EFRAG
European Financial Reporting Advisory Group

## Attachment 3: An EFRAG Proposal/Illustration of an alternative IFRS for SMEs

EFRAG had proposed an alternative structure of the SME standard to the IASB in our letter dated 1st February 2006. Although the IASB has not to date taken up this proposal, EFRAG continues to believe it is a good proposal. To help the IASB and others to full understand that EFRAG has been proposing, EFRAG decided to develop an illustration of what its alternative proposal for an IFRS for SMEs would look like. As explained in Attachment 1, EFRAG is of the view that a revised structure, a clearer display and a proper rationalisation 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, therefore departures from existing IFRS should be made if they are likely to improve financial reporting for SMEs (improvements encompass greater understandability, greater relevance, better cost/benefit trade-off).

### A – Structure and Guidance

EFRAG thinks that it would be better to 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 into one section about non-financial assets. Our proposal for a revised structure (with a 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 their concerns over the fact that the ED (or what could be guessed of the ED thanks to the regular releases of drafts) was still far too sophisticated for a great number of small/micro entities. They added that even if the future standard included the simplifications in form and content that EFRAG suggests, their view would remain.

EFRAG believes that it is unreasonable to be too restrictive in the accounting requirements such 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, much to the detriment of the medium and medium large entities. Indeed EFRAG is of the view that these entities are more likely to enter into cross-border 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 excluded from 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 GAAPs 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 replace 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, the IASB would best serve SMEs while meeting its objective of unifying accounting practice on as wide a basis as is 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 initial 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 on an asset by asset basis, 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 22.8 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:

(a) the asset meets restrictive criteria; and,

(b) 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 is 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 nor the asset given up 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 lesse 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

An entity shall include other costs in the cost of inventories only to the extent that they are incurred in bringing inventories 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.

<u>(a)</u> <u>Depreciation</u>

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 recognise an impairment loss immediately in profit or loss.

In subsequent periods, the entity will assess whether there is any indication that the impairment loss recognised 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 recognised, 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 recognised 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 recognised 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 materialise 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 has 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 broadly 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 at any point in 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 a 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 we think the measurement basis to be applied should be based on a pragmatic consideration of:

(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 which are 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 realised, or the liability is capable of being settled, in 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 highly 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 will not materialise 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.