

- Section 17 applies to property held for sale
  - Holding for sale is an impairment indicator

SLFRS 5 requires separate treatment for non-current assets held for sale

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Section 17 Property, plant & equipment

- Component depreciation only if major parts of an item of PP&E have "significantly different patterns of consumption of economic benefits"
- Majority of assets depreciated as a single asset
- Review useful life, residual value, depreciation rate only if there is a significant change in the asset or how it is used

LKAS 16 requires annual review

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Section 18 Intangibles other than goodwill

- No recognition of internally generated intangible assets

LKAS 38 requires capitalisation of development costs incurred after a determination of commercial viability

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Section 18 Intangibles other than goodwill

- Amortise intangibles that are purchased separately, acquired in a business combination, acquired by grant, and acquired by exchange of other assets
- Amortise over useful life. If unable to estimate useful life, then use 10 years

Section 19 Business combinations & goodwill

- **Acquisition method**
- **Amortise goodwill.** If unable to estimate useful life, then use 10 years.
- Impairment testing and reversal – follow Section 27
- Negative goodwill – first reassess original accounting. If that is ok, then immediate credit to P&L

Goodwill amortisation is prohibited by LKAS 38.

Section 20 Leases

- Finance and operating lease classification similar to LKAS 17
- Measure finance leases at lower of FV of interest in leased property and present value of minimum lease payments
- For operating leases, do not force straight-line expense recognition if lease payments are structured to compensate lessor for general inflation

LKAS 17 requires straight-line recognition.

Section 21 Provisions & contingencies

- Accrue if an obligation arising from a past event and amount can be estimated reliably
- Disclose (no accrual) contingent liability
- Measure at best estimate
  - Large population – weighted average calculation
  - Single obligation – adjusted most likely outcome
- Includes an appendix of examples

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Section 22 Liabilities and equity

- Guidance on classifying an instrument as liability or equity:
  - Instrument is a liability if the issuer could be required to pay cash
  - However, if puttable only on liquidation or death or retirement of owner, then it is equity

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Section 22 Liabilities and equity

- Section 22 also covers:
  - Original issuance of shares and other equity instruments
  - Sales of options, rights and warrants
  - Stock dividends and stock splits

These topics are not addressed in full SLFRSs.

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Section 23 Revenue

- Same principles as LKAS 18 and LKAS 11
  - **Goods:** Revenue recognised when risks and rewards are transferred, seller has no continuing involvement, measurable
  - **Services and construction contracts:** Recognised by percentage of completion
- Principle for measurement is fair value of consideration received or receivable

Section 24 Government grants

- All measured at the fair value of the asset received or receivable
- Recognition as income:
  - Immediately if no performance conditions are imposed
  - If conditions, recognise when conditions are fulfilled

LKAS 20 allows a wide range of methods of accounting for government grants.

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Section 25 Borrowing costs

- All charged to expense when incurred
- No capitalisation

LKAS 23 requires capitalisation of borrowing costs relating to an asset during construction.

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Section 26 Share-based payment

- Must recognise
- Measure at fair value if practicable
- If it is impracticable to determine the fair value of the option or other instrument granted, the entity's directors should use their judgement to apply the most appropriate valuation method

SLFRS 2 has intrinsic value "simplification".

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Section 27 Impairment of assets

- **Inventories** - write down selling price less costs to complete and sell, if below carrying amount
- **Other assets** - write down to recoverable amount, if below carrying amount
- **Recoverable amount** is the greater of fair value less costs to sell and value in use

Section 28 Employee benefits

- For defined benefit plans, use projected unit credit calculation only if entity is able without undue cost or effort. Otherwise, can simplify:
  - Ignore estimated future salary increases
  - Ignore future service of current employees (assume closure of plan)
  - Ignore possible future in-service mortality

These simplifications are not in LKAS 19.

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Section 28 Employee benefits

- Actuarial gains and losses may be recognised in profit or loss or as an item of other comprehensive income
  - No deferral, including no corridor approach

LKAS 19 allows various options for deferring and amortising actuarial gains and losses – though IASB has proposed to eliminate those options

Section 29 Income tax

- Recognise deferred taxes if the tax basis of an asset or liability is different from its carrying amount
- Tax basis assumes recovery by sale. (If zero capital gains tax, no deferred tax)
- No deferred tax on an asset or liability if recovery or settlement of carrying amount is not expected to affect taxable profit

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Section 29 Income tax

- Exception: No deferred tax on unremitted earnings of foreign subsidiaries and JVs
- Recognise deferred tax assets in full, with valuation allowance
  - Criterion is that realisation is probable (more likely than not)
- Deferred taxes all non-current

Section 29 model is same as IASB/FASB March 2009 exposure draft on Income Tax.

Section 30 Foreign currency translation

- Functional currency approach similar to that in LKAS 21
- No recycling of gains or losses on net investment in a foreign entity that are initially recognised in other comprehensive income

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Section 33 Related party disclosures

- Government departments and agencies are not related parties simply by virtue of their normal dealings with an entity
- Disclosure of key management personnel compensation only as one number in total
- Fewer disclosures about transactions

Section 34 Specialised activities

- Agriculture – use historical cost model unless fair value is readily determinable without undue cost or effort

LKAS 41 requires FVTPL for all biological assets and agricultural produce.

- Oil and gas and mining – not required to charge exploration costs to expense

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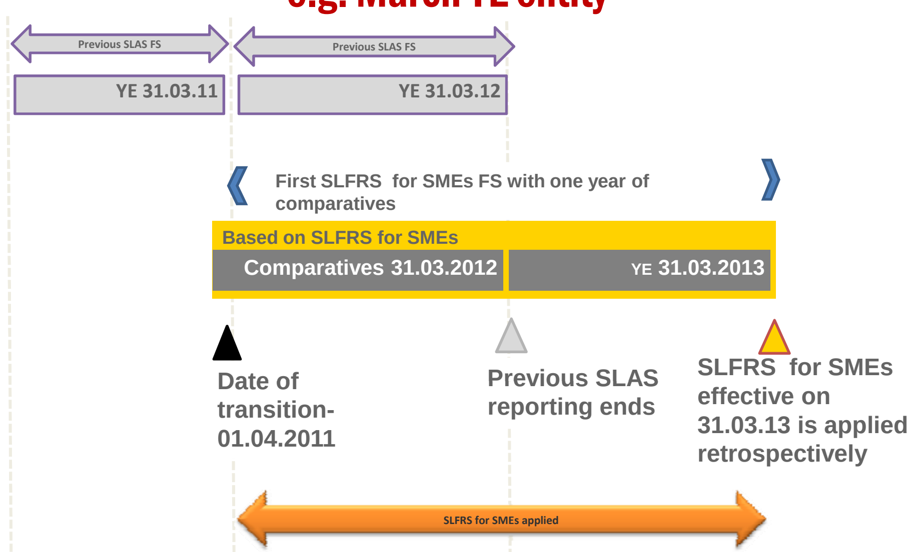
How to tackle transition from SLAS

Section 35 First-time adoption

- SLFRS for SMEs effective date: periods beginning on or after 1 January 2012
- An entity can be a first time adopter of SLFRS for SMEs only once.
- Prepare current year and one prior year's financial statements using the *SLFRS for SMEs*

Transition to SLFRS for SMEs: e.g. March YE entity



70

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Section 35 First-time adoption

- Procedure for restating the BS on date of transition:
  - The resulting adjustments arising from transition to SLFRS for SMEs should be recognized directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to this IFRS.
  - Derecognised financial assets and liabilities under SLAS- not required to be recognised.
  - Financial assets and liabilities that should have been derecognised under SLFRS for SMEs, can be either derecognised or kept till disposed / settled.
  - Accounting estimates need not be revisited unless was in error

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Section 35 First-time adoption

- But there are many exemptions (electable) for restating specific items
  - **Fair value/ Revaluation as deemed cost:** an item of PPE, an IP, or an intangible asset on the date of transition can be stated at its fair value and use that fair value as its deemed cost at that date.
  - This becomes 'deemed cost' going forward. In other words entity uses cost-depreciation-impairment model going forward

Section 35 First-time adoption

- But there are many exemptions (electable) for restating specific items
  - **Deferred income tax:** not required to recognise, at the date of transition, deferred tax assets or deferred tax liabilities relating to differences between the tax basis and the carrying amount of any assets or liabilities for which would involve undue cost or effort.

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Section 35 First-time adoption

- Exemptions (electable) *continued*
  - **Business combinations** that were effected before the date of transition can be ignored
  - **Arrangements containing a lease:** determine whether an arrangement existing at the date of transition contains a lease on the basis of facts and circumstances existing at date of transition, rather than when the arrangement was entered into.
  - **Cumulative translation differences:** deem the cumulative translation differences for all foreign operations to be zero at the date of transition *(i.e. a 'fresh start').*

Section 35 First-time adoption

- Exemptions (electable) *continued*
  - **In separate financial statements, account for its investments in subsidiaries, associates, and jointly controlled entities** either:
    - (i) at cost or deemed cost (which shall be either fair value at the date of transition or previous SLAS carrying amount on that date) less impairment, or
    - (ii) at fair value with changes in fair value recognised in profit or loss.
  - **Some more electives** on compound financial instruments, service concession arrangements, decommissioning liabilities, share based payments

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Section 35 First-time adoption

- And a general exemption for impracticability
  - If it is **impracticable for an entity to restate the opening BS** at the date of transition, make such adjustments in the earliest period for which it is practicable to do so
  - Identify the data presented for prior periods that are not comparable
  - If it is impracticable for an entity to provide any disclosures required, the omission shall be disclosed.

Section 35 First-time adoption

- Disclosures for transition
  - explain how the transition from previous SLAS to SLFRS for SMEs affected
  - a description of the nature of each change in accounting policy
  - reconciliations of its equity (on date of transition and opening date to current BS)
  - a reconciliation of the profit or loss in SLAS and SLFRS for SMEs

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No sections covering these topics

- Segment reporting
- Earnings per share
- Interim reporting
- Assets held for sale

Conclusion

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In Conclusion

The SLFRS for SMEs

- Better quality reporting
- Tailored for the capabilities and needs of SME
- When SMEs aspire to become big sound financials are a must
- If capital providers understand and have confidence in the financial figures, an SME's ability to obtain the capital it needs improves. Ultimately, the economy in which it operates improves.
- Improve consistency in audit quality