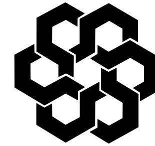

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**May 2008, London**
Project:	**IFRS for Small and Medium-sized Entities**
Subject:	**Redeliberation – Issues Relating to Sections 11 to 38 in the ED (Agenda Paper 9C)**

***Note to Observers*:**

Agenda Paper 9C includes preliminary staff recommendations for most, but not all, of the issues for ED sections 11-38. Staff are still forming their recommendations for the remaining sections. Further, some of the preliminary recommendations in this agenda paper are subject to change following discussion at the May 2008 Board meeting and further deliberation by the staff.

Staff is not asking the Board to discuss the issues in Agenda Paper 9C at the May 2008 Board meeting. Agenda Paper 9C is being provided purely for reference. Board Members may find it helpful to refer to some of the issues in ED sections 11-38 during their review of the issues in Agenda Papers 9A and 9B, because some of the issues interrelate. Agenda Paper 9C will be updated for the outstanding sections and any revised thinking regarding the issues in this paper before being finalised as an agenda paper for the June 2008 Board meeting.

1. For the May 2008 Board meeting, the SME agenda papers are organised as follows:

- **Agenda Paper 9** – Overview

- **Agenda Paper 9A** – General Issues
- **Agenda Paper 9B** – Issues Relating to ED Sections 1-10
- **Agenda Paper 9C** – Issues Relating to ED Sections 11-38
- **Agenda Paper 9D** – Recommendations of the Working Group

2. This agenda paper (Agenda Paper 9C) sets out issues relating to Sections 11-38 in the Exposure Draft (ED) of a proposed IFRS for SMEs. The issues are numbered sequentially by section number, so the first issue for Section 12 is Issue 12.1, and so on. Questions have the same number as their related issue and may also be labelled with a letter (A, B etc) if there is more than one question for a particular issue

Financial instrument issues (Section 11)

3. **TO BE DEVELOPED**.

Issue 12.1: Inventories – use most recent purchase prices (Section 12)

4. **Comment letters.** Allow SMEs to measure all of their inventory at the most recent purchase prices.

5. **Field tests.** No related comments.

6. **WG recommendation.** WG members did not support allowing SMEs to measure all of their inventory at the most recent purchase prices or most recent costs.

7. **Staff comment.** ED paragraph 12.15 already states:

> 12.15 An entity may use techniques such as the standard cost method or the retail method for measuring the cost of inventories 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.

8. **Staff recommendation.** Paragraph 12.15 is intended to explain to an SME that it may use a simplified technique for measuring the cost of inventories if the results approximate cost. The burden is on the SME to assess whether the technique approximates cost. Using the most recent purchase price is another kind of

simplification for approximating cost where prices are stable or turnover is rapid. Staff recommend that it be added to the two other methods already identified in 12.15, with the same qualifier as in 12.15 – if the results approximate cost.

Question 12.1

Does the Board agree with the staff recommendation that SMEs be permitted to measure all of their inventory at the most recent prices if the results approximate cost?

Issue 12.2: Inventories – allow LIFO (Section 12)

9. **Comment letters.** Allow LIFO as an inventory costing method.

10. **Field tests.** No related comments.

11. **WG recommendation.** WG members did not support allowing the LIFO method.

12. **Staff recommendation.** Some would allow an SME to use LIFO only if their jurisdiction allows it for tax purposes. Others would permit SMEs to use it more broadly. LIFO is prohibited under full IFRSs, a conclusion that the Board debated at length when revising IAS 2 *Inventories* in 2003. LIFO is used only in a few jurisdictions around the world, and usually its use is optional in those jurisdictions. The balance sheet distortion that results from LIFO is well recognised by accountants, but probably much less so by users of SME financial statements. Staff recommend that SMEs should not be permitted to use LIFO. Staff note that if prices are stable, LIFO may lead to a representative measure of cost (as would using recent prices). In Issue 12.1, staff propose an entity may use a yet more simplified technique than LIFO, such as using recent purchase prices, if the results approximate cost.

Question 12.2

Does the Board agree with the staff recommendation that SMEs should not be permitted to use LIFO even if it is permitted locally for tax purposes?

Issue 12.3: Simplify allocation of fixed and variable production overheads to inventories (Section 12)

13. **Comment letters.** Simplify the requirements for allocating production overheads to inventories in 12.7 and 12.8 – particularly the requirements in 12.8 for allocating fixed production overheads. Or do not require allocation of production overheads at all, that is, allow SMEs to use a direct costing model.

14. **Field tests.** Several field test entities had problems applying the full cost approach. Some field test entities feel it is administratively onerous to measure indirect production costs and they noted that their reporting systems cannot handle such costs. Other field test entities said it was difficult to determine how to allocate costs, for example allocation of transportation costs and costs not directly attributable to one product. Some field test entities said they agree with the concept in general, but, since application is difficult, more guidance is needed on how to determine which costs to include in inventories.

15. **WG recommendation.** Not discussed.

16. **Staff comment.** 12.4, 12.7, and 12.8 state:

    12.4 An entity shall include in the cost of inventories all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

    Costs of conversion

    12.7 The costs of conversion 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.

    Allocation of fixed production overheads

12.8 An entity shall allocate fixed production overheads to the costs of conversion 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.

17. **Staff recommendation.** Staff do not believe that either 12.7 or 12.8 is onerous for an SME. "Systematic allocation" is a principle, not a detailed rule. The fundamental issue is whether the principle in 12.4 is appropriate for SMEs, that is, whether the cost of inventories should include all costs of conversion including production overheads. The cost of an asset, in general, includes its purchase price and all other costs necessary to make it ready for use by the entity. Production overhead is an essential cost of producing inventory. Production overheads should be included in the cost of inventory. In all likelihood, an SME will already keep track of the full costs of inventory for pricing, income taxes, and other purposes, so allocation of production overhead will generally not add to administrative burden. A 'direct costing' approach, which includes only materials and labour cost, is not appropriate because neither the balance sheet nor the income statement is 'representationally faithful'.. Staff does not recommend any change to 12.4, 12.7, or 12.8.

Question 12.3

Does the Board agree with the staff recommendation that fixed and variable production overhead should be included in the cost of inventory and, therefore, that 12.4, 12.7, and 12.8 should not be changed.

Issue 12.4: Do not include non-production overheads in inventories (Section 12)

18. **Comment letters.** Do not require non-production overheads in inventories. ED 12.10 says "it may be appropriate" to include non-production overheads.

19. **Field tests.** No related comments.

20. **WG recommendation.** WG members generally felt that the language used in 12.10 ('it may be appropriate') regarding inclusion of non-production overheads in inventory cost should remain.

21. **Staff comment.** 12.4 and 12.10 state:

    12.4 An entity shall include in the cost of inventories all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

    12.10 An entity shall include other costs in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include, in the cost of inventories, non-production overheads or the costs of designing products for specific customers. 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.

22. **Staff recommendation.** Staff acknowledge that saying "it may be appropriate to include non-production overheads in the cost of inventories" in 12.10 is taken from IAS 2.15. Those who support keeping it in the IFRS for SMEs point out that it is an elaboration on the opening sentence of 12.10 – the principle being inclusion of all costs needed to bring the inventories to their present location and condition. Still, staff note that non-production overheads is a very broad but

undefined term, and saying 'it may be appropriate' is not helpful guidance for an SME. Staff recommend deletion of the second sentence of 12.10. The principle is set out clearly in the first sentence of 12.10.

Question 12.4

Does the Board agree with the staff recommendation to delete the second sentence of 12.10, but leave the first sentence plus the final sentence on borrowing costs?

Issue 12.5: Replace Section 12 with IAS 2 in full

23. **Comment letters.** Replace Section 12 with IAS 2 in full, as IAS 2 is short and easy to apply.

24. **Field tests.** No related comments.

25. **WG recommendation.** Not discussed.

26. **Staff comment:** Only the following paragraphs from IAS 2 are not in the IFRS for SMEs:

- IAS 2.8, which elaborates on what are inventories.
- IAS 2.17, which explains that IAS 23 allows inclusion of borrowing costs as part of inventory cost in limited circumstances. This was omitted because the default under the IFRS for SMEs is to charge borrowing cost to expense.
- Paragraphs IAS 2.26 and IAS 2.27, which are guidance on applying cost formulas.
- IAS 2.28 to IAS 2.33 on net realisable value. This issue is included in Section 26, which deals comprehensively with impairment of non-financial assets.

Otherwise, all of IAS 2 is included.

27. **Staff recommendation.** Staff recommend that Section 12 not be replaced by IAS 2 in full. However, staff will consider the paragraphs above individually when considering whether additional guidance is necessary in the final Standard. Staff has developed a list of all requests for additional guidance and is developing

recommendations about whether and how such guidance should be provided. Staff plans to bring recommendations about guidance to the Board at a future Board meeting.

Question 12.5

Does the Board agree with the staff recommendation that IAS 2 should not be used in place of Section 12?

Issue 13.1: Associates and jointly controlled entities – too many options (Sections 13 and 14)

28. **Comment letters.** The most frequent comment relating to these two sections is that the proposed IFRS for SMEs permits too many options in accounting for associates and jointly controlled entities. There were various proposals for reducing or changing the options now in Sections 13 and 14:

    a. Some respondents rejected the cost method for significant associates and joint ventures.

    b. Some respondents would not allow fair value through profit or loss.

    c. Some letters recommended that the IASB simplify the equity method and proportionate consolidation methods rather than adding the cost and fair value methods as options.

    d. Some would have the equity method as the default with the cost method the alternative if information is not available to apply the equity method.

    e. Some would allow separate policy choice for non-publicly traded investments.

    f. Some letters recommended that the IASB establish a hierarchy for when each method should be used.

    g. Some letters recommended dropping the concepts of investments in associates and joint venture entirely from the IFRS for SMEs – presumably requiring that such investments be treated as financial instruments under Section 11 *Financial Assets and Financial Liabilities*.

29. **Field tests.** Several field test entities have associates. The most popular method chosen by the field test entities was the cost method, with a few field test entities

applying the equity method. Very few field test entities have jointly controlled entities, and those that do are generally part of large groups. Regarding both associates and jointly controlled entities, some field test entities acknowledge that the cost method was simpler, but in their view the equity method often provides better information. A few field test entities see the relevance of the fair value method, but several others do not find it relevant for SMEs. A few entities agree with allowing different options, but feel all options should be fully explained in the IFRS for SMEs rather than cross-referenced to IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*.

30. **WG recommendation.** WG members had mixed views on the appropriate method(s) of accounting for associates and jointly controlled entities and, hence, the consensus was that the range of methods proposed in the ED should be retained to cater for such views. Because the ED explains the equity method and proportionate consolidated by cross-reference, elimination of all cross-references will require explanation of these two methods in the IFRS for SMEs. WG members favoured adding a description of the cost method to the IFRS for SMEs because this is likely to be the predominantly used method. WG members would not impose a hierarchy. Nor would they treat all investments in associates and joint ventures as financial instruments under Section 11.

31. **Staff comment:** Items (a) through (g) in paragraph 28 above all relate to the method(s) of accounting for associates and jointly controlled entities that respondents think should be available to SMEs. Under the ED, cost, equity method, and fair value through profit or loss are all options for associates. Those three plus proportionate consolidation are all options for jointly controlled entities. An SME would be required to adopt a single method for all associates and a single method for all jointly controlled entities.

32. The SME ED was developed before ED 9 on joint ventures, and commentators may not have taken ED 9 into account. ED 9 adopts a ‘substance over form approach’ and would, among other things, recognise an interest in a joint venture (that is, an interest in a share of the outcome generated by the activities of a group of assets and liabilities subject to joint control) using the equity method. Proportionate consolidation would not be permitted.

33. **Staff recommendation.** Staff recommend retaining the cost method as it is expected most SMEs will use this method and it is an appropriate simplification, without significant loss of information for users. Some SMEs may want to choose the equity or proportionate consolidation methods, particularly if they are currently using similar methods under their local GAAP. Staff note that currently both the equity and proportionate consolidation methods are undergoing discussion at full IFRSs level. Staff believe it is premature to start prohibiting any of those methods, requiring some SMEs to change their accounting on adoption of the IFRS for SMEs for the first time and then potentially again at the first update to the IFRS for SMEs. Any changes should first be made with respect to full IFRSs and then considered in an SME context at a future update.

Question 13.1

Does the Board agree with the staff recommendation not to restrict the use of any of the methods for accounting for investments in associates and jointly controlled entities?

Issue 13.2: Associates and jointly controlled entities – allow greater time lag between year ends (Sections 13 and 14)

34. **Comment letters.** Allow SMEs a greater time lag for associate's financial information when applying the equity method as sometimes it is difficult to obtain timely information. For example, allow information to be for the year ending six months (or even a year) before the investor's reporting date.

35. **Field tests.** No related comments.

36. **WG recommendation.** Not discussed.

37. **Staff comment.** Currently under IAS 28 (since the equity method is applied by cross-reference), when financial statements of an associate used in applying the equity method are prepared as of a reporting date that is different from that of the investor, the difference must be no greater than three months.

38. **Staff recommendation.** Staff do not believe that the three-month requirement is a hardship for SMEs since the equity method is optional. SMEs could choose the cost method if it is considered that there will be difficulties obtaining the

necessary information to apply the equity method on a timely basis. Staff recommend no change to the ED.

<u>Question 13.2</u>

Does the Board agree with the staff recommendation to keep the maximum three month differential (in IAS 28) for SMEs using the equity method?

Issue 15.1: Investment property – fair value changes through equity (Section 15)

39. **Comment letters.** Allow fair value model, but changes in fair value should go to equity. Some letters stated the proposal differently: The IFRS for SMEs should allow the IAS 16 *Property, Plant and Equipment* revaluation model for investment property.

40. **Field tests.** No related comments.

41. **WG recommendation.** There was no support amongst WG members for a fair value through equity model.

42. **Staff recommendation.** Those who supported fair value through equity expressed some concern about the volatility of profit or loss if fair value changes are recognised in profit or loss. Staff note, however, that the cost-depreciation-amortisation model is already an option proposed in the ED, and entities using that model could disclose fair values of investment properties in the notes. Staff do not recommend adding a fair value through equity option for SMEs.

<u>Question 15.1</u>

Do Board members agree with the staff recommendation that SMEs should not have an option to recognise changes in fair value of investment property directly in equity?

Issue 15.2: Investment property – do not allow fair value model (Section 15)

43. **Comment letters.** Do not allow the option to use the fair value model for reasons of complexity and lack of comparability.

44. **Field tests.** Of those field test entities with investment properties, nearly all used the cost method. Some field test entities commented that they did not use fair

value for cost-benefit reasons, and some noted that the fair value model is only useful if observable market prices exist.

45. **WG recommendation.** Members of the WG supported keeping both accounting policy options as proposed in the ED. Because the ED allows the fair value through profit or loss model by cross-reference, if cross-references are eliminated then this will mean that an explanation of that model must be included in the IFRS for SMEs.

46. **Staff recommendation.** Those who favour allowing a fair value model point out that in many jurisdictions reliable measures of the fair values of investment property are available, and even small investment property entities manage their investments on a fair value basis. Moreover, fair values are often used as the basis for financing investment properties. Proponents of requiring only a cost model say that this is still a simpler option over obtaining annual fair values. Also, allowing only one option would enhance comparability (though the comparability might be illusory because dates of property acquisition differ from entity to entity and property to property). Further, disclosures of fair values can be given in the notes. In Issue G2 of Agenda Paper 9A staff provided their detailed reasoning for removing the complex options where possible. Consistent with that view, staff recommends that the IFRS for SMEs require the cost-depreciation-impairment model and not allow the fair value through profit or loss model as an accounting policy option. An SME using the cost-depreciation-impairment model could disclose information about fair values and changes in fair values in the notes.

<u>Question 15.2</u>

Do Board members agree with the staff recommendation that the IFRS for SMEs should require the cost-depreciation-impairment model and not include an option to choose the fair value through profit-or-loss model for investment property?

Issue 15.3: Investment property – property held under an operating lease (Section 15)

47. **Comment letters.** Remove the option in ED paragraph 15.2 to classify property held under an operating lease as investment property.

48. **Field tests.** Classifying leasehold property as investment property causes problems.

49. **WG recommendation.** WG members supported retaining the option to classify property held under an operating lease as investment property.

50. **Staff comment.** This is an issue only if SMEs are allowed an accounting policy option to use the fair-value-through-profit-or-loss model for their investment property. If only the cost-depreciation-impairment model is used, all investment property would be accounted for as property, plant and equipment under Section 16 *Property, Plant and Equipment*. If the Board agrees with the staff's recommendation not to allow the fair value option in the IFRS for SMEs, then there would be little practical need to retain the option for an SME to classify property held under an operating lease as investment property. Instead, any up-front payment made under such a lease would be accounted for as a prepayment.

51. **Staff recommendation.** If the Board agrees with the staff recommendation on Issue 15.2, staff recommend deletion of ED paragraph 15.2.

Question 15.3

Assuming the Board agrees with the staff recommendation in Issue 15.2, does the Board agree with the staff recommendation to delete ED paragraph 15.2?

Issue 15.4: Separating mixed-use property

52. **Comment letters.** No related comments. This was an additional issue noted from field testing.

53. **Field tests.** Separating mixed use property between investment property and property plant and equipment is not justified based on cost benefits in certain cases. If an item of property is used both as investment property and operating property, treat it entirely as one or the other depending on its dominant use. Do not require separation of the two components.

54. **WG recommendation.** Not discussed.

55. **Staff comment.** This is an issue only if SMEs are allowed an accounting policy option to use the fair-value-through-profit-or-loss model for their investment

property. (If only the cost-depreciation-impairment model is used, all investment property would be accounted for as property, plant and equipment under Section 16 *Property, Plant and Equipment*, and separation would not be an issue.) In Issue 15.2 staff recommends that the IFRS for SMEs not include such an option.

56. **Staff recommendation.** For an SME that feels the separation is burdensome, it can choose to account for the entire property as property, plant and equipment under ED Section 16, without having to split out the investment property component. The cost-depreciation-impairment model would then have to be its accounting policy for all investment property, not just mixed-use property. Staff recommend no change to the ED.

<u>Question 15.4</u>

Does the Board agree with the staff recommendation that if an SME applies the fair value model for investment property, it should be required to separate mixed use property between investment property and property plant and equipment as proposed in the ED?

Issue 16.1: Property, plant and equipment – do not require component depreciation (Section 16)

57. **Comment letters.** Do not require component depreciation for SMEs, or make clear that it is optional.

58. **Field tests.** Component depreciation is not relevant and would cause problems if applied strictly.

59. **WG recommendation.** WG members were of mixed views. A majority would retain the component depreciation requirement, as they feel it provides good information and is not unduly burdensome. There was a minority view that felt for cost-benefit reasons this is an area that should be simplified.

60. **Staff comment:** ED 16.14 states:

> 16.14 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. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated.

61. **Staff recommendation.** Staff recommend retaining the principle in 16.14 but rewriting 16.14 to make application easier for an SME by addressing the normal case first, as follows:

16.14 If all of the significant parts of an item of property, plant and equipment have the same useful life and rate of depreciation, the entity shall recognise and measure the depreciation charge for the asset as a whole. If, however, significant parts of the asset have significantly different useful lives or rates of depreciation and the entity intends to replace the shorter-lived part(s) while continuing to use the remainder of the asset, the entity shall allocate the initial cost of an item of property, plant and equipment to its significant parts and depreciate each part separately. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated.

Question 16.1

Does the Board agree with the staff recommendation for a rewrite of 16.14?

Issue 16.2: Property, plant and equipment – do not require annual review of residual value, useful life, and depreciation method

62. **Comment letters.** Do not require annual review of residual value, useful life, and depreciation method (16.17 and 16.21), or reassess only if there is a clear indication of change.

63. **Field tests.** A high proportion of the field test entities encountered problems with the requirement to perform an annual review of residual values of assets. In addition, several field test entities stated they had deemed all assets to have no

residual value, but did not give their reasoning. Several field test entities noted that the annual review of useful lives and depreciation methods causes undue cost compared to benefits. Some field test entities suggested reviews of residual values/ useful lives should take place at longer periods of time or only if conditions arise that would require such reviews to be performed. Some of the more significant issues noted by field test entities relating to why they were unable to determine residual values, or why they believe annual remeasurement causes undue costs compared to benefits, include:

a. Residual value can be hard to estimate and it's questionable whether this has benefits in the financial statements of small entities.

b. Active markets do not exist for certain assets / in certain jurisdictions.

c. Residual value is not relevant to a long term point of view.

d. Local tax law presumes zero residual value for tax depreciation purposes.

64. **WG recommendation.** While some WG members found this requirement to be burdensome for an SME, the majority view was not to make any change to the proposal as SMEs would normally be monitoring this type of information as part of good business practice.

65. **Staff recommendation.** Staff note that the annual review of the residual value seemed to be viewed as a bigger burden than the annual review of the useful life or depreciation method. The ED does not prohibit estimating a zero residual value if, in fact, the entity expects the asset to be worthless to the entity at the end of its useful life. However, different SMEs might have different policies for maintaining and/or disposing of identical assets. One SME might do no maintenance on its vehicles because it keeps them only two years before disposal, while another SME owning the same vehicles may choose to do maintenance and dispose of the asset after a much longer period of benefit. Therefore, entity-specific estimates of useful life and residual value are essential – with the understanding that, based on some entities' circumstances, residual value could be zero. Because entities' policies for maintenance and/or disposal can change, staff do not support making estimates on the date an asset is acquired and then ignoring those possible changes thereafter. At the same time, the IFRS for SMEs should be clear that the requirement to review the residual value, useful life and depreciation

method does not require the engagement of a valuer or even a complex recalculation at each reporting date. Rather, staff believe it appropriate to reassess those factors only if there is a clear indication of change. Staff recommend that this be clarified in the IFRS for SMEs with guidance to ensure the requirement is understood and applied correctly.

Question 16.2

Does the Board agree with the staff recommendation that an SME should reassess residual value, useful life and depreciation method for an asset only if there is a clear indication of change since the last reporting date – and that ED paragraph 16.17 be clarified accordingly?

Issue 16.3: Revaluation of property, plant and equipment (Section 16)

66. **Comment letters.** Do not allow SMEs to revalue PP&E, that is, remove this option. (also covered in accounting policy discussion – see Issue G2 in Agenda Paper 9A).

67. **Field tests.** Very few field test entities used the revaluation model for property, plant and equipment. Of those that did, most used it for property and did not give specific reasons for their choice. They noted that it was problematic to need to refer to IAS 16 *Property, Plant and Equipment* in order to use this method. Several field test entities feel the revaluation option should be removed.

68. **WG recommendation.** WG members would retain this option and other accounting policy options from full IFRSs.

69. **Staff recommendation.** Staff believe that few SMEs will choose this option and notes that the ED would permit disclosure of fair values of PP&E, and changes in those fair values, if an SME chooses to provide these. Staff recommend that this option be removed from the IFRS for SMEs for PP&E (and also for intangible assets – see Issue 17.4). In Issue G2 of Agenda Paper 9A staff provided their detailed reasoning for removing the complex options where possible. SMEs wishing to follow a revaluation model can always choose to adopt full IFRSs.

Question 16.3

Does the Board agree with the staff recommendation not to allow SMEs to use the revaluation model for their property, plant and equipment?

Issue 16.4: Separation of land and buildings (Section 16)

70. **Comment letters.** Add undue cost exemption for separation of land and buildings. This issue also was raised in connection with Section 19 *Leases* and Section 15 *Investment Property*.

71. **Field tests.** No related comments.

72. **WG recommendation.** Not discussed.

73. **Staff recommendation.** Those who support this proposal say separation may require a costly valuation. Staff believe that an SME that acquires an item of land and building together for a single purchase price will be able to estimate the relative values of the two components. In most jurisdictions the relative values are estimated by tax assessors. Since land is not a depreciable asset, separation would normally be required to compute depreciation for income tax purposes, as well as for product costing purposes. In Issue 38.1, staff recommend adding all of the first time adoption exemptions available in full IFRSs (IFRS 1), and this includes a 'deemed cost' exemption. That exemption could be used to provide relief for any previous purchases of land and buildings. Staff recommend no change to the ED.

Question 16.4

Does the Board agree with the staff recommendation not to add an 'undue cost or effort' exemption for the requirement to separate the land and building components when land and building are acquired in a single purchase transaction under Sections 15, 16, and 19 of the ED?

Issue 16.5: Capitalisation of maintenance costs (Section 16)

74. **Comment letters.** No related comments. This was an additional issue noted from field testing.

75. **Field tests.** There is room for interpretation as to what the term 'incremental future benefits' in ED paragraph 16.3 actually means and further guidance is needed. A few field test entities disagreed that costs associated with a maintenance visit should be capitalised, as they did not think incremental benefits are generated.

76. **WG recommendation.** Not discussed.

77. **Staff recommendation.** Staff believe that this matter should be addressed by additional guidance rather than by changing ED paragraph 16.3.

Question 16.5

Does the Board agree with the staff recommendation that the principle in 16.3 (capitalise maintenance cost when there is incremental future benefit) be retained, but additional guidance should be provided?

Issue 17.1: Intangible assets other than goodwill – no 'indefinite life' and, hence, amortise all intangibles (Section 17)

78. **Comment letters.** SMEs should not be required to distinguish between intangible assets with finite and indefinite useful lives. All intangible assets including goodwill should be amortised over the period of benefit subject to a maximum period.

79. **Field tests.** The removal of amortisation for indefinite life intangibles causes problems as it would generally be very subjective or even impossible to carry out an impairment review.

80. **WG recommendation.** WG members unanimously supported requiring amortisation of all intangibles, subject to an impairment test. This would remove the need to distinguish between intangible assets with finite and indefinite useful lives.

81. **Staff recommendation.** Staff recommend that all intangible assets of SMEs be presumed to have a finite life and, therefore, should be amortised over their estimated useful lives. Staff make this recommendation in Section 17 for

intangibles other than goodwill and makes a similar recommendation in Section 18 for goodwill.

82. Staff make this recommendation for several reasons. Firstly, SMEs are not likely to have intangibles other than goodwill with indefinite lives. Secondly, the amortisation approach would still require impairment testing, which staff recommend should continue to be based on an indicator approach as proposed in the ED. Staff support amortisation as an appropriate simplification for SMEs as it reduces the likelihood of impairment testing over time. Staff believe that impairment testing is a burden for SMEs. Staff's recommendation for amortisation – particularly if coupled with a relative short maximum amortisation period when useful life cannot be assessed – would reduce the circumstances in which an impairment test would be triggered.

<u>Question 17.1</u>

Does the Board agree with the staff recommendation that all intangible assets of SMEs be presumed to have a finite life and, therefore, should be amortised over their estimated useful lives?

Issue 17.2: Capitalisation of internally generated intangible assets (Section 17)

83. **Comment letters.** Some comment letters said capitalisation of internally generated intangible assets should not be allowed. Others said the capitalisation model should be required.

84. **Field tests.** A few field test entities chose the capitalisation model for development costs. One of the main reasons for doing so was that it is considered to give a fairer presentation of the success of their investment in product development. Several field test entities noted that currently their systems do not allow them to determine the cost of internally generated intangible assets. Some of the entities applying or considering applying the capitalisation model stated that clearer guidance is necessary to help distinguish between research and developments costs. They also said the need to make reference to IAS 38 *Intangible Assets* in order to use the capitalisation model is problematic.

85. **WG recommendation.** WG members supported the proposal to give SMEs the option (which is not in full IFRSs) to expense all development costs for simplicity.

86. **Staff recommendation.** Staff believe that the capitalisation model should not be included in the IFRS for SMEs either as the required treatment or as an accounting policy option. It should not be required for reasons explained in BC81 and BC82: – many SMEs do not have resources to assess commercial viability on an ongoing basis, and users of SME financial statements do not generally rely on the capitalised amount in their decisions. Nor should it be an accounting policy option. The capitalised amount provides little if any information about future cash flows – a key concern to users of SME financial statements. Moreover, in Issue G2 of Agenda Paper 9A staff provided their detailed reasoning for removing the complex options where possible. ED paragraph 17.34 requires disclosure of the aggregate amount of P&D expenditure during the period. SMEs could provide additional information in the notes.

Question 17.2

Does the Board agree with the staff recommendation that the IFRS for SMEs should not include the accounting policy option to capitalise that portion of development costs that is incurred after commercial viability has been assessed?

Issue 17.3: Intangible assets – annual review of amortisation period and method (Section 17)

87. **Comment letters.** Do not require an annual review of amortisation period and amortisation method (ED paragraph 17.28), or reassess only if there is a clear indication of change.

88. **Field tests.** Annual review of useful lives and depreciation methods causes undue cost compared to benefits. It was suggested that such a review should be required at longer periods of time or when conditions arise that would require it to be performed.

89. **WG recommendation.** WG members favoured retaining the requirement as proposed in the ED.

90. **Staff recommendation.** Staff propose rewriting this requirement in a manner similar to that proposed for PP&E (see Issue 16.2) to clarify it is only appropriate to reassess amortisation period and amortisation method if there is a clear indication of change.

Question 17.3

Does the Board agree with the staff recommendation that an SME should reassess useful life and residual value only if there is a clear indication of change since the last reporting date – and that 17.28 be clarified accordingly?

Issue 17.4: Prohibit revaluation of all intangibles (Section 17)

91. **Comment letters.** Do not allow SMEs to revalue any intangibles, that is, remove the option (also covered in accounting policy discussion – see Issue G2 in Agenda Paper 9A).

92. **Field tests.** None of the field test entities appeared to use the revaluation model for intangibles, although a few of them said they would consider using it but that it would be problematic to need to refer to IAS 38 in order to do so. Several field test entities stated that a revaluation option for intangibles is unnecessary.

93. **WG recommendation.** WG members would retain this option and other accounting policy options from full IFRSs.

94. **Staff recommendation.** Staff believe that few SMEs will have intangible assets eligible for revaluation and, of those SMEs that do, few will choose the revaluation option. Further the ED would permit disclosure of fair values of intangible assets, and changes in those fair values, if an SME chooses to provide these. Staff recommend that the revaluation option be removed from the IFRS for SMEs for intangible assets (and also for PP&E – see Issue 16.3). In Issue G2 of Agenda Paper 9A staff provided their detailed reasoning for removing the complex options where possible. SMEs wishing to follow a revaluation model can always choose to adopt full IFRSs.

<u>Question 17.4</u>

Does the Board agree with the staff recommendation not to allow SMEs to use the revaluation model for their intangible assets?

Issue 18.1: Amortisation of goodwill (Section 18)

95. **Comment letters.** Permit or require amortisation of goodwill (and other indefinite life intangibles) over a limited number of years. Respondents generally acknowledged that there still would be a need to consider impairment. However, they pointed out that, over time, amortisation would lessen the need for an impairment write-down. (The proposal to amortise all intangible assets is dealt with in Issue 17.1).

96. **Field tests.** The removal of amortisation for goodwill would cause problems as it would generally be very subjective or even impossible to carry out an impairment review. It is also difficult to identify impairment indicators.

97. **WG recommendation.** WG members unanimously supported requiring amortisation of goodwill over its estimated useful life, subject to an impairment test using the indicator approach proposed in the ED. Many WG members would impose a maximum life of not more than ten years, with some favouring five years. Most WG members acknowledged that the impairment indicator approach proposed in the ED is consistent with the view that there is generally no foreseeable period over which an entity expects to consume the economic benefits embodied in goodwill, and they also acknowledge that the amortisation approach still requires impairment testing. However, many WG members supported amortisation as an appropriate simplification for SMEs as it reduces the likelihood of impairment testing over time. WG members also noted that amortisation can be justified on the basis that purchased goodwill is eventually replaced over time with internally generated goodwill that is not separately recognized. WG members were concerned that impairment testing is a burden for SMEs and therefore want to see the circumstances in which it can be triggered substantially reduced. An annual impairment calculation for goodwill was rejected as too onerous for SMEs.

98. **Staff comment:** Allowing or requiring amortisation of goodwill and other indefinite-life intangibles was proposed in many of the comment letters and by some of the field test participants. Here is the Board's reasoning (from Basis for Conclusions) for not having an amortisation approach:

Goodwill impairment

BC79 In their responses to the recognition and measurement questionnaire and at the round-table meetings, many preparers and auditors of SMEs' financial statements said that the requirement in IFRS 3 Business Combinations for an annual calculation of the recoverable amount of goodwill is onerous for SMEs because of the expertise and cost involved. They proposed, as an alternative, that SMEs should be required to calculate the recoverable amount of goodwill only if impairment is indicated. They proposed, further, that the IFRS for SMEs should include a list of indicators of impairment of goodwill as guidance for SMEs. The Board agreed with those proposals. The draft IFRS for SMEs proposes an indicator approach and includes a list of indicators based on both internal and external sources of information.

BC80 Some respondents to the questionnaire and some of those who took part in the round-table discussions proposed requiring amortisation of goodwill over a specified maximum period. Proposals generally ranged from 10 to 20 years. They argued that amortisation is simpler than an impairment approach, even an impairment approach that is triggered by indicators. The Board did not agree with this proposal for three main reasons:

(a) An amortisation approach still requires assessment of impairment, so it is actually a more complex approach than an indicator-triggered assessment of impairment.

(b) Amortisation is the systematic allocation of the cost (or revalued amount) of an asset, less any residual value, to reflect the consumption over time of the future economic benefits embodied in that asset over its useful life. By its nature, goodwill often has an indefinite life. Thus, if there is no foreseeable limit on the period during which an entity expects to consume the future economic benefits embodied in an asset, amortisation of that

asset over, for example, an arbitrarily determined maximum period would not faithfully represent economic reality.

(c) When the IASB was developing IFRS 3, and related amendments to IAS 38 Intangible Assets, most users of financial statements said they found little, if any, information content in the amortisation of goodwill over an arbitrary period of years.

99. **Staff recommendation.** Based on the reasons explained in Issue 17.1 and provided by WG members in paragraph 97, staff recommend that goodwill (and all other intangible assets) of SMEs be presumed to have a finite life and, therefore, should be amortised over their estimated useful lives. Staff's recommendation for amortisation – particularly if coupled with a relative short maximum amortisation period when useful life cannot be assessed – would reduce the circumstances in which an impairment test would be triggered. Also, from a practical standpoint many smaller entities would find it difficult to assess impairment as accurately and on such a timely basis as larger entities, meaning the information could be less reliable. Although users of financial statements said they found little, if any, information content in the amortisation of goodwill over an arbitrary period of years, users of SME financial statements also said they found little, if any, information content in goodwill at all; for example, lenders will not lend against goodwill as an asset.

Question 18.1

Does the Board agree with the staff recommendation that goodwill (and all other intangible assets) of SMEs be presumed to have a finite life and, therefore, should be amortised over their estimated useful lives?

Issue 18.2: Business combinations – separation of intangibles and allocation of cost (Section 18)

100. **Comment letters.** Simplify allocation of cost. In particular do not require separation of all or certain intangibles (such as those with no quoted market price, those that are not legal rights, and/or those that were not recognised by the acquiree).

101. **Field tests.** It was difficult to identify intangible assets in a business combination. It was noted that unless specific intangibles are given as examples within IFRS for SMEs, entities are unlikely to look for such assets.

102. **WG recommendation.** WG members would continue to require separation of intangibles as proposed in ED paragraphs 17.6 and 18.14(c).

103. **Staff recommendation.** ED paragraph 18.14(c) requires separation of intangible assets acquired in a business combination only if their fair value can be measured reliably. Staff believe such intangible assets will normally be estimated as part of the negotiating process and, hence, identification would likely have been part of the negotiation for the business combination. Staff believe that this is not unduly burdensome for an SME if coupled with a 'without undue cost or effort' condition for the fair value measurement requirement (with guidance to ensure such a condition is used appropriately). In particular, SMEs are not likely to enter into many business combinations so this is effectively a 'one-off' requirement. Apart from the addition of an 'undue cost or effort exemption', staff does not propose any changes to the ED.

Question 18.2

Does the Board agree with the staff recommendation that intangibles acquired by an SME in a business combination should be separately recognised if their fair value can be measured reliably without undue cost or effort?

Issue 18.3: Business combinations – recognition of contingent liabilities (Section 18)

104. **Comment letters.** Do not require recognition of contingent liabilities.

105. **Field tests.** No related comments.

106. **WG recommendation.** WG members supported the proposal in the ED to require recognition of contingent liabilities acquired in a business combination.

107. **Staff recommendation.** ED paragraph 18.14(c) requires separation of contingent liabilities assumed in a business combination only if their fair value can be measured reliably. Staff believe such a contingent liability will normally be estimated as part of the negotiating process and, hence, identification would likely

have been considered by the parties to the business combination. Staff believe that this is not unduly burdensome for an SME if coupled with a 'without undue cost or effort' condition to the fair value measurement requirement. In particular, SMEs are not likely to enter into many business combinations so this is effectively a 'one-off' requirement. Apart from the addition of an 'undue cost or effort exemption', staff does not propose any changes to the ED.

Question 18.3
Does the Board agree with the staff recommendation that contingent liabilities assumed by an SME in a business combination should be separately recognised if their fair value can be measured reliably without undue cost or effort?

Issue 18.4: Business combinations – adjustments of fair value after acquisition (Section 18)

108. **Comment letters.** Unclear how to account for adjustments to the fair values of identifiable assets and liabilities after acquisition, for instance it appears possible to make adjustments without any limitation. Simplify the requirements for initial accounting, for instance by prospective rather than retrospective adjustments, and provide a longer period for determination.

109. **Field tests.** No related comments.

110. **WG recommendation.** Not discussed.

111. **Staff recommendation.** Staff note this is really an issue relating to additional guidance and hence recommend including in Section 18 the requirements in IFRS 3(2008) for 'measurement period'.

Question 18.4
Does the Board agree with the staff recommendation to include in Section 18 the requirements in IFRS 3(2008) for 'measurement period'?

Issue 18.5: Consider pooling of interests method (Section 18)

112. **Comment letters.** A few comment letters suggested that use of book values/pooling of interests method should be considered. This was predominantly mentioned in relation to cooperatives, where respondents felt that the purchase method 'is not appropriate'.

113. **Field tests.** Section 18 *Business Combinations and Goodwill* appears very complex. It would be costly to apply, yet the resulting benefits seem rather limited. Field test entities suggested that this is one area where the IASB should try to give SMEs material relief, particularly regarding the disclosure requirements.

114. **WG recommendation.** WG members did not support allowing SMEs to follow merger accounting for any business combinations other than combinations of entities under common control.

115. **Staff recommendation.** Staff do not recommend allowing SMEs to use pooling of interests or book value accounting for a business combination (other than a combination of entities under common control, which would be excluded from Section 18). SMEs are not likely to enter into many business combinations so this is effectively a 'one-off' requirement that provides useful information both for users and for management, much of which should be available from discussions when setting the price. The area of Section 18 causing the most significant problems appears to be disclosure, and staff will deal with this separately in a future Board paper.

Question 18.5

Does the Board agree with the staff recommendation that SMEs should not be allowed to use pooling of interests accounting for a business combination (other than a combination of entities under common control, which would be excluded from Section 18)?

Issue 19.1: Leases – operating, straight-line method (Section 19)

116. **Comment letters.** Do not require the straight-line method for operating leases (spreading total lease payments evenly over the lease term).

117. **Field tests.** No related comments.

118. **WG recommendation.** WG members recommended that the requirement for recognising lease payments under operating leases on a straight-line basis as described in 19.13 be retained.

119. **Staff comment.** 19.13 states:

> 19.13 A lessee shall recognise lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

120. **Staff recommendation.** Those who favour the straight-line requirement (which is from IAS 17) point out that recognising contractual lease payments as expenses when paid or payable is, essentially cash basis accounting. Moreover, those payments can easily be structured in agreeing on the lease provisions. On the other hand, those who disagree with the straight-line requirement say that leases are often structured with increasing payments to compensate the lessor for anticipated increases in costs of owning and maintaining the leased property. This is structuring for a business reason, not to achieve an accounting result. Staff notes that ED paragraph 19.13 provides for a method other than straight-line if "another systematic basis is representative of the time pattern of the user's benefit". However, comment letters said this is not sufficient grounds to support using a basis other than straight-line where increases compensate the lessor for increases in costs because the benefits to the lessee may not change from period to period. Only the lessor's costs change. Staff find this reasoning persuasive. Therefore, staff recommend adding a second 'unless' to 19.13 so that 19.13 states:

> 19.13 A lessee shall recognise lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense on a straight-line basis unless either (a) another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or (b) the payments to the lessor are structured to compensate for the lessor's expected cost increases.

Question 19.1

Does the Board agree with the staff recommendation to revise 19.13 to include the case where payments to the lessor are structured to compensate for the lessor's expected cost increases?

Issue 19.2: Leases – finance, measurement (Section 19)

121. **Comment letters.** Do not require a finance lease to be measured only at fair value of leased property. Two methods were proposed: either reinstate lower of fair value and present value of minimum lease payments or just require present value of minimum lease payments. In the later case, some letters noted impairment requirements would prevent overstatement of assets.

122. **Field tests.** Some field test entities needed to recognise finance leases on their balance sheet for the first time, since under their local GAAP only note disclosure is required. A few entities feel this causes 'undesirable' effects as it impacts their capital. Some entities said information about the fair value of the leased asset was unavailable to measure finance leases or was burdensome to identify. Some entities feel that measuring the fair value of the leased asset is less practicable than if entities were able to use the present value of minimum lease payments.

123. **WG recommendation.** WG members would keep a single measurement for the leased asset and related lease obligation based on fair value, but they would not call the measurement 'fair value' because SMEs will have difficulty in understanding that term and in applying it consistently. Instead, they recommend that the IFRS for SMEs describe it as 'the cash price that the lessee would have paid if it had acquired the asset rather than leased it'. WG members agree that there shouldn't be any difference at inception between the values at which the liability and the asset should be recognised.

124. **Staff recommendation.** As noted in Issue G13 of Agenda Paper 9A, staff feel many of the problems surrounding fair value measurement could be reduced by clearer explanations of what is required plus additional guidance examples. Staff recommend retaining the single measurement as in the ED, but to describe it as 'the cash price that the lessee would have paid if it had acquired the asset rather

than leased it'. Staff also recommend stating if that cash price is not available from a price quotation in an active market it may be necessary to measure it at the present value of minimum lease payments. Staff believe this clarification is already inherent in the single measure proposed in the ED, but it should be made explicit.

Question 19.2

Does the Board agree with the staff recommendation to retain the single measurement, to describe it as 'the cash price that the lessee would have paid if it had acquired the asset rather than leased it', and to state that if that cash price is not available from a price quotation in an active market it may be necessary to measure it at the present value of minimum lease payments?

Issue 19.3: Criteria for finance lease, including all leases as operating (Section 19)

125. **Comment letters.** Simplify classification criteria, for example, use fewer criteria or introduce quantitative tests. Several letters suggested treating all leases as operating leases.

126. **Field tests.** A few field test entities encountered problems applying the classification criteria in Section 19, for example (a) applying the factors in 19.4 (determinative factors) and 19.5 (additional indicative factors) or (b) determining when factors in 19.5 (additional indicative factors) would lead to finance lease classification, in the absence of factors in 19.4 (determinative factors). Several entities suggested examples and quantitative thresholds would be very beneficial. Some field test entities noted that the requirements in Section 19 would lead to medium to high benefits for users, but some areas were costly to apply.

127. **WG recommendation.** WG members did not support adding quantitative criteria into ED paragraphs 19.4 and 19.5 (for classification of a financing lease). Some WG members felt that treating all leases as operating is an appropriate simplification for SMEs. The majority, however, did not feel strongly for or against this proposal.

128. **Staff recommendation.** Staff believes that, with one exception (namely 19.4(b)), the principles in 19.4 and 19.5 are clear and appropriate and that quantitative

guidelines should not be added. Issues may arise due to lack of experience and, perhaps, expertise when applying these principles for the first time; however, this is a matter to be dealt with when looking at what additional guidance is necessary. The only issue staff feel needs to be addressed is whereas 19.4(d) refers to 'substantially all' of the fair value of the leased asset, 19.4(b) refers to 'the major part of the economic life of the asset'. Staff believes that 'substantially all' is clear, while 'major part' is not. 'Major part' is likely to cause unnecessary implementation problems for an SME. Staff recommends changing 19.4(b) to 'substantially all of the economic life of the asset'. Staff acknowledges that this change is likely to move in the direction of fewer leases being classified as finance leases – depending on how an SME might have interpreted 'major part'. Staff believes this change is an appropriate clarification and simplification in an SME context.

Question 19.3

Does the Board agree with the staff recommendation to change 19.4(b) to 'substantially all of the economic life of the asset'?

Issue 19.4: Leases – Leasehold land (Section 19)

129. **Comment letters.** No related comments (other than with regards to leasehold land that is classified as investment property – see Issue 15.3). This was an additional issue noted from field testing.

130. **Field tests.** Some field test entities feel it is important in their particular jurisdiction to have a specific exclusion for leasehold land from 19.4(c) – "the lease term is for the major part of the economic life of the asset even if title is not transferred." The result would be to allow SMEs to capitalise more leasehold land.

131. **WG recommendation.** WG members felt that the requirements can be left as proposed in the ED.

132. **Staff comment.** Currently Section 15 (and IAS 40) allow a special case where leasehold land can be capitalised if it otherwise meets the definition of investment property and the entity applies the fair value model to all investment property (This is dealt with in Issue 15.3). It's not clear from the field test entities'

responses whether the land would meet the requirements to be classified as investment property. This is a substantive issue only if SMEs are allowed an accounting policy option to use the fair-value-through-profit-or-loss model for their investment property. If only the cost-depreciation-impairment model is used, all investment property would be accounted for as property, plant and equipment under Section 16 *Property, Plant and Equipment*.

133. **Staff recommendation.** The issue dealt with in Issue 15.3 is a special case consistent with full IFRSs, and staff sees no reason to allow other types of leasehold land to be capitalised. Staff proposes no change to the ED.

Question 19.4

Does the Board agree with the staff recommendation not to change the ED to allow leasehold land to be capitalised without regard to whether the leasehold land otherwise meets the criteria to be accounted for as investment property?

Issue 20.1: Provisions (Section 20)

134. **Comment letters.** Simplify measurement requirements for provisions, for example, simplify probability estimates and discounting (such as by using the average company borrowing rate).

135. **Field tests.** Only a small number of field test entities noted difficulties with applying paragraphs 20.8 to 20.11 of Section 20. Several entities said the requirements for provisions and contingencies in the ED are very similar to their national GAAP, and several others said they do not have provisions (other than those specifically covered by other sections of the ED) or contingencies. A few entities felt present value calculations cause undue cost or effort. A few entities noted that additional guidance or examples would be useful, for example, illustrating the accounting for an insurance receivable and use of weighted average expected amounts (20.8(a)). Examples of provisions recognised by the field test entities include provisions for warranty costs and risks in delivering live easily damaged products.

136. **WG recommendation.** WG members did not recommend any simplification of Section 20.

137. **Staff recommendation**. Staff do not recommend any simplification to the measurement requirements for provisions under Section 20 as this was only highlighted as a problem area by a relatively small number of comment letters and field test entities. The issues relating to provisions covered by Section 20 that a typical SME might encounter include sales refunds, warranties, and contingent liabilities. Most issues raised by respondents relate to the calculations required so could be mitigated by providing more measurement examples, either in the appendix to Section 20, in the IASCF training material or otherwise. The ED includes a specially developed example for calculation of a warranty provision. Other examples of provisions, for example refunds, could easily be added as implementation guidance.

Question 20.1

Does the Board agree with the staff recommendation that the requirements for measuring provisions in Section 20 do not need to be simplified?

Issue 21.1: Classification of equity/debt – different legal forms (Section 21)

138. **Comment letters.** The classification as equity versus liability is a difficult issue. More guidance is needed. Consider the different legal forms of entities within the scope of IFRS for SMEs, in particular to address the concerns that what is considered as equity by certain entities is classified as liability under Section 21. Various suggestions were made, in particular an equity definition linked to loss absorption (or participation in losses).

139. **Field tests.** Several field test entities are partnerships or cooperatives, and most of them noted that, under the ED, they have no equity (because of the rights of partners or members to withdraw their capital), which does not appropriately reflect the fact that the partners and members bear the residual risks and hold the residual interests in the assets of the entity. Several entities said clear guidance on the differentiation between equity and liability is necessary. Some suggested the recent changes to IAS 32 *Financial Instruments: Presentation* for puttables and obligations arising only on liquidation should be integrated into the IFRS for SMEs.

140. **WG recommendation.** Members of the WG recommended adopting in the IFRS for SMEs the recent changes made to IAS 32 regarding classification of puttable instruments and obligations arising on liquidation, though they would simplify the wording. Some WG members were unsure if those changes would be sufficient on their own to address the concerns of cooperatives, and they suggested that some research may be appropriate.

141. **Staff comment.** The comment letters on the ED and the reports of the field tests were prepared before the IASB's final changes to IAS 32 were adopted for classification of puttable instruments and obligations arising on liquidation. As a result of the amendments, some financial instruments that had met the definition of a financial liability will be classified as equity because they represent the residual interest in the net assets of the entity. The amendments have detailed criteria for identifying such instruments, but they generally would include:

   a. Puttable instruments that are subordinate to all other classes of instruments and that entitle the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

   b. Instruments, or components of instruments, that are subordinate to all other classes of instruments and that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

142. **Staff recommendation. TO BE DEVELOPED.**

Question 21.1

TO BE DEVELOPED

Issue 21.2: Classification of equity/debt – simplify classification and split accounting (Section 21)

143. **Comment letters.** Simplify classification of equity or liabilities. Simplify the requirements for split accounting (or do not require it at all).

144. **Field tests.** Only one field test entity appears to have convertible debt and this entity encountered problems classifying and measuring the instrument into its debt and equity parts.

145. **WG recommendation.** Not discussed.

146. **Staff recommendation. TO BE DEVELOPED.**

Question 21.2
TO BE DEVELOPED

Issue 22.1: Revenue – percentage of completion (Section 22)

147. **Comment letters.** Some comment letters proposed simplifying the percentage of completion method. Some went even further to propose allowing the completed contract method to be used for all construction contracts and revenue from services.

148. **Field tests.** Field test entities highlighted measurement issues relating to revenue, especially concerning the use of the percentage of completion method. Some entities noted that while the benefits to users of the percentage of completion method are high, so are the costs to preparers. Some said they would find additional examples useful.

149. **WG recommendation.** WG members did not support using the completed contract method for construction contracts or revenue from services. Instead, they recommended that Section 22 should be kept broadly as drafted, but that the description of the percentage-of-completion method be improved to make it more understandable to SMEs. They also recommended providing additional examples to illustrate percentage-of-completion calculations and presentation.

150. **Staff recommendation.** Staff recommend that the Board retain the percentage of completion method for construction contracts and revenue from services for the following reasons:

   a. In BC 99 of the ED it is noted why the IASB did not adopt the completed contract method for contracts that take more than one annual reporting period to complete. BC99 notes that the completed contract method can produce a

potentially misleading accounting result for the contractor, with some years of large profits and other years of large losses. The fluctuation between years of large profit and years of large losses may be magnified for SMEs because they tend to have fewer contracts than larger entities. Also users of financial statements have told the Board that, for a contractor, the percentage of completion method provides information that they find more useful than the completed contract method.

b. Many comment letters said they agreed with BC99 that the percentage of completion method provides more useful information.

c. SMEs operating in the major sectors where construction contracts are common, such as engineering and building, should have qualified professionals that can perform the necessary measurements in order to apply the percentage of completion method without too much difficulty.

d. Few comment letters proposed simplifications of the percentage of completion method (other than replacing it altogether with the completed contract method), and no proposal came up more than once.

e. Staff feel that most problems respondents have with applying the measurement requirements for the percentage of completion method can be mitigated by providing more examples, in the appendix to Section 22, in the IASCF training material, or otherwise.

Question 22.1

Does the Board agree with the staff recommendation that the percentage of completion method should be retained in Section 22?

Issue 23.1: Government grants measurement and allocation (Section 23)

151. **Comment letters.** Several comment letters suggested that only the IFRS for SMEs model for government grants in 23.3(a) should be allowed as it was simpler and produced better information. A similar number of comment letters suggested only the IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requirements should be allowed to maintain consistency with full IFRSs and because some felt the IFRS for SMEs model was unclear.

152. **Field tests.** Measuring grants at fair value caused problems for some field test entities due to lack of easily available indicators of the value of the asset or other benefit received. They noted difficulties in allocating a government grant to the components of an asset. Only a small number of field test entities have government grants. Some applied the IFRS for SMEs model and others chose an option from IAS 20. A few entities noted the description of the options is unclear, in particular for the IFRS for SMEs model. A few entities encountered problems restating existing grants to comply with IFRS for SME.

153. **WG recommendation.** Not discussed.

154. **Staff comment.** Here are the requirements of 23.3 to 23.5 in the ED (IFRS for SMEs model for government grants):

23.3 An entity shall account for its government grants using either:

(a) the IFRS for SMEs model in paragraph 23.4 for all government grants; or

(b) the IFRS for SMEs model in paragraph 23.4 for those government grants related to assets measured at fair value through profit or loss and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* for all other grants

23.4 An entity shall recognise government grants as follows:

(a) a grant that does not impose specified future performance conditions on the recipient is recognised in income when the grant proceeds are receivable;

(b) a grant that imposes specified future performance conditions on the recipient is recognised in income only when the performance conditions are met;

(c) grants received before the income recognition criteria are satisfied are recognised as a liability.

23.5 An entity shall measure grants at the fair value of the asset received or receivable.

155. The recognition of non-monetary grants at fair value is not mandatory under IAS 20. IAS 20 allows as an alternative treatment that the grant and the asset be recorded at a nominal amount. Therefore, currently under the ED, if an entity applies 23.3(b), the only time there is a mandatory fair value requirement for a non-monetary grant is when it relates to an asset measured at fair value through profit or loss (and, hence, the IFRS for SMEs model must be applied). Under the ED, this would most likely be limited to grants relating to agricultural assets whose fair value can be measured reliably without undue cost or effort and investment property for which the SME has adopted the fair value model.

156. **Staff recommendation.** Staff recommend that the Board remove the option to apply IAS 20 (namely delete 23.3) for the following reasons:

a. In Issue G2 in Agenda Paper 9A for the May 2008 Board meeting, staff have set out their reasoning for removing the more complex accounting options in the IFRS for SMEs.

b. Staff feel the IFRS for SMEs model is easier to understand than the many options in IAS 20. Many of the respondents supporting the IAS 20 requirements over the IFRS for SMEs model do so to maintain consistency with full IFRSs and also because they feel the IFRS for SMEs model is anticipating future changes to full IFRSs. Staff feel simplicity in an SME context should take precedence over consistency with full IFRSs.

c. In some cases the IFRS for SMEs model may require more fair value measurement than the IAS 20 model. Field testers expressed problems applying the fair value measurement requirement in this section. To address this concern, as proposed in Issue G13 in Agenda Paper 9A for the May 2008 Board meeting, staff recommend replacing the term ‘fair value’ with a clear description of what the basis for measurement is. Staff feel this redrafting together with providing more examples (in the IASCF training material or otherwise) will mitigate many of the application problems arising from the IFRS for SMEs model.

<u>Question 23.1</u>

Does the Board agree with the staff recommendation that the IFRS for SMEs model should be the only option available in Section 23, but that reference to the term 'fair value' should be removed and the measurement basis should be clearly described?

Issue 24.1: Borrowing costs – should both methods be retained (Section 24)

157. **Comment letters.** Approximately 75 per cent of the letters responding to the specific question in the Invitation for Comment supported retention of both methods of accounting for borrowing costs – immediate expensing and capitalisation of borrowing costs on construction of qualifying assets. Approximately 15 per cent of the letters supported capitalisation only.

158. **Field tests.** Most field test entities did not have borrowing costs eligible for capitalisation. Of those that did, about half of them chose capitalisation. No significant issues were identified.

159. **WG recommendation.** WG members supported giving SMEs the option to expense all borrowing costs since expensing is the simpler approach.

160. **Staff recommendation.** In Issue G2 in Agenda Paper 9A for the May 2008 Board meeting, staff recommended removing accounting policy options in IFRS for SMEs and, hence, only retaining the simpler options for SMEs. Staff therefore recommend only the expense model should be retained, and the option to apply the capitalisation model should be removed. Staff feel that a departure from full IFRSs is justified in this case as the benefits from applying the capitalisation model for SMEs are unlikely to exceed the costs of providing the information since the capitalisation method can be complex and subjective, so may not be applied correctly by SMEs.

<u>Question 24.1</u>

Does the Board agree with the staff recommendation that the option to apply the capitalisation model should be removed and, hence, only the expense model should be available to SMEs?

Issue 24.2: Borrowing costs – simplification of capitalisation model (Section 24)

161. **Comment letters.** A few letters suggested possible simplifications to the capitalisation method under full IFRSs, the most popular being compute all capitalisation on the basis of average borrowing cost (do not require tracing of specific borrowings).

162. **Field tests.** Most field test entities did not have borrowing costs eligible for capitalisation. Of those that did, about half of them chose capitalisation. No significant issues were identified.

163. **WG recommendation.** WG members did not support any simplification of the method from that described in IAS 23 *Borrowing Costs*, such as by using the average borrowing rate for all capitalisation.

164. **Staff recommendation.** As explained in Issue 24.1, staff recommend eliminating the capitalisation model for borrowing costs in IFRS for SMEs. However, if the staff recommendation is rejected and the capitalisation method is retained, staff would recommend that there is no need to simplify the capitalisation method by allowing the average borrowing rate to be used since the expense model is provided as a simplification if entities find the capitalisation model too complex. Moreover, SMEs are likely to have few project-specific borrowings, so tracing of borrowing costs to projects should not be burdensome in most cases.

Question 24.2

If the Board does not agree with the previous staff recommendation that the option to apply the capitalisation model should be removed, then does the Board agree with the staff recommendation that the capitalisation model does not need to be simplified, for example by allowing the average borrowing rate to be used?

Issue 25.1: Share-based payment – more simplification than just intrinsic value (including possibly disclosure only) (Section 25)

165. **Comment letters.** Simplify – the intrinsic value method is not much of a simplification. Possible simplifications include intrinsic value measured only at issuance (not updated) or FAS 123 calculated value method (again no subsequent 'true up'). Also, consider disclosure only for equity-settled share-based payments.

166. **Field tests.** Few field test entities had share-based payment transactions. Two had equity-settled share-based payment transactions, and they commented that they were unable to measure fair values of either the shares or the share options. A few entities that did not have any share-based payment transactions commented that they would have found Section 25 difficult had they needed to apply it.

167. **WG recommendation.** Most WG members felt that the intrinsic value method in IFRS 2 is not much of a simplification for SMEs because it still involves determining the fair value of unquoted instruments and additionally requires this to be done every year. Many who hold this view support a disclosure only approach. If the Board does not agree with the disclosure-only approach, WG members recommend that the Board seek further simplifications beyond the requirements of IFRS 2. WG members noted that a few comment letters provided ideas for simplification including:

    a. determining intrinsic value at grant date only,

    b. using the calculated value method like in the US Standard SFAS 123(R), which also requires measurement only at grant date, and

    c. allowing subsidiaries to record a share based payment expense on the basis of a reasonable allocation of the group charge when awards are granted by a parent company to the employees of different subsidiaries in the group.

    Some WG members felt that only determining intrinsic value at grant date would be an improvement on the current requirements. The other two methods above were not discussed.

168. **Staff comment:** Those respondents who said that the intrinsic value method is not much of a simplification pointed out that this method requires knowing the fair value of the underlying equity share when the share option (or other SBP) is granted and at each subsequent reporting date.

169. **Staff recommendation. TO BE DEVELOPED**

Question 25.1

TO BE DEVELOPED

Issue 26.1: Impairment – value in use measurement (Section 26)

170. **Comment letters.** Allow or require consideration of value in use or a simplified value-in-use calculation that uses information easily available to a small entity - for example allowing entities to use their own incremental borrowing rate and their own budgets for cash flow forecasts. Currently, the ED requires only fair value measurement. Value in use is more realistic because it takes expected future use of an asset into account.

171. **Field tests.** Several field test entities noted that value in use should be reintroduced; otherwise, impairment losses will be recognised that are not justified, for example, for computers that are being used in the business. Some entities said that the requirement to use fair value to determine impairment causes problems due to the lack of available indicators.

172. **WG recommendation.** WG members recommended reinstating the notion of 'value in use' in the measurement of impairment, since value in use considers the business reality of the future cash flows from the use of assets. Some WG members felt impairment should be measured by comparing carrying amount to the greater of net selling price and value in use. Comment letters suggested two other ways of reintroducing value in use in the IFRS for SMEs. One method would be to allow or require value in use instead of fair value less costs to sell. Another method would be to perform an impairment test on the basis of the scenario 'sale or use' that is relevant to the entity. Neither of these two additional methodologies was specifically discussed by the WG.

173. **Staff recommendation. TO BE DEVELOPED**

Question 26.1

TO BE DEVELOPED

Issue 26.2: Simplify requirements for assessing impairment of goodwill (Section 26)

174. **Comment letters.** Simplify requirements for impairment of goodwill. Comment letters raised various issues regarding the approach in ED paragraphs 26.20-26.24. In general, respondents found those paragraphs difficult to understand. Few simplifications were proposed.

175. **Field tests.** Several entities have goodwill in their balance sheet, and several of them said they needed to consider the impairment requirements for goodwill. Of those that did, most experienced problems either applying the impairment test or applying the impairment indicators. The most significant problem experienced by the entities was determining the fair value less costs to sell for the group of assets to which goodwill is allocated. For example, it was difficult to determine the fair value of a privately held subsidiary due to a lack of market transactions or lack of comparable companies with market transactions. Several entities feel that SMEs should have the option to amortise goodwill.

176. **WG recommendation.** Many WG members felt that although guidance on measuring impairment of goodwill is necessary, the requirements proposed in the ED are very complex. However, while recommending that this be simplified in the final IFRS for SMEs, WG members did not propose any specific simplifications.

177. **Staff comment:** The IFRS for SMEs requires an SME to determine whether there is an indicator that goodwill is impaired (ED 26.20-21). If impairment is indicated, then apply ED 26.22:

> 26.22 If there is an indication that goodwill has been impaired the entity shall follow a two-step process to determine whether to recognise an impairment loss:
>
> **Step 1:**
>
> (a) allocate the goodwill to the component(s) of the entity that benefit from the goodwill (generally the lowest level within the entity at which the goodwill is monitored for internal management purposes);
>
> (b) measure the fair value of each component in its entirety, including the goodwill;
>
> (c) compare the fair value of the component with the carrying amount of the component;

(d) if the fair value of the component equals or exceeds its carrying amount, neither the component nor the goodwill is impaired; if the fair value of the component is less than its carrying amount, the difference is an impairment loss that shall be recognised in accordance with Step 2.

Step 2:

(a) write down the component's goodwill by the amount of the loss determined in Step 1(d) and recognise an impairment loss in profit or loss;

(b) if the amount of the loss determined in Step 1(d) exceeds the carrying amount of the component's goodwill, the excess shall be recognised as an impairment loss in profit or loss. That excess shall be allocated to the identifiable non-cash assets and liabilities, including contingent liabilities, of the component on the basis of their relative fair values.

178. **Staff recommendation. TO BE DEVELOPED**

Question 26.2
TO BE DEVELOPED

Issue 26.3: Impairment – assessment by cash generating unit or component of an entity (Section 26)

179. **Comment letters.** Bring back the term 'cash generating unit' as this term is well understood. Use of new terminology 'component of the entity' (in 26.22–26.23) and 'group of assets' (in 26.5, 26.8, 26.9, 26.11, and 26.20,) is confusing

180. **Field tests.** No related comments.

181. **WG recommendation.** WG members recommended that value in use should be assessed for a group of assets if it cannot be assessed for an individual asset. But do not use the term 'cash generating unit'. WG did not discuss 'component of an entity'.

182. **Staff comment.** ED paragraph 26.9 states:

26.9 If an entity cannot estimate fair value for an individual asset, the entity shall measure the fair value less costs to sell for the group of assets to which the asset belongs. For this purpose, fair value less costs to sell shall be estimated for the smallest identifiable group of assets

(a) that includes the asset for which impairment is indicated and

(b) whose fair value less costs to sell can be estimated.

‘Group of assets’ is used similarly in 26.5, 26.8, 26.11, and 26.20.

‘Component of an entity’ is a different notion than a ‘group of assets’ or ‘cash generating unit’. Component of an entity is used in the ED only in the context of testing goodwill for impairment. Even if ‘group of assets’ is replaced by ‘cash generating unit’, the notion of ‘component of an entity’ (or equivalent) will still be needed. ‘Component of an entity’ is a defined term in the ED glossary.

183. **Staff recommendation.** Staff believes that ED paragraph 26.9 is a cash-generating-unit approach without using that term. 26.3 contains a similar provision for inventories. Staff believes that adding clear explanations for the term ‘group of assets’ and ‘component of the entity’ is all that is needed in this regard.

Question 26.3

Does the Board agree with the staff recommendation that the ED already covers the concept of ‘cash generating unit’ and ‘component of an entity’ and, therefore, no change, other than to clarify the new terms used, is needed?

Issue 27.1: Pensions – options for recognising actuarial gains and losses (Section 27)

184. **Comment letters.** Allow other options for actuarial gains and losses, in particular recognition outside profit or loss, such as in equity or in other comprehensive income. Give SMEs all of the options that an entity has using full IFRSs.

185. **Field tests.** Only a few field test entities commented but those who did noted that expensing all actuarial gains and losses only had a small effect on profit or loss. Therefore, these SMEs were indifferent to whether or not alternative options were allowed for actuarial gains or losses and they considered the approach in Section 27 the easiest.

186. **WG recommendation.** WG members would allow all options for actuarial gains and losses that are permitted by IAS 19 *Employee Benefits*.

187. **Staff comment.** Currently Section 27 requires immediate recognition in profit or loss of all actuarial gains and losses.

188. **Staff recommendation.** In Issue G2 in Agenda Paper 9A for the May 2008 Board meeting, staff recommend the removal of the more complex accounting policy options for SMEs for simplicity and clarity. Of the four methods allowed in IAS 19 for recognition of actuarial gains and losses, immediate recognition in profit or loss is the simplest method for SMEs to implement as it does not require preparation of a financial statement that most SMEs do not normally prepare (statement of comprehensive income) and it does not require tracking of data over many years and annual calculations. In addition, financial statement users generally have told the Board that they find immediate recognition in profit or loss provides the most understandable and useful information.

<u>Question 27.1</u>

Does the Board agree with the staff recommendation that actuarial gains and losses should continue to be recognised in profit or loss immediately?

Issue 27.2: Pensions – past service cost (Section 27)

189. **Comment letters.** Allow deferral and amortisation of past service costs, in a manner consistent with what is permitted under IAS 19.

190. **Field tests.** No related comments.

191. **WG recommendation.** WG members would allow deferral and amortisation of unvested past service costs as in IAS 19 in addition to the proposed immediate expensing.

192. **Staff recommendation.** Staff recommend retaining the requirement to immediately expense all past service cost. In Issue G2 in Agenda Paper 9A for the May 2008 Board meeting, staff recommend the removal of the more complex accounting policy options for SMEs for simplicity and clarity and, hence, staff would not support a choice of (a) either immediate expensing of all past service cost or (b) deferral and amortisation of unvested past service costs. Staff believe immediate expensing is a simplification and, hence, propose leaving this requirement unchanged.

193. If the Board supports introducing the requirement in IAS 19 for past service costs, staff recommend this should replace – rather than be added as a second option to – immediate expensing, to avoid increasing options for SMEs.

<u>Question 27.2</u>

Does the Board agree with the staff recommendation that all past service cost should continue to be recognised in profit or loss immediately?

Issue 27.3: Pensions – allow choice of actuarial method (Section 27)

194. **Comment letters.** Do not require a specific actuarial method (projected unit credit). Also clarify that even if a specific method is required, an actuarial valuation performed by an outside actuary is not required to be done every year. Clarify that updating prior period valuations for changes in circumstances can result in reasonable measurements.

195. **Field tests.** Several field test entities have defined benefit plans. Some of these entities use outside specialists to value the plans so they did not encounter any problems. A few entities noted that use of outside specialists would be needed, but would be too costly. Another problem raised was the entities were unable to gather enough data to make estimates about demographic and financial variables as required by 27.16 for defined benefit plans.

196. **WG recommendation.** Most WG members would encourage the Board to seek simplify the calculation of defined benefit obligations.

197. **Staff recommendation. TO BE DEVELOPED**

<u>Question 27.3</u>

TO BE DEVELOPED

Issue 27.4: Pensions -- Measurement at current liquidation amount (Section 27)

198. **Comment letters.** Measure as if all employees would retire as of the reporting date (that is, at current liquidation amount).

199. **Field tests.** See Issue 27.3.

200. **WG recommendation.** Most WG members would encourage the Board to seek simplify the calculation of defined benefit obligations. Some WG members suggested that the calculation could be simplified by measuring the obligation on the basis that all employees would retire at the reporting date.

201. **Staff recommendation. TO BE DEVELOPED**

<u>Question 27.4</u>

TO BE DEVELOPED

Issue 27.5: Pensions – treat all multiemployer as defined contribution (Section 27)

202. **Comment letters.** Treat all multiemployer plans as defined contribution.

203. **Field tests.** No related comments.

204. **WG recommendation.** Most WG members would encourage the Board to seek simplify the calculation of defined benefit obligations. Some WG members would simplify calculations by treating all multiemployer plans as defined contribution.

205. **Staff comment:** The ED proposes that multiemployer plans be classified as defined contribution or defined benefit based on their terms. However, if sufficient information is not available to use defined benefit accounting, then an SME can use defined contribution accounting, with disclosure.

206. **Staff recommendation.** Staff recommend allowing all multi-employer plans to be treated as defined contribution plans with appropriate disclosure (i.e. the nature of the plan and its funding arrangements) for cost benefit reasons. It is usually difficult to obtain the information necessary to apply defined benefit accounting in the financial statements of the participating employers since many of arrangements effectively share the obligation amongst participating employers without providing detailed information about underlying assets and liabilities. In particular the cost and difficulty of obtaining this information may be significant for smaller entities.

<u>Question 27.5</u>

Does the Board agree with the staff recommendation that all multi-employer plans should be treated as defined contribution plans with appropriate disclosure?

Issue 28.1: Income Taxes – which method? (Section 28)

207. **Comment letters.** Many comment letters recommended simplifying the requirements for income taxes, but there was no clear consensus of the best way to do that. Suggestions included:

   a. Taxes payable method (no deferred tax recognised), with some disclosure about 'deferrals'.

   b. Taxes payable method plus accrual of those deferred taxes that are expected to reverse in a short period (say two or three years).

   c. Timing difference method.

   d. Timing difference method plus accrual of deferred taxes relating to book/tax basis differences that were recognised directly in other comprehensive income.

   e. Do not recognise deferred tax assets, or limit the time period for assessing whether there will be sufficient future taxable profit for recovery, to avoid ongoing calculations.

   f. Do not require tax consequences of transactions to be attributed to discontinued operations or equity as this is complex.

208. **Field tests.** Several field test entities feel that deferred tax is too complex for SMEs. However, a few other field test entities support deferred tax requirements as deferred tax is useful information for assessing cash flows. Several entities had problems with areas of Section 28. Some of the more significant issues identified include:

   a. Explanation of the underlying concept should be improved. It would be easier if the IASB used only one concept, either the timing or the temporary difference concept.

b. Problems measuring temporary differences. Measurements in the field entity's restated financial statements are 'rough' or are not finalised.

c. The concept of recognising a deferred tax asset is not practical for SMEs since SMEs do not prepare the necessary budgets/forecasts. A few field test entities noted particular problems with tax loss carry forwards as the entities only prepared limited forecasts

d. Problems determining tax rates where, depending on the level of profits of the year, the entity may use a "reduced rate" on part of or all its profits.

e. Difficulties understanding certain paragraphs, for example 28.17 on initial recognition and 28.25 on measuring deferred tax at the rates applicable to undistributed profits.

f. 28.18 should note that if an entity considers the timing differences to be insignificant then there is no need to recognise deferred tax.

g. 28.18(b) should provide the same exemption for unremitted earnings of local subsidiaries as it does for foreign subsidiaries.

209. **WG recommendation.** WG members did not express a clear consensus on how SMEs should account for income taxes; however the majority felt that the requirements as proposed in the ED are too complex for SMEs. More WG members leaned toward the taxes payable method than any other method, supported by some note disclosures about tax deferrals. More WG members favoured a timing difference approach than the proposed temporary difference approach as a simplification because comparing the income statement and the tax return is relatively straightforward. There was also support for either not recognising deferred tax assets at all or restricting deferred tax assets to those that are deemed to be realisable in the very short term such as one or two years, because SMEs often do not have accurate cash flow budgets.

210. **Staff recommendation. TO BE DEVELOPED**

Questions for Section 28

TO BE DEVELOPED

Issue 29.1: Financial Reporting in Hyperinflationary Economies – existence of hyperinflation (Section 29)

211. **Comment letters.** Normally existence of hyperinflation is decided on a country-wide basis for consistency and so the criteria for assessing if an economy is hyperinflationary should be the same as IAS 29 *Financial Reporting in Hyperinflationary Economies*, rather than just having the numerical test that cumulative inflation over 3 years should approach or exceed 100 per cent.

212. **Field tests.** No related comments as not relevant to any of the field test entities.

213. **WG recommendation.** Not discussed.

214. **Staff recommendation.** Staff recommend all of the criteria for assessing if an economy is hyperinflationary in IAS 29.3 should be added to Section 29 to ensure a consistent approach in each country. The purely numerical approach to identifying whether there is a hyperinflationary economy in the ED (ie 100 per cent in 3 years) may give a different answer to IAS 29's more judgmental approach. Also staff feel there is no need to simplify the characteristics for SMEs since whether or not a country is considered to be experiencing hyperinflation is generally determined by a consensus of the accounting profession, rather than by each entity individually. It would be simpler for SMEs to use the same criteria and reach the same outcome to determine existence of hyperinflation as used by publicly accountable entities operating in that economy.

Question 29.1

Does the Board agree with the staff recommendation that all of the IAS 29 characteristics of hyperinflation should be included in the IFRS for SMEs?

Issue 30.1: Foreign currency translation – if financial statements must be presented in the national currency can that be the functional currency (Section 30)

215. **Comment letters.** Where the law requires that financial statements must be presented in the national currency, allow that to be used as the functional currency.

216. **Field tests.** SMEs should not need to apply functional currency requirements since the presentation currency required by law is the local currency and it would be costly and unnecessary to keep financial statements in both the functional and presentation currencies.

217. **WG recommendation.** Where the law requires that financial statements must be presented in the national currency, WG members would allow that national currency to be deemed as the functional currency.

218. **Staff recommendation.** Staff agree with the WG recommendations. Staff acknowledge that, in the unusual case where an SME's functional currency is not its national currency, presenting financial statements in the true functional currency would provide information about the enterprise that better reflects the economic substance of the underlying events and circumstances relevant to that entity. However, staff feel for cost-benefit reasons there should be such an exemption. For SMEs, such an exemption would significantly reduce the costs without significantly reducing the usefulness of the information presented.

Question 30.1

Does the Board agree with the staff recommendation that where the law requires that financial statements must be presented in the national currency, SMEs should be given the option to deem the national currency as their functional currency?

Issue 30.2: Translation – recycling of cumulative exchange difference in equity (Section 30)

219. **Comment letters.** Do not require, or possibly even prohibit, recognition of cumulative exchange differences deferred in equity in profit and loss when the gain or loss on disposal of a foreign operation is recognised, to avoid the administrative burden of tracking historical exchange rates.

220. **Field tests.** No related comments.

221. **WG recommendation.** WG members would leave cumulative exchange differences in equity on disposal of a foreign operation.

222. **Staff recommendation.** Staff recommend that SMEs should be prohibited from recycling these foreign exchange differences due to the significant administrative burden needed to track such historical exchange differences. Staff do not recommend that SMEs are given the option to recycle such exchange differences as staff do not support allowing SMEs a choice of accounting policy options. Staff feel that simplification should have precedence over comparability with full IFRSs.

Question 30.2

Does the Board agree with the staff recommendation that SMEs should be prohibited from recycling cumulative exchange differences deferred in equity in profit and loss when the gain or loss on disposal of a foreign operation is recognised?

Issue 33.1: Related parties – disclosure of sensitive information (Section 33)

223. **Comment letters.** Section 33 should be amended for the requirements in the Exposure Draft of Amendments to IAS 24 *Related Parties* if that amendment is finalised before the IFRS for SMEs is issued.

224. **Field tests.** No related comments.

225. **WG recommendation.** Not discussed.

226. **Staff comment:** Several other issues relating to Section 33 were raised. Other Section 33 issues will be covered together with other disclosure issues in later Board papers.

227. **Staff recommendation.** Staff recommend that the Exposure Draft of Amendments to IAS 24 is considered if finalised before the IFRS for SMEs is completed for the following reasons:

a. The main objective of the proposed changes to IAS 24 is to reduce disclosure requirements for some entities that are related only because they are each state-controlled or significantly influenced by the state. This issue equally

applies to non-publicly accountable entities in such jurisdictions. Reducing disclosure requirements is in line with the objective of simplification of requirements for SMEs.

b. The Proposed Amendments to IAS 24 also intend to improve the wording used in IAS 24, in particular to make the definition of a related party easier to understand and interpret. In many cases Section 33 adopts the same or similar wording to IAS 24 and the IAS 24 definition of a related party is used. Hence, considering the changes in the final Amendments to IAS 24 may lead to simplification.

c. The Proposed Amendments are intended to rectify some inconsistencies in IAS 24 and, hence, those inconsistencies should also be amended in IFRS for SMEs.

Question 33.1

Does the Board agree with the staff recommendation that the final amendments to IAS 24 should be reflected in the IFRS for SMEs?

Issue 35.1: Agriculture – allow cost model as option (Section 35)

228. **Comment letters.** Respondents recommended greater use of cost, for example, by allowing the cost method as an accounting policy choice or by requiring fair value only in certain circumstances.

229. **Field tests.** In this section, all significant issues identified by field test entities relate to agriculture and mainly focus on use of fair values. Of the few entities needing to apply this section, most had problems with the requirement to use fair values for biological assets and agricultural produce and feel the cost model should be allowed because fair values are either not available, or because undue cost and effort is required to determine such values.

230. **WG recommendation.** WG members felt that the addition of an ‘undue cost or effort’ criterion for use of fair value of agricultural assets is appropriate and, therefore, the approach in Section 35 should not be changed.

231. **Staff comment.** Paragraph 35.1 of the ED currently sets out the following approach

> 35.1 An entity using this [draft] standard that is engaged in agricultural activity shall determine, for each of its biological assets, whether the fair value of that biological asset is readily determinable without undue cost or effort:
>
> (a) The entity shall apply the fair value model in paragraphs 10–29 of IAS 41 Agriculture to account for those biological assets whose fair value is readily determinable without undue cost or effort, and the entity shall make all related disclosures required by IAS 41.
>
> (b) The entity shall measure at cost less any accumulated depreciation and any accumulated impairment losses those biological assets whose fair value is not readily determinable without undue cost or effort. The entity shall disclose, for such biological asset(s)....

232. **Staff recommendation.** Staff agree with the WG recommendations that the current approach in Section 35 provides appropriate simplification for an SME and there is no need to allow the cost model as an accounting policy choice for the following reasons:

a. In Issue G2 in Agenda Paper 9A for the May 2008 Board meeting, staff recommend the removal of the more complex accounting policy options for SMEs for simplicity and clarity**.** For agriculture, measurement at fair value is considered to be a simpler requirement than measurement at cost. Quoted prices are often readily available, markets are active, and measuring cost is actually more burdensome and arbitrary because of the extensive allocations required.

b. Fair value is generally regarded as a more relevant measure in this industry. Managers of most SMEs that undertake agricultural activities say that they manage on the basis of market prices or other measures of current value rather than historical costs. Users also question the meaningfulness of allocated costs in this industry.

c. Staff acknowledge in some cases fair values may not be available, particularly when applied to biological assets of those SMEs operating in inactive markets or developing countries. However staff feel that the 'undue cost or effort' criterion caters adequately for such situations. Staff feel that more guidance may be necessary to ensure the 'undue cost or effort' criterion is used appropriately.

Question 35.1

Does the Board agree with the staff recommendation that cost model should not be provided as an accounting policy choice for agricultural SMEs and that the current requirement to apply fair value measurement, with an 'undue cost or effort' criterion is a sufficient simplification for SMEs?

Issue 36.1: Eliminate held for sale classification (Section 36)

233. **Comment letters.** Remove the held for sale classification, or require note disclosure only. A few respondents said requirements could be briefly addressed within relevant sections, for example, in Section 16 *Property, Plant and Equipment*. Others said that holding an asset for sale could just be treated as an impairment indicator under Section 26 *Impairment of Non-financial Assets*, automatically triggering an impairment assessment and calculation.

234. **Field tests.** Several field test entities do not think that separate measurement requirements for discontinued operations and assets held for sale are necessary for SMEs as they are too burdensome and costly, with limited benefits. Some additional significant issues identified include:

a. Difficult to identify cash flows connected with discontinued operations and assets held for sale.

b. Difficult to determine fair value less costs to sell for held for sale items, for example for certain buildings.

c. Difficult to determine when an asset should be classified as held for sale. More guidance is necessary.

235. **WG recommendation.** WG members felt there is no need for a held for sale classification for SMEs. Instead the impairment requirements in the individual sections of the IFRS for SMEs cover this. The only substantive difference would be continued depreciation of non-current assets held for sale.

236. **Staff recommendation.** Staff agree with WG recommendations for cost-benefit reasons. Staff notes that the impairment requirements in the ED would ensure that assets are not overstated in the financial statements and this should be clarified by adding the decision to sell an asset (group of assets) in the near future as an indicator of impairment. Staff acknowledge that information on assets and liabilities identified for disposal in the near future is useful to users, however in most cases the needs of users of SME financial statements would be met by simple narrative disclosures, removing the need for the additional 'held for sale' category and its relatively complex measurement requirements.

Question 36.1

Does the Board agree with the staff recommendation that the requirements for assets held for sale be dropped from Section 36 and that holding an asset for sale should be included in Section 26 as an impairment indicator?

Issue 36.2: Discontinued operations – simplify or eliminate disclosure (Section 36)

237. **Comment letters.** Simplify (or even eliminate) discontinued operations disclosures and restatements.

238. **Field tests.** See comments for Issue 36.1 above.

239. **WG recommendation.** WG members recommended that prior period financial statements not be restated to segregate a discontinued operation.

240. **Staff comment:** If both discontinued operations disclosures and held-for-sale classification are removed from the IFRS for SMEs, Section 36 can be totally eliminated.

241. **Staff recommendation.** Staff agree with the WG recommendations that, for SMEs, disclosure and segregation of information on a discontinued operation should be limited to the current period. Restated information for prior years

should be encouraged but not required. Restatement of prior years is burdensome and is less important for SMEs since users of the financial statements of non-publicly accountable entities are not subject to the same level of scrutiny, for example by analysts, as financial statements of publicly accountable entities. Some SMEs will have limited resources to perform such a restatement.

242. Staff do not think the requirement to provide information on discontinued operations in the current year is too onerous since most SMEs' business environments are stable and constant changes due to investments and divestitures undergone by large multinational entities are not typical. Hence, the requirement to show information for discontinued operations for the current year is likely to be a one-off rare requirement for SMEs.

243. Staff feel that if these changes and the recommendations in Issue 36.1 for held for sale items are adopted, then Section 36 can be deleted and the remaining requirements for disclosure of a discontinued operation can be added to Section 5 *Income Statement*. Staff note that the definition of a discontinued operation currently refers to assets held for sale and so the definition may need to be rewritten.

Question 36.2

Does the Board agree with the staff recommendation that disclosure and segregation of information on discontinued operations should be limited to the current period only and such requirements should be added to Section 5?

Issue 38.1: First-time adoption of the IFRS for SMEs – include all IFRS 1 exemptions (Section 38)

244. **Comment letters.** The majority of respondents were happy with the approach in Section 38. However, a significant number of these suggested modifications. One modification suggested is to include all of the IFRS 1 optional exemptions for first time adopters, including:

a. parent and subsidiary adopt at different times, and

b. deemed cost for investment property and intangibles.

245. **Field tests.** No related comments.

246. **WG recommendation.** WG members were generally happy with the approach in Section 38. Most WG members would include in Section 38 all of the IFRS 1 optional exemptions for first time adopters.

247. **Staff recommendation.** Staff agree with WG recommendations since the IFRS for SMEs should not be more restrictive in this area than full IFRSs. Staff recommend all of the IFRS 1 optional exemptions that relate to requirements in the IFRS for SMEs should be included in Section 38.

Question 38.1

Does the Board agree with the staff recommendation that all of the IFRS 1 optional exemptions for first time adopters (for example, parent and subsidiary adopt at different times, and deemed cost for investment property and intangibles) should be available to SMEs adopting the IFRS for SMEs for the first time?

Issue 38.2: First-time adoption – relax use of 'impracticable' (Section 38)

248. **Comment letters.** Relax the use of 'impracticable' – that is, provide an exemption from restatement at a far lower hurdle than the 'impracticable' exemption in full IFRSs.

249. **Field tests.** A few entities said they used the impracticability exemption for certain issues, for example where information was not available, such as fair values for assets, or where adjustments were considered burdensome, for example restating the impact of government grants in the income statement. One entity suggested the impracticability exemption is likely to be needed by many small entities in its jurisdiction. A few entities are unclear how the impracticability exemption should be interpreted, for example whether several items could remain at previous GAAP measurements and / or whether they could use a previous GAAP balance sheet as the opening balance sheet if restatement was considered impracticable.

250. **WG recommendation.** WG members generally favoured adding an 'undue cost or effort' exemption from the requirement to restate prior periods (a lower hurdle

than 'impracticable') as discussed in Issue G11 in Agenda Paper 9A for the May 2008 Board meeting.

251. **Staff recommendation.** Staff agree with WG recommendations. Staff's reasoning and the decision question for the Board are presented in Issue G11 in Agenda Paper 9A.

Issue 38.3: Make it easier to move to/from the IFRS for SMEs (Section 38)

252. **Comment letters.** Relax the requirements to allow an entity to move to and from the IFRS for SMEs (maybe more than once). On the other hand, a number of respondents were concerned about entities switching between the IFRS for SMEs and another accounting framework more than once. Some said that this may be a matter left to each jurisdiction to decide.

253. **Field tests.** No related comments.

254. **WG recommendation.** Some WG members felt that it might not be a rare situation for an entity to find itself in the position of moving in and out of the category of entities required or permitted to apply IFRS for SMEs, particularly if a jurisdiction adds a quantified size test. Those WG members felt, therefore, that Section 38 should be available to entities on transitioning to the IFRS for SMEs more than one time.

255. **Staff comment.** ED Section applies only to a first-time adopter of the IFRS for SMEs. So, as written, an entity could not take advantage of the special measurement and restatement exemptions in Section 38 (similar to those in IFRS 1) more than once. Staff can envision three circumstances in which an entity might potentially be in a circumstance to adopt the IFRS for SMEs more than once:

a. The entity uses the IFRS for SMEs, switches to full IFRSs (either because it became publicly accountable or by choice) and subsequently is no longer publicly accountable (most likely a 'delisting') or no longer chooses to use full IFRSs and so wants to re-adopt the IFRS for SMEs.

b. The jurisdiction in which the entity is located requires or allows the IFRS for SMEs only for entities that exceed a specified size threshold (very

small entities are prohibited). The entity exceeds the threshold and, accordingly, switches from its national GAAP to the IFRS for SMEs. Subsequently the entity falls below the threshold and, either by regulation or by choice, switches back to its national GAAP. Subsequently the entity is once again above the threshold where the IFRS for SMEs is required or permitted, and the entity wants to re-adopt the IFRS for SMEs.

c. The jurisdiction in which the entity is located requires or allows full IFRSs for large-sized non-publicly accountable entities (for instance, entities that are regarded as 'economically significant'), and allows or requires the IFRS for SMEs for smaller entities. Initially the entity is not above the 'economically significant' threshold and so uses the IFRS for SMEs. Subsequently it exceeds the jurisdiction's size threshold for full IFRSs, and accordingly switches from the IFRS for SMEs to full IFRSs. Subsequently it falls below the 'economically significant' threshold and, by regulation or by choice, wants to re-adopt the IFRS for SMEs.

Staff believe that situations (a) and (c) – both of which involve an entity switching from full IFRSs to the IFRS for SMEs – will occur only in extremely rare circumstances. Situation (b) – will still be rare, but perhaps not as rare as (a) and (c).

256. **Staff recommendation.** Section 38 does not prohibit an entity from adopting the IFRS for SMEs more than once. What it does is offer certain special exemptions, along with a few special prohibitions, to a first-time adopter. Section 38 offers those exemptions for the same reasons that IFRS 1 offered similar exemptions – to reduce the burden of making the transition and to ensure that the effect of the transition is disclosed. Because of the rarity of the instances of an entity adopting the IFRS for SMEs twice, staff do not recommend allowing an entity to use the exemptions in Section 38 more than once.

<u>Question 38.3</u>

Does the Board agree with the staff recommendation that an entity should not be allowed to benefit from the special measurement and restatement exemptions available under Section 38 more than once?