EFRAG
European Financial Reporting Advisory Group

DRAFT COMMENT LETTER
Comments should be submitted by 5 June 2011 to
Commentletter@efrag.org

Note to constituents

Within the EU, the IFRS for SMEs cannot be applied by entities as an alternative to national requirements. In addition, Member States cannot allow the use of the IFRS for SMEs when this will result in an outcome that is not in accordance with the European Accounting Directives.

15 June 2011

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

On behalf of EFRAG, I am writing to comment on the draft Q&As:

- Captive insurance subsidiaries;
- Interpretation of 'traded in a public market'; and
- Investment funds with only a few participants.

The Q&A *Captive Insurance Subsidiaries* considers whether a captive insurance entity is publicly accountable and whether a group of entities containing captive insurance subsidiaries is publicly accountable for the purposes of preparing consolidated financial statements. The Q&A response specifies that a captive insurance entity is not publicly accountable when the insurance company is insuring the risks of a single entity or the risks of entities within the same group of entities that are related to the captive insurance company only. On the other hand, if a captive insurance company also sells insurance directly to other parties such as associates, joint ventures and unrelated third parties, the captive insurance entity will be publicly accountable if the other parties constitute a broad group of outsiders.

The Q&A *Interpretation of 'traded in a public market'* considers how the term, 'traded in a public market', should be interpreted in the definition of public accountability. More specifically, the question included in the Q&A asks how broadly 'traded in a public market' should be interpreted and whether it includes, in Europe, only those markets defined as 'regulated market' for the purpose of EU accounting regulations or whether it also includes other markets such as growth share markets and over-the-counter markets. It also asks what happens if no trading occurs in the market. The answer provided in the Q&A is that a 'public market' is not restricted to recognised and/or regulated stock exchanges, but includes all markets that bring together entities and investors. However, publicly advertising shares for sale by the shareholder, on a website or in a newspaper, does not in itself create an over-the-counter public market. For a market to be public, it must be accessible by a broad group of outsiders. Also, if no trading has occurred or is expected to occur for the foreseeable future, instruments cannot be considered to have been 'traded'. However, if trading only occurs a few times a year, this would constitute 'trading'.

The Q&A *Investment funds with only a few participants* considers whether the criterion 'broad group of outsiders' means that investment funds or similar entities that restrict their ownership to only a few participants are not publicly accountable according to paragraph 1.3(b) of the IFRS for SMEs. Although it is not explicitly mentioned in the Q&A, the Q&A seems to specify that investment funds or similar entities that restrict their ownership to only a few participants are not publicly accountable under paragraph 1.3(b) of the IFRS for SMEs.

Considering that four draft Q&As have now been issued on the first three (out of more than 750) paragraphs of the IFRS for SMEs, EFRAG is concerned that the SMEIG is not focusing on a limited number of pervasive issues when issuing Q&As, as specified as an expectation in its terms of reference and operating procedures. EFRAG would therefore recommend the SMEIG to develop guidelines for dealing with the Q&As that would assist the SMEIG in avoiding the creation of extensive additional literature. In doing so, we think the SMEIG should consider whether it is necessary and/or beneficial to develop Q&As related to terms that are also included in (full) IFRSs when additional guidance has not been considered necessary in relation to (full) IFRSs. This would be relevant to consider in relation to the interpretation of 'traded in a public market'.

To limit the number of Q&As to be issued, we also think the SMEIG should explain what a 'broad group of outsiders' is in a more principle-based manner, than solely in relation to investment funds. In addition, EFRAG thinks that if guidance is also developed on what constitutes an entity's primary businesses, issuance of a separate Q&A on captive insurance subsidiaries could be avoided.

EFRAG would therefore recommend the SMEIG to reconsider not issuing the draft Q&As proposed, but instead to issue Q&As with a broader scope.

Our detailed comments on the Q&A are set out in Appendix 1.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer or me.

Yours sincerely

Françoise Flores

EFRAG, Chairman

Appendix 1

Introduction

1 EFRAG has decided to comment on the following draft Q&As in a single comment letter:

(a) Captive insurance subsidiaries;

(b) Interpretation of 'traded in a public market'; and

(c) Investment funds with only a few participants.

We have chosen to do so, as our main comments are general comments related to the procedure of choosing issues to be considered in Q&As.

General Comments

Notes to EFRAG's constituents

2 The Terms of Reference and Operating Procedures for the SME Implementation Group (SMEIG) states:

3 In deciding whether to address an issue in a Q&A, the SMEIG shall consider the following criteria:

(a) *The issue should be pervasive, ie, it has arisen or is likely to arise in financial reporting by a broad group of SMEs in various jurisdictions.*

(b) *Owing to a lack of clarity in the IFRS for SMEs, unintended or inconsistent implementation has occurred or is likely to occur in the absence of a Q&A.*

(c) *The SMEIG can reach a consensus on the appropriate treatment on a timely basis.*

4 The SMEIG is expected to focus on a limited number of pervasive issues and not to seek to create an extensive rule-oriented environment. Nor does the SMEIG act as an urgent issues group.

View of EFRAG:

- EFRAG is concerned that the SMEIG is going to create an extensive amount of additional literature instead of focusing on a limited number of pervasive issues and would recommend the SMEIG to reconsider issuing the draft Q&As.

5 Considering that four draft Q&As have now been issued on the first three (out of more than 750) paragraphs of the IFRS for SMEs, EFRAG is concerned that the SMEIG is going to create an extensive amount of additional literature.

6 EFRAG would therefore recommend the SMEIG to develop guidelines for dealing with the Q&As that would help the SMEIG to focus only on a limited number of pervasive issues.

7 Considering the three draft Q&As issued, EFRAG would suggest to the SMEIG:

(a) To consider whether it is necessary to develop Q&As related to terms that are also included in (full) IFRSs when additional guidance has not been considered necessary in relation to (full) IFRSs. EFRAG notes that the term 'traded in a public market', which is being further explained in one of the draft Q&As, is used in (full) IFRSs when determining whether:

(i) a parent does not need to present consolidated financial statements (IAS 27.10);

(ii) an investment in an associate shall not be accounted for using the equity method (IAS 28.13);

(iii) a venture with an interest in a jointly controlled entity is exempt from recognising its interest in a jointly controlled entity using either proportionate consolidation or the equity method (IAS 31.2);

(iv) an entity should apply IAS 33 *Earnings per Share* (IAS 33.2);

(v) an entity should apply IFRS 8 *Operating Segments* (IFRS 8.2);

and it has not been considered necessary to elaborate on the term in (full) IFRSs.

(b) To explain what a 'broad group of outsiders' is more generally, than solely in relation to investment funds. One of the draft Q&As explains what a 'broad group of outsiders' is when answering whether a few participants in an investment fund constitutes a broad group of outsiders. To avoid having to issue Q&As on what a 'broad group of outsiders' is in other circumstances and for other types of entities, EFRAG would suggest general guidelines about what constitutes a 'broad group of outsiders' to be developed rather than this specific Q&A only relating to investment funds. We note that the term is also applied in the draft Q&A *Interpretation of 'traded in a public market'* and in the draft Q&A *Captive Insurance Subsidiaries*. This suggests that a more general interpretation of the term could be useful. In addition, EFRAG thinks that if guidance is also developed on what constitutes an entity's primary businesses, issuance of a separate Q&A on captive insurance subsidiaries could be avoided.

8 EFRAG would therefore recommend the SMEIG to reconsider not issuing the draft Q&As proposed, but instead to issue draft Q&As with a broader scope.

9 Should the SMEIG decide to issue the Q&As, with or without reconsideration, EFRAG has some further comments on the specific content of the individual draft Q&As, which follow below.

Captive Insurance Subsidiaries

Notes to EFRAG's constituents

10 Paragraph 1.3(b) of the IFRS for SMEs states that an entity has public accountability if it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. It is specified that this is typically the case for banks, credit unions, insurance companies, securities brokers/sellers, mutual funds and investment banks.

11 The question addressed in the Q&A is whether a captive insurance entity is publicly accountable and whether a group of entities containing captive insurance *subsidiaries is publicly accountable for the purposes of preparing consolidated financial statements.*

12 The answer provided in the Q&A is that a captive insurance entity is not publicly accountable if it is only insuring the risks of entities within the group. However, if it sells insurance directly to other parties, who constitute a broad group of outsiders, the captive insurance entity will be deemed publicly accountable.

View of EFRAG:

- EFRAG does not think the Q&A completely answers the question raised, but agrees with the part of the answer provided in the Q&A.

13 EFRAG agrees that, although paragraph 1.3(b) of the IFRS for SMEs mentions that insurance companies typically hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses, this does not mean that it is always the case. As the Q&A mentions, it is not the case when the insurance company is only insuring the risks of a single entity or the risks of entities within the same group of entities that are related to the captive insurance company.

14 Paragraph 3 of the Q&A states:

> A captive insurance company is an insurance company that is set up with the specific objective of insuring the risks of a single entity (often its parent company) or the risks of entities within the same group of entities that are related to the captive insurance company (ie fellow subsidiaries or parent entities). Where this is the case, the captive insurance company holds assets in a fiduciary capacity for other group entities, which would not be considered a broad group of outsiders.

EFRAG recommends the redrafting of the above paragraph to better reflect that the purpose of an insurance company when it was set up should not be considered in this context. In EFRAG's view, the actual activities of the entity at the balance sheet date are those that matter.

15 The Q&A specifies that when a captive insurance entity itself is not publicly accountable, it follows that the group will not be publicly accountable. However, the Q&A does not specify whether a group of entities containing a captive insurance subsidiary is publicly accountable for the purposes of preparing consolidated financial statements if the captive insurance subsidiary itself is publicly accountable (because it also sells insurance directly to unrelated third parties).

16 In the view of EFRAG, paragraph 1.3(b) of the IFRS for SMEs could also be applied to determine whether the group of entities is publicly accountable for the purposes of preparing consolidated financial statements. In that case it should be assessed whether the insurance activity with third parties is one of the group's primary businesses, as set out in paragraph 1.4 of the IFRS for SMEs. Accordingly, EFRAG thinks that this issue should also be considered in the Q&A.

Interpretation of 'traded in a public market'

Notes to EFRAG's constituents

17 According to paragraph 1.3 of the IFRS for SMEs:

> *An entity has public accountability if:*

(a) *its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets),*

[...]

18 The question addressed in the Q&A is how 'traded in a public market' should be interpreted in the definition of public accountability. More specifically, the question included in the Q&A asks how broadly 'traded in a public market' should be interpreted and whether it includes, in Europe, only those markets defined as 'regulated market' for the purpose of EU accounting regulations or whether it also includes other markets such as growth share markets and over-the-counter markets. It also asks what happens if no trading occurs in the market.

19 The answer provided in the Q&A is that a 'public market' is not restricted to recognised and/or regulated stock exchanges but includes all markets that bring together entities and investors. However, publicly advertising shares for sale by the shareholder, on a website or in a newspaper, does not in itself create an over-the-counter public market. For a market to be public, it must be accessible by a broad group of outsiders. Also, if no trading has occurred or is expected to occur for the foreseeable future, instruments cannot be considered to have been 'traded in a public market'. However, if trading only occurs a few times a year, this would constitute 'trading in a public market'.

View of EFRAG:

- EFRAG thinks the Q&A is internally inconsistent regarding trading frequencies.

20 EFRAG thinks paragraph 4 of the draft Q&A is internally inconsistent. The two last sentences of paragraph 4 reads:

> However, if trading occurs only occasionally on a public market, even just a few times a year, this would constitute trading. In other words, the frequency of such transactions is irrelevant.

21 EFRAG interprets the first of the sentences above as trading should occur a few times a year – and EFRAG thinks that is a reference to frequencies. It is therefore confusing when the second sentence mentions that frequencies are irrelevant. EFRAG suggests the two last sentences of paragraph 4 to be deleted.

Investment funds with only a few participants

Notes to EFRAG's constituents

22 According to paragraph 1.3 of the IFRS for SMEs, an entity has public accountability if:

(a) *its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or*

(b) *it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions,* *insurance companies, securities, brokers/dealers, mutual funds and investment banks.*

23 *Paragraph 1.4 of the IFRS for SMEs specifies that some entities may also hold assets in a fiduciary capacity for a broad group of outsiders because they hold and manage financial resources entrusted to them by clients, customers or members not involved in the management of the entity. However, if they do so for reasons incidental to a primary business (as, for example, may be the case for travel or real estate agents, schools, charitable organisations, co-operative enterprises requiring a nominal membership deposit, and sellers that receive payment in advance of delivery of the goods or services such as utility companies), that does not make them publicly accountable.*

24 The question addressed in the Q&A considers whether the criterion 'broad group of outsiders' means that investment funds or similar entities that restrict their ownership to only a few participants are not publicly accountable according to paragraph 1.3(b) of the IFRS for SMEs.

25 The Q&A explains the intention of paragraph 1.3 and includes examples of entities that do not hold assets in a fiduciary capacity for a broad group of outsiders.

View of EFRAG:

- In the view of EFRAG, the Q&A could result in an incomplete interpretation of a 'broad group of outsiders'.

<u>Broad group</u>

26 In the view of EFRAG, the Q&A seems to interpret 'broad' in paragraph 1.3(b) of the IFRS for SMEs as 'many'. That is, an entity has public accountability if it holds assets in a fiduciary capacity for many outsiders. However, the Q&A does not quantify the use of the term, 'many'. However, it appears from the examples (paragraph 3 of the Q&A) that:

(a) three participants; or

(b) participants limited to a parent, its subsidiaries and a few associates/joint ventures

are not 'many'.

27 In the view of EFRAG, 'broad' is not the same as 'many' and we think that by providing the examples where the focus is on the number of participants, this will be the focus when interpreting the term. We acknowledge that Ex 9 of module one in the IFRS Foundation's training material for the IFRS for SMEs also focuses on the number of participants. However, we do not think that the Q&As should be based on the training material – but on the standard.

28 EFRAG thinks that, for example, available information about relations between the different participants should also be taken into account when interpreting the term 'broad'. For example, we think that, while a sizeable assembly of independent participants would constitute a broad group, a sizeable group of subsidiaries wholly owned by the same parent entity, would not.

29 As mentioned above, we think the Q&A should be written in a more principle-based manner, dealing with the term generally and not just in relation to

participants in an investment fund. In addition, the answer should state that all facts and circumstances should be taken into account when determining whether an entity is publicly accountable.

Outsider

30 An 'outsider' in paragraph 1.3(b) of the IFRS for SMEs seems in the Q&A to be interpreted as investors or other resource providers who are not involved in the management of the entity (paragraph 2 of the Q&A). In the view of EFRAG, this seems to be in accordance with paragraph 1.4 of the IFRS for SMEs from which 'outsiders' could be interpreted as being clients, customers or members not involved in the management of the entity and BC59 of the Basis for Conclusions.

31 The Q&A states that if a participant can demand reports tailored to meet its own information needs, this is evidence that the participant is not a genuine outsider. Although this could be considered an indicator of a participant's involvement in the management of an entity, EFRAG does not think it is a particularly useful indicator for this. In relatively many cases, EFRAG thinks that major investors could demand tailored reports without being involved in the management of an entity.

32 Following the interpretations above, the question included in the Q&A seems easily answered. The criterion in paragraph 1.3(b) refers to 'a broad group of outsiders' and therefore the fact that the question only refers to a few participants, results in the entity in question not meeting the criterion. EFRAG therefore does not understand the sentence in paragraph 2 of the Q&A stating: " [...] if an entity holds and manages financial resources for only a few investors then this, on its own, would not constitute a broad group". EFRAG does not see why 'on its own' is included in the sentence, as it does not think there are other factors to consider when determining what would constitute a 'broad group'.

Structure of the Q&A

33 Considering the target group of the IFRS for SMEs, EFRAG recommends that the response in the Q&A is structured as a response. For example, the response could be something like:

Yes, investment funds or similar entities that restrict their ownership to only a few participants are not publicly accountable under paragraph 1.3(b). To meet the criterion in paragraph 1.3(b) the entity must hold assets in a fiduciary capacity for a broad group of outsiders.

The standard does not specify the characteristics of 'a broad group'. Judgement needs to be applied.

For example, the entity should take available information about relations between the different participants into account. While a sizeable assembly of independent participants would constitute a broad group, a sizeable group of subsidiaries wholly owned by the same parent entity, would not.

'Outsiders' means participants not involved in the management. Therefore, a venture capital fund in which a majority of participants are directly involved in the fund's investment and management decisions, and only a few are genuine outsiders, does not hold assets in a fiduciary capacity for a broad group of outsiders. Judgement is needed to determine whether a party is involved in the management of an entity. If a participant can demand reports tailored to meet its own information needs, this indicates that the participant is involved in the management. On the other hand, if a participant can only obtain financial reports prescribed by law or regulation, this indicates that the participant is a genuine outsider. However, this indicator is not conclusive on its own and must be considered together with all other facts and circumstances when determining whether participants are outsiders.