Australian Government

Australian Accounting Standards Board

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Dear Paul

Exposure Draft of A Proposed IFRS for SMEs

The Australian Accounting Standards Board (AASB) is pleased to provide comments on the abovenamed Exposure Draft. Our comments on the questions raised in the Exposure Draft are in an attachment to this letter. In forming its views, the AASB held two Roundtables with constituents and considered over 70 submissions received in response to an Invitation to Comment on the Exposure Draft and the related issue of application in the Australian context.

Current differential reporting regime

In Australia, a differential reporting regime based on the concept of a reporting entity is in place. Australia adopted IFRSs in 2005 and they apply to all entities that are reporting entities whether they are for-profit or not-for-profit, although in respect of not-for-profit entities some modifications were made to the standards promulgated by the IASB. The publication of the IASB's Exposure Draft prompted a reconsideration by the AASB of the current differential reporting regime in Australia, including possible use of a forthcoming IFRS for SMEs.

Publication of an Invitation to Comment

After extensive deliberations, the AASB published an Invitation to Comment comprising the IASB's Exposure Draft and its own proposals for a revised differential reporting regime. The proposals draw on the concept of public accountability introduced by the IASB's Exposure Draft in respect of for-profit entities and also size thresholds as indicators of the degree of public interest in the affairs of non-publicly accountable entities in various sectors.

Australian constituents have expressed mixed views on the proposals. Some support using the IFRS for SMEs as a basis for a revised differential reporting regime. Others see the IFRS for SMEs as only one element in a revised differential reporting regime, possibly combined with the Australian reporting entity concept. A third group advocate a continuing prominent role for the reporting entity concept for differential reporting purposes.

We note that the decision to apply the IFRS for SMEs is a jurisdictional issue, and support the IASB statements in this regard. The AASB is firmly of the view that it is a decision of each jurisdiction to determine the appropriateness of the IFRS for SMEs in the context of jurisdictional requirements, government policy and the local economic environment.

Accordingly, the AASB is considering how it might use the IFRS for SMEs in its differential reporting regime. The extent to which the AASB might use an IFRS for SMEs will depend on a number of domestic factors and the extent to which the final IFRS for SMEs standard meets the needs of Australian constituents. In this respect we have a number of overall concerns with the Exposure Draft as noted below.

Overall concerns

The attached specific comments contain a number of suggestions for improving the proposed IFRS for SMEs. The AASB's overall concerns are as follows:

(a) the proposed IFRS is not a truly stand-alone document. The stand-alone nature of the document should be improved by including more of the appropriate treatment options in full IFRSs instead of cross-referencing to full IFRSs;

(b) it is not clear how the IFRS for SMEs might operate for the purposes of selecting accounting policies. The hierarchy for selecting an appropriate accounting policy should allow an entity to consider *either* the 'Concepts and Pervasive Principles' *or* the full IFRSs if the policy is not specifically addressed in the IFRS for SMEs. This equal ranking of the 'Concepts and Pervasive Principles' and full IFRS would effectively provide an entity with acceptable alternative accounting treatments in a range of circumstances;

(c) there is a need for further simplification of the recognition and measurement requirements;

(d) the disclosure requirements of the proposed IFRS for SMEs are too onerous and should be reduced to those disclosures deemed necessary based on a consideration of user needs for SMEs at a general level and taking account of the financial statements as a whole. To this end we would recommend a separate section for 'Disclosures' rather than separate disclosures in each section; and

(e) there is a need to specifically address the general purpose financial statements of subsidiaries to enable them to apply full IFRS recognition and measurement requirements (to be consistent with their parent, where appropriate) without having to comply with the disclosure requirements of full IFRSs.

It is also considered that the IASB will have to reconsider the adequacy of the definition of general purpose financial statements (e.g. lodgement with regulators with public access, availability of financial statements on websites, and distribution by other means) given that both full IFRSs and the IFRS for SMEs would apply to general purpose financial statements.

If you require further information on this response, please contact me or Ahmad Hamidi (ahamidi@aasb.com.au).

Yours sincerely

David Boymal.

David Boymal
Chairman

Attachment: AASB's specific comments

Application of IFRS for SMEs

Definition of public accountability

Although it would be up to each jurisdiction to determine the entities to which the IFRS for SMEs should apply, the following clarifications are needed in relation to the definition of public accountability in order to assist jurisdictions in this determination:

(a) the first leg of the definition appears to be intended to capture entities that are publicly listed. However, an established listed entity that has no need for raising further capital may argue that it is not publicly accountable on the grounds that it only files its financial statements for the purposes of compliance with legislation or Listing Rules. It would be helpful to clarify that an entity is publicly accountable if it has its equity or debt instruments traded in a public market;

(b) the term "public market' may have different connotations in different jurisdictions. It would be helpful to clarify the term by explaining the types of markets it is intended to encompass. For example whether the term is restricted to recognised public markets where listed securities are traded; and

(c) the term 'fiduciary' in the definition of public accountability is not helpful because it can be interpreted to refer to many types of entities such as companies and trusts. For example, directors of all companies incorporated in Australia have fiduciary obligations. It would be clearer if the IASB were to explain the characteristics of entities that are 'fiduciaries', such as banks and other deposit takers. Other deposit takers would presumably include insurers that sell investment products and the IASB would need to clarify if it intends that general insurers and term life insurers are publicly accountable because, technically, they do not hold deposits since they retain their assets to the extent those assets are not needed to pay claims (there is usually no minimum deposit amount associated with a general insurance contract or 'pure' term life contract).

Classification about users

Under paragraph 1.1 of the IASB's Exposure Draft, existing and potential creditors are regarded as external users who would rely on general purpose financial statements of the entity for their information needs. In the case of providers of finance, this may be true in jurisdictions where there is intensive competition between those providing finance and where requiring tailored reports may lead to loss of clientele. However, in many jurisdictions providers of finance would be able to demand tailored reports in place of the client's general purpose financial statements. Accordingly, the assumption that finance providers cannot command specific information may not hold in all jurisdictions and this point may need to be clarified. In turn, this might affect the level of disclosures in general purpose financial statements.

Question 1 – Stand-alone document

In deciding on the content of the proposed IFRS for SMEs, the IASB focused on the types of transactions and other events and conditions typically encountered by SMEs with about 50 employees. For such entities, the proposed IFRS is intended to be a stand-alone document, with minimal cross-references to full IFRSs.

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?

AASB comment

Stand-alone Objective

The AASB supports the idea of an IFRS for SMEs being a stand-alone document. However, the IFRS for SMEs in its present form is not a stand-alone document as it contains numerous cross-references to full IFRSs. To meet its stand-alone objective:

(a) the document should not carry any explicit cross-references to particular full IFRSs since that would require knowledge of two sets of Standards by users;

(b) more topics should be dealt with based on whether a sufficient number of SMEs are expected to enter such transactions. This may require a reassessment of the benchmark that a typical SME of about 50 employees would be the target. This would help to widen the usability of the IFRS for SMEs; and

(c) given that the IFRS for SMEs should be applicable to a wide range of SMEs, the IFRS for SMEs should include more of the treatment options in full IFRSs expressed in simplified language and accompanied by the minimum necessary disclosures (but not necessarily all the treatment options).

Including more topics and more of the treatment options in the IFRS for SMEs would enhance the stand-alone status of the standard, and allow the hierarchy to be used for selecting appropriate accounting policies for transactions and events that would be encountered by only a small number of SMEs.

Subsidiaries of Publicly Accountable Entities

The proposed IFRS for SMEs is silent on the reporting obligations for subsidiaries of publicly accountable entities where these subsidiaries themselves are required to prepare general purpose financial statements. Their reporting requirements should be explicitly addressed.

The AASB notes that subsidiaries of publicly accountable entities would find it burdensome to apply the proposed IFRS for SMEs. They would need to prepare financial information based on the recognition and measurement requirements of full IFRSs for the purposes of the parent entity consolidation. If such subsidiaries are not themselves publicly accountable but apply full IFRS (as they are already applying full IFRS recognition and measurement for consolidation purposes), they are required to disclose information that is onerous to prepare and is often of no benefit to users. If they were to adopt the IFRS for SMEs as proposed, they could choose to refer to a full IFRS for an option that is not included in the IFRS for SMEs. However, they are then required to follow the disclosure requirements of that full IFRS. A stand-alone IFRS for SMEs that includes only the absolute minimum necessary disclosures, more topics and more of the treatment options from full IFRSs may alleviate the problem. However, it seems likely that subsidiaries within large groups would be involved in a wider range of activities and transactions than an equivalent SME that is not part of a group. Accordingly, it may be necessary for the IASB to consider permitting subsidiaries of publicly accountable entities to prepare general purpose financial statements by applying all the recognition and measurement requirements of full IFRSs, but permitting reduced disclosures similar to those required by the IFRS for SMEs.

Question 2 – Recognition and measurement simplifications that the Board adopted

The draft *IFRS* for *SMEs* was developed by:

(a) extracting the fundamental concepts from the IASB *Framework* and the principles and related mandatory guidance from full IFRSs (including Interpretations), and

(b) considering the modifications that are appropriate in the light of users' needs and cost-benefit considerations.

Paragraphs BC70–BC93 of the Basis for Conclusions describe the simplifications of recognition and measurement principles contained in full IFRSs that have been made in the proposed *IFRS* for *SMEs* and explain the Board's reasoning.

Are there other recognition or 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; and

(c) how that problem might be solved.

AASB comment

<u>Concern over Introduction of New Recognition and Measurement Methods</u>

Introducing new recognition and measurement methods through the IFRS for SMEs is a cause for concern. The addition to recognition and measurement requirements of full IFRSs, or their modification, usually involves a lengthy and focused due process — far more detailed than that being undertaken for the IFRS for SMEs.

It would also be inconsistent with the proposal to amend the IFRS for SMEs through an Omnibus Standard if the IASB's ED pre-empts proposals to amend full IFRSs that would result from other IASB projects which have not yet been finalised. Proposed new recognition and measurement methods should be the subject of a full and focussed due process and should be considered for inclusion in full IFRSs before, or at the same time as, contemplating their use in an IFRS for SMEs.

If the IASB adopts a policy of including new recognition and measurement treatments in the IFRS for SMEs that are not available under the corresponding full IFRS, the AASB considers that these should not be more complex or onerous than the treatments in full IFRSs. Any such new treatments should be 'simpler and more relevant' to SMEs.

Financial Instruments Section Needs to be Self-contained

Consistent with the view that the IFRS for SMEs should be a stand-alone document, section 11 *Financial Assets and Liabilities* should be made self-contained and the option of applying IAS 39 *Financial Instruments: Recognition and Measurement* removed. The section should include reduced disclosures from IFRS 7 *Financial Instruments: Disclosures* and make available to SMEs some of the methods available in IAS 39 that have been omitted. Suggestions for improvement of Section 11 are:

(a) the amortised cost method should be the default method with fair value permitted if it is readily determinable without undue cost or effort. This approach would avoid including detailed criteria for applying the amortised cost method;

(b) commonly used hedge strategies such as those based on borrowings and cash instruments should be included. Hedge accounting should be expanded to cater for hedging arrangements commonly undertaken by SMEs, such as swaps and options. It would also be helpful if the documentation and the effectiveness testing were explained in a simple manner;

(c) the available for sale category (but not the trading category) should be reinstated since SMEs would otherwise use the 'through profit or loss' option; and

(d) clarification that a hedging relationship be formally designated at the inception of the hedge should be included to provide certainty.

Lack of Clarity over 'Readily Determinable'

The IFRS for SMEs should explain when fair value ought to be readily determinable without undue cost or effort by, for example, indicating when the inputs need to incorporate observable market values or a professional valuation or a reasoned estimate by management. Guidance on the meaning and use of the term 'undue cost or effort' is also required.

Consistent with our proposal on section 11, consideration should be given to the use of 'fair value if it is readily determinable without undue cost or effort' when fair value is required by other sections of the IFRS for SMEs.

Simplifications that do not go far enough

The AASB considers that there should be further simplifications in the recognition and measurement treatments required in the IFRS for SMEs. In particular, the IFRS for SMEs should be simplified in the following respects.

Income taxes

The AASB regards the proposed treatment of income taxes in the IASB's Exposure Draft as onerous and suggests that tax-effect accounting should only be required for temporary differences that are timing differences because it is likely that deferred taxes arising from temporary differences other than timing differences are infrequent in the case of SMEs.

Government grants

The AASB proposes that only the IAS 41 model (based on the 'conditional' versus 'unconditional' distinction) should be allowed in relation to government grants because this is regarded as more relevant and simpler than the requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (with its many optional treatments).

Leases

The AASB considers that the finance lease simplification is not helpful since it can be difficult to determine the fair value of leased property. The present value of minimum lease payments is typically calculated when determining whether a lease is a finance lease or an operating lease. Accordingly, requiring the measurement of property acquired through a finance lease at the present value of minimum lease payments instead of the fair value of leased property may be a more practical simplification.

Question 3 – Recognition and measurement simplifications that the Board considered but did not adopt

Paragraphs BC94–BC107 identify some recognition and measurement simplifications that the Board considered but decided not to adopt, for the reasons noted.

Should the Board reconsider any of those and, if so, why?

AASB comment

The AASB supports the IASB's decisions in this respect except to the extent of further simplifications suggested above.

Question 4 – Whether all accounting policy options in full IFRSs should be available to SMEs

The draft *IFRS for SMEs* proposes that accounting policy options available under full IFRSs should generally also be available to SMEs. As explained more fully in paragraphs BC108–BC115 of the Basis for Conclusions, the Board concluded that prohibiting SMEs from using an accounting policy option that is available to entities using full IFRSs could hinder comparability between SMEs and entities following full IFRSs. At the same time, the Board recognised that most SMEs are likely to prefer the simpler option in the proposed *IFRS for SMEs*. Therefore, the Board concluded that in six circumstances in which full IFRSs allow accounting policy options, the *IFRS for SMEs* should include only the simpler option, and the other (more complex) option(s) should be available to SMEs by cross-reference to the full IFRSs.

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?

AASB comment

At Question 1, the AASB comments that the IFRS for SMEs should include more of the treatment options in full IFRSs and should be a stand-alone document. The AASB's preference is for this to be done using simplified language within the IFRS for SMEs and not by cross-referencing to full IFRSs for further options.

As to the appropriateness of options selected, except for cases indicated in comments on other questions, cost methods should be made available as such methods are usually the simpler option. However, the AASB supports the IASB's decision that cherrypicking of accounting policies from full IFRSs should not be allowed. If the IASB decides to adopt a cross-referencing approach in the IFRS for SMEs, the extent of that cross-referencing should be specified by the IFRS for SMEs.

Question 5 – Borrowing costs

IAS 23 *Borrowing Costs* currently allows entities to choose either the expense model or the capitalisation model to account for all of their borrowing costs. In May 2006 the IASB published an Exposure Draft proposing to amend IAS 23 to prohibit the expense model and to require the capitalisation model. Section 24 *Borrowing Costs* of the draft *IFRS for SMEs* proposes to allow SMEs to choose either the expense model or the capitalisation model.

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?

AASB comment

As a general principle, the AASB considers that the methods required in the full IFRSs should be available to SMEs where they are simpler and more relevant to the users of SMEs' general purpose financial statements. Notwithstanding the recently revised IAS 23, in this particular case, the AASB considers the expensing of all borrowing costs to be a far simpler and more relevant treatment that should be available to SMEs.

Question 6 – Topics not addressed in the proposed IFRS for SMEs

Some topics addressed in full IFRSs are omitted from the draft *IFRS for SMEs* because the Board believes that typical SMEs are not likely to encounter such transactions or conditions. These are discussed in paragraphs BC57–BC65 of the Basis for Conclusions. By a cross-reference, the draft standard requires SMEs that have such transactions to follow the relevant full IFRS.

Should any additional topics be omitted from the *IFRS for SMEs* and replaced by a cross-reference? If so, which ones and why?

AASB comment

The AASB considers that there should not be any cross-referencing to the full IFRSs in the IFRS for SMEs. The AASB does not propose any further omissions, rather it proposes that more topics be included in the IFRS for SMEs to enhance its stand-alone status and make it useful to a wider range of SMEs.

Question 7 – General referral to full IFRSs

As noted in Question 1, the *IFRS for SMEs* is intended to be a stand-alone document for typical SMEs. It contains cross-references to particular full IFRSs in specific circumstances, including the accounting policy options referred to in Question 4 and the omitted topics referred to in Question 6. For other transactions, events or conditions not specifically addressed in the IFRS for SMEs, paragraphs 10.2–10.4 propose requirements for how the management of SMEs should decide on the appropriate accounting. Under those paragraphs, it is not mandatory for SMEs to look to full IFRSs for guidance.

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?

AASB comment

The hierarchy for determining accounting policies should allow an entity to consider either the 'Concepts and Pervasive Principles' or the full IFRSs if the SME cannot determine the relevant accounting treatment from the IFRS for SMEs. If the IASB rejects this approach, the AASB agrees with the hierarchy proposed in paragraphs 10.2 to 10.4 of the IASB's Exposure Draft since it is more likely to lead to a conceptual solution than does the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* because the concepts are the second tier in the SMEs hierarchy. However, the AASB notes that the hierarchy should be aimed at those transactions and events that only a small number of SMEs may encounter. To reduce excessive reliance on the hierarchy, the extent to which the IFRS for SMEs is stand-alone must be improved. The AASB comments on Questions 1 and 6 include some suggestions in this regard.

If the AASB's proposal on the hierarchy is not taken up, the possibility of divergent interpretation exists. This could arise when there is a conflict between a full IFRS and the Concepts and Pervasive Principles and the entity refers to that full IFRS in forming its judgement about the most appropriate accounting policy. The entity would be in breach of the proposed hierarchy in the IASB Exposure Draft because of the precedence of concepts over the full IFRSs in the hierarchy. Accordingly, the entity may not be compliant with the accounting standards relevant to the preparation of its financial statements. However, entities undertaking similar transactions and applying full IFRSs would be compliant with accounting standards. Such an outcome in individual jurisdictions would be unfortunate and could be avoided by providing full IFRS with equal status in the hierarchy as the 'Concepts and Pervasive Principles'.

Question 8 – Adequacy of guidance

The draft *IFRS for SMEs* is accompanied by some implementation guidance, most notably a complete set of illustrative financial statements and a disclosure checklist. A sizeable amount of guidance that is in full IFRSs is not included. Accordingly, additional guidance especially tailored to the needs of SMEs applying the proposed IFRS may be required.

Are there specific areas for which SMEs are likely to need additional guidance? What are they, and why?

AASB comments

In the interest of brevity, the extent of guidance should be kept to a minimum.

Question 9 – Adequacy of disclosures

Each section of the draft *IFRS for SMEs* includes disclosure requirements. Those requirements are summarised in the disclosure checklist that is part of the draft implementation guidance *Illustrative Financial Statements* and *Disclosure Checklist.*

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?

AASB comment

The principles identified in paragraph BC120 used to determine SME disclosures should themselves be incorporated in the IFRS for SMEs. That is, SMEs should be required to make disclosures that provide information about short-term cash flows, obligations, commitments or contingencies, liquidity and solvency, measurement uncertainties, accounting policy choices and disaggregation of amounts reported on the face of the financial statements. If there is a need to add further specific disclosure requirements, these should be determined by considering the particular needs of SMEs and not by reference to full IFRSs. That would necessitate identifying at a 'whole-of-financial statements' level the disclosures that would provide useful information for the users of SMEs' financial statements, rather than starting with disclosures in full IFRSs.

In particular, a reduction in the number and detail of disclosures in relation to the following is desirable:

(a) disclosures that are required by the IFRS for SMEs that cross-references to a treatment option in full IFRSs. For example, disclosures required by IFRS 7 in the event that an SME chooses to apply IAS 39. SMEs should not be penalised by onerous disclosure requirements for choosing the more complex treatment; and

(b) disclosures that users of SMEs' financial statements are not expected to benefit from. In some cases, the quantity of disclosures that an SME might be required to make is excessive. For example, the reconciliations between opening and closing balances for particular assets and liabilities (for example, each class of property, plant and equipment) seem likely to have little information value based on the criteria in paragraph BC120 and SMEs should not be required to disclose them.

The AASB also suggests that the disclosure requirements should be in one section of the IFRS for SMEs for ease of use, which would also remove the need for the disclosure checklist.

Question 10 – Transition guidance

Section 38 *Transition to the IFRS for SMEs* provides transition guidance for SMEs that move (a) from national GAAP to the *IFRS for SMEs* and (b) from full IFRSs to the *IFRS for SMEs*.

Do you believe that the guidance is adequate? If not, how can it be improved?

AASB comment

The transition guidance should explicitly cover situations where an entity:

(a) applies the IFRS for SMEs, later adopts full IFRSs and subsequently applies the IFRS for SMEs again; and

(b) applies the full IFRSs, later adopts the IFRS for SMEs and subsequently applies full IFRSs.

Such guidance is particularly critical for jurisdictions that use size thresholds to distinguish between entities that should apply full IFRSs and those that should apply an IFRS for SMEs. Changes in size of entities, based on revenue or asset measures, may cause entities to switch between the two sets of Standards.

There is ambiguity about whether a change in accounting policy on transition from full IFRSs to the IFRS for SMEs is subject to the provisions of the IFRS for SMEs in regard to changes in accounting policies. Under paragraph 10.6 of the IASB's Exposure Draft, an entity can change an accounting policy only if the change is required by changes to the IFRS for SMEs or results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or the conditions on the entity's financial position, financial performance or cash flows. When an entity applies a certain treatment allowed under an IFRS, such as capitalising development costs, and on transition to the IFRS for SMEs applies an alternative treatment, such as expensing development costs, it is not clear whether this change is an accounting policy change under the IFRS for SMEs. If the change is regarded as a change in accounting policy, then the entity may not be able to change to a simpler treatment on the grounds that it does not meet the criteria in paragraph 10.6. That is, the current accounting policy may provide reliable and more relevant information than the proposed accounting policy and therefore the proposed accounting policy would not be available. This may hinder the use of simpler options included in the IFRS for SMEs in some cases.

Question 11 – Maintenance of the IFRS for SMEs

The Board expects to publish an omnibus exposure draft of proposed amendments to the *IFRS for* SMEs approximately every other year. In developing such exposure drafts, the Board expects to consider new and amended IFRSs that have been adopted in the previous two years as well as specific issues that have been brought to its attention regarding possible amendments to the *IFRS for SMEs*. On occasion, the Board may identify a matter for which amendment of the *IFRS for SMEs* may need to be considered earlier than in the normal two-year cycle.

Is this approach to maintaining the proposed *IFRS for SMEs* appropriate, or should it be modified? If so, how and why?

AASB comment

The AASB supports the proposal to update the IFRS for SMEs through an Omnibus Standard every two years where necessary. However, there are two issues that need to be clarified:

(a) the AASB considers that an entity applying the currently applicable version of the IFRS for SMEs should not have to make disclosures about a revised IFRS for SMEs that is available to be applied but is not yet mandatory; and

(b) the AASB considers it should be made clear that an entity applying the IFRS for SMEs need not consider revisions to particular full IFRSs until the IFRS for SMEs incorporates those changes through an Omnibus Standard.