

STAFF PAPER

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SME Implementation Group

Project	Second Comprehensive Review of the <i>IFRS for SMEs</i>[®] Standard	
Paper topic	Other topics—recognition and measurement of development costs	
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Purpose of the paper

1. The purpose of this paper is to:
 - (a) discuss feedback on the recognition and measurement of development costs raised in questions N4 and N5 in the Request for Information *Comprehensive review of the IFRS for SMEs Standard* published in January 2020, following the International Accounting Standards Board (IASB) tentative decision in November 2021; and
 - (b) seek SME Implementation Group (SMEIG) members' views on whether and, if so, how to propose amendments to the *IFRS for SMEs* Standard for the recognition and measurement of development costs.
2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

Structure of the paper

3. This paper is structured as follows:
 - (a) questions in the Request for Information (paragraphs 4–6 of this paper);

- (b) feedback (paragraphs 7–16 of this paper);
- (c) staff analysis (paragraphs 17–48 of this paper); and
- (d) questions for the SMEIG.

Questions in the Request for Information

4. Question N4 in the Request for Information asked whether there are any topics the *IFRS for SMEs* Standard does not address that respondents think should be the subject of specific requirements (for example, topics not addressed by the Standard for which the general guidance in paragraphs 10.4–10.6 of the *IFRS for SMEs* Standard is insufficient).
5. Question N5 in the Request for Information asked respondents to describe any additional issues that they would like to bring to the IASB’s attention relating to the *IFRS for SMEs* Standard.
6. Feedback on the recognition and measurement of development costs was raised in responses to both questions N4 and N5 in the Request for Information.

Feedback

7. This section of the paper summarises the feedback on the recognition and measurement of development costs:
 - (a) feedback on the Request for Information (paragraphs 8–10 of this paper);
 - (b) feedback from SMEIG meeting in September 2021 (paragraphs 11–12 of this paper); and
 - (c) feedback from IASB meeting in November 2021 (paragraphs 13–16 of this paper).

Feedback on the Request for Information

8. The scope of the Second Comprehensive Review of the *IFRS for SMEs* Standard primarily focuses on new or amended IFRS Standards and IFRIC interpretations issued since the first comprehensive review, rather than revisit topics the IASB has

previously discussed or topics with no changes in IFRS Standards since the first comprehensive review. Consequently, the Request for Information did not seek views specifically on whether and, if so, how to propose amendments to the *IFRS for SMEs* Standard to align the recognition and measurement of development costs with IAS 38 *Intangible Assets*.

9. Respondents to the Request for Information raised comments on the treatment of development costs in the *IFRS for SMEs* Standard through questions N4 and N5. The *IFRS for SMEs* Standard requires development costs to be expensed when incurred, whereas IAS 38 requires development costs that meet specified criteria to be recognised as intangible assets. A small number of respondents suggested the IASB introduce an accounting policy option to recognise development costs as intangible assets based on similar criteria to IAS 38.
10. Respondents to the Request for Information that commented the IASB should permit an accounting policy option to recognise development costs as intangible assets for entities applying the *IFRS for SMEs* Standard said:
 - (a) development costs are significant costs for SMEs in some industries. A respondent said industries most affected include agriculture (improvements of seeds), engineering (development of prototypes to be produced on scale) and technology (development of computer programs and other topics emerging in the light of the 4th industrial revolution).
 - (b) expensing development costs that meet the criteria in IAS 38 to be recognised as intangible assets shifts an SME's financial statements away from its economic reality and does not faithfully represent transactions.
 - (c) in some cases, development costs have a direct relationship with future cash flows. Prohibiting an SME to recognise these costs as intangible assets affects the SME's performance measures and therefore users' evaluation of SMEs profitability and estimated future cash flows.
 - (d) the inability to recognise development costs as intangible assets has discouraged entities from applying the *IFRS for SMEs* Standard.

Feedback from SMEIG meeting in September 2021

11. At the SMEIG meeting in September 2021, the staff recommended the SMEIG propose the IASB take no further action on the feedback on development costs.¹ In developing this recommendation the staff:
- (a) took into consideration the fact that the IASB had considered the recognition of development costs as intangible assets in the first comprehensive review of the *IFRS for SMEs* Standard; and
 - (b) noted the subset of SMEs inclined towards applying recognition and measurement of IFRS Standards (that includes recognition of development costs as intangible assets) would be eligible to apply the reduced-disclosure requirements proposed by the IASB in its Exposure Draft *Subsidiaries without Public Accountability: Disclosures*.²
12. A small number of SMEIG members raised concerns on the staff recommendation. These SMEIG members said:
- (a) some SMEs, such as software developers, start-ups and entrepreneurs, have the resources to assess whether development costs meet the criteria of IAS 38 to be recognised as intangible assets;
 - (b) some SMEs will not be within the scope of the IASB's Exposure Draft *Subsidiaries without Public Accountability: Disclosures* and thus would not be able to benefit from applying recognition and measurement requirements of IFRS Standards with fewer disclosures as an alternative to the *IFRS for SMEs* Standard; and
 - (c) introducing an accounting policy option to permit, rather than require, an SME to recognise development costs as intangible assets would not add complexity to the Standard.

¹ See [Agenda Paper 8](#) of the September 2021 SMEIG meeting and the [SMEIG meeting report September 2021](#).

² The IASB's proposal in the [Exposure Draft Subsidiaries without Public Accountability: Disclosures](#) would permit subsidiaries eligible to apply the *IFRS for SMEs* Standard to apply the recognition, measurement and presentation requirements of IFRS Standards with reduced-disclosure requirements.

Feedback from IASB meeting in November 2021

13. At the IASB meeting in November 2021, based on the feedback on the Request for Information and advice from the SMEIG, the staff recommended the IASB:
- (a) retain the *IFRS for SMEs* Standard unchanged unless the IASB has sufficient evidence or new information to support the reconsideration of its previous decision on this topic, reached during the first comprehensive review of the *IFRS for SMEs* Standard in 2013, when the IASB decided to take no further action;³ and
 - (b) ask a question in the Exposure Draft proposing amendments to the *IFRS for SMEs* Standard resulting from the second comprehensive review of the Standard to help identify whether there is any new information that would warrant the IASB to revisit this topic.
14. IASB members overall disagreed with the staff recommendations as, in their view, this would lead to asymmetry in feedback. The IASB members said the staff should explore proposing amendments to the recognition (and measurement) of development costs in the Exposure Draft of amendments to the *IFRS for SMEs* Standard so that the IASB could then seek views on these proposed amendments.
15. Eight of 12 IASB members voted in favour of exploring possible amendments to the recognition and measurement of development costs in the *IFRS for SMEs* Standard.⁴
16. Consequently, the staff plan to present possible amendments to the *IFRS for SMEs* Standard for recognition and measurement of development costs for discussion at a future IASB meeting and to ask the IASB to decide whether and, if so, how to propose amendments in the Exposure Draft for this topic.

Staff analysis

17. This section of the paper presents the staff analysis for the recognition and measurement of development costs:
- (a) background (paragraphs 18–22 of this paper);

³ See [AP8D of the April 2013 IASB Meeting](#) and the [IASB Update April 2013](#).

⁴ See [AP30E of the November 2021 IASB Meeting](#) and the [IASB Update November 2021](#).

- (b) approaches to amending recognition and measurement of development costs for SMEs (paragraphs 23–30 of this paper); and
- (c) amending the recognition and measurement of developments costs for SMEs (paragraphs 31–48 of this paper).

Background

18. The *IFRS for SMEs* Standard requires an SME to expense development costs when incurred, whereas IAS 38 requires an entity:
 - (a) to recognise development costs that meet specified criteria as intangible assets. Paragraphs 57(a)–(f) of IAS 38 set out the criteria to recognise an intangible asset arising from development costs.
 - (b) to expense development costs that do not meet those criteria.
19. The *IFRS for SMEs* Standard simplifies the requirements of IFRS Standards. In developing the *IFRS for SMEs* Standard the IASB considered:
 - (a) the feedback from preparers and auditors that SMEs do not have the resources to assess whether a project is commercially viable on an ongoing basis; and
 - (b) the feedback from bank lending officers that information about development costs recognised as intangible assets is of little benefit in making lending decisions.⁵
20. As part of the first comprehensive review of the *IFRS for SMEs* Standard, the IASB considered revisiting the requirement that SMEs recognise all development costs as expense when incurred, including considering whether to give SMEs an accounting policy option to recognise development costs based on similar criteria to IAS 38.⁶ Although there was some support for introducing such an option, the IASB continued to look at the balance of costs and benefits, and chose to retain unchanged the recognition and measurement of development costs in the *IFRS for SMEs* Standard as part of the first comprehensive review.⁷

⁵ See paragraphs BC113–BC114 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

⁶ See paragraphs BC213–BC214 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

⁷ See [AP8D of the April 2013 IASB meeting](#) and the [IASB Update April 2013](#).

21. In 2013, SMEIG members had mixed views on the recognition of development costs:
- (a) some members recommended permitting SMEs an option to either expense or recognise development costs as intangible assets based on similar criteria to IAS 38;
 - (b) some members recommended requiring recognition of development costs on the statement of financial position but with an undue cost or effort exemption; and
 - (c) other members recommended retaining the Standard unchanged for cost-benefit reasons.⁸
22. The staff also note that the IASB may decide to retain unchanged the recognition and measurement requirements of development costs in the *IFRS for SMEs* Standard as part of the second comprehensive review.

Approaches to amending recognition and measurement of development costs for SMEs

23. As mentioned in paragraphs 14–15 of this paper, at the November 2021 IASB meeting, the IASB agreed that the staff should explore possible amendments to the recognition (and measurement) of development costs to include in the Exposure Draft of amendments to the *IFRS for SMEs* Standard. This section of the paper explores possible approaches to amending the recognition and measurement requirements for development costs in the *IFRS for SMEs* Standard.
24. The staff think possible approaches to amending the recognition and measurement requirements for development costs in the *IFRS for SMEs* Standard the IASB may consider are:
- (a) introducing an accounting policy option to recognise as intangible assets the development costs meeting similar criteria to those in IAS 38 (see paragraphs 25–28 of this paper); or

⁸ See [Agenda Paper 2](#) of the February 2013 SMEIG meeting and [Agenda Paper 4](#) for the March 2013 SMEIG meeting report.

- (b) requiring an SME to recognise as intangible assets the development costs meeting similar criteria to those in IAS 38 with an undue cost or effort exemption (see paragraphs 29–30 of this paper).

As an accounting policy option

25. The *IFRS for SMEs* Standard could be amended to introduce an accounting policy option enabling an SME to either recognise development costs as intangible assets or expense them. An SME that elected to recognise development costs as intangible assets as its accounting policy would apply requirements similar to those in paragraph 57 of IAS 38.
26. The staff think permitting an SME to elect to recognise development costs as intangible assets as an accounting policy (not on a project-by-project basis):
 - (a) would enable SMEs capable of assessing the commercial viability of their development activities to recognise intangible assets arising from development costs;
 - (b) would enable SMEs that would not benefit from incurring the ongoing cost of assessing commercial viability of development activities to opt to expense development costs as incurred; and
 - (c) would enable SMEs to balance the cost-benefit of recognising development costs as intangible assets, meet the information needs of users of their financial statements and not impose unnecessary burden on SMEs.
27. Further, the staff note that *FRS 102*, which is the Financial Reporting Standard applicable in the UK and Republic of Ireland derived from the *IFRS for SMEs* Standard, permits the recognition of intangible assets arising from development costs as an accounting policy option to allow a treatment that existed in previous UK and Ireland accounting standards.
28. However, the staff note that the IASB observed that introducing accounting policy options in the *IFRS for SMEs* Standard would:
 - (a) increase complexity of the *IFRS for SMEs* Standard;⁹

⁹ See paragraphs BC208–BC209 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

- (b) reduce comparability between SMEs;
- (c) generally increase cost for both preparers and users of SMEs financial statements;¹⁰ and
- (d) result in more accounting policy options than in IFRS Standards.¹¹

Requiring recognition of intangible assets with an undue cost or effort exemption

29. As the IASB aims to limit accounting policy options, the staff think the IASB may balance the costs and benefits of requiring the recognition of development costs as intangible assets by providing an undue cost or effort exemption:

- (a) if recognition of development costs as intangible assets can be assessed on an ongoing basis without undue cost or effort, SMEs would be required to recognise and measure development costs on a basis aligned to IAS 38.
- (b) if recognition of development costs as intangible assets cannot be assessed on an ongoing basis without undue cost or effort, SMEs would continue to expense development costs when incurred as currently required by paragraph 18.14 of the *IFRS for SMEs* Standard.

30. As per paragraph 2.14B of the *IFRS for SMEs* Standard, an undue cost or effort exemption is dependent on each SME's specific circumstances and management's judgement of the costs and benefits from applying the requirement.

Amending the recognition and measurement of development costs for SMEs

31. As part of the second comprehensive review, the IASB tentatively decided to apply three 'alignment principles' in considering whether and, if so, how to align the *IFRS for SMEs* Standard with new and amended IFRS Standards. The three principles are 'relevance to SMEs', 'simplicity' and 'faithful representation'.

32. Although IAS 38 is not a new or amended IFRS Standard, the staff think those three principles could assist the IASB in deciding whether to propose amendments to the recognition and measurement of development costs. This section of the paper therefore assesses the potential for amending the recognition and measurement

¹⁰ See paragraphs BC208–BC209 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

¹¹ See paragraph BC214 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

requirements for development costs applying the principles of relevance to SMEs, simplicity and faithful representation.

Relevance to SMEs

33. The *Conceptual Framework for Financial Reporting* sets out relevant financial information as information capable of making a difference in the decisions made by users. In this context, the staff are of the view that recognising intangible assets arising from development costs that meet specified criteria would be relevant to SMEs as they provide useful information about SMEs business models and expected future cash-flow to users, whilst upholding the principle of faithful representation amongst others. This is further supported by feedback on the Request for Information which states the inability to recognise intangible assets arising from development costs has affected user's evaluation of SMEs.¹²
34. As noted in paragraph 19 of this paper, paragraphs BC113–BC114 of the Basis for Conclusions on the *IFRS for SMEs* Standard set out the IASB's basis for requiring SMEs to expense all development costs when incurred. However, in November 2021, the IASB tentatively decided to reassess the basis for prohibiting recognition of development costs as intangible assets in the *IFRS for SMEs* Standard. In September 2021, a SMEIG member also said that SMEs today, especially those engaged in significant research and development activities as their primary business, are likely to be able to assess whether a project is commercially viable on an ongoing basis. Additionally, the staff note that recognition of development costs as intangible assets would also benefit users such as lenders. Feedback from outreach with lenders indicated the need to understand SMEs business models and sustainability of business models when making lending decisions. The staff think the recognition of development costs as intangible assets would improve information made available to lenders on the sustainability of revenue streams and completeness of business models of SMEs in making lending decisions. In short, the staff think this feedback suggests that the recognition of development costs as intangible assets today is relevant to SMEs and would benefit users of SMEs financial statements in decision making.

¹² See [comment letter 40](#) of the *Comprehensive Review of the IFRS for SMEs Standard* October 2020.

35. The staff also think the recognition of development costs as intangible assets would ensure consistency with principle-based accounting requirements as opposed to a uniform accounting requirement to expense such costs.
36. Further, the staff note that the feedback on the IASB's Third Agenda Consultation includes calls for the IASB to undertake a comprehensive review of IAS 38 to better reflect the increasing importance of intangible assets in today's business models, particularly for unrecognised internally generated assets.¹³ In the staff's view, this feedback indicates that the holding of intangible assets is becoming more prevalent among entities today, and continuing to prohibit the recognition of intangible assets arising from development costs in the *IFRS for SMEs* Standard is not consistent with ensuring relevant financial information is made available to users of SMEs financial statements, in light of the evolving digital economy.
37. Finally, the staff note that permitting an SME to recognise development costs as intangible assets would address feedback from the Request for Information that said the limitation on recognition of development costs as intangible assets may have deterred jurisdictions and/or individual entities from adopting and/or applying the *IFRS for SMEs* Standard.
38. Therefore, the staff think the recognition of development costs as intangible assets would be relevant to SMEs, especially SMEs engaged in research and development activities, given these types of SMEs may be increasingly prevalent in the light of the evolving digital economy.

Simplicity

39. Paragraph 57 of IAS 38 states that an intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate its fulfilment of all criteria set out in paragraphs 57(a)–(f) of IAS 38.
40. The staff note that aligning the recognition and measurement of development costs in the *IFRS for SMEs* Standard with IAS 38 would require SMEs to assess on an

¹³ See [AP24D of the November 2021 IASB Meeting](#) and the [IASB Update November 2021](#).

ongoing basis whether the costs fulfil all six criteria set out in paragraphs 57(a)–(f) of IAS 38.

41. The staff think requiring all SMEs to assess all six criteria in IAS 38 on an ongoing basis would impose burden on SMEs, especially those that have limited research and development activities. Therefore, the staff think requiring the recognition of intangible assets arising from development costs as per IAS 38 would complicate the application of the *IFRS for SMEs* Standard and not maintain its simple application.
42. The staff are of the view that aligning the recognition and measurement requirements of development costs in the *IFRS for SMEs* Standard with IAS 38 and providing an undue cost or effort exemption may also be burdensome for SMEs. If the IASB requires an SME to recognise development costs meeting the criteria in IAS 38 as intangible assets, the benefit of an undue cost or effort exemption may be limited as the SME may still need to assess the criteria in IAS 38. To avoid this the IASB would need to apply the undue cost or effort exemption to the process of assessing the criteria in IAS 38. This would save on costs if it is clear to an SME that the assessment itself would be time-consuming.
43. The staff are of the view that permitting the recognition of development costs as intangible assets (as opposed to requiring as per IAS 38) would be less burdensome for SMEs. The staff think permitting recognition of intangible assets arising from development costs as an accounting policy would enable each SME to assess and balance the costs and benefits of the recognition model. Nevertheless, the staff note that introducing an accounting policy option for the recognition of intangible assets arising from development costs reduces comparability of SME financial statements.
44. The staff note that retaining the *IFRS for SMEs* Standard requirement to expense all development costs would minimise costs of preparing financial statements for SMEs and maintain the simple application of the *IFRS for SMEs* Standard. This is consistent with the IASB's acknowledgement of the different user needs of SMEs financial statements and SMEs limitations in, and cost of accounting expertise available to SMEs.¹⁴ This viewpoint relies on the view that requiring recognition of development

¹⁴ See paragraph BC47 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

costs as intangible assets is complex and thereby choosing not to include the requirement is a simplification in the *IFRS for SMEs* Standard.

45. Accordingly, the staff think retaining the *IFRS for SMEs* Standard requirement to expense all development costs when incurred best ensures that the simple application of the *IFRS for SMEs* Standard is maintained.

Faithful representation

46. Faithful representation refers to depicting financial statements in a manner that is complete, neutral and free from error.¹⁵ In the staff's view, aligning the recognition of development costs meeting specified criteria as intangible assets with IAS 38 would attain the faithful representation objective—that is to faithfully represent both the relevant phenomena and substance of the phenomena arising from development costs.
47. Consistent with the principle of faithful representation, the staff think aligning the *IFRS for SMEs* Standard with IAS 38 for the recognition of intangible assets arising from development costs would encourage value-added forward-looking voluntary disclosures to users of SMEs financial statements, as recognition requirements include gathering substantial information about project feasibility and commercial viability, which can then be used to compile disclosures.¹⁶ Improved disclosures and information on SMEs development costs made available would enable users to develop a better understanding of SMEs profitability, business model and future cash-flows, therefore faithfully representing SMEs financial performance.
48. Similarly, the staff think permitting (as an accounting policy option or requiring with an 'undue cost or effort exemption') an SME to recognise development costs as intangible assets would lead to similar benefits discussed in paragraphs 46–47 of this paper. However, the staff note that permitting (as opposed to requiring as per IAS 38) recognition of development costs as intangible assets will enable SMEs whose benefits exceed the costs of assessing the commercial viability of their projects on an ongoing basis to recognise development costs as intangible assets when applicable.

¹⁵ See paragraphs 2.12–2.19 of the *Conceptual Framework for Financial Reporting*.

¹⁶ Chen, Ester and Gavious, Ilanit and Lev, Baruch Itamar, The Positive Externalities of IFRS R&D Capitalization: Enhanced Voluntary Disclosure (November 23, 2016). *Review of Accounting Studies*, Forthcoming, Available at SSRN: <https://ssrn.com/abstract=2874953>

On the other hand, SMEs whose costs exceed the benefits of assessing the commercial viability of their projects on an ongoing basis may continue to expense development costs when incurred. This would better ensure faithful representation of SMEs financial statement whilst maintaining the simple application of the *IFRS for SMEs* Standard.

Questions for the SMEIG

Questions for the SMEIG

1. Do SMEIG members agree with the staff analysis in paragraphs 31–48 of this paper on applying the alignment principles to the recognition and measurement requirements of development costs in the *IFRS for SMEs* Standard?
2. Do SMEIG members agree that the IASB should propose amending the recognition and measurement requirements of development costs in the *IFRS for SMEs* Standard to permit, but not require, an SME to recognise development costs as intangible assets, as described in paragraph 48 of this paper? Why or why not?