STAFF PAPER

February 2013

IASB Meeting

Project	**IFRS for Small and Medium-sized Entities (IFRS for SMEs)**
Paper topic	**A Micro-sized Entity's Guide for Applying the IFRS for SMEs**

CONTACT(S)	Darrel Scott (Board Advisor)	dscott@ifrs.org	+44 (0) 20 7246 6489
	Michelle Fisher	mfisher@ifrs.org	+44 (0) 20 7246 6918

Purpose of this paper

1. The purpose of this paper is to introduce the International Accounting Standards Board (IASB) to guidance prepared by IASB staff titled *A Micro-sized Entity's Guide for Applying the IFRS for SMEs* (the Guide). The Guide contains guidance to help micro-sized entities (micro entities) apply the requirements of the *IFRS for Small and Medium-sized Entities* (*IFRS for SMEs)*. It is not a separate standard for micro entities.

Structure of this paper

2. This Agenda Paper 10 answers the following questions:
   (a) Why has the Guide been prepared?
   (b) What is the objective of the Guide?
   (c) What does the content of the Guide look like?
   (d) How is a micro entity defined for the purposes of the Guide?
   (e) Who has been involved in developing the Guide?
3. One of the sections of the Guide has been included in Appendix A for illustration purposes.

Why has the Guide been prepared?

4. Over 80 jurisdictions have either adopted the *IFRS for SMEs* or stated a plan to do so within the next few years. In some of these jurisdictions the *IFRS for SMEs* is being used by very small companies with just a few employees. The IASB has received requests from interested parties to develop guidance suitable for micro entities currently applying the *IFRS for SMEs* and also those considering doing so in the future.

What is the objective of the Guide?

5. The Guide is intended to help micro entities apply the requirements of the *IFRS for SMEs*. Many requirements in the *IFRS for SMEs* will not be relevant to typical micro entities as they only encounter a narrow range of simple transactions. The Guide will help these entities to more easily identify the requirements in the *IFRS for SMEs* that are relevant to them.
6. The Guide is intended for a micro entity that is either required to or chooses to prepare general purpose financial statements in accordance with the *IFRS for SMEs*. It is not intended for micro entities that are preparing financial statements solely for tax reasons or to comply with company law (unless that law requires micro entities to use the *IFRS for SMEs*). However, those micro entities may still find the Guide helpful in preparing such financial statements.
7. Compliance with the Guide will result in compliance with the *IFRS for SMEs*. If an entity applies the Guide, the basis of presentation note and audit report can still refer to conformity with the *IFRS for SMEs* because the Guide does not modify the *IFRS for SMEs.* This is further explained in paragraphs 8 -11 below.

What does the content of the Guide look like?

8. The Guide extracts requirements from the *IFRS for SMEs* without modifying any of the principles for recognising and measuring assets, liabilities, income, and expenses, and without changing any of the presentation or disclosure requirements. The Guide includes only those requirements from the *IFRS for*

SMEs that are likely to be necessary for a typical micro entity. If an entity encounters a transaction in any of the periods for which financial statements are presented (or that affects those periods) that is not dealt with in the Guide, the entity is required to apply the applicable requirements in the *IFRS for SMEs*.

9. If a transaction, other event or condition covered in the *IFRS for SMEs* is not included in the Guide, it is clearly identified in a 'box' at the beginning of the relevant section of the Guide, with a reference to the requirements that must be followed in the *IFRS for SMEs*. Appendix A illustrates how this has been done for the requirements in *IFRS for SMEs* Section 20 *Leases*.

10. While many of the paragraphs in the Guide have been taken word-for-word from the *IFRS for SMEs*, it has been necessary to make some wording changes to improve the flow of the drafting or for other editorial reasons. Those editorial changes do not modify the requirements of the *IFRS for SMEs*.

11. In a few places the Guide contains guidance and illustrative examples that are not included in the *IFRS for SMEs*. The additional guidance and examples are included to help a micro entity apply the principles taken from the *IFRS for SMEs* and they do not modify the requirements of the *IFRS for SMEs*.

How is a micro entity defined for the purposes of the Guide?

12. The Guide provides examples of typical characteristics of micro entities but does not define a micro entity in quantitative terms. A strict definition is unnecessary for the purposes of the Guide. This is because in theory it is possible for any SME to use the Guide to prepare its financial statements because that SME would be referred back to the *IFRS for SMEs* for any transactions not covered by the Guide. However, an entity that is required to refer to the *IFRS for SMEs* in several instances will normally find it easier to use the *IFRS for SMEs* on its own, rather than starting with the Guide. That is why the Guide is only intended for typical micro entities.

13. A jurisdiction may wish to use the Guide as a basis to develop its own similar Guide. For example the Guide does not include requirements for defined benefit

plans. Consequently, micro entities with defined benefit plans will need to refer the relevant requirements in the *IFRS for SMEs*. In a jurisdiction where entities, including micro entities, commonly have defined benefit plans, a jurisdiction may wish to issue its own Guide to applying the *IFRS for SMEs* that includes the *IFRS for SME* requirements for defined benefit plans, rather than having a reference to the *IFRS for SMEs* in the box at the start of the relevant section in the Guide.

Who has been involved in developing the Guide?

14. The IASB staff have developed the Guide with input from the SME Implementation Group. The SMEIG have reviewed and commented on three drafts of the Guide. In January 2013 the SMEIG approved the final version of the Guide (draft three) for issue.

15. The Guide is currently undergoing a thorough final review from the IFRS Foundation education initiative staff.

Appendix A – Illustrative section of the Guide

16. The Guide follows the sequence of the 35 sections in the *IFRS for SMEs*. This Appendix A illustrates how Section 20 *Leases* of the *IFRS for SMEs* has been presented in the Guide (Guide Section 20 *Leases*)

Guide Section 20 *Leases*

An entity shall refer to the *IFRS for SMEs* in the following situations because they are not addressed by this Guide:

- if the entity is a lessor (see *IFRS for SMEs* 20.17-20.31).
- if the entity sells an asset and then leases back the same asset (see *IFRS for SMEs* 17.28, 17.29, 20.32 - 20.35).
- if the entity is party to a lease that could result in a loss to the lessee or the lessor as a result of contractual terms that are unrelated to changes in the price of the leased asset, changes in foreign exchange rates or a default by one of the counterparties (such a lease shall be accounted for under *IFRS for SMEs* Section 12).

Scope of Guide Section 20

G170 A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. Guide Section 20 covers the accounting for all leases other than operating leases that are onerous (see Guide Section 21 *Provisions and Contingencies*).

G171 Guide Section 20 applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Guide Section 20 does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

G172 Some arrangements do not take the legal form of a lease but convey rights to use assets in return for payments. Such arrangements are in substance leases of assets, and they should be accounted for under Guide Section 20.

Classification of leases

G173 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

G174 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term.

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred.

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

G175 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease but the lessee must compensate the lessor for losses associated with the cancellation.

(b) gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (eg in the form of a payment at the end of the lease).

(c) the lessee has the ability to continue the lease for a renewal period at a rent that is substantially lower than market rent.

G176 The examples and indicators in paragraphs G174 and G175 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease.

G177 Lease classification is made at the inception of the lease and is not changed during the term of the lease unless the lessee and the lessor agree to change the provisions of the lease (other than simply by renewing the lease), in which case the lease classification shall be re-evaluated.

Financial statements of lessees—finance leases

Initial recognition

G178 At the commencement of the lease term, a lessee shall recognise its rights of use and obligations under finance leases as assets and liabilities in its statement of financial position at amounts equal to the fair value of the leased property (normally the retail selling price of the asset) or, if lower, the present value of the minimum lease payments, determined at the inception of the lease. Any initial direct costs of the lessee (incremental costs that are directly attributable to negotiating and arranging a lease) are added to the amount recognised as an asset.

G179 The present value of the minimum lease payments should be calculated using the interest rate implicit in the lease, ie the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

G180 If this cannot be determined, the lessee's incremental borrowing rate shall be used. This is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Subsequent measurement

G181 A lessee shall apportion minimum lease payments between the finance charge and the reduction of the outstanding liability using the effective interest method (see paragraphs G106-110). The lessee shall allocate the finance charge to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. A lessee shall charge contingent rents as expenses in the periods in which they are incurred.

G182 A lessee shall depreciate an asset leased under a finance lease in accordance with the relevant section of this Guide for that type of asset, eg Guide Section 17. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life. A lessee shall also assess at each reporting date whether an asset leased under a finance lease is impaired (see Guide Section 27 *Impairment of Assets*).

Financial statements of lessees—operating leases

Recognition and measurement

G183 A lessee shall recognise lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense on a straight-line basis unless either

(a) another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis, or

(b) the payments to the lessor are structured to increase in line with expected general inflation (based on published indexes or statistics) to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition (b) is not met.

Disclosures

Disclosures for lessees—finance leases

G184 A lessee shall make the following disclosures for finance leases:

(a) for each class of asset, the net carrying amount at the end of the reporting period.

(b) the total of future minimum lease payments at the end of the reporting period, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years; and

(iii) later than five years.

(c) a general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options, subleases, and restrictions imposed by lease arrangements.

G185 In addition, the requirements for disclosure about assets in accordance with other sections of the Guide apply to lessees for assets leased under finance leases (eg Guide Sections 17 and 27).

Disclosures for lessees—operating leases

G186 A lessee shall make the following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years; and

(iii) later than five years.

(b) lease payments recognised as an expense.

(c) a general description of the lessee's significant leasing arrangements including, for example, information about contingent rent, renewal or purchase options, subleases, and restrictions imposed by lease arrangements.