

27 July 2007

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

Our ref: TR/IASB/27.07.07

Your ref:

Dear Sirs

Response to request for comments on the proposed IFRS for SMEs

Following the recent issue of the draft 'IFRS for Small and Medium-sized entities' we are writing to provide our comments on the draft Standard as requested.

As an initial observation, we are very pleased to note the extent of the simplification of the proposed Standard from full IFRS. We are also pleased to note the efforts made to write the proposed Standard in plain English. This will undoubtedly make the proposed Standard much more accessible to the average financial controller – and indeed to the average auditor – than full IFRS, which in some cases, such as IAS 39, are extremely complex and difficult to get to grips with.

However, we would observe that the title of the proposed Standard is misleading. To title the Standard 'IFRS for SMEs' when it applies, in fact, not to small and medium-sized entities but rather to those entities which are not publicly accountable, is not only confusing but totally inaccurate. It will be necessary for someone – whether the IASB, or the Government of each country applying the proposed Standard – to set out clearly the scope of the proposed Standard and to what type of entities it will apply.

It will also be necessary to define clearly public accountability (and therefore the requirement to adopt full IFRS). The definition in the proposed Standard would catch some entities which are publicly traded but which are not at present required to adopt IFRS (those traded on Plus, formerly OFEX). Whilst this may have logic to it, we are concerned that the definition of 'public accountability' would also encompass many charities and pension schemes and the requirement to adopt full IFRS would place an intolerable burden on such entities. Surely this is not the intention!

Invitation to comment

We have set out below our views on the questions on which the IASB has specifically requested commentary. We have also set out some other comments on the proposed IFRS at the end of this letter.

Stand-alone document

Overall, we believe that the approach taken by the IASB to making the proposed Standard as self contained as possible is the correct one. Given that the Standard is a significant simplification from full IFRS, reference to full IFRS is inevitable in some circumstances.

There are a number of points where guidance from full IFRS could helpfully be incorporated in the proposed Standard, in a simplified form. We would suggest that the following need to be incorporated:

- The requirements for investment property held under the revaluation model;
- The requirement for other fixed assets held under the revaluation model;
- The requirements for accounting for changes in accounting estimates;
- The criteria for capitalisation of development costs as an intangible asset.

We do not believe that inclusion of the above requirements would significantly increase the length or complexity of the proposed Standard and would enhance its status as a stand-alone document.

Recognition and measurement simplifications

Overall, we believe that the Standard is suitable for medium-sized and large private entities, but we have concerns over its suitability for very small entities, for instance those that have historically adopted the FRSSE, as the additional burden on such companies will be much greater than on medium-size or larger companies who have previously used 'full UK GAAP'. We would recommend that certain further simplifications are written in to the Standard for small companies only. As these potential simplifications were considered by the IASB and not then adopted, we have discussed these points in detail in the next section of this letter.

The alternative would be to produce a true 'IFRSSE' aimed at the type of companies which, where registered in the UK, have historically applied the FRSSE in their accounts.

Further, we disagree with one of the simplifications made in the proposed Standard, namely the proposal that in consolidated financial statements companies should be able to account for interests in associates and joint ventures at cost, or at fair value. This appears inconsistent with the requirement of the group accounts to show a true and fair view (or to present fairly) the results and state of affairs of the group. It is also a significant change from both full IFRS and UK GAAP. We would recommend that in consolidated financial statements the requirement should be to equity account for associates and joint ventures with proportional consolidation permitted for the latter.

Whilst acknowledging that it reduces the burden on companies, we are also surprised that the requirement to test goodwill annually for impairment has been removed, given that amortisation would no longer be permitted. The risk is that companies will not identify clearly situations in which impairment reviews should be performed as a result of circumstances.

Recognition and measurement simplifications that the Board did not adopt

We would recommend that the Board reconsider the adoption of a number of the proposed simplifications that were not included in the current draft Standard, as follows.

Cash flow statements. We believe that the Board should consider including in the Standard an exemption for small companies from preparing a cash flow statement. This has long been available to small companies under the current UK accounting framework. To incorporate this exemption into the proposed Standard would help mitigate the time and costs which small companies will incur in the process of transition to the new framework.

Exemption from consolidation. In the same vein, we would recommend that small groups are exempt from the requirement to prepare consolidated accounts. Again, this would reduce the burden on the smaller company. Many small companies do not have the in house expertise to prepare consolidated financial statements and will request help from their professional advisers- which has cost implications as well as ethical implications where the firm is engaged as the company's auditor.

Equity-settled share-based payment arrangements. We would recommend that small companies are permitted to take a disclosure-only approach to equity-settled share-based payment arrangements as permitted by the current version of the FRSSE. Although the proposed Standard permits use of the intrinsic value method where the fair value of the equity instruments granted cannot be reliably measured, there is still a cost burden for the smaller company in calculating the value of its shares before any option valuation – even one using the intrinsic value method – can be performed.

We have commented in a separate section on the need for clarification on the use of the intrinsic value method.

In respect of the remainder of the potential simplifications which have not been adopted, we believe that the IASB has taken the correct approach.

Availability of all accounting policy options in full IFRS

We do not have any comments on the accounting policy options available and the options given in the proposed IFRS appear sensible. We would agree that the accounting policy options available under full IFRS should also be available to SMEs.

Capitalisation of borrowing costs

We agree with the proposal to allow SMEs to choose either the expense model or the capitalisation model to account for their borrowing costs because this retains the element of choice set out in IAS 23 – and indeed in UK GAAP. It therefore presents fewer transitional issues for companies on adoption of the proposed Standard.

Topics not addressed in the proposed IFRS

We do not believe that any additional topics require omission from the proposed IFRS and replacement by a cross-reference to full IFRS.

General referral to full IFRS

As noted in the invitation to comment, paragraphs 10.2 to 10.4 of the proposed Standard do not mandate general referral to full IFRS if an issue is not covered in the proposed Standard. Rather, referral is made to full IFRS for certain circumstances; in other circumstances it is down to management to determine an appropriate accounting policy, with referral to IFRS being noted as an option.

It is interesting to note that referral to recent pronouncements of other accounting bodies is also permitted. Given that if the proposed Standard is adopted in the UK, UK GAAP will effectively disappear, UK companies will probably have no realistic choice but to look to full IFRS or to formulate their own accounting policies. The temptation will potentially be to default back to 'old' UK GAAP rather than full IFRS.

Although not mandating reference to full IFRS increases choice for management in formulating accounting policies, it will potentially lead to inconsistencies in treatment. It would be more logical to mandate reference to full IFRS, unless a particular situation is outside the scope of current IFRS (for instance group reconstructions involving entities under common control). On this point we are in agreement with the dissenting view in paragraph AV4 that there is a risk that non-comparability will result. (We would stress however that we do not agree with the dissenting view generally and that we do believe that the proposed Standard is necessary rather than mandating that all companies should adopt full IFRS).

We have made a number of suggestions elsewhere in this letter of some requirements of full IFRS that could usefully be incorporated in the proposed Standard to enhance its usefulness as a standalone document.

Adequacy of guidance

We believe that the implementation guidance incorporated into the proposed Standard, namely a disclosure checklist and an illustrative set of financial statements, is very helpful.

Although there are no specific areas or topics where we believe fuller application guidance is necessary, it is likely that entities will need to default to the application guidance in full IFRS

(or for that matter to the Standards themselves) in circumstances where the guidance in the proposed IFRS is too brief.

In short, although the IASB has probably gone as far as it can in ensuring that the proposed Standard is a 'standalone' document, there will undoubtedly be issues where reference needs to be made to full IFRS both to obtain guidance and to determining the correct accounting policy – in the same way that a company which has adopted the FRSSE in the UK needs to refer back to full UK GAAP when a particular accounting issue is not covered in the FRSSE.

Adequacy of disclosures

The level of disclosure prescribed in the draft Standard appears to be sensible and we have no further comments to make.

Transition guidance

We believe there may be scope for more guidance on the transition from local GAAP to the proposed Standard, for instance on GAAP differences encountered by a typical SME. However, this would need to be specific to each country which applies the proposed Standard.

The reconciliations required on first time adoption of the proposed Standard are essentially the same as those required under first time adoption of full IFRS. There will therefore be an additional cost to companies in calculating transitional adjustments, although this will be a one off.

Maintenance of the IFRS for SMEs

The proposed approach to maintaining the proposed IFRS appears to parallel that for maintaining the FRSSE and therefore appears sensible.

Commentary on specific points in the proposed IFRS

In addition to our responses above to the questions posed, there are a number of other matters on which we believe it is important to express our views. We very much hope that the IASB will take our comments on board for the final version of the Standard.

1. We note that all business combinations are to be accounted for using acquisition accounting, however, group reconstructions are outside the scope of the proposed Standard (as indeed they are from IFRS 3). We understand that, in effect, merger accounting will continue to be used for such combinations. We await further clarification from the IASB on accounting for such combinations for all companies.
2. We would note that the proposed Standard imposes an additional disclosure burden in respect of related party transactions as the exemption available in UK GAAP from disclosing intercompany transactions will disappear. We believe that a similar exemption should be included.

3. We believe clarification is needed of the treatment of equity-settled share-based payment transactions. The proposed Standard refers to IFRS 2 and calculating the fair value of equity instruments granted, but then goes on to state that IFRS 2 permits the use of the intrinsic value method when the fair value of equity instruments granted cannot be reliably measured. The implication in the proposed Standard – although it is not explicitly stated – is that private companies cannot measure fair value reliably and that the intrinsic value method should therefore be used.

This is a significant departure from the requirements of IFRS 2 which states in its application guidance that companies which are not publicly traded should still be able to calculate the fair value of equity instruments granted, except in rare cases, by looking at data from comparable listed companies. The obvious impact is that companies whose share options are issued whilst ‘underwater’ will again not trigger a p&l charge. This contradicts the aim of IFRS 2 which is to recognise the fact that when a share-based payment award is made, the company must have received something, whether goods or services, in return for making the award.

The proposed Standard therefore needs to make it clear whether all private companies can default to the intrinsic value method, or whether they first need to consider whether the fair value of options and similar arrangements can in fact be reliably measured.

4. We applaud the enormous simplification of the rules on the recognition and measurement of financial instruments, and on hedge accounting, which is very welcome as requiring SMEs to adopt the requirements of IAS 39 in full would have been a nightmarish scenario. We are also pleased to note that the disclosure requirements of IFRS 7 have not been incorporated in the proposed Standard.
5. Whilst noting that the proposal to permit expensing of research and development expenditure is a relaxation of the requirements of full IFRS to capitalise such costs if certain criteria are met, this brings the proposed Standard closer in line with UK GAAP and therefore removes one of the transitional issues that has caused difficulties in the past for companies that expensed their R&D costs.

In conclusion, our reaction to the proposed Standard is on the whole positive, but more work needs to be done before it can be a ‘blanket solution’ to the adoption of IFRS by all UK companies.

Should you have any questions on this letter, then please contact either Peter Holgate or Tessa Ratcliffe.

Yours faithfully,