November 2007

AFRAC

AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

Comment Letter

Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities

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The **AFRAC Small and Medium-sized Entities Working Group** prepares comment letters on recent IASB publications for final approval by AFRAC. Principal authors of this comment letter were Otto Altenburger, Romuald Bertl, Eva Eberhartinger, Martin Feige, Christoph Krischanitz, Thomas Leissing, Felix Mayrhofer-Grünbühel, Gerhard Prachner, Bernd Spohn and Alfred Wagenhofer. More information about the Working Group and AFRAC is available under www.afrac.at.

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Outline

1. General Comments

AFRAC is pleased to have the opportunity to share with IASB its views and comments on the Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities (for further references: ED IFRS for SMEs) of the International Accounting Standards Board (IASB).

AFRAC supports the development of a simplified set of international financial reporting standards with requirements that are consistent with the conceptual basis of IFRS. Given a good understanding of users' needs, such a set of standards ought to increase the understandability of financial reporting by companies without public accountability. It would, though, need to strike a reasonable balance between costs and benefits.

In AFRAC's opinion IASB's ED represents a considerable advance, because it establishes the objective of a stand-alone document, introduces recognition and measurement simplifications, and separates the ongoing maintenance of the future standard from the revision process for full IFRSs.

However AFRAC believes that the proposed standard can be further improved. Our detailed comments are in the form of answers to the questions. As a preliminary, this is a general comment.

AFRAC suggests that clarity for SMEs could be improved if defined terms are printed bold every time they appear rather than only the first time in each paragraph. We believe users do not read each paragraph from the beginning to the end.

2. Specific Comments

Q1. ***Stand-alone document*** *– With the objective of a stand–alone document in mind, are there additional transactions, other events or conditions that should be covered in the proposed standard to make it more self-contained? Conversely, is there guidance in the draft standard that should be removed because it is unlikely to be relevant to typical SMEs with about 50 employees?*

AFRAC believes that the ED is an advance on previous discussion papers and staff drafts of an IFRS for SMEs, since the stand-alone approach is clearly defined as an objective of the standard. AFRAC also welcomes the reduction of mandatory fall-backs to full IFRS and the proposed separate update procedure.

AFRAC supports the deletion of paragraph 10.3(c) of former staff drafts of the ED referring to the requirements and guidance in full IFRS and Interpretations of full IFRSs dealing with similar and related issues. We believe that the IFRS for SMEs should deal with and include the requirements for all transactions that are common for SMEs and should be a complete, stand-alone document. If the transactions are not frequent for SMEs, then the accounting treatment should rely on general principles. We are therefore of the opinion that paragraph 10.4 could also be deleted. Furthermore, we believe that options should not be dealt with by means of a reference to full IFRS (e.g., PPE in paragraph 16.13) but rather by providing a short description for SMEs of the option in the IFRS. Moreover, AFRAC believes that it is not stated clearly enough that the standard must be consistently applied and does not permit cherry-picking, and that it requires full disclosure (by reference to the same IFRS) (see Implementation Guidance page 26).

AFRAC is of the opinion that no mandatory requirement should be included in the IFRS for SMEs for segment and interim reporting or earnings per share. We believe that segment and interim reporting are not appropriate for SMEs. To the extent that it is considered that they should be, SMEs should be permitted to follow either some mandatory requirements specifying the information that needs to be provided or to base themselves on internal reporting that users are likely to find useful.

***Q2. Recognition and measurement simplifications that the Board adopted** – Are there other recognition and measurement simplifications that the Board should consider? In responding, please indicate:*

(a) the specific transactions, other events or conditions that create a specific recognition or measurement problem for SMEs under IFRSs;

(b) why it is a problem;

(c) how that problem might be solved.

Financial Instruments

Accounting for financial instruments remains too complex. The ED lacks clarity and understandability.

(a) Simplification does not just mean brevity

AFRAC welcomes the effort made by the IASB to significantly reduce the complexity of accounting for financial instruments. However, AFRAC is concerned that in doing so the IASB has primarily succeeded in shortening the text but not in making the requirements fully understandable or easy to implement. To be easy to understand and to implement, accounting requirements need to be explicit, i.e. transactions that need to be accounted for and the accounting treatment that needs to be applied to them must be clearly identified and described.

In choosing the fair value measurement by default, and omitting the definition of derivatives, the IASB has created implicit requirements. SME preparers may fail to identify this kind of financial instrument. Also, the language used is not simple enough: for example, the scope exclusions are very difficult to read. The guidance for fair value measurement that has been imported from IAS 39 contains details and terminology which are not easy for SMEs to understand. Requirements are not necessarily clear: for example, the requirement to test hedge effectiveness and to recognise ineffectiveness in profit or loss is not clear from the text in the ED although it can be found in the basis for conclusions.

For the reasons expressed above, we do not think that section 11 meets the criteria "easy to understand, easy to implement" for IFRS for SMEs.

(b) Scope out for insurance contracts is unclear

The scope exclusions of section 11 should be clarified, as some insurance contracts are within its scope. We are of the opinion that insurance contracts should be scoped out from the IFRS for SMEs, because they are usually not relevant for SMEs.

(c) Scope in for commodities is too complex for SMEs

Paragraph 11.4 for non-financial items and the scope exclusions of paragraph 11.3(c) and (e) for leases and insurance contracts lead to a scope extension for commodities that are similar to instruments dealt with in IAS 39.11. Compared to IAS 39.11, section 11 only covers non-financial contracts with (i) underlyings other than prices and foreign exchange rates and (ii) only when losses could arise to the buyer or seller as a result of the contractual terms. AFRAC questions whether that means that non-financial contracts with interest rate risks are in the scope of section 11 and should be measured at fair value in their entirety. We suggest that embedded derivatives should be scoped out, for the sake of simplicity.

(d) Two measurement categories are needed – but formulated in a different way from IASB's proposal

AFRAC welcomes the reduction of categories as an effective simplification. However we disagree with the de facto full fair value option given to a variety of financial instruments by paragraph 11.7(a) and (b)(iii).

Overall, we suggest a complete reorganisation of the paragraph on financial instruments. We propose two subparagraphs, subparagraph 1 dealing with all financial instruments, which most SMEs might have (e.g., 11.2(a), (b), (c) and (d)).

Subparagraph 2 should deal with the more complicated 11.2(f), (g) and (h) instruments.

Goodwill Impairment

The changes made to impairment recognition requirements lack relevance and the requirements remain burdensome.

(a) The elimination of value in use is not considered appropriate.

AFRAC does not support the change made to the definition of a recoverable amount. In IAS 36 the recoverable amount is defined as the higher of the asset's fair value less costs to sell and its value in use, whereas in paragraph 26 it is restricted to fair value less costs to sell. AFRAC believes that value in use needs to be reinstated as a possible measurement basis for impairment tests, for the following reasons:

- Fair value less costs to sell does not adequately capture the importance to the concept of impairment of the best alternative use of the impaired asset. Fair value assumes a market transaction but not the internal use of the asset together with other assets in the entity. Value in use is more relevant to the impairment test than a valuation based on a disposal scenario when the assets are in use in the operations in the entity
- Fair value less costs to sell may be very difficult to establish for non-financial long term assets such as PP&E and intangible assets
- Assets may need to be tested as part of a group; this is always the case for goodwill and can be appropriate for other assets, too (e.g., intangible assets with cash inflows that are not separable)
- Fair value less costs to sell may require additional valuation effort to obtain market estimates of cash flows, whereas the necessary forecasts for entity-specific cash flows may be readily available
- Value in use is likely to be more relevant to the impairment test than a valuation based on a disposal scenario when the assets are in use in the entity's operations

(b) The impairment test should be carried out on the basis of either value in use or fair value less costs to sell, on the basis of the scenario relevant to the entity.

Value in use can be based on a discounted cash flow calculation, as in IAS 36. We suggest two simplifications that should ease the burden of the impairment test:

- Leave out the requirements related to cash generating units; replace them with concise guidance for testing group of assets including goodwill
- Provide an exemption from the restriction put on the definition of future cash flows, and require the DCF calculation to be based on information available in the entity.

<u>All intangible assets (including goodwill) should be accounted for as assets with a finite life and be amortised</u>

The ED proposes that an SME shall assess whether the useful life of an intangible asset is finite or indefinite. Practice has shown that the impairment approach for goodwill as required by IAS 38 is too costly and burdensome for entities applying IFRS. Therefore, AFRAC disagrees with the impairment approach for goodwill and other intangibles with indefinite useful life. Fair valuing components of an entity is costly and unnecessary where there is no plan to sell the component.

AFRAC believes that SMEs should not be required to distinguish between intangible assets with finite and indefinite useful life. This means that all intangible assets should be treated as assets with a finite life and be amortised, over a period of, e.g., a maximum of 20 years. The assumption of an indefinite useful life is that if the expected cash inflows that are associated with the intangible assets are to continue indefinitely, the useful life of that asset is indefinite. After acquisition is completed, however, the value of intangible assets and goodwill does not have much meaningful content in any event. We therefore believe that reinstating amortisation of goodwill and intangible assets would not deprive users of SMEs financial statements of the information they need to assess cash flows. We agree with the IASB that amortisa-

tion would be in some sense arbitrary. However, AFRAC disagrees with the other arguments proposed by the IASB in BC 80.

Elimination of reference to fair value

The ongoing debate on fair value measurement shows that fair value is a difficult and sophisticated notion, and not immediately understandable. Fair value is not part of the everyday business life of entities, particularly SMEs. It belongs to the vocabulary of accountants, actuaries and other valuers and not to the vocabulary of entrepreneurs and the parties with whom they do business.

We believe that referring to fair value measurement generates complexity and reduces understandability.

In addition, fair value measurement is unlikely to be relevant for SMEs. In our opinion, no systematic priority should be given to current market values in SMEs' accounts because of the objectives of their financial statements, and in the absence of a market, values should not be modelled based on fictitious markets.

Nonetheless, we believe that revaluation may be relevant in specific circumstances. In those cases we believe the IFRS for SMEs should refer to "current value", defined as "the current estimate of future cash-flows embodied in the asset or liability". Current value reflects economic parameters as of the balance sheet date. Current value may be based on market values or entity-specific data, depending on the circumstances, which would need to be specified in the various paragraphs of the standard.

Treat all research and development costs as expenses

We agree with this simplification.

Cost method for associates and joint ventures

We agree with this simplification. Furthermore, in the light of ED 9 Joint Arrangements the proportionate consolidation in 14.8 (c) should be eliminated.

Income taxes – “timing differences plus” approach

We do not agree with the proposed approach in paragraph 28 for income taxes. We do not really see the difference between the temporary approach in IAS 12 and the ED’s “timing differences plus” approach.

AFRAC therefore proposes a simpler approach: a genuine timing differences approach should be used, and only differences as described in paragraph 28.6 (differences included in income and expense) should be used as basis for deferred taxes and no deferred taxes on tax loss carryforwards, and no deferred taxes on temporary differences arising in consolidation.

Less fair value for agriculture

We agree with this simplification.

Employee benefits – defined benefit plans

We agree with the proposed simplification. We would draw the IASB’s attention to some other possible simplifications.

With respect to other long-term employee benefits, we would propose using simple arithmetic calculations and not using actuarial methods for calculation of the benefit obligation. Such benefits (e.g., jubilee payments) are much more simply structured than pension plans.

Share-based payments

See Question 3.

Leases

See Question 3.

Transition to the IFRS for SMEs

We agree with this simplification.

***Q3. Recognition and measurement simplifications that the Board considered but did not adopt** – Should the Board reconsider any of those and, if so, why?*

We do not agree with the non-adoption of some of the simplifications considered by the IASB (see BC95 – BC107), as explained below.

Non-recognition of share-based payment

We agree that SMEs should be required to disclose information in the notes on share-based payments, since most of the users of the financial statements are less likely to be shareholders, and share-based payments do not influence future cash flows. Share-based payments are unlikely to be very common in SMEs, so most SMEs would not need to consider these requirements.

However, we support the non-recognition of equity-settled share-based payments contracts.

Treat all leases as operating leases

We propose treating all leases as operating leases, which is a truly significant simplification. Practice shows that large companies, too, choose not to treat some leases as finance leases although they would satisfy the requirements of IAS 17. This is because of the costly and burdensome calculations needed, as compared with the benefits.

We suggest instead that the amounts of the minimum lease payments for the next five years should be disclosed.

No consolidated financial statements

We would support introducing either in the Standard or as a country option upon introduction certain size limits (e.g., like the EU 7th Directive) for mandatory consolidation. Practice shows that lenders do not require consolidated financial statements. This is contra to the IASB's arguments in BC 104.

Q4. Whether all accounting policy options in full IFRSs should be available to SMEs *– Do you agree with the Board's conclusions on which options are the most appropriate for SMEs? If not, which one(s) would you change, and why? Should any of these options that would be available to SMEs by cross-reference to the full IFRSs be eliminated from the draft IFRS for SMEs and, if so, why?*

No, we do not agree. AFRAC believes the standard should not contain any options for SMEs. This would make the standard much simpler and shorter. Cross-references to full IFRS would not be necessary.

Q5. Borrowing costs *– Do you agree or disagree with the proposal to allow SMEs to choose either the expense model or the capitalisation model for borrowing costs, and why?*

<u>Choice of either expense or capitalisation model reasonable for SMEs</u>

AFRAC supports the option in paragraph 24 of allowing SMEs to choose either the expense model or the capitalisation model. The proposed changes in an amended IAS 23 to prohibit the expense model are not of any benefit to SMEs wishing to continue expensing borrowing costs; rather, the proposed change would be likely to be perceived as an added burden.

On a practical level, the implementation of capitalisation of borrowing costs implies quite sophisticated information systems. The proposed prohibition of the expense model therefore creates an administrative burden with no added value for the preparers.

<u>Capitalisation of borrowing costs could be simplified</u>

We do not believe that the identification of potential "specific" borrowings is useful. Instead, we suggest that capitalisation of borrowing costs should in all circumstances be computed on the basis of the average borrowings of the entity.

***Q6. Topics not addressed in the proposed IFRS for SMEs** – Should any additional topics be omitted from the IFRS for SMEs and replaced by a cross-reference? If so, which ones and why?*

No, there should be no cross-references to full IFRS.

***Q7. General referral to full IFRSs** – Are the requirements in paragraphs 10.2–10.4, coupled with the explicit cross-references to particular IFRSs in specific circumstances, appropriate? Why or why not?*

AFRAC believes that paragraphs 10.2–10.4 are appropriate. Nevertheless, we are of the opinion that for the avoidance of doubt the standard could be made still more explicit by stating that there is no expectation that one has to look back to full IFRSs. For this reason, we would suggest amending the wording of paragraph 10.4 by replacing "may also consider…" with "is not required but may wish to consider…". In addition, we would also suggest amending the wording of paragraph 10.4 by replacing "If additional guidance is needed…" by "If further additional guidance…". We believe that this would make even clearer that this is not meant to be a mandatory fallback.

***Q8. Adequacy of guidance** – Are there any specific areas for which SMEs are likely to need additional guidance? What are they, and why?*

AFRAC believes that the approach adopted by the IASB (building the proposed standard by extracting the main principles for each standard) does not offer adequate guidance. Minimal guidance is provided paragraph by paragraph, with the aim of limiting the total length of the final document. More complex paragraphs (e.g., paragraphs 10, 17, 18, 25) could include more guidance, depending on the final contents of the paragraphs.

There is guidance with examples in some paragraphs (e.g., paragraph 20, 22). In some cases guidance is included in the body of the text (paragraph 28), and in others there is no guidance. AFRAC suggests that guidance should be provided similarly for all paragraphs, perhaps best in the IG.

Q9. ***Adequacy of disclosures*** *– Are there disclosures that are not proposed that the Board should require for SMEs? If so, which ones and why? Conversely, do you believe that any of the proposed disclosures should not be required for SMEs? If so, which ones and why?*

AFRAC agrees with the disclosure simplifications, but we believe that further simplifications are possible based on the principles set out in BC120. In the Implementation Guidance , we believe the following paragraphs of the Disclosure requirements should be eliminated:

5.7, 8.6, 8.7, 8.8, 10.16, 10.17, 11.44, 11.50, 11.51, 13.7(b) and (c), 16.29(e), 17.32, 17.33, 18.23(h) and (i), 18.24, 19.12(c), (d) and (e), 19.14(c) and (d), 19.15, 19.23(b) and (c), 20.14(e), (f) and (g), 20.15(a), (b) and (c), 22.28(c), 22.30, 25.9, 27.38(c), (d), (e), (f), (g), (h), (i) and (j), paragraph 28 should be changed to the proposed approach, 29.2, 30.29, 31.1, 32.9(b), 33.5, 33.6, 33.7, 33.8, 33.9, 33.10, 34.1, 36.2(b) and (c), 36.3, 37.1, 38.12, 38.13.

Q10. ***Transition guidance*** *– Do you believe that the transition guidance is adequate? If not, how can it be improved?*

AFRAC believes that the transaction guidance is adequate.

Q11. ***Maintenance of the IFRS for SMEs*** *– Is the approach to maintaining the IFRS for SMEs appropriate, or should it be modified? If so, how and why?*

AFRAC is strongly in favour of maintenance of the IFRS for SMEs not being connected with revisions of full IFRSs. Amendments to full IFRSs might be considered for inclusion in IFRS for SMEs, but need not necessarily be the subject of an exposure draft or adopted at the same time.