IFRS Accounting

Staff paper

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IASB® meeting

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Project	**Second Comprehensive Review of the *IFRS for SMEs®* Accounting Standard**
Topic	**Recognition of development costs**
Contacts	Edlyn Chigerwe (edlyn.chigerwe@ifrs.org)

Introduction and purpose of the paper

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to:

   (a) consider feedback on development costs—a topic that the IASB considered but for which amendments were not proposed in the Exposure Draft *Third edition of the* IFRS for SMEs *Accounting Standard* (Exposure Draft); and

   (b) decide whether to amend the recognition requirements for development costs in the *IFRS for SMEs* Accounting Standard (the Standard).

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the Standard.

Structure of the paper

3. This paper is structured as follows:

   (a) staff recommendation (paragraph 4);

   (b) current requirements for development costs (paragraphs 5–8);

   (c) feedback on the 2020 Request for Information (paragraphs 9–10);

(d) question in the Exposure Draft (paragraphs 11–14);

(e) feedback from comment letters (paragraphs 15–20);

(f) staff analysis (paragraphs 21–35);

(g) staff recommendation and question for the IASB (paragraph 36); and

(h) Appendix—extract from the Basis for Conclusions on the *IFRS for SMEs* Accounting Standard.

Staff recommendation

4. The staff recommend the IASB amend the *IFRS for SMEs* Accounting Standard to introduce an accounting policy option that permits an SME to recognise intangible assets arising from development costs that meet the criteria in paragraphs 57(a)–(f) of IAS 38 *Intangible assets*.

Background

Current requirements for development costs

5. Section 18 *Intangible Assets other than Goodwill* of the *IFRS for SMEs* Accounting Standard requires SMEs to recognise expenditure incurred on research and development activities as an expense, whereas IAS 38 requires the recognition of intangible assets arising from development costs that meet specified criteria. The requirement to recognise expenditure on research and development activities as an expense is a simplification of the requirements in IAS 38 and was made for cost-benefit reasons.

6. In developing the *IFRS for SMEs* Accounting Standard, the IASB considered:

(a) 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 meet the recognition criteria for intangible assets in IAS 38; and

(b) feedback from bank lending officers that information about development costs recognised as intangible assets is of little benefit in making lending decisions (see paragraphs BC113–BC114 of the Basis for Conclusions on the Standard).

7. Paragraph 57 of IAS 38 sets out the recognition requirements for development costs and states:

> 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 all of the following:
>
> (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.
>
> (b) its intention to complete the intangible asset and use or sell it.
>
> (c) its ability to use or sell the intangible asset.
>
> (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
>
> (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
>
> (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

8. As part of the first comprehensive review of the *IFRS for SMEs* Accounting Standard, the IASB reconsidered the requirement that SMEs recognise all expenditure on research and development as an expense when incurred, including considering whether to give SMEs an accounting policy option to recognise development costs based on similar criteria to IAS 38. Although there was some support from

stakeholders and members of the SME Implementation Group (SMEIG) for introducing such an option, the IASB decided to retain the recognition requirements of development costs in the *IFRS for SMEs* Accounting Standard for cost-benefit reasons. The IASB's reasoning is further explained in paragraph BC213–BC214 of the Basis for Conclusions on the Standard (See paragraph A2 of the Appendix to this paper).

Feedback on the 2020 Request for Information

9. In January 2020, the IASB published Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard* (2020 Request for Information) as a first step in its second comprehensive review.

10. A few respondents to the 2020 Request for Information said the IASB should amend the Standard to permit an SME to recognise intangible assets arising from development costs meeting the criteria in paragraph 57(a)–(f) of IAS 38.

Question in the Exposure Draft

11. Given the feedback to the 2020 Request for Information, at its February 2022 meeting[1], the IASB discussed two approaches to amending recognition and measurement requirements for development costs:

    (a) permitting an SME to recognise as intangible assets the development costs meeting similar criteria to those in IAS 38, by introducing an accounting policy option; or

    (b) requiring an SME to recognise as intangible assets the development costs meeting similar criteria to those in IAS 38 unless this would involve undue cost or effort (that is providing an undue cost or effort exemption).

[1] See AP30D Towards an Exposure Draft—Other topics (Recognition and measurement of development costs) of the February 2022 meeting and IASB update.

12. The IASB asked the advice of the SMEIG on these approaches. The majority of SMEIG members said the IASB should permit an SME to recognise as intangible assets development costs meeting similar criteria to those in IAS 38, as an accounting policy option. These SMEIG members said:

    (a) an accounting policy option would be easier to apply as it would require less judgement than requiring recognition of development costs as intangible assets with an undue cost or effort exemption. Therefore, it would be consistent with the objective of keeping the *IFRS for SMEs* Accounting Standard simple; and

    (b) intangible assets arising from development costs represent a significant asset class for some SMEs. Such SMEs should, therefore, be given the option to recognise development costs as intangible assets to ensure faithful representation.

13. The IASB aims to restrict accounting policy options in the Standard because including more complex options generally increases complexity and reduces comparability. However, in applying its alignment approach, the IASB noted that introducing an accounting policy option would be more consistent with the principle of simplicity compared to requiring recognition of intangible assets arising from development costs unless doing so involves undue cost or effort. The IASB noted that the undue cost or effort assessment for recognising intangible assets arising from development costs would require judgement and would add complexity for all SMEs.

14. In developing the Exposure Draft, the IASB continued to agree with its reasoning that typically SMEs should recognise development costs as expenses considering the feedback in paragraph 6 of this paper. Therefore, IASB did not propose to amend the recognition and measurement requirements for development costs in the Exposure Draft but acknowledged new information might be identified that would warrant amending these requirements. Therefore, in the Invitation to Comment on the Exposure Draft, the IASB asked about the costs and benefits of introducing an accounting policy option permitting an SME to recognise intangible assets arising from development costs meeting the criteria in paragraph 57(a)–(f) of IAS 38.

Feedback from comment letters

15. The question asked in the Invitation to Comment is reproduced below:

Question 13

What are your views on the costs and benefits, and the effects on users, of introducing an accounting policy option that permits an SME to recognise intangible assets arising from development costs that meet the criteria in paragraphs 57(a)–(f) of IAS 38?

16. Most respondents who commented on Question 13 supported introducing an accounting policy option that would permit the recognition of intangible assets arising from development costs that meet the specified criteria in IAS 38. A few of these respondents made the following comments on the costs, benefits and effects of this proposal:

    (a) it would enable entities that incur significant development costs to demonstrate the extent to which the entity's operations may give rise to assets that generate future economic benefits, which will result in faithful representation and improve the quality of financial reporting. This will be particularly relevant for entities in the technology industry and in the start-up phase. Such entities are incurring more development costs than when the *IFRS for SMEs* Accounting Standard was first issued in 2009, for example because they are investing more in technology and innovation.

    (b) it would encourage those SMEs to adopt the *IFRS for SMEs* Accounting Standard that are deterred from doing so because development costs are not recognised as intangible assets. Adopting this Standard could reduce the cost and effort of preparing financial statements for these entities.

    (c) for many SMEs, the effort of tracking such costs and analysing them against subjective criteria may not justify the benefits. Providing an accounting policy option would enable SMEs that prefer to expense development costs based on cost-benefit considerations to continue to do so.

(d) such an accounting policy option has been introduced in other local GAAP such as Argentine GAAP, Swedish GAAP (K3), Canadian Accounting Standards for Private Entities and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and there are no known issues.[2]

17. A few respondents said if an accounting policy option is introduced, the criteria for capitalisation should be aligned with IAS 38 because the use of different words to convey the same principles would introduce additional complexity and uncertainty about the intended meaning. Furthermore, a few respondents suggested that field testing should be conducted for the criteria for capitalisation.

18. A few respondents suggested the requirement in the Standard to recognise both research and development costs as an expense should remain unchanged. These respondents provided the following reasons:

(a) lenders disregard information about intangible assets arising from development costs when making lending decisions.

(b) SMEs lack the resources to demonstrate whether development costs meet the criteria in paragraphs 57(a)–(f) of IAS 38. Furthermore, the accounting policy option will introduce complexities due to subsequent judgment to be applied in determining useful life and impairment tests of the intangible assets arising from development costs.

(c) retaining the current accounting requirement supports the principle of simplification and is consistent with the IASB's aim to restrict accounting policy options in the Standard (see paragraph BC257 of the Basis for Conclusions on the Exposure Draft).

19. A few respondents suggested the IASB await the results of its research pipeline project on intangible assets before making amendments to the *IFRS for SMEs* Accounting Standard.

[2] Some of these local GAAP, such as Argentine GAAP and FRS 102 *The Financial Reporting Standard applicable in the* UK *and Republic of Ireland*, are based on the *IFRS for SMEs* Accounting Standard.

20. A few respondents suggested the IASB should consider full alignment with IAS 38, which requires the recognition of intangible assets arising from development costs that meet specified criteria. These respondents provided the following reasons:

    (a) an entity selecting an accounting policy to recognise development costs as an expense when the criteria to recognise an intangible asset is met would not result in faithful representation.

    (b) entities that incur significant development costs would have completed a research phase and be aware of the status of their development activities and be able to make the necessary judgements in determining whether these costs meet the specified criteria for recognition of intangible assets.

    (c) many start-ups and entities in the technology sector are funded specifically to conduct research and development activities, and consequently, development costs might be the most significant asset in their statements of financial position.

    (d) introducing an accounting policy option would reduce comparability between entities and increase complexity in the Standard.

Staff analysis

21. The staff analysis is set out as follows:

    (a) application of the alignment approach (paragraphs 22–23 of this paper);

    (b) assessment of relevance to SMEs (paragraphs 24–27 of this paper);

    (c) assessment of simplicity and cost-benefit (paragraphs 28–32 of this paper); and

    (d) assessment of faithful representation (paragraphs 33–35 of this paper).

Application of the alignment approach

22. The alignment approach treats alignment with full IFRS Accounting Standards as the starting point for developing the *IFRS for SMEs* Accounting Standard, and applies the principles of relevance to SMEs, simplicity and faithful representation, including the

assessment of costs and benefits, in determining whether and how that alignment should take place. The IASB applies the alignment approach to each new or revised IFRS Accounting Standard within the scope of the review.

23. Although IAS 38 is not a new or amended IFRS Accounting Standard in the scope of the review, the staff think the alignment approach could assist the IASB in assessing the feedback and deciding whether to amend the recognition requirements of development costs.

Assessment of relevance to SMEs

24. The IASB determines relevance to SMEs by assessing whether the problem addressed by a new requirement in full IFRS Accounting Standards would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Accounting Standard (see paragraph BC30 of the Basis for Conclusions on the Exposure Draft).

25. At its February 2022 meeting, the IASB discussed the relevance of recognising intangible assets arising from development costs for SMEs. The staff maintain the view from that meeting that recognising intangible assets arising from development costs that meet the IAS 38 criteria meets the relevance principle whilst upholding the principle of faithful representation. This is because it would provide useful information about SMEs business models and expected future cash-flow as explained in paragraph 26 of this paper.

26. Respondents to the 2020 Request for Information and the Exposure Draft, said some SMEs today, especially entities in the technology industry and in the start-up phase, are incurring more development costs and can assess whether a project is commercially viable on an ongoing basis. The staff think that recognition of intangible assets arising from development costs for these SMEs may benefit users such as lenders. Feedback from outreach with lenders indicated their need to understand SMEs business models and sustainability of business models when making lending

decisions[3]. The staff think where SMEs have significant development costs, the recognition of intangible assets arising from those development costs that meet specified criteria would improve information made available to lenders on the sustainability of revenue streams and completeness of business models of SMEs in making lending decisions.

27. In summary, the staff think the feedback suggests that the recognition of intangible assets arising from development costs would be relevant to SMEs. Recognising such assets would be especially relevant to SMEs engaged in research and development activities. These types of SMEs are increasingly prevalent in the evolving digital economy.

Assessment of simplicity and cost-benefit

28. Most respondents who commented on Question 13 of the Invitation to Comment and most SMEIG members supported introducing an accounting policy option that permits the recognition of intangible assets arising from development costs that meet the criteria in IAS 38.

29. The staff understand the IASB's reasoning for restricting accounting policy options in the *IFRS for SMEs* Accounting Standard, as explained in paragraphs BC208–BC209 of the Basis for Conclusions on the Standard. However, in limited cases, the IASB has included accounting policy options in the Standard applying the simplification principle. For example, the cost model, the equity method or the fair value model is permitted for accounting for investments in associates. The staff think introducing an accounting policy choice would be an appropriate application of the simplification principle for development costs because this would:

    (a) enable those SMEs that are capable of assessing the commercial viability of their development activities to recognise intangible assets arising from development costs;

[3] See slide 40 and 43 of the 2020 Request for Information user survey and user interview feedback summary, discussed at the February 2021 SME Implementation Group (SMEIG) meeting.

(b) not add excessive complexity to the Standard for SMEs that are unable to assess the commercial viability of their development activities, as those SMEs could continue to expense development costs as incurred; and

(c) enable SMEs to apply judgement in developing an accounting policy considering their own circumstances and the information needs of users of their financial statements, without imposing unnecessary burden on SMEs.

30. The staff think permitting SMEs to recognise intangible assets arising from development costs as an accounting policy choice would lead to the benefits discussed in paragraph 29 of this paper without complexities introduced by an undue cost or effort exemption. This is because the undue cost or effort exemption would require all SMEs to assess their development costs against the six criteria in paragraph 7 of this paper. This would require judgement that would impose an undue burden on some SMEs.

31. The staff agree with the respondents that suggested that the criteria for assessing whether an intangible asset that arises from development costs should be recognised as an asset should be aligned with paragraphs 57(a)–(f) of IAS 38. This is because respondents have told us that some SMEs now have the ability to apply the criteria in paragraphs 57(a)–(f) of IAS 38. In addition, the staff think recognising an intangible asset from development costs could result in reliable and more relevant information for users of these SMEs' financial statements. On the other hand, if an SME does not have the ability to apply the IAS 38 criteria and/or does not have significant development costs, the staff think that recognising an intangible asset from development costs would not generally result in the financial statements providing reliable and more relevant information. Therefore, these SMEs would continue to expense their development costs (see paragraphs 10.8–10.10 of the Standard).

32. The staff do not agree with respondents that suggested full alignment with IAS 38, which requires recognition of intangible assets from development costs that meet specified criteria. The *IFRS for SMEs* Accounting Standard simplifies the principles and requirements in full IFRS Accounting Standards for SMEs based on users' needs

and cost-benefit considerations. The staff think requiring all SMEs to assess all six criteria in IAS 38 on an ongoing basis would impose an undue burden on SMEs, especially those that have limited research and development activities.

Assessment of faithful representation

33. The principle of faithful representation is intended to help the IASB assess whether financial statements prepared applying the Standard would faithfully represent the substance of economic phenomena in words and numbers.

34. The staff note that retaining the *IFRS for SMEs* Accounting Standard requirement to expense all development costs would minimise costs of preparing financial statements for SMEs and maintain the simple application of the Standard. However, as noted in paragraph 16(a) of this paper, SMEs in the technology industry and in the start-up phase are now incurring more development costs than when the Standard was first issued in 2009. The IASB has received feedback that these SMEs are able to assess whether a project is commercially viable on an ongoing basis and determine whether development cost meet the criteria in paragraphs 57(a)–(f) of IAS 38. Continuing to prohibit these SMEs from recognising intangible assets arising from development costs is not considered consistent with ensuring relevant financial information is made available to users of SMEs financial statements.

35. Furthermore, the staff think awaiting results of the research pipeline project on intangible assets before making amendments to the *IFRS for SMEs* Accounting Standard would delay the benefits to SMEs and users of their financial statements of recognising an intangible asset arising from development costs. Any improvements to IFRS Accounting Standards introduced by the project on intangible assets will be considered through the periodic reviews of the Standard.

Staff recommendation and question for the IASB

36. The staff recommend the IASB amend the *IFRS for SMEs* Accounting Standard to introduce an accounting policy option that permits an SME to recognise intangible assets arising from development costs that meet the criteria in paragraphs 57(a)-(f) of IAS 38.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 36 of this paper to amend the *IFRS for SMEs* Accounting Standard to introduce an accounting policy option that permits an SME to recognise intangible assets arising from development costs that meet the criteria in paragraphs 57(a)-(f) of IAS 38.

Appendix—extract from the Basis for Conclusions on the *IFRS for SMEs* Accounting Standard

A1. The following extract summarises the considerations of the IASB when developing the recognition and measurement requirements for borrowing costs.

Charge all development costs to expense

BC113 IAS 38 requires all research costs to be charged to expense when incurred, but development costs incurred after the project is deemed to be commercially viable are to be capitalised. Many preparers and auditors of SMEs' financial statements said that SMEs do not have the resources to assess whether a project is commercially viable on an ongoing basis and, furthermore, capitalisation of only a portion of the development costs does not provide useful information. Bank lending officers told the Board that information about capitalised development costs is of little benefit to them, and that they disregard those costs in making lending decisions.

BC114 The Board accepted those views, and the *IFRS for SMEs* requires all research and development costs to be recognised as expenses when incurred.

A2. The following extract summarises the considerations of the IASB during the first comprehensive review of the *IFRS for SMEs* Accounting Standard when reviewing the recognition and measurement requirements for development costs.

Capitalisation of development or borrowing costs

BC213 Only a small number of respondents to the RFI and the 2013 ED supported a requirement for SMEs to capitalise development and/or borrowing costs based on similar criteria to full IFRS. However, several respondents supported giving SMEs an option to capitalise development and borrowing costs based on similar criteria to full IFRS. They supported introducing this option for reasons similar to those expressed by respondents in paragraph BC210, ie the effect on current and future borrowing arrangements and high-inflation environments. However, many respondents did not support changing the current requirements and would continue to require SMEs to expense all development and borrowing costs.

BC214 The *IFRS for SMEs* requires all borrowing and development costs to be recognised as expenses. Full IFRS requires the capitalisation of borrowing and development costs meeting certain criteria; otherwise they are recognised as expenses. Consequently, the *IFRS for SMEs* simplifies the requirements in full IFRS, instead of removing an option permitted in full IFRS. The IASB therefore noted that allowing options to capitalise certain development and borrowing costs would involve different considerations than allowing a revaluation option for property, plant and equipment. In particular the IASB observed that permitting accounting policy options to capitalise development and borrowing costs that meet the criteria for capitalisation in IAS 38/IAS 23, in addition to the current approach, would result in more accounting policy options than full IFRS. The IASB noted that it continues to support its rationale for requiring the recognition of all development and borrowing costs as expenses, for cost-benefit reasons as set out in paragraphs BC113–BC114 and BC120, and for not providing the additional, more complex, accounting policy options for SMEs as set out in paragraphs BC208–BC209. The IASB noted that an SME should disclose additional information about its borrowing or development costs if it is considered relevant to users of its financial statements.