EFRAG
European Financial Reporting Advisory Group

Attachment 1: Responses 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 has made good progress compared to former discussion papers and staff drafts of an IFRS for SMEs. It is now clear that the objective is that the standard should be a stand-alone document. EFRAG welcomes the reduction in the number 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 this 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 stand-alone document. Therefore if the transactions are not frequent for a SME, SMEs who encounter those transactions should rely on the pervasive principles, and more generally on the hierarchy spelt out in section 10 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 assess each remaining mandatory fallback and make the following decision according to the situation:

(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:

(a) Requirements which should be excluded from the IFRS for SMEs

- EFRAG is of the view that there should be no mandatory requirement in the IFRS for SMEs for segment and interim reporting or earnings per share. EFRAG agrees that segment and interim reporting are rarely produced by

[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.

SMEs. If they are, they may either follow particular legal requirements that may detail what information needs to be provided, or be based on some extract from internal reporting that users are likely to find useful. EFRAG believes that the IASB should not discourage SMEs from providing users with useful supplementary information. Moreover, a mandatory requirement to apply IAS 33 *Earnings per Share* may be usefully replaced with both a prohibition from providing any form of ratio or other indicator on the face of the financial statements and a requirement to disclose on what basis any form of ratio or other indicator provided in the notes has been prepared. Consistent with this, sections 31, 34 and 37 should be deleted.

(b) Requirements which should be 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 possibly simplified in their drafting;

- requirements for accounting for finance leases by lessors: receivables arising from finance leases should be brought into the scope of the section dealing with financial instruments. A separate paragraph should 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 should be included in the revenue section;

- biological assets should be brought into the scope of the section on non-financial assets, and be accounted for at cost at initial recognition, and subsequently accounted for at cost or at a revalued amount (see our proposal);

- a specific section should 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; and we then describe the areas in which more simplifications are necessary.

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

<u>(a) Brevity is not the most important factor in simplification</u>

EFRAG welcomes the effort made by the IASB to reduce significantly 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 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 instrument.

Furthermore, the language used is not simple enough. For example, the sections on scope exclusions 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 or at a level of detail which SMEs are familiar with or find easy to understand.

Requirements are not necessarily clear. For example, the requirement to test hedge effectiveness and to recognise 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) The scope-out for insurance contracts is unclear

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

(c) The scope-in for commodities is too complex for an SME

Paragraph 11.4 for non-financial items and the scope exclusions of paragraph 11.3(c) and (e) for leases and insurance contracts lead to a scope extension to bring in commodities that are similar to instruments dealt with in IAS 39.11. Compared to IAS 39.11, section 11 covers only 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 fair value in their entirety.

Furthermore it is EFRAG's understanding that section 11 results in non-financial contracts which include an embedded derivative with economic characteristics not closely related to the contract to be accounted for at fair value in their entirety.

View 1

EFRAG disagrees with the latter requirement and would instead support an approach in which the IFRS for SMEs does not call for the accounting for these instruments (i.e. no *embedded* derivatives). Indeed EFRAG believes that it is too complex for an SME to identify this kind of instrument and to determine its fair value.

View 2

EFRAG disagrees with the latter requirement and instead would support an approach which requires that the derivative be separated out irrespective of 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 themselves, and to keep track of the basic financial consequences of all the 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 recognised) or view 2 (they are recognised via split accounting)? Please explain your view.

(d) Treatment of transaction costs

No mention is made of transaction costs. 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 directly from IAS 39. However we do not believe it is clear enough for SMEs. SMEs need to know when financial instruments ought to be recognised. The standard is silent on this. Moreover the formulation “only when the entity becomes a party to the contractual provisions of the instrument” could be misinterpreted as “as soon as the entity becomes a party to the contractual provisions of the instrument” and could lead to inappropriate accounting. The definitions of financial assets and liabilities refer to contractual rights and obligations, not unconditional contractual rights and obligations. Therefore we believe that, in addition to the recognition criteria set out in paragraph 2.24, the standard ought to indicate that financial assets and liabilities ought to be recognised 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 requirement of paragraphs 11.7(a)[,11.8] and (b)(iii) for full fair value measurement to be applied to a variety of financial instruments.

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 EFRAG 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 their current state 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 borne until the contract expires.

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

(g) Consequently there is no need for any option for measurement

In EFRAG's view, all financial instruments ought to be measured in one of two ways, which would depend on their characteristics:

- At "market-based exit value" for easily disposable financial assets and easily transferable financial liabilities, (equal to the cash in- or outflows 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.

The market value of easily disposable assets or easily transferable liabilities can always be determined, although an 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 would be no option available for accounting, hence this would increase the 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 response 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 process has been simplified but at the cost of not 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 securitisations 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 securitisations and factoring transactions would not result in a derecognition of the corresponding financial assets under section 11. EFRAG however believes that securitisation and factoring transactions are not uncommon for SMEs.

<u>Questions to EFRAG constituents:</u>

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

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

<u>(i) Hedge accounting becomes simpler but also more restrictive</u>

The simplified hedging approach proposed in section11 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 for use when appropriate as this will limit the cost and burden of testing for hedge effectiveness. As a consequence, EFRAG would support both methods being available in the standard.

Clarification is needed in the proposed standard on how to measure effectiveness when an effectiveness test is needed.

<u>Questions to EFRAG constituents:</u>

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

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

2. Paragraph 11.32 only allows hedging for certain hedging instruments. Is that too restrict tive ?

Other recognition and measurement simplifications

EFRAG believes the following further opportunities to simplify recognition or measurement requirements should be considered – or reconsidered - by the IASB. We believe that the simplifications proposed below 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 determined separately. EFRAG's recommendation therefore makes 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 be the case for other assets (for example, intangible assets whose cash inflows are not independent of other assets);

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

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

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 performed on the basis of either value in use or fair value less costs to sell, whichever is consistent 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 constraints placed on 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 is believed to be too costly and burdensome for entities applying IFRS for SMEs

EFRAG disagrees with the impairment approach for goodwill. Fair valuing the 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 overstated. Reinstatement of amortization would help reduce circumstances where assets need to be tested for impairment (please see our recommendation below). EFRAG believes that guidance for impairment must remain as simple as possible. An illustration of what constitutes a relevant and useful guidance for 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. The guidance of IAS 38 is that an asset should be regarded as of an indefinite useful life if the expected cash inflows that are associated with the intangible assets are to continue without foreseeable limit in time. Some users have, however, suggested that after acquisition values of intangible assets and goodwill do not have much meaningful content. Thus, although we agree with the IASB that amortization may be somewhat arbitrary, we believe that reinstating amortization of goodwill and intangible assets would not deprive users of SMEs' financial statements of the information they need to assess cash flows. 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 which we would suggest to be of a maximum 20 years. As stated above, 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 merely 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 recognised;

- 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 decided to eliminate amortisation of goodwill and other intangible assets with indefinite useful life, it imposed 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 test. Therefore EFRAG believes that reinstating amortisation, even though this might appear to be on an arbitrary basis, is likely to better ensure that assets within financial reporting by SMEs are not overstated and to achieve this at a lesser cost.

5 – Restatement requirement for discontinued operations should be reduced

Restatement of information is usually quite burdensome for all entities. However, restatements do 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. Furthermore, 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 in which 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. All that is required in the appropriate guidance is to identify the decision to sell an asset or a group of assets in the near future as an internal indicator of impairment. . 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 consequently 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 the 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 making the IFRS for SMEs simpler and more easily understandable, while the information remains meaningful and relevant for users.

7 – Elimination of reference to fair value

The current debate on fair value measurement illustrates that “fair value” is a difficult notion, quite a sophisticated notion, which cannot be understood easily. “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 the context of the IFRS for SMEs.

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 if the economic environment in which the entity operates were 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 this therefore 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 in the transition from full IFRS to IFRS for SMEs the IASB should eliminate as much of the complexity of full IFRS as possible where such complexity appears to have been generated more by past practice or principles than by users' needs (complexities such as exceptions, useless differences which are being made today in various accounting treatments for different assets) In the existing IFRS, most subsequent re-measurements of non-financial assets include an option or 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, with some being recycled and others being accounted for permanently in equity.

We do not believe that it is likely that such differences can make sense to users of SME financial statements when they are in the first stages of getting to understand the IFRS for SMEs. We therefore believe that there should be a single method of accounting 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, while SMEs were likely to fully understand the underlying economics of their transactions, they would probably not be sophisticated enough to select appropriate accounting treatment in all circumstances. Therefore we believe that appropriate application guidance should be included to guide entities in selecting the measurement model that 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 and assets carried at cost, and indications of the nature of assets as sub-categories of those primary classifications;

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

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 response to BC95 – BC107.

EFRAG agrees with most of the IASB's conclusions (but not necessarily with the 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 the IASB believes. We believe that the frequency of such transactions warrants specific requirements in the standard that are tailored specifically to the SME environment. 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 recognising 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 be required only to disclose the information in a note describing the principal terms and conditions of any equity-settled share-based payment transactions that exist during the period. This would include, for example, the number of shares, the number of employees and other parties 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 provide the information that users need, i.e. the consumption of resources by the entity that is not all reflected in the income statement, and the extent to which supplementary consumption of resources potentially dilutes shareholders' interests. Equity-settled share based payments do not trigger any cash outflow and users should not have to restate the accounts in order to identify 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 define the computation of the amount 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. Here 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 rationalisation and a further effort to make the IFRS for SMEs as understandable as possible could allow the inclusion of various options in 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 the subsequent measurement technique. EFRAG believes that there is no valid reason to maintain several different revaluation models in the IFRS for SMEs (see our response 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, but the selection between the two would no longer be an option available to the entity;

- 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 identified the 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 is believed necessary,

- the options in the separate financial statements for associates and joint ventures should remain available, with appropriately simplified guidance included in the IFRS for SMEs, However we propose 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 capitalisation 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 either 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 section 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, and indeed the imposition of capitalisation would likely to be perceived as an added burden. Although eliminating options in the IFRS for SMEs ought to help simplify the accounting requirements and thus make things easier for users, we doubt that elimination of this option would benefit users of an SMEs' financial statements to any noticeable extent.

On a practical level, the implementation of capitalisation of borrowing costs implies quite sophisticated information systems. The proposed prohibition of the expense model in full IFRS would create 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 capitalisation of borrowing costs should be computed on the basis of the average borrowings of the entity in all cases. We also believe that such guidance should be part of the 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 response to question 1 above, where we explain why there should not 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 laid out in our response 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 shorter than the proposed ED.

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 (that is, to compose the proposed standard by extracting the main principles for each standard from full IFRS) does not result in adequate guidance. It seems that the selection of the pieces of guidance to be included in each section has been guided more with the aim of minimizing the total length of the final document than with the aim of providing the necessary comprehensive guidance to preparers. We believe that our approach to drafting (see our illustration in Attachment 3) allows more comprehensive guidance to be provided in less volume because of the avoidance of repetition and the rationalisation of 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 welcomes the effort made by the IASB in including a disclosure checklist intended to help SMEs prepare the notes to their financial statements. EFRAG also welcomes that the disclosures proposed in the ED are significantly reduced compared to full IFRS requirements.

However, EFRAG believes that the proposed disclosures remain too detailed and too burdensome for SMEs as well as for the users of SMEs financial statements. EFRAG has already emphasised that the IFRS for SMEs should have been prepared based on an in-depth analysis of users' needs. In the absence of such an analysis, and without any basis for conclusions justifying how the IASB has proceeded EFRAG believes that the differences in users' needs have even a greater impact on disclosures than they have on measurement. In EFRAG's view, users of SME financial statements need limited supplementary information. Basically, users of SME financial statements need:

(a) to ascertain whether the entity is able to meet its obligations when due and how sustainable its operations are (banks, suppliers, employees etc.);

(b) in addition to the above, to assess whether their interests in the entity are safely handled (non-controlling owners).

In addition, EFRAG believes that users of SME financial statements must be provided with a set of very concise, simple financial information.

As a result, EFRAG believes that users of SME financial statements need information that helps them understand the financial position of the entity and changes therein during the period even without giving them the ability to project future cash flows (which might be necessary to value the entity or to challenge the assumptions or methods used in preparing the financial statements).

Notes to SME financial statements should, in EFRAG's view, be limited to the following:

- description of the major accounting policies used in the preparation of the accounts;

- impact of all changes in accounting policies and of prior error corrections on opening balance of equity for the current period (in addition to restatement of the prior period);

- details of assets and liabilities by category or origin (ex: provisions), where relevant (bearing in mind that EFRAG's proposals lead to separate disclosure on the face of the balance sheet of assets carried at current value (easily disposable assets) from assets carried at cost);

- reconciliations between opening and closing balances for assets subject to depreciation and impairment and provisions ; these reconciliations should be based on a standard reconciliation;

- a specific reconciliation between the opening and closing balance of net pension liabilities;

- details of maturity and interest rate for all financial debt (including finance lease related debt and minimum payments for operating leases);

- summarised information related to ownerships in associates and joint ventures (interest share, joint control or significant influence, total revenue, net income and equity for each entity);

- description and main information related to significant transactions and events of the reporting period (business combinations, major impairments, disposals etc.);

- off balance sheet items such as commitments, pledges and collaterals;

- contingencies;

- hedging strategies and related amounts in the balance sheet; and
- income tax: basic tax and effective tax rates.

Similar to the requirements on recognition and measurement, the requirements on disclosure could, in EFRAG's view, benefit from restructured drafting of the IFRS for SMEs. EFRAG does not believe that these requirements need to be included in both sections and the specific checklist. The checklist also includes items which, in EFRAG's view, belong to requirements relating to presentation. A more concise presentation would help to better identify the objective pursued in setting the requirement.

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, for which the hurdle would be set far lower than the hurdle included in the full IFRS.

1 – Keeping the four exceptions is reasonable

EFRAG agrees with the four *exceptions* from retrospective application contained in section 38 of the ED, which require that 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 for those same items for which listed and larger entities have asked for exemptions. Wherever restatement would be too burdensome, an SME should retain the carrying amounts of assets and liabilities under its previous GAAP at the date of adoption.

EFRAG has based the above recommendation on 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". In the absence of further guidance, this is understood to be a far lower hurdle than the notion of impracticability in full IFRS that the IASB quite frequently refers to as meaning "impossibility". Were the IASB to confirm the latter 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 with the proposed approach, i.e. that the 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 proposed or adopted.

Indeed, EFRAG believes that the exposure draft adheres too closely to full IFRS. In common with many IASB constituents, we agreed that a top-down approach from full IFRS was a good start for the project, but believe that there is still a need for freedom from full IFRS in order 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 adhere strictly to the inconsistencies of full IFRS, which are the result of compromises that may have accumulated as IFRSs have been developed throughout the years. Getting rid of those inconsistencies has the following advantages:

- It provides from the outset 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 protects SMEs from the need to endure changes in their accounting practices in later periods and to bear the costs associated with those changes.

Furthermore EFRAG believes that there is very little benefit, if any, in keeping IFRS for SMEs 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 facilitate 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. In addition to bringing the IFRS for SMEs to the state of an easy-to-understand stand-alone document, they resolve the operational difficulty of keeping two separate versions of those IFRS to which optional or mandatory fallbacks from the IFRS for SMEs to individual standards of full IFRS are possible or required. As a consequence of the IASB's decision to maintain the the IFRS for SMEs as a separate process from that of the issuance of exposure-drafts for other IFRS, two different versions of other IFRS would indeed need to be kept in parallel. .

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

EFRAG believes that in developing 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 pre-defined criteria for simplification. EFRAG provides its input on these two fundamental issues below.

A – Users' needs

1 – The necessary analysis of users' need 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 of whether users of SMEs' financial statements needed 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 is quick to assert that no change in either recognition or measurement is required in order to respond to these differences in user needs (BC 25). We do not share this view at all.

2 – Financial reporting requirements in excess of users' needs is contrary to the 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 the extra benefit to be derived from increased sophistication or increased amounts of 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 the financial information provided in financial statements should be presented in a way that makes it comprehensible to users who have a reasonable knowledge of business and economic activities and accounting. The level of reasonable knowledge that can be expected varies from one user group to another, and users of SME financial statements are assessed as being less sophisticated and less organised than users in the 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 the cost (to both entities and user groups) and undermine the understandability of financial information. 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 said to be 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 level of 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, wants to assess whether the entity's financial position is robust enough to justify the risk of lending money to it or of making it a sustainable preferred supplier. Whether other entities can be assessed to be 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 **sufficiently standardised** to avoid the users the burden of having to understand differences in the definitions or accounting treatments applied prior to any analysis.

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 realise easily or to liabilities that the entity cannot easily 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 in order 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 former group tends 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 treatment 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 has achieved its objective of simplicity if it is easy to understand and easy 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. For example, 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 unnecessary detailed requirements have been accumulated 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 presentation 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 few 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 for relevance and reliability, it is extremely important that external reporting is fully consistent with 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. In respect of measurement principles for assets, for example, 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 useful supplementary information.

Furthermore EFRAG has the view that the ED contains implicit accounting requirements which make it all the more difficult to implement. One example for this might be the omission of the term "derivative": Although the ED does not define derivatives an SME has to identify this kind of financial instruments. The recognition and measurement of financial instruments with the characteristics of a derivative are implicit and unexplained requirements.

3 – Conclusion and Consequences

EFRAG believes that the ED is not easy to understand nor simple to implement for SMEs as too many accounting principles of full IFRSs have been adopted without changes aimed at meeting an appropriate cost/benefit-balance. In EFRAG's view this is not appropriate for SMEs.