Talking SMEs
June 2012

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

In this issue...

**Valuation of defined benefit obligations**
The standard provides an option to use a simplified approach to account for employee defined benefit plans. We look at this in more detail and discuss the financial statement implications.

**Close family members and common control**
Transactions with family members and relatives are a normal feature of many SMEs. In this edition, we take a closer look at the standard's requirements dealing with disclosure of such transactions.

**IASB developments**
We give an overview of developments at the International Accounting Standards Board (IASB) that relate to IFRS for SMEs.
In July 2009, the IASB issued *IFRS for SMEs* with the intention of providing a common framework to facilitate financial reporting for SMEs in response to strong international demand for a rigorous and uniform set of accounting standards for SMEs. The purpose of IFRS for SMEs is to simplify and reduce the detailed requirements that exist under full IFRS. Over the past few years, many jurisdictions have either adopted or publicly indicated or proposed a plan to adopt the standard in the future. Whilst we have observed that the standard has largely simplified the financial reporting process for SMEs, in practice, entities still face many technical accounting issues. In this publication, we take a closer look at some of these issues and give our perspectives.

**Valuation of defined benefit obligations**

Under *IFRS for SMEs*, Section 28 *Employee Benefits* deals with accounting for employee benefits including defined benefit obligations. The section requires measurement of the post-employment defined benefit plan obligation using the projected unit credit method, similar to the requirements under IAS 19 *Employee Benefits* in full IFRS.

If an entity is not able, without undue cost or effort, to use the projected unit credit method to measure its obligation and cost under defined benefit plans, use of a simplified approach is permitted.

Under the simplified approach, future salary increases, future service and possible in-service mortality are ignored. Any entity that takes advantage of these measurement simplifications must, nonetheless, include both vested and unvested benefits in measuring its defined benefit obligation. However, a question that arises is whether the obligation should still be discounted when future salary increases and possible in-service mortality are ignored.

**Example**

A lump-sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7 per cent (compound) each year. The discount rate used is 10 per cent per year. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions.

---

1 Source: IASC Foundation: *Training Material for the IFRS for SMEs Module 28 – Employee Benefits* example 30 and example 33 on accounting for defined benefit plans.
For simplicity, this example ignores the additional actuarial adjustments needed to reflect the probability that the employee may leave the entity at an earlier or later date.

**Figure 1: Table showing closing obligation and P&L charge for each year:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected unit credit method</th>
<th>Simplified method (discounted)</th>
<th>Simplified method (undiscounted)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Closing obligation</td>
<td>Closing obligation</td>
<td>Closing obligation</td>
</tr>
<tr>
<td></td>
<td>89</td>
<td>68</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>196</td>
<td>160</td>
<td>214</td>
</tr>
<tr>
<td></td>
<td>324</td>
<td>283</td>
<td>343</td>
</tr>
<tr>
<td></td>
<td>476</td>
<td>445</td>
<td>490</td>
</tr>
<tr>
<td></td>
<td>655</td>
<td>655</td>
<td>655</td>
</tr>
<tr>
<td></td>
<td>P&amp;L charge</td>
<td>P&amp;L charge</td>
<td>P&amp;L charge</td>
</tr>
<tr>
<td></td>
<td>89</td>
<td>68</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>107</td>
<td>92</td>
<td>114</td>
</tr>
<tr>
<td></td>
<td>128</td>
<td>123</td>
<td>129</td>
</tr>
<tr>
<td></td>
<td>152</td>
<td>162</td>
<td>147</td>
</tr>
<tr>
<td></td>
<td>179</td>
<td>210</td>
<td>165</td>
</tr>
</tbody>
</table>

**Figure 2: Chart showing closing obligation at the end of each year:**

[Chart showing closing obligation at the end of each year]

---

2 Source: IASC Foundation: Training Material for the IFRS for SMEs Module 2B – Employee Benefits example 30 and example 33 on accounting for defined benefit plans.
The table and the chart above demonstrate that the annual P&L charge and the closing obligation varies significantly under each of the approaches.

The requirement to discount the obligation is contained in that Section 28.15. This section states that an entity must measure a defined benefit liability for its obligations under defined benefit plans at the present value of its obligations at the reporting date minus the fair value of plan assets. The simplified approach in Section 28.19(b) only provides relief on the manner in which the future value of the benefit obligation is derived based on current salary levels, but not on the measurement of the obligation itself. Therefore, in the absence of a specific relief from discounting the obligation, the requirements of Section 28.15 continue to apply. However, as indicated in the graph above, this leads to an under-accrual of the liability and defers the recognition of the expense to later periods.

Alternatively, as Section 28.19(b) requires the entity to assume closure of the plan for both existing and new employees, there is a view that it would not be appropriate to discount the obligation. Although this method provides a somewhat higher liability and accelerated expense, it provides information that more closely reflects the projected credit unit methodology.

In our view, in the absence of a specific relief, it would be appropriate to continue to discount the obligation. In many countries where IFRS for SMEs is permitted, entities may not necessarily have defined benefit pension schemes, but often pay a lump sum to employees on retirement. Usually this is based on the number of years of employment and final salary levels. As the IASB, assisted by the SME Implementation Group (SMEIG), has initiated its comprehensive review of the standard, this is an area that may be reconsidered. The simplification may be extended by removing discounting, but, ultimately, this may provide better information to users of the financial statements.

Close family members and common control

Transactions with family members and relatives of directors, substantial shareholders and key employees are a normal feature for many SMEs. Such transactions can take a variety of forms ranging from transactions in the normal course of business, for example, purchases or sales of goods, to significant one-off transactions that may not be on an arm’s length basis.
Section 33 Related Party Disclosures of the standard considers related party disclosures. Section 33 requires a close member of that person's family to be treated as a related party if that person:

- Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity
- Has control over the reporting entity
- Has joint control or significant influence over the reporting entity or has significant voting power therein.

The standard does not define the term “close member of family”, although Section 33.3 generally requires an entity to assess the substance of the relationship, rather than merely the form, in identifying related party relations. If one opts to look at full IFRS (through the hierarchy in Section 10 Accounting Policies, Estimates and Errors), IAS 24 Related Party Disclosures defines close family members of a person as those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity. The standard further notes that they include:

- That person's children and spouse or domestic partner
- Children of that person's spouse or domestic partner

And

- Dependants of that person or that person's spouse or domestic partner.

Apart from the specific relations mentioned above under IAS 24, any other members of family expected to influence or be influenced by that person in their dealings with the reporting entity may also be considered as “close member of family”. For example, this may include parents, siblings or other relatives that are even more distant.

Consider a case where four brothers A, B, C and D run four different SMEs; A Ltd, B Ltd, C Ltd and D Ltd. There are numerous transactions between the four SMEs. The question that arises in whether B, C and D can be considered as “close members of family” of A. In our view, this would depend on the facts and circumstances of each relation, and whether the siblings act collectively as a family, and therefore influence the transactions, or they act independently. Due to the subjectivity of these conclusions, we believe that entities should make appropriate disclosures of these judgements as required by Section 8 Notes to the Financial Statements.

Furthermore, similar judgement may also be required in the accounting for business combinations. Section 19 Business Combinations and Goodwill excludes from its scope combinations of entities or businesses under common control.

To illustrate, consider that A Ltd has three shareholders X, Y and Z. X and Y are family members who each hold a 30% interest in A. In addition, X and Y also each hold a 30% interest in B Ltd. If A Ltd were to acquire 100% of Entity B, would this be a business combination involving entities under common control and, therefore, out of the scope of Section 19?

Often there will be no written contractual arrangement between X and Y requiring them to act collectively as shareholders of A Ltd and B Ltd and, generally, the facts and circumstances of the relationship between the two individuals need to be considered. In certain cases, a conclusion may be drawn relatively easily, such as when X is a parent and Y is a young dependent child. In other cases, it may be more difficult to reach a conclusion. These may include situations where:

a) X is the patriarch of a family and traditionally has strong influence on members of his family, including his adult son, Y

Or

b) X and Y are adult siblings, who have numerous other joint ventures

We believe that the question of whether common control exists between family members very much depends on the facts and circumstances present. If X and Y are close family members, then it is possible that they will act collectively. It is possible in scenario (a) when there has been clear evidence that the family influence has resulted in a pattern of collective family decisions that this may be a common control transaction. It may be less likely to exist in scenario (b) where the adult siblings are more likely to act independently.

As in related party transactions, it would be considered appropriate that judgements that are made as to who constitutes close members of family should be disclosed in terms of Section 8. There also needs to be a consistency in these judgements when applied to different sections of IFRS for SMEs.
IASB Developments

Q&As about the IFRS for SMEs:

List of SME Implementation Group (SMEIG) Q&As issued to date:

<table>
<thead>
<tr>
<th>Q&amp;A</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q&amp;A 2011/01</td>
<td>Use of IFRS for SMEs in a parent's separate financial statements</td>
</tr>
<tr>
<td>Q&amp;A 2011/02</td>
<td>Entities that typically have public accountability</td>
</tr>
<tr>
<td>Q&amp;A 2011/03</td>
<td>Interpretation of ‘traded in a public market’ in applying the IFRS for SMEs</td>
</tr>
<tr>
<td>Q&amp;A 2012/01</td>
<td>Application of ‘undue cost or effort’</td>
</tr>
<tr>
<td>Q&amp;A 2012/02</td>
<td>Jurisdiction requires fallback to full IFRSs</td>
</tr>
<tr>
<td>Q&amp;A 2012/03</td>
<td>Fallback to IFRS 9 Financial Instruments</td>
</tr>
<tr>
<td>Q&amp;A 2012/04</td>
<td>Recycling of cumulative exchange differences on disposal of a subsidiary</td>
</tr>
</tbody>
</table>

After considering public comments, the SMEIG has decided not to issue final Q&As on the remaining three draft Q&As:

- **General Issue 1** – Application of the IFRS for SMEs for financial periods ending before the IFRS for SMEs was issued
- **Section 3 Issue 2** – Departure from a principle in the IFRS for SMEs
- **Section 3 Issue 3** – Prescription of the format of financial statements by local regulation

Q&As are published by the SMEIG, which assists the IASB in supporting the implementation of the IFRS for SMEs. The Q&As are intended to provide non-mandatory and timely guidance on specific accounting questions that are being raised with the SMEIG by users implementing the IFRS for SMEs.

For more information refer IFRS for SMEs Update newsletter issued by the IASB. This can be accessed at www.ifrs.org/IFRS+for+SMEs/Update.htm.
Resources

The IFRS for SMEs publications below are available at www.ey.com:

- IFRS for small and medium entities: A comparison with IFRS – the basics
  This publication helps preparers, users and auditors to gain a general understanding of the similarities and key differences between IFRS and IFRS for SMEs.

- Talking SMEs series
  This series of periodic publications considers topical issues on the IFRS for SMEs.

Upcoming publications

Good Small and Medium Entity 2012: Illustrative financial statements for small and medium entities
This publication contains an illustrative set of financial statements for a small and medium entity for the year ending 31 December 2012 prepared in accordance with IFRS for SMEs.
About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

About Ernst & Young's International Financial Reporting Standards Group
The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources – people and knowledge – to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

© 2012 EYGM Limited.
All Rights Reserved.
EYG no. AU1209
ED none.

In line with Ernst & Young's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.