STAFF PAPER

April 2013

IASB Meeting

Project	**Comprehensive review of the *IFRS for SMEs***		
Paper topic	Optional fallback to full IFRSs for financial instruments		
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Purpose of this paper

1. Agenda Paper 8E (this agenda paper) asks the IASB to consider the responses received to the question in the IASB's 2012 Request for Information (RFI) on the optional 'fallback' to IAS 39 *Financial Instruments: Recognition and Measurement* and to consider whether any amendments should be made to the *IFRS for SMEs*.

Structure of the paper

2. This agenda paper includes:

    (a) the question asked in the RFI (slightly condensed for this agenda paper);

    (b) a detailed summary of the main comments received (see Appendix B of Agenda Paper 8D for an explanation of the process staff followed in summarising responses in the comment letters);

    (c) staff analysis;

    (d) recommendations of the SME Implementation Group (SMEIG) and the IASB staff;

(e) the question for the IASB to discuss; and

(f) an appendix containing the full extract of the SMEIG recommendations on this issue from the final SMEIG report.

Use of recognition and measurement provisions in full IFRSs for financial instruments (Issue 7: Question S5)

Question S5 in the RFI: Use of recognition and measurement provisions in full IFRSs for financial instruments (Section 11)

The *IFRS for SMEs* currently permits entities to choose to apply either (paragraph 11.2):

- the provisions of both Sections 11 and 12 in full; or
- the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of Sections 11 and 12.

Any amendments to the *IFRS for SMEs* from this comprehensive review would most probably be effective at a similar time to the effective date of IFRS 9. The *IFRS for SMEs* refers specifically to IAS 39. SMEs are not permitted to apply IFRS 9.

How should the current option to use IAS 39 in the *IFRS for SMEs* be updated once IFRS 9 has become effective?

(a) There should be no option to use the recognition and measurement provisions in either IAS 39 or IFRS 9. All SMEs must follow the financial instrument requirements in Sections 11 and 12 in full.

(b) Allow entities the option of following the recognition and measurement provisions of IFRS 9 (with the disclosure requirements of Sections 11 and 12).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Note: the purpose of this question is ask whether the fallback to full IFRSs in Sections 11 and 12 should be removed completely, should continue to refer to an IFRS that has been superseded, or should be updated to refer to a current IFRS. It does not ask respondents to consider whether any of the recognition and measurement principles of IFRS 9 should result in amendments of the *IFRS for SMEs* at this stage.

Responses from comment letters

3. Approximately 35% of comment letters responding to Question S5 would not allow an option to use the recognition and measurement provisions in either IAS 39 or IFRS 9. They would require all SMEs to follow Sections 11 and 12 in full (choice (a)). The following points cover the main reasons given:

(a) Introducing options increase complexity of the Standard. They generally increase costs for both preparers and users of financial statements. They also reduce comparability between SMEs.

(b) The *IFRS for SMEs* should be a self-contained, standalone Standard with no fallbacks to full IFRSs. There is no reason to have an exception for financial instruments. Any options or requirements considered appropriate for SMEs should be incorporated in the *IFRS for SMEs*, not via a cross-reference to full IFRSs. Once IFRS 9 is effective, it may be appropriate to update Section 11 and 12 to incorporate its requirements, modified as appropriate for SMEs.

(c) Requirements in IFRS 9 are too complex for SMEs. Many SMEs do not have sufficient expertise or resources to apply these requirements properly and it would result in poor quality financial information if they decided to apply IFRS 9.

(d) If SMEs have the capability and want to apply complex accounting requirements, eg IFRS 9, they can apply full IFRSs.

(e) Based on our experience of use of the *IFRS for SMEs* (in South Africa), few SMEs are using the fallback to IAS 39 except for subsidiaries that produce full IFRS information for consolidation purposes.

4. Approximately 50% of the comment letters responding to Question S5 would allow SMEs the option of following the recognition and measurement provisions of IFRS 9 (with the disclosure requirements of Sections 11 and 12) (choice (b)). However, some supporters of an option to use IFRS 9 suggest waiting until IFRS 9 is established and the post-implementation review of IFRS 9 is completed. In contrast, others think the fallback to full IFRSs must be updated as soon as IFRS 9 becomes effective as it would not make sense to fallback to IAS 39 once it has been superseded. Many of the reasons given for allowing a fallback option to full IFRSs are similar to the reasons given for aligning the *IFRS for SMEs* with new and revised IFRSs (see Appendix B in Agenda Paper 8C (Issue 4), allowing SMEs an option to revalue property, plant and equipment (see paragraph 6 in Agenda Paper 8D (Issue 5)), and permitting or requiring SMEs to capitalise

borrowing/development costs (see paragraphs 15 and 16 in Agenda Paper 8D (Issue 6)). Additional reasons not covered under Issues 4-6 include:

(a) A fallback to IFRS 9 is necessary due to the wide spectrum of entities of different sizes and legal forms applying full IFRSs. Some SMEs have complex financial instrument transactions and it would be more appropriate for these entities to be able to use the fallback to full IFRSs. If the scope of the *IFRS for SMEs* is extended to include small financial institutions (Question S2) then an option to fallback to IFRS 9 is even more important.

(b) The reasons for permitting an option to use full IFRSs for financial instruments as stated in BC106 of the Basis for Conclusions remain valid.

(c) Compared with IAS 39, IFRS 9 is more consistent with Sections 11 and 12. Hence, a fallback to IFRS 9 will lead to more comparability with SMEs applying Section 11 and 12 than the previous fallback to IAS 39.

(d) The *IFRS for SMEs* should not make reference to a full IFRS standard that has been superseded. The target effective date of the revisions to the *IFRS for SMEs* coincides with the effective date of IFRS 9. If the option to apply IAS 39 is not changed to IFRS 9, the IASB will have to maintain IAS 39 only for SMEs or force all SMEs using IAS 39 to apply Sections 11/12. Preparers who have elected to use IAS 39, may also want the option to use IFRS 9 for the same reasons they had for using IAS 39.

5. Approximately 15% of comment letters responding to Question S5 chose (c) “other”. Other suggestions made by comment letters include:

(a) Before removing the option to fallback to full IFRSs, it is necessary to review the IASB’s reasons in BC106 for permitting the option. The IASB should also perform outreach to see to what extent entities are using the fallback in practice, and for what reasons.

(b) The IASB should incorporate the requirements of IFRS 9 (modified appropriately for SMEs) into Sections 11 and 12 when IFRS 9 has been implemented under full IFRSs and the post-implementation review has been concluded. Once this has been done the fallback to full IFRSs can be removed. In the interim period (ie until the next triennial review of the *IFRS for SMEs* is carried out) the fallback to IAS 39/IFRS 9 should remain to ensure consistency of application by SMEs.

(c) The wording in Section 11 should be revised to refer to "current full IFRS for financial instruments". The fallback to IAS 39 should be replaced by IFRS 9 when IFRS 9 becomes effective.

(d) IFRS 9 should be fully completed and not likely to change again before it is permitted for use by SMEs. Until that time the fallback to IAS 39 should remain.

(e) The fallback to IAS 39 should be updated to IFRS 9 as an interim solution. Once IFRS 9 becomes established under full IFRSs the IASB should consider whether to incorporate the requirements into Section 11.

Staff analysis

6. Paragraphs BC106 in the Basis for Conclusions accompanying the *IFRS for SMEs* contain the IASB's reasoning for permitting SMEs a choice of following Sections 11 and 12 or IAS 39:

> BC106 The *IFRS for SMEs* gives SMEs a choice of following Sections 11 and 12 or IAS 39 in accounting for all of their financial instruments. The Board's reasons for proposing that choice in this case are as follows:
>
> (a) Although Sections 11 and 12 are a simpler approach to accounting for financial instruments than IAS 39, some of the simplifications involve eliminating options that are available to companies with public accountability under IAS 39, for instance:
>
> (i) the fair value option.
>
> (ii) available-for-sale classification and the available-for-sale option.
>
> (iii) held-to-maturity classification.

(iv) a continuing involvement approach to derecognition (ie partial derecognition).

(v) the use of hedge accounting for hedges other than the four specific types identified in paragraph BC101(c).

The Board is currently reconsidering IAS 39 in its entirety and concluded that SMEs should be permitted to have the same accounting policy options as in IAS 39 pending completion of the comprehensive IAS 39 project.

(b) Because the default category for financial instruments in the scope of Section 12 is fair value through profit and loss under the *IFRS for SMEs*, and cost or amortised cost is permitted only when specified conditions are met, some items measured at cost or amortised cost under IAS 39 because of their nature would be measured at fair value through profit or loss under the *IFRS for SMEs*. Some SMEs might find this added fair valuation burdensome.

(c) Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. Those entities generally believe that the available-for-sale classification of IAS 39 is appropriate to account for strategic investments. Under the *IFRS for SMEs*, however, these strategic investments would be accounted for either at fair value through profit or loss or at amortised cost.

(d) The derecognition provisions of the *IFRS for SMEs* would not result in derecognition for many securitisations and factoring transactions that SMEs may enter into, whereas IAS 39 would result in derecognition.

SMEIG recommendation

The SMEIG recommends:

a) Removing the fallback to IAS 39.

b) Failing that, the IAS 39 fallback should be retained until IFRS 9 is considered for incorporation in the *IFRS for SMEs*.

If the second alternative is followed, the SMEIG recommends that the fallback to full IFRSs should be deleted once IFRS 9 has been considered for incorporation.

Staff recommendation

7. The staff analysis of the overall considerations when addressing new and revised IFRSs during this comprehensive review is in paragraph 15 of Agenda Paper 8C. In line with that analysis, staff recommend that IFRS 9 should not be considered

during this comprehensive review because it has not yet been completed in its entirety and so is subject to further amendment, and it is expected to result in complex changes that will benefit from significant implementation guidance in practice (paragraph 15(a) and (d) of Agenda Paper 8C).

8. The staff support part (b) of the SMEIG recommendation (but not part (a), at least during this comprehensive review). Consistent with the primary aim of developing a standalone, simplified set of accounting principles for SMEs the staff would prefer the fallback to IAS 39/IFRS 9 be ultimately removed. However, staff recommend that the fallback to IAS 39 is retained until IFRS 9 is considered at a future triennial review for the following reasons:

   (a) One of the main reasons for permitting a fallback to IAS 39 is the IASB felt that SMEs should be permitted to have the same accounting policy options as in IAS 39 pending completion of the IAS 39 project and this argument remains valid.

   (b) Where entities are currently applying IAS 39, it does not seem appropriate to require them to change to Section 11 and 12 when it is likely those sections will be amended during the next review.

   (c) The staff think most SMEs, except subsidiaries of full IFRSs groups, will have found the fallback to full IFRSs onerous and will have chosen to follow Sections 11 and 12 in full. However, without evidence that this is the case the staff does not believe the fallback to full IFRSs should be removed during this review.

9. In summary, staff propose that no change is made to Section 11 and 12 to incorporate the requirements of IFRS 9 during this review. Staff propose that the fallback to IAS 39 remains for the time being, even if IAS 39 is superseded before the next review of the *IFRS for SMEs*.

Question for the IASB
1) How should the current option to use IAS 39 in the *IFRS for SMEs* be updated once IFRS 9 has become effective?

Appendix A: Extract from near final draft of the SMEIG (Issue 7)

Issue 7) Use of recognition and measurement provisions in full IFRSs for financial instruments

A1. How should the current option to use IAS 39 in the IFRS for SMEs be updated once IFRS 9 has become effective?

The SMEIG recommends:

a) Removing the fallback to IAS 39.

b) Failing that, the IAS 39 fallback should be retained until IFRS 9 is considered for incorporation in the *IFRS for SMEs*.

If the second alternative is followed, the SMEIG recommends that the fallback to IAS 39 should only be deleted once IFRS 9 has been considered for incorporation.

SMEIG discussion

A2. The SMEIG generally felt the fallback to full IFRSs should be removed. However, it was agreed that before doing so it was important to assess to what extent the fallback was being used in practice. This could be done by asking a question in the exposure draft of amendments to the *IFRS for SMEs*. Several SMEIG members stated that in their experience few entities were using the fallback in practice and it was limited to subsidiaries of full IFRS groups.

A3. If feedback on the exposure draft indicates that the fallback to full IFRSs is being used more widely in practice, the SMEIG felt the fallback to IAS 39 should be retained until IFRS 9 is considered for incorporation in the *IFRS for SMEs* (under the criteria established in Issue 4). Once IFRS 9 is considered for incorporation, the fallback to full IFRSs could be deleted.

A4. SMEIG members would not support allowing a fallback to IFRS 9 once it becomes effective as this would result in entities needing to do a two-step transition (firstly from IAS 39 to IFRS 9, and secondly from IFRS 9 to Section

11/12 when IFRS 9 is incorporated and the fallback to full IFRSs is deleted). It was generally noted that a fallback to a superseded standard is not ideal. However the strong preference is to remove the fallback altogether if it is found that the fallback to IAS 39 has limited use in practice.