

IFRS for SMEs

Is it relevant for your business?*

*connectedthinking

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Content

A IFRS – More than just an accounting change	3
B The business case for SMEs	5
C Moving ahead with IFRS	7
D Working with IFRS.....	12
About us	13
Contacts	14

A IFRS – More than just an accounting change

This publication aims to provide owners of small and medium-sized entities (SMEs) with an understanding of recent developments in financial reporting for unlisted entities. It outlines the reasons why some unlisted SMEs have already made the change to International Financial Reporting Standards (IFRS) and illustrates what might be involved in a conversion process. It is intended to help you answer the question, 'Should we, as a private entity, adopt IFRS as the standard for our company?'

IFRS is fast becoming the global financial reporting language for companies – those that cannot communicate with it might miss a competitive advantage for their business. Many countries around the world now require all listed companies to report financial information according to IFRS. In some countries, national regulators accept IFRS for all companies – listed and private – while in a few, such as Australia, IFRS (or national equivalents) is mandatory for all companies.

Why some unlisted SMEs have chosen IFRS

More and more unlisted SME management teams want to know if it makes sense for them to prepare their financial information using IFRS, even though they are not required to do so. That decision will depend on each company's circumstances, but growing numbers are deciding that the benefits for their business do make the change to IFRS worthwhile. For them, having financial information that is universally understood and comparable to other companies' information can improve relationships with customers, suppliers, investors and bankers.

If these business partners have more confidence in the financial information being provided using IFRS, this can be a crucial factor in securing a new supplier, obtaining finance, reducing the cost of borrowing, and arriving at an acquisition or cooperation agreement.

Internally too, the move to IFRS can make sense as the basis for group reporting for SMEs with overseas subsidiaries, as well as those engaged in international business. If both the parent company and subsidiaries are using IFRS, it removes the need for individual companies to prepare a second set of financial information for group reporting purposes. Internal management reporting under IFRS can also help to improve the quality and consistency of information that management needs in order to make effective and timely decisions for the business.

The IASB recognises varied needs of SMEs

The International Accounting Standards Board (IASB) recognises, however, that for some SMEs without a capital market focus, the potential benefits of full IFRS can be outweighed by the difficulty or cost of preparing IFRS information. To address this, the Board is working on special standards for SMEs that will have the same framework as full IFRS but requirements will be tailored to meet the different needs. The final standards are expected during or after 2007.

Companies that use the SME standards will not be able to say that they comply with IFRS. However, the SME standards are expected to significantly improve the standardisation of accounting across different markets and therefore make financial information more comparable and better understood. (For further information, see the flyer on the IASB project in the back pocket of this publication.)

A chance to make process improvements

For some SMEs, the benefits of changing to IFRS can be very significant; but a fundamental change in reporting is not something that can be undertaken lightly. In our experience, companies converting to new accounting standards tend to underestimate what's involved, particularly in terms of time and resources. Some have been tempted to assume that a move to IFRS is simply a technical accounting exercise. In practice, it

involves careful management of the change to deal with both the accounting changes and their wider implications. For example, it is not enough just to understand how to account for financial instruments under IFRS; you also need to know what implications this has for your systems. Similarly, revenue is likely to be accounted for differently under IFRS and this may precipitate business changes in the way you contract with third parties.

Companies that have benefited most from the transition are those that have made a careful preliminary assessment of the scope of the change project and the cost/ benefit analysis. They have looked at this as a chance to make some strategic improvements to their finance systems and processes as well as to reduce costs in the longer term. And the change to IFRS has been used as a focus for faster, more efficient and more meaningful internal and external financial information.

Key success factors

In our experience, key success factors in these projects have included:

- establishing a clear vision and realistic expectations to help people recognise the change as both useful and achievable;
- using a tried and tested IFRS transition methodology to ensure that all the essential elements of the project are appropriately addressed (strategic planning, people capabilities, systems, processes and controls), responsibilities are clear and surprises are avoided;
- clear commitment and active sponsorship from senior management, as well as the involvement of the different business units so that the change is not seen as just something imposed from the centre;
- an effective communications programme that engages key stakeholders (internally and externally) and explains the significance of the changes.

Stakeholder expectations are rising; how you respond has a direct impact on their confidence and, ultimately, on your competitive advantage. Whether you are considering full IFRS or planning to wait for the IASB to come up with specific standards for SMEs, it makes sense to consider your options carefully.

We hope you find this publication helpful when you start to consider the implications of IFRS for your business, and we look forward to answering your questions and discussing your specific issues.

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B The business case for SMEs

1 Comparability of companies' financial information

The voluntary application of IFRS by SMEs will significantly improve the comparability of entities within an industry and across different industries, regardless of where the reporting entity is domiciled. Under IFRS, similar transactions and economic circumstances are accounted for and presented more consistently than under varying national requirements.

It is rarely possible in the current environment to make a satisfactory assessment of private entities' financial information, at either national or international levels, because key financial indicators are not comparable between companies. At the national level statutory accounting regulations allow choices between alternative accounting treatments or tolerate differences in the treatment of expenses and income. Internationally, financial indicators are not comparable because different recognition and valuation principles are applied in each country. This makes it difficult for users of financial statements to make informed decisions and increases transaction costs.

Private equity investors, venture capitalists and their advisers operate in international markets and depend on comparable financial information to assess investment opportunities in different companies. Companies that move to IFRS (including SMEs) have found that it improves both the comparability of information and the quality of communications to their stakeholders. This helps to decrease investor uncertainty, reduce risk and minimise the cost of capital.

2 Acquisitions, partnerships and cooperation agreements

Adopting IFRS can make it easier for SMEs to implement planned cross-border acquisitions and to initiate proposed partnerships or cooperation agreements with foreign entities. Furthermore, IFRS can simplify the sale of the reporting entity itself, either as a whole or on a piecemeal basis.

This is because a financial statement is a key document for evaluating an acquisition and negotiating a purchase price, as well as for assessing potential partnership or cooperation agreements. Interpreting the performance of the other party's business becomes significantly easier, and agreement is more likely, when both sides already have IFRS financial statements. If financial information is based only on national requirements, additional time and expense must be invested in order to understand the different basis of accounting and reach a clear assessment of the other party's performance.

Post acquisition, the costs of integrating the financial reporting systems are lower where both the acquirer and the acquiree already apply IFRS.

3 Building relationships with overseas customers

IFRS information can help SMEs involved in buying / selling goods or services across national borders to initiate new relationships with customers and suppliers. As the spread and acceptance of IFRS grows internationally, so does the importance of IFRS financial statements as a tool to cultivate a positive image. It is not only large foreign groups that now demand financial statements from SMEs as part of the process of supplier selection and evaluation.

Suppliers that only prepare financial statements under national GAAP may well find themselves at a disadvantage compared to competitors with IFRS financial statements, particularly if their customers are based in Anglo-Saxon countries.

To eliminate disadvantages in the global competition for new contracts and allow businesses to compete on their merits, an entity must be able to provide high-quality

information that, at the very least, is as convincing and as relevant for decision-making as the information its competitors provide.

This is particularly important when entering into long-term trading relationships: in these circumstances, potential customers or suppliers usually want reassurance about the entity's solvency before committing to a relationship. This information can be better conveyed using an internationally-accepted accounting framework, such as IFRS, rather than a national framework that needs to be explained.

4 Dealing with finance providers

IFRS can strengthen SMEs' position in negotiations with credit institutions and reduce the costs of borrowing because of the positive effect it can have on credit ratings. For example, the application of IFRS often leads to a revaluation of fixed assets and therefore to an increase in the equity ratio. This ratio is an important evaluation criterion in many ratings systems.

IFRS can also result in more accurate risk evaluations by lenders and, in many cases, to a lower risk premium. This is because financial information prepared using IFRS emphasises the economic substance of transactions and tends to provide higher-quality information, with better disclosures and transparency than national accounting frameworks.

IFRS can help SMEs to take advantage of alternative forms of finance. Equity financiers, just like credit institutions, want top-quality information to help them assess the risks and rewards of the entity or project to be financed. IFRS information enables clearer comparison of investment opportunities in various countries to be made, and helps investors to identify the specific advantages of each. The better the information for investors, the easier it is to attract them, and the lower the risk premium for the company.

5 Streamline preparation of financial information

Many parent companies currently require their foreign subsidiaries to adjust individual financial statements to conform to the national GAAP of one country. This can reduce financial reporting effectiveness and add costs to the group reporting process because the national peculiarities of those standards are likely to need further explanation at the subsidiary level.

Internationally-active SMEs can profit from group-wide application of IFRS: it can facilitate faster and more cost-effective preparation of financial information. If both parent and subsidiaries (i.e. all individual companies in the group) apply IFRS, it means there is no need for a second set of financial statements for group accounting. It also reduces the risk of misunderstanding and facilitates the more efficient collation of comparable, decision-relevant information from all group companies.

C Moving ahead with IFRS

Whether you are already moving ahead with IFRS or simply examining the business case for your company, PricewaterhouseCoopers can help. We are uniquely positioned to ensure that there are no surprises and that the benefits of using internationally-accepted standards make a real difference to your business.

As world leaders in services to SMEs and in conversions of this kind, we have a unique insight into the whole issue of IFRS conversions for SMEs. This puts us ahead of the game, and we pass that competitive advantage on to our clients.

We can help you decide on the right course of action for your particular circumstances. If this is the right moment for you to make the change to IFRS, our extensive experience and proven methodology can help you bring your IFRS project to a successful conclusion by providing solutions tailored to your business.

'You need to make a realistic plan for the conversion. It may take more than one accounting year before you get the full effect'

'Our IFRS project is helping some functions speak to other functions'

'Transition to IFRS is a good way to check that we are doing things in the best way for our business'

Advice from CFOs responding to the PwC IFRS survey

At PricewaterhouseCoopers, we have a proven track record in assisting many hundreds of companies of all sizes and in all sectors to successfully convert to new financial reporting standards. Our conversion specialists deliver practical solutions to help you address the key challenges, such as training your people, defining data and systems requirements, communicating with key stakeholders, and managing the change without disruption to your usual business activities.

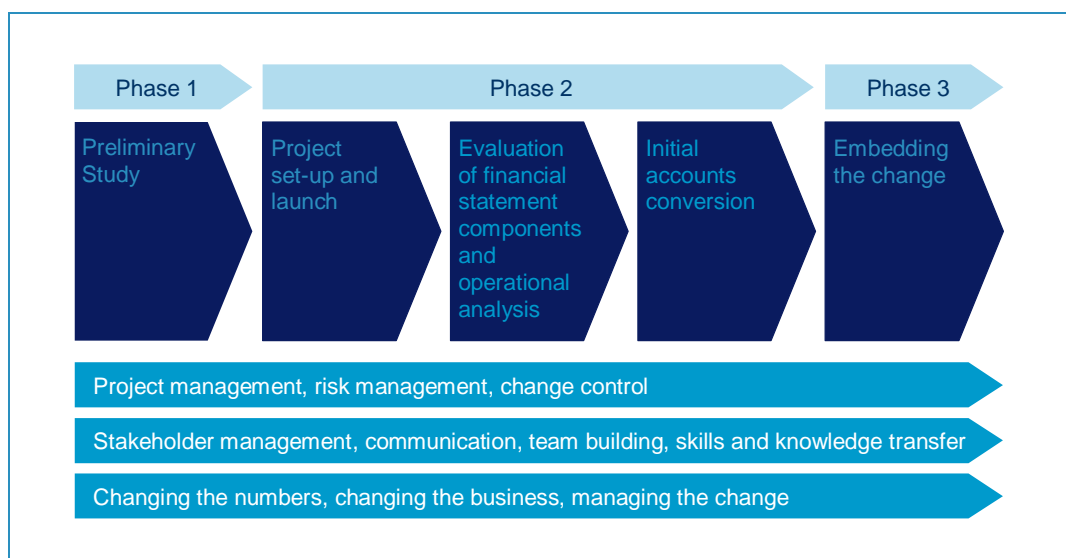
Our experience indicates that a methodical approach to the conversion process can yield wider benefits. Our TransitionIFRS Methodology is a robust, tried and tested framework that has an inherent flexibility, enabling us to adapt it to your organisation's needs.

You can also take advantage of our IFRS change management tool – the TransitionIFRS e-Platform – which eases implementation by enabling you to manage and control every aspect of the IFRS conversion and to work collaboratively with everyone involved. From this communications platform you can easily access the expert guidance, top-quality research, training, and the one-to-one support that you need as the implementation progresses.

The change to IFRS is not just an accounting issue - target-orientated project management can be as important as knowledge about specific IFRS provisions.

PricewaterhouseCoopers' approach enables you to:

- Control the process from start to finish
- Be guided smoothly through operational problems, process and systems changes, as well as organisation and reporting issues
- Clarify resource needs, roles and responsibilities up-front
- Acquire the knowledge your people need to ensure lasting benefits to your organisation.



Transition IFRS conversion methodology – three steps to steps

Phase 1: Preliminary study

- This prudent first step gives the company a high level of understanding about the impact of IFRS on key numbers and ratios, and highlights key accounting issues and any potential “surprises”.

Phase 2: Initial conversion

- Project set-up
This is done so that the business can be run effectively while the transition project is managed to a successful conclusion.
- Component evaluation and issues resolution
This results in fully-informed decisions on IFRS accounting policies and conversion strategy, as well as on operational and systems changes.
- Initial financial reporting conversion
At this stage, the first comprehensive IFRS financial statement will be prepared (but not reported externally), so that the business can see itself in the new IFRS context for the first time.

Phase 3: Embedding

- This phase enables the business to implement change in a smooth transition to a new way of operating, using the new IFRS language comfortably and authoritatively.

SMEs that have successfully made the transition to IFRS have usually approached each phase of the project by focusing on three main streams that run simultaneously: changing the numbers; people and process change; adapting information systems. The priority of each stream gradually changes as progress is made.

Here are some examples of SMEs that have already made the change to IFRS with advice from PricewaterhouseCoopers. These are based on real cases, but the names have been changed.

IFRS transition case study: X Beverage

X Beverage is an unlisted drinks company (turnover €160m) involved in the development, production and sales of drinks. It had strong business reasons for deciding to prepare IFRS financial information.

The company is owned by its management and two other listed drinks companies. The three agreed that they would derive significant business benefits – such as better comparability, efficiency and business insight – if X Beverage prepared financial information on the same basis as its partners, even though there was no requirement for it to do so.

Key challenges

- **Internal communications and accounting:** The transition process was particularly complex because the company had subsidiaries in more than 10 different countries.
- **Determining the useful lives for fixed assets:** This was an issue because companies in the group had a lot of machinery for bottle production and processing, but they did not know how long the machines would work for – the information had not been needed under national requirements.
- **Fair values:** Identifying the fair values of unlisted financial assets held to maturity.
- **Accounting for deferred taxes:** There were different capitalisation and valuation rules for tax purposes, and this presented some difficult calculation issues, such as with foreign currency balances.
- **Intangible fixed assets:** This was a major issue, particularly because the company changed to IFRS before IFRS 1, First-time Adoption, became effective and could not benefit from the concessions it included. X Beverage had to capitalise its intangible fixed assets in accordance with IAS 38, Intangible Assets. Under its previous GAAP, the brand value of the registered trademarks that the company bought was all part of goodwill. But on conversion to IFRS these had to be recognised as separate intangible assets, and a value had to be established for each.

X Beverage used external advisers to help them assess the scope of their IFRS transition project, identify the data gaps and advise on effective internal communications. It also brought in specialists to run a tailored training programme to meet varying needs across the group. Specialists were also consulted on specific challenges, such as showing staff how to determine brand values separately from goodwill, and advising on the different models for determining a brand's fair value.

Outcome

The beverage company achieved its conversion to IFRS in five months. It recognised, however, that to achieve this it had needed to take a tactical approach, including the use of various spreadsheets – making the accounting processes more complicated and labour-intensive than necessary. The IFRS information was an immediate benefit for the business, particularly in improving its relations with its business partners, but the company wanted to capitalise on these benefits by using IFRS for all business purposes across all subsidiaries.

Management has taken the decision to embed IFRS more fully so that IFRS numbers can be produced across the whole organisation as part of everyday business processes. The company is taking advice on the steps needed to generate IFRS information in the most efficient and flexible way; including the necessary modifications to their IT systems and accounting processes.

IFRS Transition case study: Y Coffeetrade

Y Coffeetrade is a group involved in the cultivation and trade of natural products such as coffee, cocoa and sugar. The company also provides financial services, such as interest-rate hedging arrangements, commodity futures contracts and export financing.

Y Coffeetrade's high gearing was a key trigger for the decision to prepare IFRS consolidated financial statements. Management wanted to ensure that the company's economic performance was well understood so that its credit rating and the interest rates payable on its loans were as competitive as possible. As part of this strategy, it had agreed to new credit arrangements with its bankers, which included the requirement to produce consolidated IFRS financial statements.

Key challenges

- **Hedging:** To assess whether and to what extent the company used financial instruments for hedging purposes. This was particularly difficult because the criteria for the application of hedge accounting were challenging to understand.
- **Financial instruments:** To determine initial recognition of all derivative financial instruments in the balance sheet. The company had many financial instruments because of its role in pre-financing arrangements with plantations and mills etc – it had to look at every financial instrument and assess whether it was derivative or not.
- **Group accounting for deferred taxes:** To assess the detailed differences between the value of an asset/ liability for financial reporting purposes and for tax purposes placed a significant strain on the company's resources. Generating a sufficiently detailed record of these differences involved much time-consuming research, because there was no historical documentation.

Management used external advisers to show them how to differentiate between derivative financial instruments and other financial instruments. Advisers also assisted in the valuation of financial instruments, specific technical issues, and tailored training for key staff.

Outcome

The change to IFRS has enabled Y Coffeetrade to improve the terms of its credit agreements and also to improve the quality of its management information for decision-making purposes.

IFRS transition case study: Z Shipyard

Z Shipyard, a medium-sized company (turnover €150m) that operates a yard to repair and refit ships, recently decided to change to IFRS. The key reason for this was that a significant new investor – a foreign private-equity firm – could not fully understand the company's financial information, which was based on national standards. The investor therefore requested a set of IFRS financial statements.

Key challenges

- **Shortage of resources:** Although the shipyard had a healthy balance sheet total of €1,500m, economic pressures on the shipping industry had forced it to pare down its finance function to a skeleton staff. This meant that they did not have enough people or the appropriate skills internally to make the change to IFRS.
- **Extent of the disclosures:** Very few notes to the accounts were required under the shipyard's national GAAP, so the relatively extensive notes required under IFRS came as something of a surprise, and one that intensified the resource constraints.
- **Accounting for construction contracts:** Under IAS 11, Long-term Contracts, the 'percentage of completion' method is quite different from the national GAAP approach of accounting for the contract once it is completed. The IFRS approach meant that the shipyard had to be able to track the development of its shipbuilding and the specific costs related to each stage.

Z Shipyard used external advice on the planning process and structure of its conversion project. An important step in the process was to look at each component of the balance sheet and the income statement, and set out the accounting and reporting requirements of IFRS applicable to that component, together with the current accounting and reporting practices. In this way the differences were clearly identified, allowing accounting issues to be properly resolved, relevant accounting and reporting practices to be implemented and any additional information gathered ready for the initial conversion.

Outcome

Z Shipyard immediately noticed some improvement in the quality of information available for internal decision-making. In addition, it was able to complete successfully the initial conversion process in a relatively short time – just three months.

A key reason for this was that the shipyard already had a detailed internal reporting system capable of providing most of the data needed for IFRS reporting. Only minor adjustments to the existing system were needed. Another factor in the quick timing was the high level of external support that the shipyard received.

The shipyard will now assess its next steps in IFRS reporting to see if it can embed the knowledge of IFRS within its business and be more self-sufficient in its future financial reporting periods.

D Working with IFRS

PricewaterhouseCoopers has developed a user-friendly and authoritative range of publications, research tools and newsletters to provide you with the very latest information, guidance and best practice examples. They are used to help thousands of organisations worldwide, including companies that already prepare IFRS information and those working with IFRS for the first time.

IFRS publications

- Acquisitions – Accounting and transparency under IFRS 3
- Adopting IFRS – IFRS 1, First-time Adoption of IFRS: A step-by-step illustration of the transition to IFRS
- Applying IFRS – Finding the right solution (available on Comperio IFRS)
- Case studies: experience of companies that have made the transition
- Disclosure Checklist
- Financial Instruments under IFRS – Revised IAS 32 and IAS 39
- IFRS News – monthly electronic newsletter shedding light on the IASB's activities
- IFRS Pocket Guide
- Illustrative Corporate Consolidated Financial Statements
- Illustrative Interim Consolidated Financial Statements for First-time Adopters
- Impact of improvements, amendments and new standards for continuing users of IFRS
- Measurement Checklist 2004
- Share-based Payment – A practical guide to applying IFRS 2
- SIC-12 and FIN 46R
- Survey: Ready for take-off? IFRS readiness
- World Watch – magazine on governance and corporate reporting

IFRS learning and research tools

- P2P IFRS – from principle to practice. Electronic learning tool (Demo CD available)
- Comperio IFRS – Comprehensive electronic research tool
- Working with IFRS CD-Rom – PwC tools and publications
- Disclosure Checklist and Measurement Checklist – CD-Rom

Hardcopies of our publications can be obtained from your local PricewaterhouseCoopers office or by e-mailing ebru.isiltan@de.pwc.com.

About us

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