EFRAG
European Financial Reporting Advisory Group

xx Month 2007

Paul Pacter
Project Director

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 31 August 2007

Dear Paul

Re: ED IFRS for SMEs

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *IFRS for Small and Medium-sized Entities* (ED). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process. In the attachments to this letter, we provide detailed comments and proposals in response to the invitation for comments. Our comments and proposals are derived from our key observations, as described below.

Full IFRS continue to be developed with the objective of serving primarily the needs of capital markets and benefit from the most recent sophisticated information technology. Such objectives have resulted in IFRS that are more complex and sophisticated. There exists a widely held view that full IFRS is too complex to serve the needs of users of financial statements within the context of entities without public accountability.

For this reason, EFRAG is supportive of the development of a simplified set of international financial reporting standards with requirements that are consistent with the conceptual basis of IFRS. Such a set of standards ought to increase the understandability of financial reporting by companies without public accountability and should be developed on the basis of a good understanding of users' needs. It also needs to be prepared on a reasonable basis having considered the balance between costs and benefits.

EFRAG believes that the IASB has made good progress with the ED, by setting the objective of a stand-alone document, accepting recognition and measurement simplifications, and separating the ongoing maintenance of the future standard from the revision process for full IFRS.

However EFRAG believes that the proposed standard can be further improved, in the following suggested ways:

1 – The final standard should be a comprehensive stand alone document

EFRAG believes that the objective of a self contained, comprehensive set of standards can be achieved. The IASB has already taken key steps towards achieving that goal, i.e. they have included some measurement pervasive principles in the standard and have also eliminated the general fall back to full IFRS from the requirement hierarchy. To fulfil the objective entirely, all remaining cross-references, both optional and mandatory should be eliminated. EFRAG provides in its more detailed comments recommendations on how to eliminate those cross-references. This, in EFRAG's view, can be accomplished while making the standard even more concise than is currently reflected in the ED. EFRAG has also provided re-drafting and restructuring guidelines that can eliminate the need for cross references.

2 – "IFRS for SMEs" is not the most appropriate label

EFRAG has observed that the present label "IFRS for SMEs" quite often creates misunderstandings. The label "SME" is widely used internationally to refer to the size of entities in general. The scope of the ED, which excludes all entities which meet the proposed definition for public accountability, does not refer to size criterion of any kind, and EFRAG believes, rightfully so. Therefore EFRAG recommends that a different label be selected when naming the final standard. EFRAG recommends that the IASB revert to one of its earlier tentative decisions and re-label this set of standards as "IFRS for NPAE's" (non publicly accountable entities), unless it is able to identify a better label.

3 – Users' needs ought to be analysed further and more changes to recognition and measurement principles may be needed

In its basis for conclusions, the IASB acknowledges that users' needs of NPAEs are different from those of users of financial statements of publicly accountable entities. The IASB also clearly indicates that these differences need to be reflected in different recognition and measurement principles. EFRAG agrees with those conclusions. However EFRAG believes that these conclusions have not been fully taken into account in the decisions made by the IASB. Therefore EFRAG recommends that a further analysis be conducted and more changes to the existing measurement requirements may be necessary in order to better serve the needs of users'. For example, EFRAG believes that the use of market prices should only be used for the revaluation of assets and liabilities when an active market exists and a disposal or transfer is a possible scenario for the entity.

4 – More simplifications in recognition and measurement should be considered

The IASB has put forward in its ED some simplifications in the recognition and measurement requirements in general, which denotes a valuable and vital step forward in this project. However EFRAG believes that further simplifications can be made, while remaining consistent with the IFRS conceptual framework. These simplifications include, inter alia, reinstating the amortisation of goodwill and other intangible assets, promulgating only one cost model and one revaluation model for non-financial assets, eliminating the reference to the name "fair value", and eliminating the recognition of equity settled share-based payments. Also, simplifications already made by the IASB need to be improved. For example, fair value as the default measurement attribute for financial assets and liabilities is inappropriate, in EFRAG's view, and results in requirements which are still quite difficult to understand and to implement.

5 – Differences with full IFRS may be warranted when a need for improvement has been identified and is particularly relevant for SMEs (equity/liability split)

EFRAG is aware that in some jurisdictions partnerships, cooperatives or other forms of corporation have puttable equity instruments. Often these entities are not publicly accountable and are therefore within the scope of this standard. EFRAG believes that some changes are warranted with respect to the debt/equity classification (such as but not limited to what the IASB is considering for full IFRS) in order to address the anomalous outcome of an entity having negative or no equity at all although it is still very much a going concern.

6 – The standard could benefit from being redrafted

Although the IASB has made the right decision in terms of organising the standard by topic, we believe that the final IFRS for SMEs ought to be more user-friendly than is currently the case. EFRAG believes that the standard can benefit from restructuring and re-drafting in the following ways:

- The standard could be reorganised in sections and subsections, so that for example, all requirements for non-financial assets or group accounting would be grouped together;

- Principles and application guidance could be separated from each other, so that principles could be emphasised and better understood, while more guidance would be provided;

- Where principles and guidance are the same, no repetition from section to section is needed; this approach could aid understandability and conciseness.

Our detailed comments and proposals on how to achieve the above objectives are provided in the various attachments to this letter:

- attachment 1 answers the questions set in the invitation to comment;

- attachment 2 includes detailed comments provided on each section of the proposed standard (some of them by cross-reference to the other attachments), in addition to the comments to the specific questions;

- attachment 3 presents and illustrates EFRAG's proposals for restructuring and redrafting the standard to achieve the desired level of simplification and understandability referred to above. It also includes EFRAG's basis for conclusions on measurement.

If you would like further clarification of the points raised in this letter, either Sven Morich or I would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

EFRAG
European Financial Reporting Advisory Group

Attachment 1: Answers to the invitation to comment

Question 1 – Stand alone document

With the objective of a stand alone document in mind, are there additional transactions, other events or conditions that should be covered in the proposed standard to make it more self-contained? Conversely, is there guidance in the draft standard that should be removed because it is unlikely to be relevant to typical SMEs with about 50 employees?

EFRAG believes that the ED made good progress compared to former discussion papers and staff drafts of an IFRS for SMEs, as we can clearly see the standalone approach as an objective of the standard. Furthermore EFRAG welcomes the reduction of mandatory fallbacks to full IFRS and the proposed separate update procedure.

EFRAG supports the deletion of paragraph 10.3 (c)[1] of former staff drafts of the ED referring to the requirements and guidance in full IFRS and Interpretations of full IFRSs dealing with similar and related issues. The reasoning behind is that EFRAG believes that the IFRS for SMEs should deal with and include the requirements for all transactions that are common for SMEs and should be a standalone document. Therefore if the transactions are not frequent for a SME it should rely on the pervasive principles to solve the accounting.

EFRAG believes that the remaining fallback to IFRS when there is no accounting requirement included in the IFRS for SMEs has to be eliminated. The IASB has to decide:

(a) If there are only remote possibilities that the mandatory fallback is useful to SMEs, there is no compelling argument not to rely on the IFRS for SMEs hierarchy included in section 10.

(b) If it is of the utmost importance that SMEs who encounter those transactions account for them in accordance with the existing requirements, those requirements should be included in the IFRS for SMEs, with the benefit of more simple drafting and homogeneous presentation.

EFRAG's recommendation for eliminating mandatory fallbacks is as follows:

- no requirement in the IFRS for SMEs

  EFRAG is of the view that no mandatory requirement should be included in the IFRS for SMEs for segment and interim reporting as well as earnings per share. EFRAG agrees that segment and interim reporting are rarely produced by SMEs. If they are, they may follow, either some legal requirements that may detail what information needs to be provided, or be based on some extract from internal re-

[1] Paragraph 10.3c) used to refer to full IFRS. One of the final modifications made by the IASB has hence been to mention full IFRS as being only one – among others – of the possible references for SMEs in quest of an accounting treatment.

porting, that users are likely to find useful. EFRAG believes that the IASB shouldn't discourage SMEs to provide users with supplementary useful information. Moreover, a mandatory requirement to apply IAS 33 *Earnings per Share* may be usefully replaced with a prohibition to provide any form of ratio or other indicator on the face of the financial statements and to necessarily disclose on what basis any form of ratio or other indicator provided in the notes has been prepared. As a result, sections 31, 34 and 37 should be deleted.

- requirements included in the IFRS for SMEs

  - Guidance on how to account for hyperinflation needs to be included in the IFRS for SMEs. Hyperinflation is a question of location, and SMEs are likely to be faced with it just as frequently as publicly accountable entities. Relevant extracts of IAS 29 and IAS 21 need to be selected and eventually simplified in drafting and be included in the IFRS for SMEs;

  - requirements for accounting for finance leases by lessors: receivables arising from finance leases could be scoped in the section dealing with financial instruments. A separate paragraph would state that receivables arising from finance leases are initially accounted for at an amount equal to the net investment in the lease. Revenue recognition for finance leases by lessors would be included in the revenue section;

  - biological assets can be scoped in non-financial assets, and be accounted for at cost at initial recognition, with either cost or revaluation as subsequent accounting (see our proposal);

  - specific sections would deal with share-based payments (see proposals for simplifications in our answer to question 3).

Question 2 – Recognition and measurement simplifications that the Board adopted

Are there other recognition and measurement simplifications that the Board should consider? In responding, please indicate:

(a) the specific transactions, other events or conditions that create a specific recognition or measurement problem for SMEs under IFRSs;
(b) why it is a problem;
(c) how that problem might be solved.

In answering to this question, we first assess those simplifications which in EFRAG's view are not satisfactory; we then describe the areas in which more simplifications are necessary.

1 – Accounting for financial instruments remains too complex and the revised and shortened drafting lacks clarity and understandability

<u>(a) Simplification does not only mean shortness</u>

EFRAG welcomes the effort made by the IASB to significantly reduce the complexity of the accounting for financial instruments. However EFRAG is concerned that in doing so the IASB has primarily succeeded in shortening the section rather than in making the requirements fully understandable or easy to implement. To be easy to understand and to implement, accounting requirements need to be explicit, i.e. transactions that need to be accounted for and the accounting treatment that needs to be applied to them must be clearly identified and described.

In choosing the fair value measurement by default, and omitting the definition of derivatives, the IASB has created implicit requirements. SMEs' preparers may fail to identify this kind of financial instruments.

Also the language used is not simple enough. We address the issue of scope exclusions which are very difficult to read. We also wish to point out that the guidance for fair value measurement that has been imported from IAS 39 is not written in language and details which are familiar or easy to understand by SMEs.

Requirements are not necessarily clear. For example, requirement to test hedging effectiveness and to recognize ineffectiveness in P/L is not clear from the text in the ED but is to be found in the basis for conclusions.

For the reasons expressed above, we do not think that section 11 meets the criteria we have set ("easy to understand, easy to implement") for the IFRS for SMEs.

(b) Scope out for insurance contracts is unclear

The scope exclusions of Sec. 11 should be clarified as some insurance contracts are covered by Sec. 11. The term "insurance contracts" is not defined in the standard. For example financial guarantees would be in the scope of Sec. 11 for the guarantor as Sec. 11.3(c) scopes out rights (but not obligations) under insurance contracts.

(c) Scope in for commodities is too complex for an SME

Sec. 11.4 for non-financial items and the scope exclusions of Sec. 11.3(c) and (e) for leases and insurance contracts lead to a scope extensions for commodities that are similar to instruments dealt with in IAS 39.11. Compared to IAS 39.11 Sec. 11 only covers non-financial contracts with (i) underlyings other than prices and foreign exchange rates and (ii) only when losses could arise to the buyer or seller as a result of the contractual terms. EFRAG questions whether that means that non-financial contracts with interest rate risks are in the scope of section 11 and should be measured at FV in their entirety.

Furthermore it is EFRAG's understanding that Sec. 11 results in every contract including an embedded derivative not economically related to the contract to be accounted for at fair value.

View 1

EFRAG disagrees with that requirement and would rather support that the IFRS for SMEs does not ask for a separation from the host contract of these instruments (ie no *embedded* derivatives). EFRAG suggests that IASB should omit the above mentioned paragraphs in Sec. 11 as it too complex for an SME to identify this kind of instruments and to determine their fair value.

View 2

EFRAG disagrees with that requirement and would rather support that the derivative be separated out, whether the host contract is a financial instrument or a non-financial item. In EFRAG's view, it is useful for SMEs to have to identify risks they accept beyond the risks inherent to the contracts to which they commit and to keep track of the basic financial consequences of the other contractual terms they accept in the normal course of their business.

EFRAG believes that derivatives ought to be defined in the IFRS for SMEs. Criteria set out in 11.3 and 11.4 could be used to identify the derivatives which need to be accounted for separately from host contracts.

Question to EFRAG constituents:

Do you prefer view 1 (embedded derivatives are not recognized) or view 2 (they are recognized via split accounting)? Do you wish to gather some input and raise a question to our constituents?

(d) Treatment of transaction costs

No mention of transaction costs is made. We believe that transaction costs need to be adequately dealt with.

(e) Recognition

We acknowledge that the recognition principle set out in section 11 is copied-pasted from IAS 39. However we do not believe it is clear enough for SMEs. SMEs need to know when financial instruments ought to be recognized. The standard is silent on this. Moreover the formulation "only when" could be misinterpreted as "when" and lead to unwanted accounting. The definitions of financial assets and liabilities refer to contractual rights and obligations, not unconditional contractual rights and obligations. Therefore we believe that beyond recognition criteria set out in par 2.24 the standard ought to indicate that financial assets and liabilities ought to be recognized as soon as the contractual rights and obligations they embody become unconditional, i.e. as soon as they become enforceable, even where they remain contingent on future events that are beyond the control of the parties to the contract.

(f) Two measurement categories are needed – but articulated in a different way from IASB's proposal

EFRAG welcomes the reduction of categories as an effective simplification. However EFRAG disagrees with the de facto full fair value option given to a variety of financial instruments by paragraph 11.7(a) and (b)(iii).

Consistently with our basis for conclusions on measurement, EFRAG is of the view that measurement requirements should aim at providing the most useful information to help users forecast *the entity's* future cash flows. EFRAG therefore recommends the adoption of classification criteria for financial assets and liabilities similar to those it recommends for non- financial assets:

- easily disposable financial assets and easily transferable financial liabilities are those assets and liabilities which can be immediately traded in the state they are and without any specific negotiation and for which there are observable prices; the best estimate of the entity's future cash in- and outflows arising from these assets and liabilities is, in EFRAG's view, measured on the basis of an exchange scenario;

- the best estimate of the entity's future cash in- and outflows arising from other financial assets and liabilities is, in EFRAG's view, measured on the basis of an "in-use" scenario, i.e. a scenario by which the asset is held and the liability is born until the contract expires.

In that framework, derivatives are always classified as easily disposable assets or easily transferable liabilities.

(g) Consequently no option in measurement is needed

In EFRAG's view, all financial instruments ought to be measured at:

- "market-based exit value" for easily disposable financial assets and easily transferable financial liabilities, (equal to the cash in- (or out-flows) which would result from the entity selling the easily disposable financial asset (or transferring the easily transferable financial liability) at the balance sheet date, on the market to which the entity has access);

- at cost or amortised cost for other financial assets and liabilities would be measured.

The market value of easily disposable assets or easily transferable liabilities can always be determined. A SME is unlikely to have the in-house skills to measure the value of complex instruments or derivatives. In those instances, it should rely on external appraisals.

The accounting outcome of our proposals would not significantly differ from the IASB's proposal except that:

- there wouldn't be any accounting option, hence increasing understandability of SME financial reporting by users with less effort (please refer to our supplementary comments on users' needs in the end of this Attachment);

- no reference would be made to fair value (please refer to our answer to question 2);

- no priority would be given to market prices, market prices would be used insofar as they are relevant to the entity's specific economic conditions (in line with our basis for conclusions on measurement – please refer to Attachment 3, appendix 4).

(h) Derecognition scheme has been shortened at the cost of covering certain transactions

EFRAG welcomes the attempt to simplify the derecognition criteria for financial assets. However as acknowledged in the basis for conclusions (BC73), simplifications may remove guidance on how to account for "complex" transactions. In EFRAG's view, removing the continuing involvement criterion may prevent SMEs from accounting for securitizations and factoring transactions appropriately. Indeed, if an SME retains control of a transferred asset the entity has to continue to recognise the transferred asset in its entirety. This could lead to the result that certain securitizations and factoring transactions would not result in a derecognition of the corresponding financial assets under Sec. 11. EFRAG however believes that securitization and factoring transactions are not uncommon for SMEs.

Questions to EFRAG constituents:

1. Are securitization and factoring transactions common transactions for SMEs? Is the simplification made by the IASB appropriate?

2. If not, what accounting guidance should be provided?

(i) Hedge accounting became simpler but also more restrictive

The simplified hedging approach proposed in Sec 11 is welcomed as a genuine attempt to simplify a very complex set of provisions. EFRAG agrees that restricting hedging accounting to the circumstances in which the "almost fully offset" test is met would have been too restrictive. However EFRAG believes that the shortcut method should remain available to be applied in all circumstances in which the cost and burden of testing the effectiveness of hedges could be spared. As a consequence, EFRAG would support both methods being available in the standard.

When using an effectiveness test as criteria for hedge accounting clarification is needed on how to measure this effectiveness.

Questions to EFRAG constituents:

The simplified hedging approach goes along with some restrictions which might cause problems in practice:

1. Sec. 11.31 only allows hedging for four specific risks. Is that too restrictive ?

2. Sec. 11.32 only allows hedging for certain hedging instruments. Is that too restrictive ?

Other recognition and measurement simplifications

EFRAG believes the following other recognition or measurement simplifications need to be considered – or reconsidered - by the IASB. We believe that the proposed simplifications will make the IFRS for SMEs easier to understand and easier to implement and still meet the user's needs.

2 – Assets and liabilities in a finance lease should be measured at an amount equal to the present value of the minimum lease payments and not at fair value

EFRAG disagrees with the proposal in the ED that lessees should measure assets and liabilities arising from finance leases at fair value. EFRAG recommends that lessees measure assets and liabilities arising from finance leases "at an amount equal to the present value of the minimum lease payments". This amount is readily available in the contract whereas the fair value of the asset would need to be measured separately and EFRAG's recommendation makes therefore implementation of the standard easier. As most contracts are likely to be exchanges of equal values, this measurement requirement does not weaken the resulting financial information. In case there is an indication that this is not the case, impairment requirements would ensure that no asset is overstated.

3 – Changes made to impairment requirements lack relevance and remain burdensome for goodwill

(a) The elimination of value in use is not deemed relevant

EFRAG is not supportive of the change made to the definition of a recoverable amount. In IAS 36 recoverable amount is defined as the higher of the asset's fair value less costs to sell and its value in use, whereas in section 26 it is limited to being fair value less costs to sell. EFRAG believes that value in use needs to be reinstated as a possible basis for impairment tests, for the following reasons:

- fair value less costs to sell may be far from easily determinable for non financial long term assets such as PP&E and intangible assets;

- assets may need to be tested as part of a group; this is always the case for goodwill and can verify for other assets (for example, intangible assets which are not separable;

- fair value less costs to sell may require a supplementary valuation effort whereas the necessary forecasts may be readily available;

- value in use is likely to be more relevant to the impairment test than a valuation based on a disposal scenario, when the assets are in use in the operations in the entity.

EFRAG believes that "fair value less costs to sell" should be replaced by "net selling price", i.e. be based on the selling price less costs to sell that an entity could expect to obtain from the asset (or the group of assets) in a disposal scenario.

(b) The impairment test should be carried on the basis of either value in use or fair value less costs to sell, consistently with the scenario relevant to the entity

To achieve the simplification sought by the IASB, EFRAG recommends that the impairment test be carried out on the basis of the scenario – sale or use – which is relevant to the entity. EFRAG believes that computing value in use can be based on a discounted cash flow calculation, as in IAS 36. However EFRAG suggests two simplifications that should ease the burden of the impairment test:

(a) leave out the requirements related to cash generating units; replace them with concise guidance for testing group of assets including goodwill;

(b) give relief to the constraint put to the definition of future cash flows, and require the DCF calculation to be based on forecasts available in the entity.

(c) The impairment approach proposed for goodwill has been deemed too costly and burdensome for entities applying IFRS

EFRAG disagrees with the impairment approach for goodwill. Fair valuing components of an entity is costly and unnecessary, when there is no plan to sell the component.

The IFRS for SMEs needs to bring more simple guidance. The overriding objective for an impairment test in an SME is to ensure that assets are not overestimated. Reinstatement of amortization would help reduce circumstances where assets need to be tested for impairment (please see our recommendation below). EFRAG believes that guidance to impairment must remain as simple as possible. An illustration of what constitutes a relevant and useful guidance to impairment testing in SMEs is provided in Attachment 3, appendix 3.

4 – All intangible assets (including goodwill) should be accounted for as assets with a finite life and be amortised

The ED proposes that a SME shall assess whether the useful life of an intangible asset is finite or indefinite. EFRAG believes that SMEs should not be required to distinguish between intangible assets with finite or indefinite useful life. This means that all intangible assets should be treated as assets with a finite life and be amortized, over a period of maximum 20 years we suggest. The assumption of an indefinite useful life is that if the expected cash inflows that are associated with the intangible assets are to continue indefinitely, the useful life of that asset is indefinite. After acquisition however, values of intangible assets and goodwill do not have much meaningful content anyhow, or so users say. We therefore believe that reinstating amortization of goodwill and intangible assets would not deprive users of SMEs financial statements from the information they need to assess cash flows. We agree with the IASB that amortization would be somehow arbitrary. However EFRAG disagrees with the other arguments brought by the IASB in BC 80:

- amortization is likely to reduce the frequency at which impairment tests might be triggered; it therefore indeed eases the burden on entities;

- BC 80 advocates that amortization is contrary to presenting economic reality faithfully. EFRAG believes that an impairment only approach is only a refinement which does not solve the more basic issue of dealing differently with acquired intangible assets and goodwill from other internally generated assets; nor does the impairment only approach ensure that no internally generated asset is ever recognized;

- users do not indeed find much information content in the amortization of goodwill and other intangible assets with an indefinite useful life. However users appear not to find much information content in amounts shown as goodwill and intangible assets with indefinite useful life either (cf PwC survey on Measurement Assets and Liabilities – Investment Professionals' views – February 2007).

When the IASB has decided to eliminate amortization of goodwill and other intangible assets with indefinite useful life, the IASB has requested systematic annual impairment tests. EFRAG observes that entities which apply full IFRS are likely to be better equipped than SMEs to monitor reliably an indicator triggered impairment. Therefore EFRAG believes that reinstating amortization, though on an arbitrary basis, is likely to better ensure - and at a lesser cost - that assets within financial reporting by SMEs are not overstated.

5 – Restatement requirement for discontinued operations should be reduced

Restatement of information is usually quite burdensome for all entities. Restatements however help present information on a comparable basis, and are therefore useful. For this reason, EFRAG supports restatement requirements which stem from section 10 dealing with changes in accounting policies and corrections of errors. However the process of isolating income and expense and cash-flows of discontinued operations for years prior to the decision to sell or discontinue might be burdensome and costly for SMEs. Indeed SMEs are not required to present information about operating segments Therefore, EFRAG believes that the requirement for SMEs should be limited to isolating the information in the year where the decision to sell or discontinue is made. Providing restated information for prior years should be encouraged but not required.

> Note: guidance for presentation of discontinued operations does not justify a separate section. In our proposal for a revised structure (Attachment 3, appendix 1), the guidance on how to restate and present discontinued operations on the face of the income statement is included in the income statement section.

6 – A separate section to deal with non-current assets held for sale is not needed

We believe there is no need to include the measurement provisions of non-current assets held for sale in a separate section as suggested in the ED. Identifying the decision to sell an asset or a group of assets in the near future as an internal indicator of impairment in the appropriate guidance is all what is required. If any such indication exists, the entity shall estimate the fair value less costs to sell of the asset. When the fair value less costs to sell of an asset is less than its carrying amount, the entity shall reduce the carrying amount of the asset to its fair value less costs to sell. At the same time, guidance for depreciating PP&E requires that residual value be revalued and that depreciation ceases if and when the residual value is equal to the carrying amount of the asset. The same could apply to intangible assets in case of a plan to sell the asset (if fair value less costs to sell can be estimated reliably, so can the residual value of the asset). Finally, we acknowledge that information on assets and liabilities which are identified for disposal in a near future is useful to users. To meet this need, EFRAG is of the view that such information should be provided as disclosures. This contributes to make the IFRS for SMEs simpler, more easily understandable, while the information remains meaningful and relevant for users.

7 – Elimination of reference to fair value

The ongoing debate on fair value measurement illustrates that "fair value" is a difficult notion, quite a sophisticated notion, which cannot be understood spontaneously. "Fair value" does not belong to the everyday business life of entities. It belongs to the vocabulary of accountants, actuaries and other valuers, and not to the vocabulary of entrepreneurs and the parties with whom they make business deals or negotiate financing resources.

We therefore believe that referring to fair value measurements generates complexity and hinders understandability.

In addition, requiring fair value measurements may not be relevant for SMEs. As we explain in the appendix presenting our basis for conclusions on measurement (Attachment 3, appendix 4):

(a) We do not believe that priority should be given systematically to market data in SMEs accounts;

(b) we do not believe that market values should be modelled in the absence of a market, in other words we believe that assets and liabilities which are revalued should still embody real potential future economic benefits and not a representation of what these economic benefits might be, would the economic environment in which the entity operates be different from what it is.

Nonetheless we believe that revaluation may be relevant in specific circumstances (please refer to our basis for conclusions on measurement). In those cases we believe the IFRS for SMEs should refer to "current value", current value being defined as "the current estimate of future cash-flows embodied in the asset or liability". Current value reflects economic parameters as of the balance sheet date. Current value may be based on market values or entity-specific data, depending on circumstances and as has to be specified in the various sections of the standard.

8 – Generalise a cost or current value choice for all assets

EFRAG believes that the IASB should eliminate from full IFRSs as many complexities as possible, if the complexities appear justified more by history than by users' needs (complexities such as exceptions, useless differences which are being made today in various accounting treatments, for different assets) This in our view is an essential factor in reducing the level of complexity and making the requirements more easily understood. In the existing IFRS, most subsequent re-measurements of non-financial assets offer an option or include a requirement for measuring at cost or at fair value. However, there may be slight differences in the guidance on how to measure cost. There are also different ways of applying the revaluation model, with changes being recorded in equity or through P/L, some being recycled, some other being accounted for in equity for good.

We do not believe that these differences have any chance of making sense for users of SME financial statements when they first get to understand the IFRS for SMEs. We therefore believe that there should be only one and unique guidance for the revaluation model, with changes in value being accounted for through P/L.

In our answer to the IASB questionnaire, we had pointed out that in our view SMEs were likely to fully understand the underlying economics of their transactions, however would probably not be sophisticated enough to select appropriate accounting treatment in the circumstances. Therefore we believe that appropriate application guidance should be included to guide entities in selecting what measurement model is to be applied in the circumstances (see illustrative application guidance provided as Attachment 3, appendix 3 to this letter). We also believe that the selection should be made asset by asset with appropriate designation documentation, and not category by category as is required in full IFRS today.

Our proposals need, if accepted, to be accompanied by appropriate presentation in the financial statements:

(a) distinction between revalued assets from assets carried at cost, and indications of nature of assets as sub-categories;

(b) separate presentation in the income statement of changes in value.

In addition EFRAG believes that this proposal is consistent with the IASB's conclusions on the relevance of the cost model for agriculture as set out in BC 103.

Question 3 – Recognition and measurement simplifications that the Board considered but did not adopt

Should the Board reconsider any of those and, if so, why?

We refer in this answer to BC95 – BC107.

EFRAG agrees with most IASB's conclusions (but not necessarily with IASB's basis for these conclusions) on all measurement simplifications considered but not adopted except for share based payments.

1 – Equity settled share-based payment transactions should trigger disclosure only

EFRAG believes that SMEs enter into share-based payments more frequently than assessed by the IASB. We believe they deserve that requirements are specified in the standard and designed specifically to SMEs situations. As the IASB acknowledges in BC91, most of what is described and explained in IFRS 2 is irrelevant for SMEs. In addition EFRAG believes that measuring and recognizing expenses arising from equity settled share-based payment transactions does not meet the cost/benefit trade off for SMEs. We therefore believe that SMEs should only be required to disclose the information in a note to describe the principal terms and conditions of any equity settled share-based payment transactions that exist during the period including, the number of shares and the number of employees and other potentially involved, the grant date, any performance conditions and over what period these apply and, where applicable, any option exercise prices. We believe these disclosures would bring the information that users need, i.e. that consumption of resources by the entity are not all reflected in the income statement, and the extent to which supplementary consumption of resources potentially dilute shareholders. Equity settled share based payments do not trigger any cash- outflow and users should not have to restate the accounts in order to isolate recurring streams of cash flows more than they already have to.

2 – Measurement of liabilities incurred in a cash-settled share-based payment transaction should be simplified

Cash settled share based arrangements in the environment of SMEs include formulas that allow to compute the amounts to be paid to employees or other parties to the arrangement as the amount falls due. In EFRAG's view, liabilities should be measured on that basis at the balance sheet date, after appropriate discounting and taking into account the impact of vesting conditions. There again no reference to IFRS 2 seems to be relevant for SMEs.

Question 4 – Whether all accounting policy options in full IFRSs should be available to SMEs

Do you agree with the Board's conclusions on which options are the most appropriate for SMEs? If not, which one(s) would you change, and why?

Should any of these options that would be available to SMEs by cross-reference to the full IFRSs be eliminated from the draft IFRS for SMEs and, if so, why?

EFRAG agrees that most options in full IFRSs should be available in the IFRS for SMEs. However here again, EFRAG disagrees with the use of cross-references to other IFRSs for these options. EFRAG believes that rationalization and efforts to make the IFRS for SMEs as understandable as possible can allow the inclusion of various options into the IFRS for SMEs, and still achieve a substantially shortened document.

EFRAG observes that most options left in IFRS deal with choosing between the cost and revaluation models as subsequent measurement technique. EFRAG believes that there is no valid reason to maintain in the IFRS for SMEs several different revaluation models (see our answer to question 2 above – par 8).

EFRAG's position on other options is as follows:

- Keep the choice between the cost and the revaluation model for all non-financial assets, with the exception of intangible assets; include that choice for biological assets and inventories of commodities; provide application guidance on how to select between the two (please refer to our proposal in Attachment 3, appendix 3 – AG2). As a result, the IFRS for SMEs would still include both the cost and the revaluation models; however the selection between would no longer be optional;

- the option to apply IAS 39 should be deleted; although EFRAG is not satisfied with the financial instrument section, EFRAG believes nonetheless that the IASB has well identified transactions most common to SMEs,

- the SME model for government grants is satisfactory and the option to revert to IAS 20 can be dropped,

- the direct method for the cash flow statement should be dropped; practice in listed entities, supported by users' groups, has indeed shown that it is either not used or not useful and that the reconciliation from operating or net income to operating cash flows deemed necessary,

- the options in the separate financial statements for associates and joint ventures should remain available, with an appropriate simplified guidance included in the IFRS for SMEs, However we suggest some simplifications of the measurement principles to be applied in the consolidated financial statements for these investments. We refer to our proposal in Attachment 2 paragraph E.

- capitalisation of borrowing costs and development costs should also remain available options: we have included the appropriate guidance in the illustrative guidance that we provide in Attachment 3, appendix 3; we have done so with a proposed simplified drafting for borrowing costs and capitalization of development costs, and proposed further simplification in the treatment of borrowing costs.

Question 5 – Borrowing costs

Do you agree or disagree with the proposal to allow SMEs to choose rather the expense model or the capitalisation model for borrowing costs, and why?

1 – Option between expense and capitalisation model is reasonable for SMEs

EFRAG supports the option in Sec. 24 of allowing SMEs to choose either the expense model or the capitalisation model. The proposed changes in an amended IAS 23 to prohibit the expense model are not of any benefit to SMEs wishing to continue expensing borrowing costs, instead the proposed change were likely to be perceived as an added burden. That is because, although eliminating options in the IFRS for SMEs ought to help simplify the accounting requirements thereby making things easier for users that we doubt that this would benefit users of an SME to any noticeable extent.

On a practical level, the implementation of capitalization of borrowing costs implies quite sophisticated information systems. Therefore the proposed prohibition of the expense model creates an administrative burden with no added value for the preparers.

2 – Capitalisation of borrowing costs could be simplified

We do not believe that the identification of potential “specific” borrowings is needed. Rather we believe that capitalization of borrowing costs should be computed on the basis of the average borrowings of the entity in all circumstances. We also believe that such guidance belongs to guidance on how to account for non-financial assets at cost. Please refer to our illustrative example in Attachment 3, appendix 3 – AG1.

Question 6 – Topics not addressed in the proposed IFRS for SMEs

Should any additional topics be omitted form the IFRS for SMEs and replaced by a cross-reference? If so, which ones and why?

Please refer to our answer to question 1 above, where we explain why there shouldn’t be any cross-reference to full IFRS.

Question 7 – General referral to full IFRSs

Are the requirements in paragraphs 10.2 – 10.4 coupled with the explicit cross-references to particular IFRSs in specific circumstances appropriate? Why or why not?

For the reasons expressed in our answer to question 1, EFRAG is fully satisfied with the hierarchy as set out in paragraphs 10.2-10.4. No explicit cross-reference is needed and nevertheless the final fully stand-alone document can be shortened.

Question 8 – Adequacy of guidance

Are there specific areas for which SMEs are likely to need additional guidance? What are they and why?

EFRAG believes that the approach adopted by the IASB (build the proposed standard by extracting the main principles for each standard) does not bring adequate guidance. Indeed, pieces of guidance are included in each section, the minimum being sought in view of the total length of the final document. We believe that our approach to drafting (see our illustration in Attachment 3) allows a more comprehensive guidance to be provided in less volume because of the avoidance of repetitions and rationalisation in principles.

Question 9 – Adequacy of disclosures

Are there disclosures that are not proposed that the Board should require for SMEs? If so, which ones and why? Conversely do you believe that any of the proposed disclosures should not be required for SMEs? If so, which ones and why?

EFRAG has not yet dealt with that issue.

Question 10 – Transition guidance

Do you believe that the transition guidance is adequate? If not, how can it be improved?

In EFRAG's view the listed exemptions might be too restrictive, unless coupled with a general impracticability exemption, of which hurdle would be far lower than the hurdle included in the full IFRS.

1 – Keeping the four exceptions is reasonable

EFRAG agrees that Sec. 38 of the ED has four *exceptions* from retrospective application which means an SME shall not change the accounting that it followed under its previous GAAP for any derecognition of financial assets and financial liabilities, hedge accounting,estimates or assets held for sale and discontinued operations (please note that EFRAG has recommended that no specific accounting requirement be set for assets held for sale).

2 – The listed exemptions might be too restrictive

Furthermore the ED lists certain *exemptions* from retrospective application. EFRAG thinks that these exemptions might be too restrictive, unless coupled with a general impracticability exemption: Indeed it is very unlikely that restatements would be easy for SMEs where listed and larger entities have required exemptions. Wherever restatement would be too burdensome, an SME should retain the previous carrying amounts of assets and liabilities at the date of adoption.

EFRAG in making the above recommendation refers to the definition of "impracticable" as provided in the glossary of the ED, i.e. "cannot be applied after making every reasonable effort to do so". Without any extra wording, this is being understood as a far lower hurdle than the impracticability in full IFRS, that the IASB quite frequently refers to as meaning "impossibility". Were the IASB to confirm this meaning, EFRAG would no longer support the exception for impracticability. A far lower hurdle would need to be defined.

Question 11 – Maintenance of the IFRS for SMEs

Is the approach to maintaining the IFRS for SMEs appropriate, or should it be modified? If so, how and why?

EFRAG is satisfied that maintenance of the IFRS for SMEs is to be disconnected from revisions of full IFRS and that changes brought to full IFRS might be considered for IFRS for SMEs but not necessarily exposed or adopted.

Indeed, EFRAG believes that the exposure draft is sticking too closely to full IFRS. We agreed, with many IASB constituents, that a top-down approach from full IFRS was a good start for the project, but there is still need for freedom from full IFRS to meet the objectives of an IFRS for SMEs. The IFRS for SMEs is to be looked at as a new standard. A common set of basic concepts is a robust enough basis to ensure consistency. IFRS for SMEs does not need to strictly adhere to the inconsistencies, results of compromises that may have accumulated as IFRS have been developed throughout the years. Getting rid of those inconsistencies has the following advantages:

- It provides right from the start an understandable standard and hence serves one of the main objectives of simplification;
- it therefore makes the IFRS for SMEs more attractive at a time when it will first be considered for adoption or use;
- it spares SMEs to have to bear later changes in their accounting practices with the cost associated to those changes.

Furthermore EFRAG believes that there is very little benefit if any in having IFRS for SMEs to be as similar as possible to full IFRS:

- Most SMEs will never go public and hence may never apply full IFRS;
- IFRS for SMEs being easier to implement than full IFRS will support more cost efficient accounting and financial analysis practices;

- there is little need for comparability between listed and non-listed entities; when such need for comparability arises, the option to adopt full IFRS will be available for non-publicly accountable entities.

Future maintenance of the standard should be carried out consistently with the above arguments.

We wish to emphasise that our proposals for a fully stand-alone document provide a supplementary advantage. Beyond bringing the IFRS for SMEs to the state of an easy to understand stand-alone document, they resolve the operational difficulty of having the IFRS for SMEs on one hand, full IFRS on the other hand to be updated as a result of different projects lead at different times.

In addition to the questions raised in the invitation to comment, EFRAG wishes to offer the following supplementary comments.

EFRAG believes that in finalising its exposure draft into a final standard the IASB needs to reconsider the impact of different users' needs and to assess the outcome of its work against criteria for simplification. EFRAG is providing below its input on these two fundamental issues.

A – Users' needs

1 – The necessary user need analysis is missing

In its previous comment letters on the two discussion papers issued by the IASB in relation to IFRS for SMEs, EFRAG had insisted on the need for a thorough analysis whether users of SMEs financial statements may need different - or less sophisticated - financial reporting than users in a listed entity environment.

Unfortunately this thorough analysis is missing. In its basis for conclusions, the IASB suggests that users of financial statements of SMEs have different needs. For example, in BC 24, the IASB acknowledges that users of financial statements of SMEs are less interested in value and more interested in how the entity may be able to meet its obligations when due. However the IASB very quickly asserts that in particular no change in either recognition or measurement is required in order to fit these differences in user needs (BC 25). We do not share this view at all.

2 – Financial reporting requirements in excess of user needs work against public interest

We observe that the IASB further asserts in BC 27 that full IFRS would be suitable for SMEs. This argument is supported by the IASB referring to size again and no longer to users' needs. We therefore believe that this assertion is flawed.

The cost/ benefit trade off is usually looked at from the perspective of whether the entity can afford an extra benefit to be derived from increased sophistication or detail in financial reporting. We believe that this constraint also works in the opposite direction, i.e. when users' needs are being fulfilled, financial reporting requirements should not be made more costly than necessary.

In addition financial reporting requirements must remain consistent with characteristics of users. The framework indicates that financial information provided in financial statements should be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting. The level of reasonable knowledge that can be expected vary from one user group to another, and users of SME financial statements are assessed as less sophisticated and less organised than users in listed entity environment. Therefore bringing accounting requirements to the highest level is not necessarily compatible with the level of knowledge that can be expected from users of SMEs financial statements.

As a consequence we believe that financial reporting requirements, in excess of users' needs, would unduly increase cost (of both entities and user groups) and undermine financial information understandability. Excess in financial reporting sophistication and detail is contrary to general public interest and hence the IASCF objectives would not be met, were full IFRS to be said suitable for all.

3 – Our perception of how users' needs differ in the public- or private-equity worlds.

EFRAG believes that users in a SME environment generally require **less complex and less sophisticated** financial reporting than users of listed entity financial statements since they are less capital market oriented.

EFRAG believes that the different information needs of different types of users could lead to a different importance being attached to the individual qualitative characteristics and this could result in different pervasive recognition and measurement principles. For example, there might be less need for comparability amongst SMEs. A bank or a customer, for example, want to assess whether the entity's financial position is robust enough to justify the risk of lending money or of making it a sustainable source reference. Whether other entities can be assessed more or less robust may have no influence on the decision made. On the other hand, users of SME financial statements may have little resource to devote to an in-depth analysis of financial statements. Therefore preparation and presentation of financial statements should be **standardised enough** in order to save the burden of having to understand prior to any analysis refinements in the definitions or accounting treatments applied.

Even if the qualitative characteristics of the Framework are adopted in the ED EFRAG does not conclude that this leads to similar pervasive measurement principles in the ED compared to the Framework. As explained above the users of the financial statements have different information needs. As a result measurement bases which are primarily based on **market values have less relevance to users of SME financial statements** when applied to assets which the entity does not have the ability to realize or to liabilities that the entity cannot transfer.

The typical medium-sized entity has relatively few non-manager shareholders compared to listed entities, and those shareholders' investments tend to be for a far longer term. This difference has, we believe, implications for the way the shareholders use the financial statements. In particular, they use them primarily to **assess the quality of management** (effectiveness of strategies, performance etc.) rather than to reach decisions about whether to buy, hold or sell the shares

There is a greater focus amongst users of SME financial statements on the entity's ability to generate positive cash-flows in the normal course of business in the **short- and medium-term to meet liabilities as they fall due**. This underlines the importance of ensuring that all liabilities are recognised in the financial statements. It also underlines the importance of using measurement bases that enable users to assess the level of cash inflows in the short- to medium-term.

B – Criteria for simplification

As already explained, users of SME financial statements might be less sophisticated than users of the listed entity financial statements, because the users tend generally not to include capital market analysts, the credit-rating agencies, or employee representative groups (such as Unions). As a result, SME financial statements need to be easily understandable and every unnecessary complexity or variety in accounting treatments must be eliminated.

Therefore in our view the main justification for a simplification for a SME will be either because user's needs are different or on cost benefit grounds. An accounting standard is simple if it is easy to understand and simple to implement. EFRAG wants to make the following remarks how the IFRS for SMEs can be made simpler:

1 – Easy to understand

Accounting requirements for SMEs need to be robustly rooted in few, simple, clear and understandable general principles. Accounting requirements should vary only where there are substantial differences to capture. E.g. there is no need to have several different definitions of cost, or different ways of applying the revaluation model.

Accounting requirements for SMEs need to be cleared of whatever details have been aggregated in the past in full IFRS, as the result of long evolutions, lengthy discussions and compromises. To make the IFRS for SMEs easy to understand, a clearer structure and display is in our view necessary.

In being understandable financial statements must tell the entity's story. This includes a clear description of the information that the different statements have to portray.

EFRAG believes that understandability also means that an IFRS for SMEs should have as little departures from pervasive principles as possible. As many exceptions as possible should be removed from the recognition and measurement principles for assets and liabilities.

In EFRAG's view, the ED would be easier to understand if there was no repetition of the same accounting principles that appear differently worded in different sections, because they deal with different natures of assets or liabilities.

Accounting requirements must also be understandable to the managers. The cost of issuing financial information must first be beneficial to the entity itself. Small entities in particular cannot afford to have two sets of reporting. For cost/benefit purposes as well as relevance and reliability, it is extremely important that external reporting is the same as information used for internal reporting.

2 – Easy to implement

EFRAG believes that accounting standards are easy to implement if they use entity-specific data. This also means that the financial statements should be in line with the entity's strategy and decision making process. Regarding measurement principles for assets this could lead to a distinction between values in-use and values in-exchange.

The number of data and bookings necessary should be minimized. That means revaluation should only be used when necessary to provide supplementary useful information.

Furthermore EFRAG has the view that the ED contains implicit accounting requirements (requiring that a financial instrument be measured at fair value as soon as it incorporates an embedded derivative which meets specific conditions is an example of implicit and unexplained requirement).

3 – Conclusion and Consequences

EFRAG believes that the ED is not easy to understand and simple to implement for SMEs as too many accounting principles of full IFRSs were adopted without changes aimed at meeting an appropriate cost-benefit-balance. In EFRAG's view this is not appropriate for SMEs.

EFRAG
European Financial Reporting Advisory Group

Attachment 2: Detailed comments on existing sections

A – Comment on scope

1 – Clarification needed on changes in scope of the different sections in IFRS for SMEs compared to full IFRSs

The proposed IFRS for SMEs is intended to be a stand-alone document for SMEs. However the draft IFRS for SMEs is developed by the IASB by:

(a) extracting the fundamental concepts from the IASB Framework and the principles and related mandatory guidance from IFRSs (including Interpretations), and

(b) considering the modifications that are appropriate based on user needs and cost-benefit considerations.

The Basis of Conclusions paragraphs BC70-BC93 explain the significant simplifications that the IASB proposes to the recognition and measurement principles in IFRSs, and the reasons for the proposals. The Basis of Conclusions does not include any reasons for proposing differences in the scope of the different sections compared to IFRS, from which the content of the sections is extracted.

Part of the differences in scope we understand is a consequence of the defined scope of IFRS for SMEs in section 1. However we find that far from all differences in the scope of the SME sections compared to full IFRS can be explained as consequence of this. Furthermore it is not consistent whether the sections in IFRS for SMEs include a scope paragraph or only a definition paragraph.

We believe that it is necessary to clarify the differences in the scope of the sections in IFRS for SMEs and the full IFRSs as a consequence of extracting from IFRSs and to avoid any misunderstandings. We believe such clarifications should be included as part of the Basis of Conclusions. One example is that in contrary to IAS 18 *Revenue* section 22 *Revenue* does not exempt revenue arising from the extraction of minerals ores. We cannot follow the reasoning behind not including the same exemption in section 18 and it is not explained in the Basis of Conclusions.

B – Section 1: Scope

The scope of the exposure-draft is based on the definition of “publicly accountable entities”, the intention being that the scope of this standard be restricted in order not to include “publicly accountable entities”.

1 – "IFRS for SMEs" is not the right label

As acknowledged in the Preface (paragraph 10), many jurisdictions around the world have developed their own definitions of the term SME for a broad range of purposes including prescribing financial reporting obligations. As indicated, those definitions often include quantified criteria. Although the definitions and quantified criteria may vary from a jurisdiction to another, SME seems to be always used in order to refer to the size of entities.

However the "publicly accountable" definition that the IASB uses and which is basic to the scope of this standard does not refer to size in anyway. Publicly and non publicly accountable entities may be small, medium-size, large or extremely large. We therefore believe that the IASB ought to revisit the labelling, as the existing labelling –SMEs – refers to a notion very different from what the definition of publicly accountability intends to capture. As such, it is somewhat misleading and has already led to numerous misunderstandings in various discussions that have taken place on this issue.

We therefore recommend that the IASB adopts for this standard a label more descriptive of the scope of the standard. Although we do not find a negative labelling very attractive, we would suggest "IFRS for NPAEs" (IFRS for non-publicly accountable entities) to be adopted in replacement for "IFRS for SMEs", as had been briefly envisaged in 2005 (BC53-54). We disagree that the way the IASCF objectives have been restated make it necessary for the IASB to stick to the "for SMEs" label. IASB, we believe, should give priority to promoting a clear understanding of the scope of this standard.

2 – The notion of "fiduciary capacity" needs either to be explained or to be replaced

In addition to listed entities, the scope excludes entities that "hold assets in a fiduciary capacity for a broad group of outsiders".

We understand from the basis for conclusions (BC36) that this description intends to exclude banks and insurance companies and other similar entities. On the basis of that understanding, we support the definition of public accountability as proposed by the IASB.

However there appears to be a lack of common understanding of what "fiduciary capacity" should encompass and the potential difficulty that this choice of terms may raise in translation. Also native English speakers describe "fiduciary capacity" as some form of management of assets on behalf of others, i.e. assets which would neither be accounted for as the entity's own assets, nor generate liabilities of the entity to a broad group of outsiders. We therefore recommend that an explanatory definition be included in the glossary or another description be given, in order to avoid any misunderstanding of the definition of public accountability. Hence all jurisdictions will clearly understand for what type of entities the standard has been intended.

3 – Leaving a lot of freedom to jurisdictions is likely to make the standard as useful as possible

In our response to the first discussion paper, we had also stressed that as much freedom as possible should be left to jurisdictions in defining what entities should be allowed to use IFRS for SMEs. We are pleased to note that these comments have been fully taken into account as reflected in BC33 -44.

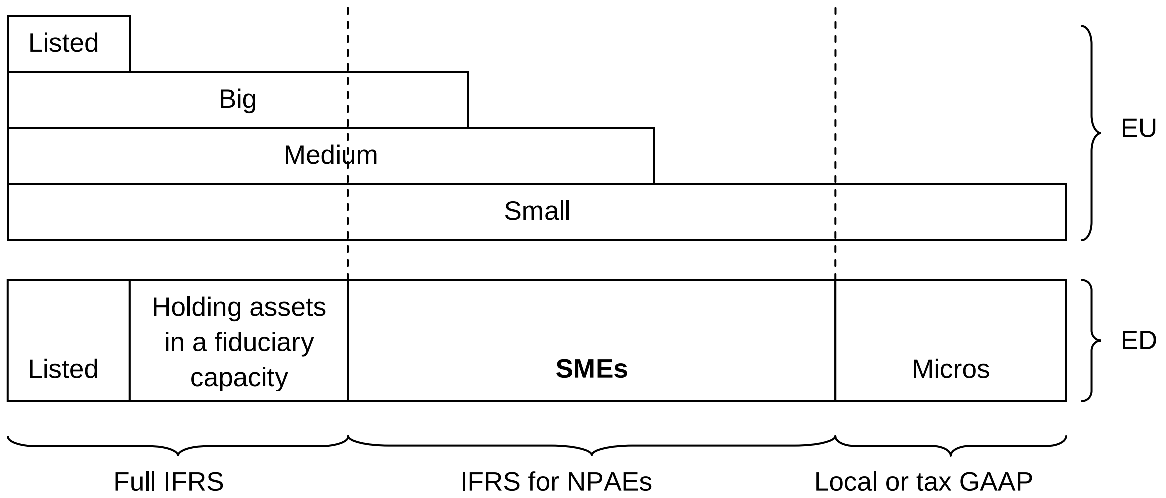
4 – No link ought to be established between the scope and the conformity with the "IFRS for SMEs"

Conformity with a standard or a set of standards in the usual acceptance indicates that all accounting and disclosing requirements included in the standard(s) have been appropriately satisfied. We therefore believe that whether financial statements are "in conformity with the IFRS for SMEs" is not dependent on the nature or the structure of the entity.

As a consequence we believe that the condition set in par 1.3 should be removed. The definition of public accountability is helpful in conveying to jurisdictions that the IFRS for SMEs has been intended for non publicly accountable entities. In order to adequately draw the attention of users, publicly accountable entities may be required to disclose that although they are publicly accountable they apply the IFRS for SMEs in accordance with the legal requirements of their jurisdictions. However it shouldn't preclude them from declaring their financial statements in conformity with the IFRS for SMEs when indeed they are in conformity with the standard.

5 – Size is definitely not a relevant criterion in assessing the applicability of the IFRS for SMEs and every reference to size ought to be removed.

We illustrate below the potential scope of IFRS for SMEs as it could apply in the European context.



As shown on the above illustration, a great variety of entities, ranging from rather large private-equity entities to micro-entities are scoped in the standard. As indicated above, we agree with the IASB that leaving individual jurisdictions decide for themselves to what entities IFRS for SMEs ought to apply is consistent with a principle based approach to standard setting.

In our view, full IFRS should not be required for non publicly accountable entities whatever their size. Large entities, on one side of the spectrum, may at some stage in their development, decide to opt for full IFRS for example in order to be comparable to some of their competitors who are listed companies and report under IFRS, or because they enter into very sophisticated transactions that, in their view, would be best accounted for under IFRS, or because some of the users of their financial reporting (banks or rating agencies) require it. Until such circumstances arise, the IFRS for SMEs is likely to adequately serve their financial statement users' needs.

On the other side of the spectrum, jurisdictions may decide to exempt very small entities from issuing general purpose financial statements, altogether, or to derive from the IFRS for SMEs a further simplified set of accounting standards applicable to micros, that they would publish as their national GAAP for micros. At this end of the spectrum, such decisions may be made on very stringent cost/benefit trade-offs.

For these reasons, we believe that the IFRS for SMEs is likely to be suitable for indeed quite a large range of entities. Indeed cost of financial reporting need not be increased just because larger entities would be able to afford it, although there would be no specific user need identified.

Consequently, we believe the IASB should refrain from mentioning any reference to size. Although we understand the need for IASB members to relate to some practical representation of the entities for which they are setting standards, we believe that the reference to 50 employees should be eliminated from the basis for conclusions:

(a) differences from IFRS are to be derived primarily from different users' needs (see our analysis below) and/or in order to satisfy a more stringent cost/benefit constraint; the reference to 50 employees brings the focus back to size criteria instead of concentrating on what needs to make financial reporting different;

(b) there is no further reference to that criterion in the basis for conclusions, to assert the relevance of the reference;

(c) a number of employees is not, in itself, a relevant depiction of complexity or of economic significance; some labour intensive manufacturing entities, for example, may employ many more people although their operations do not require them to enter sophisticated transactions, whereas some capital venture entities may employ a very small number of employees and still require quite sophisticated financial reporting;

(d) 50 employee may vary in significance from one economic environment to the next; therefore no reference to a specific size is relevant, for the same reasons that the IASB excluded setting defined size criteria.

6 – Is the supplementary criterion (publication of general purpose financial statements) useful?

We do not believe that whether an entity publishes general purpose financial statements determines whether it is an "SME (SME)". We therefore recommend the second criterion in the definition of SME (SME) to be removed (par 1.1 b)).

We believe however that this section of the standard could include reference to the publication of general purpose financial statements, indicating, for example, that "this standard has primarily been designed for the preparation of general purpose financial statements".

C – Section 2: Concepts and pervasive principles

1 – Objectives of financial statements of SMEs, qualitative characteristics, definitions of elements and recognition criteria

EFRAG welcomes the full IFRS framework as the conceptual basis for the IFRS for SMEs.

Decision usefulness is one main objective of financial statements of SMEs. EFRAG also believes that, beyond that objective, financial statements must also show the results of management's stewardship of the resources entrusted to it. However decision usefulness is very dependent on who the users are, how they work, how they are organised, how sophisticated they are. As a result, accounting requirements decided in the context of listed entities may meet the objective of decision usefulness for these entities and yet not be suitable for users of SMEs.

SMEs financial statements should, EFRAG agrees, meet the qualitative characteristics described in section 2: understandability, relevance, reliability and comparability. EFRAG believes that sub-characteristics such as materiality, timeliness, substance over form, prudence, completeness and balance between benefit and cost should be shown as such. Also EFRAG believes that neutrality should not have been eliminated as it ought to apply to financial statements of SMEs as it applies to financial statements of other entities. However there again the analysis of who the users are should guide what type of accounting requirements will ensure that these qualitative characteristics are met in an SME environment. For example, understandability which refers to "reasonably knowledgeable users" should be met for users who are "reasonably knowledgeable" in an SME environment.

Consistently with its first sets of comments in answer to IASB DPs on SMEs, EFRAG believes that the IFRS for SMEs should be based on the same definition of elements as in full IFRS. EFRAG also approves of the two recognition criteria, based on probability and reliability, which are particularly important to SMEs. Keeping that level of consistency with full IFRS is necessary for having the IFRS for SMEs playing a significant role in serving the IASCFobjectives appropriately.

In EFRAG's supplementary comments to invitations to comment in Attachment 1, EFRAG has described how EFRAG believes users' needs in an SME context may differ from users in a listed entity context. In its response to the IASB questionnaire on simplifications in recognition and measurement, EFRAG had already described, how in its view, users' needs might differ. EFRAG had also stressed how it was essential in order to assess the relevance of the IFRS for SMEs that a specific analysis of users' needs be conducted. EFRAG believes that in the absence of such an analysis setting the objective as is done in section 2 of the IFRS for SMEs is meaningless.

2 – Measurement Pervasive Principles

EFRAG welcomes the introduction of measurement pervasive principles as part of the IFRS for SMEs. Measurement pervasive principles are indeed necessary to have the IFRS for SMEs as a stand-alone document. EFRAG agrees with, and commends the IASB for, having designed the hierarchy as described in paragraph 10.3 of the draft standard.

Nonetheless to be truly useful and best serve the consistency of financial reporting in accordance with the IFRS for SMEs, measurement pervasive principles must be clear and applicable to all transactions which are not specifically covered in sections of the IFRS for SMEs. EFRAG is concerned that the IASB has rather listed some examples of existing measurement requirements, hence suggesting that the hierarchy does no better than working by analogy. We believe that pervasive principles must be drawn in order to be fully workable.

Having in mind that measurement pervasive principles apply to assets and liabilities not specifically addressed in the present draft standard, EFRAG's recommends the following changes. Measurement pervasive principles should be limited to the following:

(a) All assets and liabilities to be accounted for at cost at initial recognition;

(b) all liabilities to be accounted for at cost or amortised cost or discounted current settlement value subsequently;

(c) all assets to be accounted for applying the cost or revaluation model subsequently. How to apply the cost and revaluation models, and how to select one or the other model should be developed in appropriate sections of an appendix of the IFRS for SMEs, as application guidance of the standard. (Please refer to our Illustrative example in Attachment 3 (appendix 3 – AG1).

The rationale for these recommendations is explained in Attachment 3, appendix 4 to this letter (Basis for our conclusions on measurement).

D – Sections 3 to 8: Presentation of financial statements

Overall EFRAG agree with the sections on presentation of financial statements. Several comments arise however from comments made on recognition and measurement requirements:

(a) distinction between revalued assets and assets carried at cost should be made in the balance sheet (please refer to our answer to question 2 – paragraph 8);

(b) changes in value of assets carried at current value ought to be shown in the income statement separately from other gains and losses, as part of profit and loss (please refer to our answer to question 2 – paragraph 8);

(c) some other changes shouldn't, in EFRAG's view, be presented as part of profit and loss: they include actuarial gains and losses arising from a change in a net defined benefit obligation, changes in value of cash flow hedging instruments and foreign currency exchange differences (please refer to our comments in the relevant sections below); EFRAG suggests that these items be systematically presented in a SORIE, and be presented in a separate category of equity. Recycling of cash flow hedges need also to be dealt with in the presentation section dealing with the income statement and the statement of changes in equity;

(d) EFRAG has not yet dealt with disclosures. Comments, if any, are still to come.

E – Section 9: Consolidated Financial Statements and separate financial statements

1 – Supportive of requirement to prepare consolidated financial statements

EFRAG agrees with the IASB that SMEs should be required to prepare consolidated financial statements.

2 – Supportive of one single accounting policy for all investments in subsidiaries, jointly controlled entities and associates in the separate financial statements

Paragraph 9.18 requires a parent to adopt a policy of accounting for all of its investments in subsidiaries, jointly controlled entities and associates either at cost or at fair value through profit and loss in its separate financial statements. We support that the entity has to apply the same measurement method for all these investments and not only for each category of investments. We furthermore support the option to apply either cost or fair value (or rather either cost or current value as we believe fair value should be replaced with current value –

please refer to our answer to question 2 paragraph 8) through profit and loss when measuring the investments in the separate financial statements.

3 – Proposal to limit the measurement principles to cost or fair value only for both jointly controlled entities and investments in associates in the consolidated financial statements (Section 13 and 14)

In BC83 it is argued that many preparers of SME's financial statements questioned the usefulness of measuring its investment in associates by using the equity method and the usefulness of measuring its investment in jointly controlled entities by either using the equity method or proportionate consolidation. The preparers had expressed that they have particular difficulty applying these methods because of inability to obtain the required information and the need to conform accounting principles and reporting dates. We support allowing cost or fair value (or rather cost or current value – as we believe fair value should be replaced with current value – please refer to our answer to question 2 paragraph 8) to be applied in the consolidated financial statements for both investments in associates and jointly controlled entities. However this allow 3 options (cost, equity and fair value) for subsequent measurement of investments in associates and 4 options (cost, equity, proportionate consolidation and fair value) for subsequent measurement of investments in jointly controlled entities in the consolidated financial statements. Based on the arguments in BC83 to allow cost or fair value to be applied we believe the measurement principles could be simplified by only allowing cost and fair value as measurement principles in the consolidated financial statements, which are the ones to be applied in the entity's separate financial statements in paragraph 9.18 for such investments.

4 – Elimination of cross-reference to IAS 28 Investments in Associates and IAS 31 Interests in Joint Ventures (Section 13 and 14)

Section 13 and 14 include cross references to IAS 28 for application of the equity method and IAS 31 for application of proportionate consolidation. As mentioned in our answer to question 1 of the invitaiton to comment we believe that this Standard needs to be a stand alone document, which means the cross-references to IAS 28 and IAS 31 should be eliminated and the necessary requirements should be included in the section itself or as proposed, (please refer to our restructuring and redrafting proposals), in a guidance section dealing with group accounting.

Of course if our suggestion to simplify the measurement principles is adopted the need for this cross-reference is eliminated.

5 – Comments on drafting

The structure of the SME sections is that most definitions are included in the glossary. However a definition or explanation of the cost model is neither included in the glossary nor in section 9. Such definition is needed to clarify how to account for income from an investment in a subsidiary, when applying the cost model in the separate financial statements. Both section 13 *Investments in Associates* and section 14 *Investments in Joint Ventures* include explanation of the applications of the cost model in details in paragraph 13.4 and 14.9. We believe a similar explanation of the applications of the cost model is necessary to help accounting for investments in the separate financial statements. Our restructuring and redrafting proposals (to form a section dealing with group accounting, which means including sections 9, 13, 14 and 18 and some other relevant extracts (intangible assets purchased in business combinations, foreign currency requirements applicable to consolidation) in one section), repetitions of definitions would be avoided and the comment on drafting solved.

We believe it needs to be clarified that the accounting of investments in jointly controlled entities in section 14 *Investments in joint ventures* and the accounting in section 13 *Investments in Associates* only apply to the accounting in the consolidated financial statements. Whereas section 9 *Consolidated and Separate Financial Statements* apply for the accounting of these in the separate financial statements. We believe this is needed because different measurement principles are to be applied in respectively section 13/14 and section 19 for such investments. This comment would be solved if our proposals for restructuring and redrafting the standard were applied (one single section on group accounting).

F – Section 10: Accounting Policies, Estimates and Errors

1 – Too burdensome to require SMEs to change its accounting policy in accordance with the transitional provisions of full IFRS, if an amendment is made

Paragraph 10.9b requires that when the IFRS for SMEs requires or permits an entity to follow the requirement of afull IFRS and the requirement of that IFRS change, the entity shall account for that change in accounting policy in accordance with the transitional provisions, if any, specified in that IFRS. The requirement in paragraph 10.9b is a consequence of the use of cross-references to the full IFRSs in the IFRS for SMEs. Application of paragraph 10.9b means that *any* amendment to an IFRS in full IFRS that is applied via a cross-reference has to be applied by SMEs. EFRAG believes this will be very burdensome for the SMEs as it means that SMEs have to be up-dated on all amendments to both the full IFRSs and the IFRSs for SMEs just because they choose to apply an option that is available by a cross-reference to full IFRS. This underlines the importance of that the IFRSs for SMEs need to be a standalone document. We refer to our answer to question 1 in the invitation to comment.

2 – Comments on drafting

EFRAG supports retrospective application for changes in accounting policy. However we believe that part of the wording of paragraph 10.10 needs to be changed. The paragraph as it stands requires the entity when it is impracticable to determine the individual period effects of changing an accounting policy for one or more prior periods presented, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.

This means that both the credit and the debit adjustments are recognised in equity. We believe that the correct wording is that one adjustment is made to each affected component of equity and the other adjustment is to the carrying amount of assets or liabilities.

G – Section 11: Financial assets and financial liabilities

Please refer to our answer to question 2 (paragraph 1) in the invitation to comment.

H – Section 12: Inventories

We have no comment to this section.

I – Section 13: Investment in associates and 14: Investment in Joint Ventures

Our comments on section 13 and 14 are included in the comments to Section 9 *Consolidated and Separate Financial Statements* to which we refer.

J – Section 15: Investment property

1 – Guidance on accounting of lease transactions which are in the scope of the section is not sufficient

According to section 19 Leases, section 15 applies for "property held by lessees that is accounted for as investment property" and "investment property provided by lessors under operating leases".

(a) Property held by lessees that is accounted for as investment property – the financial statements of the lessee

Section 15 does not provide further guidance on the accounting of "property held by lessees that is accounted for as investment property", except from saying in paragraph 15.2 "that a property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model for that property and for all of its other property classified as investment property". We also refer to our comments on scope to section 19 in paragraph M below.

We believe the option to account for a property interest that is held by a lessee under an operating lease as an investment property add unnecessary complexity to section 15 Investment property and section 19 Leases. We find that the option should not be part of the IFRS for SMEs. If nonetheless the IFRS for SMEs continues allowing a property interest that is held by a lessee under an operating lease to be classified and accounted for as investment property, more detailed guidance needs to be provided in section 15 Investment Property.

(b) Investment property provided by lessors under operating leases – the financial statements of the lessor

We agree that the measurements principles in section 15 should apply for "investments property provided by lessors under operating leases". However section 15 only provides guidance on the basis of measurement of the investment property, it does not provide any guidance in respect of other aspects of the accounting of operating leases in the financial statements of the lessors. We therefore believe these transactions should only be scoped out of section 19 in relation to measurement of the investment property and for all others aspects of the accounting of the lease transactions section 19 should apply.

We believe this inconsistency between section 15 and 19 needs to be removed.

2 – Elimination of cross-reference to IAS 40 *Investment Property*

The section includes a cross reference to IAS 40 for application of the fair value model. As explained in our answer to question 1 in the invitation to comment, we believe that this Standard needs to be a stand alone document, which means the cross-reference to IAS 40 should be eliminated and the necessary requirements should be included in the section itself or as proposed in our alternative structure in Attachment 3 (appendix 1 and 2) to this letter, which is dealing with accounting principles for non-financial assets and application guidance on measurement of non-financial assets.

K – Section 16: Property, Plant and Equipment

1 – Both the cost model and revaluation model should be retained as subsequent measurement

EFRAG supports that proposal that both the cost model and revaluation model should be retained for SMEs for Property, Plant and Equipment. However we believe that the models should no longer be optional but mandatory when certain criteria are fulfilled. This approach is illustrated in Attachment 3 (appendix 3) of this letter. We refer to our basis for recommendations provided in paragraph 8 of our answer to question 2 in the invitation to comment.

2 – Comments on drafting

Section 16 does not include the recognition criteria to determine whether to recognise a property, plant and equipment. The reasoning may be that the recognition criteria to apply are the general recognition criteria in paragraph 2.24. However this is not consistent with the approach adopted in paragraph 17.2 *Intangible Assets other than Goodwill*, where the recognition criteria are repeated even though a reference is made to paragraph 2.24. The use of references back to the pervasive principles of section 2 should be used consistent in the sections. Our drafting proposals, as illustrated in Attachment 3, appendix 2, solve this type of issue.

L – Section 17: Intangible Assets other than Goodwill

1 – All intangible assets (including goodwill) should be accounted for as assets with a finite life and be amortised

Please refer to our answer to question 2 (paragraph 4) in the invitation to comment.

2 – Supportive of the expense model

EFRAG agrees that SMEs should be allowed to expense costs incurred in both research and development activities when incurred. We support this because we believe users do not need internally-generated intangible assets to be capitalized in order to assess the entity's ability to pay its liabilities in the short- and medium-term. Furthermore it eases the burden for the preparers who would no longer have to demonstrate whether the recognition criteria have been met or not. We agree with the proposal in paragraph 34 that the option to apply the expense model for development costs should be supported by disclosure of the aggregate amount of research and development costs recognised as an expense during the period.

3 – The revaluation model should not be retained for intangible assets

EFRAG believes that the revaluation model for intangible assets should not be retained for SMEs. We believe the option to apply the revaluation is rarely used by listed entities, why we believe it will be uncommon for SMEs to apply this option.

4 – Emphasise that internally generated goodwill shall not be recognised

The SME standard should emphasise that internally generated goodwill shall not be recognised as an asset. Please refer to our illustrative example in Attachment 3, appendix 2.

M – Section 18: Business Combination and goodwill

1 – The requirement to allocate the cost of the business combination to contingent liabilities should be eliminated

EFRAG agrees that all business combinations shall be accounted for by applying the purchase method. However we suggest simplifying the method for allocating the cost of a business combination by eliminating the requirement to allocate contingent liabilities. Indeed recognising these liabilities would be inconsistent with the recognition criteria in section 2.

N – Section 19: Leases

1 – Assets and liabilities in a finance lease should be measured at an amount equal to the present value of the minimum lease payments and not fair value

Please refer to our answer to question 2 (paragraph 3) in the invitation to comment.

2 – Some change to the scope is needed

Paragraph 1 (c) and (d) of section 19 exempt "property held by lessees that is accounted for as investment property" and "investment property provided by lessors under operating leases" from the scope of the section. For both exemptions there is a reference to section 15 *Investment Property*. Accordingly section 15 should apply for such lease transactions. As mentioned in our comments to section 15 we do not find that section 15 provide sufficient guidance on the accounting of these 2 exemptions.

Furthermore we believe that the transactions should only be exempted in relation to the basis of measurement as we believe that the remaining requirements in section 19 apply for these transactions.

In the way we interpret paragraph 16 of section 19 (see next paragraph) we basically believe that as a consequence of paragraph 16 section 15 *Investment Property* will apply as basis of measurement of "investment property provided by lessors under operating lease" **without** exempting these transactions from the scope of section 19. This means that exemption (d) in paragraph 1 is not necessary in our opinion. We believe proper justification needs to be provided in the basis of conclusion if these scope exemptions are to be retained.

As mentioned in our comments to section 15 we believe that the option to account for a property interest that is held by a lessee under an operating lease as an investment property should be deleted.

3 – Our interpretation of paragraph 16 of section 19 – the financial statements of the lessors – operating lease

We question the requirement in paragraph 16 of section 19, which says that a lessor "shall present assets subject to operating leases in its balance sheet in accordance with the nature of the assets". Our interpretation of paragraph 16 is that it means that for example if the lessor leases out a tangible assets under an operating lease – the tangible asset is recognised and measured in the financial statements of the lessors (operating lease) in accordance with the requirements of section 16 *Property, Plant and Equipment* and for an investment property section 15 *Investment Property* is to be applied to recognise and measure the investment property etc.

We suggest expanding the meaning of paragraph 16 to avoid misinterpretation.

4 – Elimination of cross-reference to IAS 17 *Leases*

The section includes a cross reference to IAS 17 for the accounting of finance lease in the financial statements of the lessor. As explained in our answer to question 1 in the invitation to comment, we believe that this Standard needs to be a stand alone document, which means the cross-reference to IAS 17 should be eliminated and the necessary requirements should be included in the standard.

Our understanding indeed is that lessors are not necessarily publicly accountable entities, as their loans may be financed without raising funds from the public. As indicated in our comments on section 1 above (Scope), we however have not a full understanding of what exactly “fiduciary capacity” means.

5 – Comments on drafting

In accordance with paragraph 19.11 a lessee will be required to depreciate an asset leased under a finance lease in accordance with section 16 *Property, Plant and Equipment.* A reference to section 17 “Intangible Assets”, in case of a finance lease of an intangible asset, is missing.

The subsequent measurement principles (paragraph 19.9-19.11) regarding the accounting for finance lease in the financial statements of a lessee do not include any reference to section 26 *Impairment of Assets* for determining whether the leased asset has become impaired. We believe such reference should be included as part of the measurement principles.

We have proposed in our answer to question 2 (paragraph 8) of the invitation to comment to have an application guidance on measurement of non-financial assets. We believe that paragraph 19.11 could be replaced with a paragraph referring to the accounting requirements for non-financial assets, stating that following initial recognition, the asset is being recognized and presented as it would be, had the ownership rights been purchased. The guidance includes the accounting of impairment. By doing this our comments above is solved and repetition is avoided. Here again our recommendations on drafting solve this type of issue.

O – Section 20: Provisions and Contingencies

1 – No liability arising from executory contracts should be recognised

In the exposure draft, no mention is made of executory contracts. We believe that this mention is missing, as no liability arising from executory contracts ought to be recognised, unless the contract is onerous.

2 – Other comments

We agree with section 20 measurement requirement’s focus on settlement, as we believe that provisions and contingencies are hardly ever transferable. We suggest that par 20.8 be written “at the best estimate **at the reporting date** of the amount required to settle the obligation” (to make it clear that the best estimate reflects current economic conditions at the reporting date and NOT a settlement scenario at the reporting date).

P – Section 21: Equity

1 – Missing or outsourced definitions make the section difficult to read

EFRAG has the view, that this section is difficult to understand for users and preparers of SME's financial statements, primarily because the core material from which it is drawn (ie IAS 32) is also confusing. EFRAG reaches the conclusion that, bearing in mind the definition of a financial liability in the glossary of the ED, there are no simplifications regarding the accounting of equity for an SME. EFRAG thinks the section would be easier to read were "equity shares" to be defined and were a reference to financial liabilities included in section 21 to avoid misunderstandings of the meaning of equity.

2 – Definition of financial liabilities leads to doubtful or no distinction between equity and liability

In EFRAG's view, the IASB did not take into account the different company laws SMEs might have to follow compared to listed companies. E.g. partnerships and cooperatives are quite common legal forms for SMEs. In some European legal environments, especially (but not only) for this types of entities the current definition of financial liabilities might not give a true and fair view of the financial position of the entity. This is, because the members in these legal forms often have individual rights (e.g. a right to put the share back to the entity due to the shares not being tradable at all). The current distinction is based on liabilities; liabilities being certain obligations which are being defined as individual rights, the exercise of which potentially leading to an outflow of resources the entity cannot avoid. Thus, in every legal form in which membership is associated with individual rights, the entity will only present liabilities, no equity. This presentation, in our view, does not properly reflect the economic situation.

We are also concerned that the acceptance and the willingness to apply the IFRS for SMEs in Europe will be significantly reduced if these SMEs do not find their economic situation reflected properly. We think that an entity will be very reluctant to apply the IFRS for SMEs if - due to its legal form - the standard does not allow them to represent equity in an appropriate way.

This, in EFRAG's view, justifies that an exception be made to the definition of liabilities in section 2 of the ED (or an exception to equity being defined as the residual interest in the assets of the entity after deducting all its liabilities). Indeed, EFRAG believes that the conceptual basis of the IFRS for SMEs should remain consistent with the IFRS framework. The change to be made should be similar, but not limited to, what the IASB is considering for full IFRS.

3 – Other comments

EFRAG agrees with the principles in section 21 that an entity should measure the equity at the fair value of the cash or other resources received or receivable, net of direct costs of issuing the equity shares.

EFRAG agrees to the accounting treatments for compound financial instruments and that an SME shall deduct the fair value of the consideration given for treasury shares from equity.

Furthermore we disagree with the accounting principles for minority interest transactions in shares of a consolidated subsidiary set out in paragraph 21.11 for the same reasons we disagree with the proposed amendments to IAS 27, as explained in detail in our letter of comments dated November 28, 2005.

Q – Section 22: Revenue

1 – Comments on drafting

We believe that as a consequence of including revenue from constructions contracts in the scope of section 22, revenue from construction contracts should be listed as transactions being in the scope of section 22 in paragraph 1. To follow the structure of the section we support having it as a separate caption. However we suggest that this caption immediately follows the caption dealing with rendering of services.

2 – Guidance on the elements of contract revenue and contract cost are not included in the ED

We believe some guidance is needed. We refer to our illustrative example set out in Attachment 3, appendix 3. Were our drafting recommendations followed, accounting for the cost of contracts could be referred to the guidance dealing with costs of inventories.

The illustrative examples in section 22 should include examples of both construction contracts and other revenue transactions covered by the section.

R – Section 23 Government Grants

As already mentioned in our answer to question 4 in the invitation to comment we believe the SMEs model for government grants is satisfactory and the option to revert to IAS 20 should be deleted. The only argument to find in Basis for Conclusions for permitting the use of the other methods permitted by IAS 20 Accounting for Government Grants is that all options should be available in the IFRS for SMEs as jurisdictions can remove options. We believe that the IFRS for SMEs model justify the user's needs and is easy to understand and implement for SMEs.

S – Section 24 Borrowing Cost

Please refer to our answer to question 5 in the invitation to comment.

T – Section 25: Share-based payments

1 – Equity settled share-based payment transactions should trigger disclosure only

Please refer to our answer to question 3 (paragraph 1) in the invitation to comment.

2 – Measurement of liabilities incurred in a cash-settled share-based payment transaction should be simplified

Please refer to our answer to question 3 (paragraph 2) in the invitation to comment.

3 – Transfer of equity instruments within the group

It is useful to underline the fact that section 25 also applies to transfers of equity instruments of the entity's parent, or equity instruments of another entity in the same group as the entity, to parties that have supplied goods or services to the entity.

U – Section 26: Impairment of Non-financial Assets

1 – Changes made to impairment requirements lack relevance and remain burdensome for goodwill

Please refer to our answer to question 2 in the invitation to comment.

2 – Comments on drafting

EFRAG finds that the heading “Impairment of non-financial assets other then inventories” is not correct as the investor in associates shall in accordance with paragraph 13.4 of section 13 *Associates* recognise impairment in accordance with section 26. Similar reference to section 26 is to find in paragraph 14.9 in section 14 *Joint Ventures*. This means that impairment of some financial assets is covered by section 26 or at least the same principles are applied.

Paragraph 26.12 requires that an entity shall recognise an impairment loss immediately in profit and loss. As long as an entity can apply the revaluation model for both tangible assets and intangible assets the following sentence needs to be added: “unless the asset is carried at revalued amount in accordance with the revaluation model in section 16 *‘Property, Plant and Equipment* and 17 *“Intangible Assets other than Goodwill”*.

V – Section 27: Employee Benefits

EFRAG’s main comments on this section deal with unrecognised actuarial gains and losses and past service costs which are not mentioned in Sec. 27.15 in particular when it comes to measurement of a defined benefit liability.

1 – Presentation of actuarial gains and losses in the income statement

The so called corridor approach is not being made available to SMEs, as Sec. 27.21 and 27.22(d) ask for immediate recognition of all actuarial gains and losses. EFRAG agrees that this will mean a simplification for SMEs and EFRAG supports this. However, in EFRAG’s view this raises an issue of presentation, as actuarial gains and losses, which reflect changes in very long-term that in EFRAG’s view ought to be presented in a SORIE. (Please see our comment on section 5 above).

2 – Treatment of unvested past service costs is not clear

Another effect might be that Sec. 27 asks for immediate recognition of all (vested and unvested) past service costs. EFRAG is concerned about the wording in Sec. 27.19 which says that changes in a defined plan should be reflected by increasing or decreasing the defined benefit liability. The increase or decrease should be recognised as income or expense.

EFRAG suggest that the wording of Sec. 27 should be clarified regarding whether the term “defined benefit liability” in Sec. 27.19 also covers unvested past service costs. If this is the intention of Sec. 27, EFRAG will disagree. In EFRAG’s view unvested past service costs should be recognised as an expense on a straight-line basis over the average period until the benefits become vested.

W – Section 28: Income Taxes

1 – Offsetting principles are missing for current taxes

Regarding current taxes, the recognition and measurement principles of the ED and IAS 12 (no reference to IAS 12 should be made?) are the same. EFRAG generally supports that approach, although it also wants some principles added regarding the presentation of current income taxes because the ED does not contain any offsetting principles.

2 – EFRAG supports temporary approach for deferred taxes

Regarding deferred taxes EFRAG wants to refer back to its answer to the IASB Questionnaire, and welcomes the approach in the ED. EFRAG is in favour of SMEs being required to use the temporary approach for deferred taxes, rather than a modified timing difference approach.

EFRAG agrees with the ED that deferred taxes should be recognised on book/tax basis differences that arise in business combinations or on the initial recognition of an asset or liability.

Furthermore EFRAG supports the ED's view, which is that for unused tax loss carry-forwards and tax credit carry-forwards tax assets should be recognised like for deductible temporary differences.

Questions to EFRAG constituents:

Transactions that do not affect accounting or taxable profit on the initial recognition

Different from IAS 12.15(b) and 12.24(b) Sec. 28.15 and 28.16(a) allow an SME to recognise deferred tax asset and liabilities for all temporary differences arising on the initial recognition of an asset or liability outside a business combinations regardless whether the transactions at that time affects accounting or taxable profit.

1. Do constituents think this is appropriate ?

2. Does this cause any problems considering your national tax environment ?

General simplification of deferred taxes

3. Do you have proposals to further simplify deferred tax accounting ?

X – Section 29: Financial Reporting in Hyperinflationary Economies

1 – Accounting of hyperinflationary economies needs to be included in the standard and cross-reference to full IFRS should be deleted

Please refer to our answer to question 1 in the invitation to comment.

Y – Section 30: Foreign Currency Translation

1 – Relevant requirements related to hyperinflationary currencies should be included in the standard and cross-reference to full IFRS should be deleted

Please refer to our answer to question 1 in the invitation to comment.

Z – Section 31: Segment Reporting

1 – Delete section 31 from IFRS for SMEs

Please refer to our answer to question 1 in the invitation to comment.

AA – Section 32: Events after the end of the Reporting Period

1 – Clarification of the requirement to update disclosure about conditions at the balance sheet date

Clarification is needed in section 32 so that it is clearly understood that disclosures in the financial statements need to reflect information received after the balance sheet date, even when the information does not affect the amount that is recognised in the financial statements.

BB – Section 33: Related Party Disclosure

This section will be dealt with as part of EFRAG's work on disclosures.

CC – Section 34: Earnings per share

1 – Delete section 33 from IFRS for SMEs

Please refer to our answer to question 1 of the invitation to comment.

DD – Section 35: Specialised Industries

1 – Agriculture: Cross-reference to full IFRS should be deleted and the accounting of agriculture should be scoped in non-financial assets

Paragraph 35.1 requires that if an entity applies the fair value model for its biological assets it shall apply the fair value model in IAS 41 *Agriculture*. As mentioned in our answer to question 1 of the invitation to comment we believe that this Standard needs to be a stand alone document, which means the cross-reference to IAS 41 should be eliminated. In addition we believe this cross-reference is unnecessary. Please refer to our answer to question 2 (paragraph 8: "generalise cost or current value choice for all non-financial assets").

2 – No need to explain that insurance is not in the scope of the IFRS for SMEs

We believe there is not need to include a paragraph explaining the reasoning behind that insurance is not part of the IFRS for SMEs as the scope of the IFRS for SMEs is dealt with in section 1.

3 – Extractive Industries should be scoped in in other sections

We believe it is not necessary to deal with the accounting of in extractive industries in a separate section. The accounting should be in the scope of the sections to which paragraph 35.2 already refers.

EE – Section 36: Discontinued Operations and Assets held for sale

Please refer to paragraphs 5 and 6 in our answer to question 2 in the invitation to comment.

FF – Section 37: Interim Financial Reporting

1 – Delete section 37 from IFRS for SMEs

Please refer to our answer to question 1 in the invitation to comment.

GG – Section 38: Transition on the IFRS for SMEs

Please refer to our answer to question 10 of the invitation to comment.

EFRAG
European Financial Reporting Advisory Group

Attachment 3: Proposal and Illustration of an alternative IFRS for SMEs

EFRAG had proposed an alternative structure of the standard to the IASB in our letter dated early 2006. This proposal having had no success, EFRAG has felt it worth illustrating it to show concretely what it could look like. As explained in Attachment 1, EFRAG is of the view that a revised structure, a clearer display and a proper rationalization of accounting requirements can help increase the understandability of the whole document. EFRAG does not believe that doing so preempts future debate and decisions on the evolution of future IFRS. As already explained, this IFRS would be new to the vast majority of entities adopting it, so that departures from existing IFRS should be made if they are likely to improve financial reporting for SMEs (greater understandability, greater relevance, better cost/benefit trade-off).

A – Structure and Guidance

EFRAG thinks that it would be re-organize the ED in sections and sub-sections. For example, sections 3-8, 10, 30, 32 and 24 could be grouped in a section dealing with the preparation and presentation of financial statements. Sections 9, 13, 14 and 18 and some other relevant extracts (intangible assets purchased in business combinations, foreign currency requirements applicable to consolidation) could form a section dealing with group accounting. Sections 12, 16, 17, 24, 26 and 36 could be merged to a section about non-financial assets. Our proposal for a revised structure (with concordance table) is provided as appendix 1 to this attachment.

B – Extract for micro entities

In discussions that EFRAG has had on the issue of IFRS for SMEs, a lot of constituents have voiced that the ED (or what could be guessed of the ED thanks to the regular releases of drafts) reflected a standard that was still much too sophisticated for a great number of small and very small entities. Even if the future standard included the simplifications in form and content that EFRAG suggests, this view would remain shared by a great number of stakeholders.

EFRAG is of the view that it would not be reasonable to be so restrictive in the accounting requirements that the future standard would become unsuitable for medium or medium-large entities. EFRAG is of the view that it would be odd to give precedence to increasing on an international basis the understandability of financial reporting by small and very small entities, while leaving out the medium and medium large entities. Indeed EFRAG is of the view that these entities are more likely to enter into cross-boarder transactions where understandability of financial reporting on an international basis brings most benefits.

EFRAG is also of the view that the great number of small and very small entities should not be left out of this improvement process. EFRAG hence believes that the revised structure that it suggests paves the way for future national/regional set of standards for the smallest entities. Indeed these national/regional GAAP could exclude (because they would not be applicable):

- group accounting requirements;
- accounting for specific transactions or circumstances;
- most if not all options;
- selected disclosures.

It could also substitute more simple financial statements to the requirements in sections 3-8.

EFRAG believes that in helping jurisdictions to best use the IFRS for SMEs, either as the IFRS standard, or as national accounting standards directly extracted from it, IASB would best serve SMEs and SMEs while meeting its objective of unifying accounting practice on an as wide a basis as possible.

Appendix 1: Revised structure

		Revised structure	Current ED
		Preface	Preface
1		Scope	Section 1: scope
2		Understanding the concepts and pervasive principles	Section 2: concepts and pervasive principles
3		Preparing and presenting financial statements	
	3.1	Complying with general presentation requirements	Section 3: Financial statement presentation
	3.2	Presenting the balance sheet	Section 4: Balance sheet
	3.3	Presenting the income statement	Section 5: Income statement, including guidance for discontinued operations
	3.4	Presenting the statement of changes in equity	Section 6: Statement of changes of equity and statement of income and retained earnings
	3.5	Presenting the cash flow statement	Section 7: Cashflow statement
	3.6	Presenting the notes to the financial statements	Section 8: Notes to the financial statements
	3.7	Accounting policies, estimates and errors	Section 10: Accounting policies, estimates and errors
	3.8	Foreign currency translation	Section 30: Foreign currency translation (excl. Requirements in consolidation)
	3.9	Events after the end of the reporting period	Section 32: Events after the end of the reporting period
	3.10	Related party transactions	Section 24: Related party transactions
4		Recognising and measuring assets and liabilities	
	4.1	Accounting for non-financial assets	
	4.1.1	General requirements	Sections 12, 15, 16, 17
	4.1.2	Additional requirement specific to the recognition of intangible assets	Extract from section 17
	4.1.3	Accounting for leases by lessees	Extract from section 19 (Lessee)
	4.2	Accounting for provisions and contingencies	
	4.3	Accounting for employee benefit liabilities	DB Plans excluded
	4.3	Accounting for financial instruments	
		Accounting for leases by lessors	Extract from section 19 (Lessor)
	4.4	Accounting for income tax	
5		Identifying and accounting for equity	Section 21: Equity
6		Recognising revenue	
	6.1	General requirements for sale of goods, rendering of services, interest, royalties and dividends	Section 22: Revenue
	6.2	Specific requirements for government grants	Section 23: Government grants
7		Group accounting	
	7.1	Consolidated and separate financial statements	Section 9: consolidated and separate financial statements
	7.2	Investments in Associates	Section 13: investments in Associates
	7.3	Investments in Joint Ventures	Section 14: Investments in Joint Ventures
	7.4	Business Combinations and goodwill	Section 18: Business combination and goodwill + section 26+ section 17 relevant for goodwill and intangible acquired in a BC
	7.5	Foreign currency translation	Extracts from Section 30 relevant in consolidation
8		Accounting for specific transactions or circumstances	
	8.1	Share-based payments	Section 25: Share based payment - intrinsic value only

8.2	Post employment benefits	Section 27: Employee benefits -DB plans
8.3	Financial reporting in hyper-inflationary economies	Section 29: including relevant extracts of IAS 29
8.4	Transition to the IFRS for NPAEs	Section 38: Transition to the IFRS for NPAEs

Glossary

Disclosure check-list

AG Application guidance

AG1	How to apply the cost and revaluation models to non-financial assets	Sections 12, 15, 16, 17, 24 and IAS 23, 26 and IAS 36
AG2	How to apply the capitalisation model to internally generated intangible assets	Section 17 and IAS 38

IE Implementation guidance

IE1	How to select between the cost and revaluation model for non-financial assets
IE2	Illustrative financial individual statements
IE3	Illustrative financial consolidated statements

The following sections have been eliminated

Segment reporting	not needed
Interim reporting	not needed
Earnings per share	not needed
Specialised industries	not needed

The following sections are included in others

Borrowing costs
Impairment of non financial assets
Leases

Appendix 2: Accounting principles for non-financial assets

A – Accounting requirements applying to all non financial assets

Scope

1 Non-financial assets include property, plant and equipment, intangible assets, investment property and inventories. These assets can be either owned by the entity or carried by the entity under finance leases.

2 PROPERTY, PLANT AND EQUIPMENT are tangible assets that:

(a) are held for use in the production or supply of goods or services, for rental to others, for investment, or for administrative purposes, and

(b) are expected to be used during more than one period.

3 Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.

4 Parts of some items of property, plant and equipment may require replacement at regular intervals. An entity shall add to the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the replacement part is expected to provide incremental future benefits to the entity. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

5 A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

6 Land and buildings are separable assets, and an entity shall account for them separately, even when they are acquired together.

7 An INTANGIBLE ASSET is an identifiable non-monetary asset without physical substance. Such an asset is identifiable when:

(a) It is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

(b) It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

8 INVESTMENT PROPERTY is property (land or a building- or a part of a building- or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.

9 INVENTORIES are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Recognition

10 All non-financial assets are recognised in conformity with the recognition criteria in paragraphs 2.24 – 2.29 (refer to section 2 in ED).

11 Additional requirements specific to intangible assets are detailed in paragraph B of this Appendix.

Measurement

1 – at initial recognition

12 An entity shall measure non-financial assets at cost at initial recognition.

2 – after recognition

13 All non-financial assets, with the exception of inventories and intangible assets, can be measured after recognition in accordance with either the cost model or the revaluation model. Inventories and intangible assets are measured after recognition using the cost model only.

14 Application guidance for measuring cost at initial recognition and applying the cost or the revaluation model after recognition is provided in the appendix.

15 The selection between the cost model and the revaluation model is to be made asset by asset, at inception. It is irrevocable. Application guidance to select between the cost model and the revaluation model is provided in the appendix.

3 – Impairment

16 At the end of each financial period, an entity shall determine whether an item or group of non-financial asset is impaired and if, so, how to recognise and measure the im-

pairment loss. In doing so, the entity will apply the application guidance provided in the appendix.

17 Compensation from third parties for non-financial assets that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.

Derecognition

18 An entity shall derecognise a non-financial asset:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal

except for inventories which are derecognised on disposal only.

19 When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised.

20 Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

21 When an entity disposes of other non-financial assets, either through sale or otherwise, the entity shall recognise the gain or loss on derecognition of the asset in profit or loss when the item is derecognised.

22 An entity shall determine the gain or loss arising from derecognition of other non-financial assets as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

23 An entity shall not classify such gains as revenue.

24 In determining the date of disposal of an item, an entity shall apply the criteria in paragraph 8 Revenue for recognising revenue from the sale of goods.

25 An entity shall transfer a property to, or from, investment property only when the property first meets, or ceases to meet, the definition of investment property.

B – Additional requirements specific to the recognition of intangible assets

26 An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

27 An entity uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

28 The probability recognition criterion in paragraph 2.24 a) is always considered satisfied for intangible assets that are separately acquired.

29 Most internally generated assets are expensed when incurred, except if:

- the asset meets restrictive criteria, and,
- the entity opts for the capitalisation model as its accounting policy.

Application guidance for capitalisation of intangible assets is provided in appendix AG3.

30 An entity shall recognise expenditure on an intangible item as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in paragraphs 2.24 a).

31 An entity shall recognise expenditures on the following items as an expense and shall not recognise such expenditures as intangible assets:

(a) internally generated brands, mastheads, publishing titles, customer lists and items similar in substance;

(b) expenditure on start up activities (ie start up costs), unless this expenditure is included in the cost of an item of property, plant and equipment. Start up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre opening costs) or expenditures for starting new operations or launching new products or processes (ie pre operating costs);

(c) expenditure on training activities;

(d) expenditure on advertising and promotional activities; and

(e) expenditure on relocating or reorganising part or all of an entity.

32 Paragraph 31 does not preclude recognising a prepayment as an asset when payment for the delivery of goods or services has been made in advance of the delivery of goods or the rendering of services.

33 Expenditure on an intangible item that was initially recognised as an expense shall not be recognised at a later date as part of the cost of an intangible asset.

Appendix 3: Application guidance on measurement of non financial assets

AG-1: How to apply the cost and revaluation models to non-financial assets

A – Measurement at initial recognition

All non-financial assets are measured at cost at initial recognition, unless acquired in a business combination. Cost at initial recognition includes all costs incurred in bringing the non-financial asset to the location and condition of its intended use. Depending on whether non-financial assets are purchased, transformed or produced, these costs may include:

1 – Costs of purchase

The costs of purchase of a non-financial asset comprise

(a) the purchase price, legal and brokerage fees, import duties and other non-refundable taxes, after deducting trade discounts, rebates and other similar items;

(b) any costs directly attributable to the acquisition of the non-financial asset and to bringing it to the location and condition of its intended use. These can include, for example, the costs of transport, handling, initial delivery, installation and assembly, and testing of functionality;

(c) for property, plant and equipment, the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the items is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period;

(d) Borrowing costs, measuring the cost of financing the asset during the period it is being acquired, upon option of the entity that, if selected, is applied to all non-financial assets of the entity (see specific guidance below).

An entity may purchase non-financial assets on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

If the non-financial asset it acquired in exchange for a non-monetary asset or assets, or a combination of monetary assets, the cost of the acquired asset is measured at current market based value unless (a) the exchange lacks commercial substance or (b) the current market based value of neither the asset received not the asset given ip is reliably measurable. In this case, the asset's cost is measured at the carrying amount of the asset given up.

If the non-financial asset is acquired in a finance lease, the cost of the acquired asset is measured at the present value of the minimum lease payments, determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessess are added to the amount recognised as an asset.

2 – Costs of conversion or production

The costs of conversion or production include:

(a) Costs of materials and services used or consumed in converting, producing or generating the non-financial asset;

(b) costs of employee benefits arising either directly or indirectly from the conversion, production or generation of the non-financial asset;

(c) all other – direct or indirect - costs necessary to create, transform, produce and prepare the asset to reach its intended finished state or to be capable of operating in the manner intended by management;

(d) borrowing costs, measuring the cost of financing the asset during the period it is being converted or produced, upon option of the entity that, if selected, is applied to all non-financial assets of the entity (see specific guidance below).

The costs of conversion or production do not include:

(a) Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance or desirable level of quality;

(d) the income and related expenses of incidental operations during construction or development of an item of property which are not necessary to bring the item to its intended location and operating condition; (These incidental income and expense are recognised in profit or loss when incurred);

(e) expenditure on training staff to operate the asset.

3 – Guidance specific to determining the cost of conversion of inventories

The costs of conversion or production of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour. [IAS 2.12]

<u>(a) Allocation of fixed production overheads</u>

The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity.

The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities. [IAS 2.13]

A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost. [IAS 2.14]

(b) Other costs included in inventories

En entity shall include other costs in the cost of inventories only to the extent that they are incurred in bringing to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories [IAS 2.15]. If an entity chooses to capitalise borrowing costs as provided by paragraph 24.2 (b), IAS 23 Borrowing costs identifies limited circumstances when borrowing costs are included in the cost of inventories.

(c) Costs included in the work in progress of a service provider

To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers. [IAS 2.19]

(d) Techniques for measuring cost, such as standard costing and retail method

Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions. The retail method measures cost by reducing the sales value of the inventory by the appropriate percentage gross margin. [IAS 2.21-22]

(e) Cost formulas

En entity shall assign the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs. [IAS 2.23]

An entity shall assign the cost of inventories, other than those dealt with in paragraph 12.15, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified. [IAS 2.25] The last-in, first-out method is not permitted by this IFRS.

4 – Cost of assets carried under finance leases

At the commencement of the lease term, the cost of the asset carried under a finance lease is equal to the sum of the present value of the minimum lease payments under the lease and of any initial direct costs incurred at inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used.

5 – Guidance for capitalising borrowing costs as part of the cost of non-financial assets

As indicated in paragraph 12.5.4, including borrowing costs as part of the cost of acquisition is optional.

Borrowing costs can be capitalised as part of the acquisition of non-financial assets that necessarily take a substantial period of time to get ready for its intended use or sale (IAS 23.4)

To the extent that funds are borrowed generally, the amount of borrowing costs eligible for capitalisation shall be determined by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period. The amount of borrowing costs capitalised during a period shall not exceed the amount of borrowing costs incurred during a period (IAS 23.17).

The capitalisation of borrowing costs as part of the cost of a qualifying asset shall commence when;

(a) expenditures for the asset are being incurred;

(b) borrowing costs are being incurred; and

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

Capitalisation of borrowing costs shall be suspended during extended periods in which active development is interrupted.

Capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

B – Subsequent measurement

All non-financial assets, with the exception of inventories and intangible assets, can be measured after recognition in accordance with either the cost model or the revaluation model. Inventories and intangible assets are measured after recognition using the cost model only.

1 – Cost model

Property, plant and equipment, intangible assets and investment property are measured at cost less any accumulated depreciation and any accumulated impairment losses.

Inventories are measured at cost less any accumulated impairment losses, except for:

(a) agricultural produce after harvest,

(b) commodity inventories held by brokers and dealers,
for which the option of the fair value model is available to the entity.

(a) Depreciation

Property, plant and equipment, intangible assets and investment property when accounted for in accordance with the cost model are depreciated over their useful life.

An entity shall allocate the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciate separately each such part. However, if a significant part of an item of property, plant and equipment has a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item, those parts may be grouped in determining the depreciation charge. [IAS 16.44-45]

The DEPRECIATION charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset. For example, the depreciation of manufacturing property, plant and equipment or of patents is included in the costs of inventories. [IAS 16.43]

Depreciable amount and depreciation period

An entity shall allocate the DEPRECIABLE AMOUNT of an asset on a systematic basis over its useful life.

An entity shall review the RESIDUAL VALUE and the useful life of an asset at least at each financial year-end and, if expectations differ from previous estimates, amend the residual value or useful life. The entity shall account for the change in residual value or useful life as a change in an accounting estimate in accordance with Section 10 *Accounting Policies, Estimates and Errors.*

An entity shall assume that the residual value of an intangible asset is zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

i. residual value can be determined by reference to that market; and

ii. it is probable that such a market will exist at the end of the asset's useful life. [IAS 38.100]

Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases when the asset is derecognised. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production. [IAS 16.55].

An entity shall consider all the following factors in determining the useful life of an asset:

(a) the expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output;

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair maintenance programme, and the care and maintenance of the asset while idle;

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset;

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases, patents, or other legal and contractual rights.

Depreciation method

An entity shall select a depreciation method that reflects the pattern in which it expects to consume the asset's future economic benefits. The possible depreciation methods include the straight-line method, the diminishing balance method and the units of production method.

An entity shall review the depreciation method at least at each financial year-end. If there has been a significant change in the pattern in which the entity expects to consume the asset's future economic benefits, the entity shall change the method to reflect the new pattern. The entity shall account for the change as a change in an accounting estimate in accordance with Paragraph 10 *Accounting Policies, Estimates and Errors.*

<u>(b)</u> <u>Impairment</u>

Determining whether an asset is impaired.

An entity shall assess at each reporting date whether there is any indication that a non-financial asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset at the reporting date.

The recoverable amount of the asset is equal to:

(a) its net selling price less costs to complete and sell, if the economic benefits arising from the asset are expected through sale,

(b) its value-in use, if the economic benefits arising from the asset are expected from continued use of the asset.

Inventories are always expected to be recovered through sale.

In assessing whether there is any indication that an asset may be impaired, and entity shall consider, as a minimum, the following indications:

External sources of information

(a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use;

(b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated;

(c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect materially the discount rate used in calculating an asset's value in use and decrease the asset's net selling price less costs to complete or sell;

Internal sources of information

(d) evidence is available of obsolescence or physical damage of an asset;

(e) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, and plans to dispose of an asset before the previously expected date;

(f) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. In this context, economic performance includes operating results and cash flows;

(g) the entity has decided to dispose of the asset in the short-term.

Measuring an impairment loss

Net selling price is the estimated net proceeds that the entity can expect from the sale of the asset.

Value in use is equal to the discounted net cash flows that are expected from the use of the asset, based on the most recent forecasts available to management at, or near of, the balance sheet date.

If an entity cannot estimate the net selling price or the value in use for an individual asset, the entity shall measure the net selling price or the value in use for the group of assets to which the asset belongs. For this purpose, the entity uses the estimate of net selling price or forecast net cash flows which are available for the smallest group of assets.

Recognition and reversal of an impairment loss

When the recoverable amount of an asset (or a group of assets) is less than its carrying amount, the entity shall reduce the carrying amount to its recoverable amount. That reduction is an impairment loss.

An impairment loss within a group of assets is allocated first to goodwill, than to other intangible assets with an indefinite useful life, and finally to the other assets proportionally to their carrying amounts.

An entity shall recognize an impairment loss immediately in profit or loss.

In subsequent periods, the entity will assess whether there is any indication that the impairment loss recognized previously may have decreased.

If so, the entity will determine the recoverable amount of the asset and account for a partial or total reversal of the impairment loss previously recognized, if the recoverable amount exceeds the carrying amount of the asset.

The increased carrying amount of an asset attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognized for the asset in prior years.

Impact on the depreciable amount and useful life of an asset

After recognition of an impairment loss, or of a reversal of an impairment loss, the depreciation charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

2 – Revaluation model

After recognition as an asset, property, plant and equipment, whose current market value can be measured reliably, shall be carried at a revalued amount, being its current market value at the date of the revaluation less any subsequent accumulated depreciation.

After recognition as an asset, investment property whose current market value can be measured reliably shall be carried at a revalued amount, being its current market value at the date of the revaluation.

If there is no market-based evidence of current market value because of the specialised nature of the non-financial asset and the item is rarely sold, the asset cannot be measured reliably at current market value and only the cost model is available for this asset.

Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using current market value at the balance sheet date.

The frequency of revaluations depends upon the changes in current market values of the non-financial assets being revalued. When the current market value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some non financial assets experience significant and volatile changes in current market value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for non-financial assets with only insignificant changes in current market value. Instead, it may be necessary to revalue the item only every three or five years.

The current market value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The current market value of items of other non-financial assets is usually their market value determined by appraisal.

When a non-financial asset is revalued, any accumulated depreciation, if any, at the date of the revaluation is eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset.

Any depreciation charge, if any, attributable to the current period is being expensed before the revaluation and shown separately from the change in value on the face of the income statement.

Gains and losses arising from a change in value of non-financial assets shall be recognized in profit or loss for the period in which they are measured.

AG-2: How to select between the cost and the revaluation model for non-financial assets

It is important that the measurement bases used in SME financial statements are relevant to users' assessments of the level of cash inflows, in the short- to medium-term. The revaluation model can be very relevant in this context, though only if:

(a) current value is the measurement attribute relevant for assets, in accordance with the business model or internal reporting of the entity, or

(b) the assets involved are easily disposable without disrupting the entity's activities. As a result, in cases where an asset is not easily disposable or cannot be disposed of without disrupting the business, the revaluation model is not helpful in an SME context because it features cash inflows which are not likely to materialize in a disposal scenario.

Of course, in circumstances in which the revaluation model is not relevant, the use of the cost model should be applied instead. For the purpose of this recommendation, easily disposable assets are assets for which the following conditions can be verified:

(a) Observable market prices are available.

(b) Either the asset can be sold on the market at any time without causing any disruption or major change in the entity's operations or management is committed to a plan to sell the asset and an active programme to locate a buyer and complete the plan have been initiated.

In other words, the revaluation model applies to circumstances when assets are easily disposable.

AG-3: How to apply the capitalisation model to internally generated assets

Under the capitalisation model, all costs incurred in research activities are recognised as an expense when incurred. Costs incurred in development activities are also recognised as expense except for those development costs incurred after specified criteria are met, which are recognised as the cost of an intangible asset.

An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset;

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Appendix 4: Basis for our recommendations on measurement

In an SME environment, the use of financial statements as a basis for estimating future cash flows can be described roughly along the following lines:

(a) The income statement serves as a basis for identifying the sustainable stream of cash flows that has been generated during the period (unlike the cash flow statement, the income statement is served by accrual accounting in order to separate different periods). Along with other information such as economic parameters relevant to the industrial sector and indications of the strategic and financial policies decided by the entity, a first basis for assessing future cash flows derived from operations is hence available;

(b) The balance sheet brings valuable supplementary data to identify:

  i. Future streams of cash flows derived from the financing structure of the entity (specific disclosures related to liabilities are necessary to help assess those cash-flows) and from the classification between current and non-current assets and liabilities;

  ii. How specific risks and opportunities may influence future cash in- and outflows: assets which are being held and are not used in the operations, non-financial liabilities which may have arisen from litigations are examples of such risks and opportunities.

(c) The cash flow statement helps understand how and why the cash position of the entity has varied over time (investments, changes in the financing structure, impact of relationships with owners etc.). A presentation through the indirect method is essential to reconcile the income statement with past cash information.

In addition, users' needs indeed vary, depending on the possible outcome of their relationship with the entity. Holders of listed equity and debt instruments may invest and disinvest at any time. As is explained in OB4 and OB6 of the IASB discussion paper of the revised framework, their interest in an entity's ability to generate net cash inflows is strongly interrelated with how this ability may affect the prices of their equity or debt instruments. Decisions of holding, selling or buying interests in private equity are not short-term decisions that can be taken any time. Other stakeholders as banks, suppliers, employees, members of the public, are also primarily interested in the entity's sustainability, as they have entered in mid- or long-term relationship. Their first concern is whether the entity will be able to meet its obligations when due. These differences may in our view have an impact on measurement requirements. We believe that measurement requirements may differ, whether users focus on value or on the assessment of entity-specific streams of cash flows.

As a result the choice of measurement attribute should be guided by the attempt at providing, in a very practical, non-dogmatic approach:

(a) The information which is truly useful for assessing future cash flows.

(b) The information which is the least costly and the most straightforward to produce.

Current value measurement attributes being more complex and costly to use (revaluations are not necessarily easy to make, often require the use of external valuers, and bring additional internal and external control burdens) should therefore be limited to those assets and liabilities of which changes have a direct impact on streams of cash-flows, i.e. assets and liabilities which are not used and consumed in the operations, in other words assets and liabilities of which impact on cash-flows is not reflected in the stream of sustainable cash-flows that the income statement helps separating out. For example, a manufacturing plant could be carried at cost as long as it is still in operations while marketable securities which can be disposed of anytime would be best valued at current value.

In addition to the above, the choice between current market based values or current entity-specific values should be guided by the search for the valuation that best features the future potential cash-flow stream for the entity. As a result, current market based values should be used only when the asset has the ability, consistently with the disclosed strategic and financial policies of the entity, of being realized, or the liability being settled, on the market place. In other situations, for example when a performance obligation is to be settled by performance (warranty obligations are an example of such obligations), current entity-specific measures are more relevant for users of SMEs financial statements.

As already explained, it is important that the measurement bases used in SME financial statements are relevant to users' assessments of the level of cash inflows, in the short- to medium-term. Current value measures can be very relevant in this context, though only if the assets involved are easily disposable without disrupting the entity's activities. EFRAG believes that, in cases where an asset is not easily disposable or cannot be disposed of without disrupting the business, current valuing that asset in the balance sheet is not helpful in an SME context because it features cash inflows which are not to materialize in a disposal scenario.

Of course, in circumstances in which a current value measurement basis is not relevant, the use of cost-based measure should be applied instead. For the above reasons, we believe that current value measures are best used if both the following criteria are met:

(a) Observable market prices are available.

(b) Either the asset can be sold on the market at any time without causing any disruption or major change in the entity's operations or the management is committed to a plan to sell the asset and an active programme to locate a buyer and complete the plan have been initiated.

In other words, the use of current value measures should be limited to circumstances when assets are easily disposable.