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Belgium

## **EFRAG's Draft Comment Letter on the Exposure Draft of an International Financial Reporting Standard for Small and Medium-Sized Entities (ED-IFRS for SMEs)**

Dear Stig,

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on EFRAG's draft comment letter on the Exposure Draft of an IFRS for SMEs. We appreciate the opportunity to comment on this draft comment letter.

The GASB acknowledges that EFRAG has put in much effort to analyse the ED-IFRS for SMEs in great detail and to lay out suggestions to improve and simplify the ED-IFRS for SMEs. However, we sometimes find the comment letter quite complex and hard to understand. We therefore suggest concentrating on major aspects that EFRAG wants to address in addition to the overall support for this IASB project.

In its covering letter EFRAG comments on the ED-IFRS for SMEs with regard to six general aspects which we would like to refer to first. Following you will find our answers to the specific questions EFRAG raised to be answered by the constituents.

### **1 – The final standard should be a comprehensive stand alone document**

The GASB fully agrees with the objective that the IFRS for SMEs should be a self-contained, comprehensive set of accounting requirements. This will be a crucial factor for the acceptance and applicability of the IFRS for SMEs. EFRAG suggests two options: either including in the IFRS for SMEs all of those full IFRSs requirements which the ED-IFRS for SMEs currently only refers to, or to fully exclude all references

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to full IFRSs. The GASB fully supports the general objective to delete all references to full IFRSs.

In addition to the deletion of cross-references, contrary to EFRAG, the GASB believes an IFRS for SMEs could be simpler and more of a stand alone document if in principle all options were deleted. The financial statements of SMEs would be more comparable and therefore easier to understand by the users of SME financial statements. Moreover, there would be no need for SMEs to look at the full IFRSs in order to assess different accounting options. Especially smaller companies find it much easier not to have to look at two different sets of accounting requirements. Overall the GASB believes this to be an appropriate approach to reduce costs for the preparers while enhancing the benefit for the users of SME financial statements.

## **2 – “IFRS for SMEs” is not the most appropriate label**

The GASB generally agrees with EFRAG that “SME” is a label that generally refers to size. But since the IASB explicitly states that each local jurisdiction is to define the scope of the standard, we believe that the term used is of less relevance. Moreover, it appears that the SME-label despite being less accurate better conveys the idea of the general group of entities that the standard is aiming at and might be most commonly used by. In its comment letter EFRAG will need to explicitly define which kind of companies it has in mind when evaluating the ED-IFRS for SMEs.

## **3 – Users’ needs ought to be analysed further and more changes to recognition and measurement principles may be needed**

EFRAG’s view, that user needs have not yet been fully taken into account in the decisions made by the IASB, is generally shared by the GASB. In advance, the IASB should have considered more thoroughly who the users of SME financial statements are and what their specific interests with regard to those financial statements are.

Taking into account the valid criticism noted, at this stage of the project the IASB should concentrate on and making full use of the results of the ongoing field tests. In addition the IASB should carefully consider the constituents’ comment letters on the ED-IFRS for SMEs.

The GASB participates in these field tests which provide valuable input for our discussions about the ED-IFRS for SMEs. Partly, we relate to those results in our comments. However, the detailed report about the survey amongst German SMEs and the trial financial statements prepared by 16 SMEs and their SMPs in accordance with the ED-IFRS for SMEs will be available shortly.

## **4 – More simplifications in recognition and measurement should be considered**

Again, we generally agree with EFRAG that more simplifications with regard to recognition and measurement are necessary. Nevertheless, the GASB does not share all of the specific proposals that EFRAG lays out in the draft comment letter. The GASB supports, for example, EFRAG’s views on:

- Section 11 still being too complex and still lacking clarity and understandability (suggestion to not have fair value as the default category);



- reinstating the amortisation of goodwill;
- measurement of finance lease arrangements equal to the present value of the minimum lease payments (not at fair value);
- reinstating the concept of recoverable value as per IAS 36 and accordingly value in use as a relevant measure for impairment testing;
- not including the accounting for equity-settled share-based payments in the ED-IFRS for SMEs, and
- no separate section for assets held for sale needed.

However, we are sceptical about other suggestions brought forward by EFRAG. For example, EFRAG suggests that the IFRS for SMEs should have no reference to fair value at all as the “fair value does not belong to the everyday business life of entities. It belongs to the vocabulary of accountants, actuaries and other valuers, and not the vocabulary of entrepreneurs and the parties with whom they make business deals or negotiate financing resources.” From our point of view the fair value has become a common notion even for SMEs and their business partners. Moreover, the fair value is a basic principle of the IFRS in general. Since the IFRS for SMEs is to be based on the principles of full IFRS it will not be appropriate or efficient to eliminate all references to fair value in the IFRS for SMEs. As supported by our surveys, even SMEs and the users of their financial statements find the fair value to be a relevant measurement for certain transactions. As long as market prices exist SMEs even believe the fair value to have a higher information benefit than cost accounting, while costs to determine the fair value are relatively low.

We do nevertheless support the “observable market price-concept” that EFRAG explicitly addressed in its earlier comment letter (with regard to the IASB-questionnaire). In that letter EFRAG suggested to reduce the measurement at fair value to such transactions where observable market prices are available. We understand that this is still the underlying concept of EFRAG’s detailed proposals in the current comment letter draft. If this is the right understanding, we suggest clarifying that this is the approach suggested by EFRAG. The different scenarios laid out in the current draft comment letter are difficult to grasp as EFRAG does not explain principles but rather accounting and measurement requirements for very specific accounting issues.

An example for such detailed suggestions is the measurement concept for non-financial assets (“only one cost model and one revaluation model”) as laid out in the letter and the accompanying attachment 3, appendices 2 and 3. Because of numerous references within EFRAG’s comment letter it is difficult to grasp the underlying concept. In addition, there is still a considerable complexity in these measurement requirements which as a whole does not seem to justify such a systematic change in measurement requirements.

**5 – Differences from full IFRS may be warranted when a need for improvement has been identified and is particularly relevant for SMEs (equity/liability split)**

The GASB very much appreciates that EFRAG takes up this significant concern in its comment letter to the IASB. According to the German compulsory company law, the statutory capital of some legal forms such as commercial partnerships, limited liability

partnerships or cooperatives, is puttable. And as EFRAG points out, the presentation of 'no equity' or even negative equity would undoubtedly disturb investors' confidence. However, the IASB itself stated that the application of the liability definition (which is identical for IFRS for SMEs on this issue) lacks relevance and understandability if applied by companies in those legal forms. Apparently this is overall an issue with regard to the application of IFRS and not just IFRS for SMEs. Those companies applying full IFRSs are facing the same problems.

The GASB acknowledges that changes are momentarily under discussion in order to address the anomalous accounting for those entities and we support the current IASB's re-deliberations of the Exposure Draft on IAS 32 "puttable instruments". However, since the equity/liability split is not an SME-specific issue the GASB would prefer the same solution, which hopefully will be found for IAS 32, being integrated in the SME standard as well. Nevertheless, we agree with EFRAG that the IFRS for SMEs will not find acceptance, at least not in Germany, if this issue is not shortly resolved by the IASB. Therefore, if the IASB cannot provide an acceptable solution within IAS 32, the GASB supports the view expressed by EFRAG, i.e. a SME-specific solution within the IFRS for SMEs.

Furthermore, in its comment letter EFRAG might also refer to its equity/liability project under the 'Pro-active Accounting Activities in Europe' and the approach taken.

## **6 – The standard could benefit from being redrafted**

EFRAG's opinion with regard to the structure of the ED-IFRS for SMEs is shared by the GASB. We too believe that there is no need for certain topics to be addressed in a separate section (e.g. assets held for sale). It is also a shared view that the concepts and pervasive principles laid out in section 2 should be expanded. We are also pleased to see a specific suggestion for a redrafted IFRS for SMEs laid out by EFRAG in attachment 3 (appendix 1). However, it seems that the suggested structure could be improved by highlighting the importance of recognition and measurement requirements. This could be achieved by laying out the principles for assets and liabilities in separate sections. So far only one out of 8 sections is intended to address all issues with regard to recognition and measurement of assets and liabilities.

### **EFRAG's questions to constituents:**

#### **1) *embedded derivatives***

It is EFRAG's understanding that section 11 results in non-financial contracts which include an embedded derivative with economic characteristics not closely related to the contract to be accounted for at fair value in their entirety.

View 1: EFRAG disagrees with that requirement and would rather support that the IFRS for SMEs does not ask for a separation from the host contract of these instruments (ie no embedded derivatives). EFRAG suggests that IASB should omit the above mentioned paragraphs in Sec. 11 as it is too complex for an SME to identify this kind of instruments and to determine their fair value.

View 2: EFRAG disagrees with that requirement and would rather support that the derivative be separated out, whether the host contract is a financial instrument or a non-financial item. In EFRAG's view, it is useful for SMEs to have to identify risks they accept beyond the risks



inherent to the contracts to which they commit and to keep track of the basic financial consequences of the other contractual terms they accept in the normal course of their business.

EFRAG believes that derivatives ought to be defined in the IFRS for SMEs. Criteria set out in 11.3 and 11.4 could be used to identify the derivatives which need to be accounted for separately from host contracts.

***EFRAG's question: Do you prefer view 1 (embedded derivatives are not recognized) or view 2 (they are recognised via split accounting)?***

Considering that the separation of embedded derivatives is burdensome the GASB suggests that embedded derivatives should not be bifurcated and accounted for separately if the contract with the embedded derivative is commonly used in the usual operating business and embedding the derivative is economically sensible. Thus, in essence the requirement to separate embedded derivatives would be restricted to those which are of a speculative nature. We acknowledge that ED-IFRS for SMEs 11.4 already covers many of those commonly used derivatives by referring to contracts where potential losses are related to changes in the price of the non-financial item, changes in foreign exchange rates, or a default by one of the counterparties. In our view, however, this list is not necessarily all-inclusive. We are not convinced, that the following examples should be accounted for separately: If contracts to deliver a non-financial item include a condition under which the price of the non-financial item to be delivered could be adjusted for significant changes in the price of a substantial component of the non-financial item, such as:

- a contract to deliver a piece of machinery for which the price can be adjusted subject to changes in the price of steel;
- a long term contract to deliver power cable where the price can be adjusted as a consequence of subsequent changes in the price of copper.

We are concerned that the examples mentioned above would not meet the conditions of ED-IFRS for SMEs 11.4 since the non-financial item specified in the contract (machinery, power cable) is different from not the underlying of the embedded derivative (steel, copper). Thus, losses resulting from the contract are unrelated to changes in the price of the non-financial item.

A respective note disclosure would be sufficient to make users of SME financial statements aware of the risks inherent in these contracts. Other embedded derivatives – not related to the usual business operations – should be separated from the host contract and accounted for as derivatives.

## **2) securitization and factoring**

In EFRAG's view, removing the continuing involvement criterion may prevent SMEs from accounting for securitizations and factoring transactions appropriately. Indeed, if an SME retains control of a transferred asset the entity has to continue to recognise the transferred asset in its entirety. This could lead to the result that certain securitizations and factoring transactions would not result in a derecognition of the corresponding financial assets under Sec. 11. EFRAG however believes that securitization and factoring transactions are not uncommon for SMEs.



***EFRAG's question: 1. Are securitization and factoring transactions common transactions for SMEs? Is the simplification made by the IASB appropriate? 2. If not, what accounting guidance should be provided?***

We are of the opinion that securitizations do not tend to be common transactions for SMEs in Germany while factoring is. Although on the one hand the derecognition principles as defined by the IASB in 11.24 et seq. might be more restrictive when compared to full IFRS, on the other hand we believe that they are easier to apply. Therefore, on balance we consider these requirements appropriate for SMEs.

### ***3) hedge accounting and effectiveness testing***

The simplified hedging approach proposed in Sec 11 is welcomed as a genuine attempt to simplify a very complex set of provisions. EFRAG agrees that restricting hedging accounting to the circumstances in which the "almost fully offset" test is met would have been too restrictive. However, EFRAG believes that the shortcut method should remain available to be applied in all circumstances in which the cost and burden of testing the effectiveness of hedges could be spared. As a consequence, EFRAG would support both methods being available in the standard. When using an effectiveness test as criterion for hedge accounting clarification is needed on how to measure this effectiveness.

***EFRAG's questions: The simplified hedging approach goes along with some restrictions which might cause problems in practice: 1. Paragraph 11.31 only allows hedging for four specific risks. Is that too restrictive? 2. Paragraph 11.32 only allows hedging for certain hedging instruments. Is that too restrictive?***

The GASB believes that the suggested hedge accounting requirements are generally sufficient for SMEs, i.e. it is appropriate to limit hedge accounting to the four risks specified in 11.31. It is also reasonable to limit hedge accounting to certain hedge instruments. Furthermore, the GASB agrees with EFRAG that simpler hedge accounting, i.e. the short-cut method should be introduced for SMEs, where appropriate. Moreover, we agree with EFRAG that the IASB should include further guidance on effectiveness testing since so far 11.30 only states that the entity needs to expect the hedging instrument to be highly effective. 11.30 of the ED-IFRS for SMEs also states what is to be understood by "effectiveness of a hedge", however, how or when to measure effectiveness is not explained in the ED-IFRS for SMEs.

### ***4) Deferred taxes***

Transactions that do not affect accounting or taxable profit on the initial recognition. Different from IAS 12.15(b) and 12.24(b) Sec. 28.15 and 28.16(a) allow an SME to recognise deferred tax asset and liabilities for all temporary differences arising on the initial recognition of an asset or liability outside a business combinations regardless whether the transactions at that time affects accounting or taxable profit.

***EFRAG's questions:***

***1. Do constituents think this is appropriate?***

***2. Does this cause any problems considering your national tax environment?***



**3. Do you have any other proposals to further simplify deferred tax accounting?**

The GASB is of the opinion that it is appropriate to not include requirements with regard to transactions that do not affect accounting or taxable profit on the initial recognition because this exemption in IAS 12 created manifold issues and was often misunderstood and misinterpreted.

Concerning the overall approach to accounting for deferred taxes, the GASB agrees that accounting for deferred taxes is necessary in order to provide a fair presentation of the financial position of the entity. According to our survey the reasoning and benefits of deferred tax accounting was well accepted but it was also considered as being very costly thus seriously impacting the cost/benefit analysis.

If you have any further questions, please do not hesitate to contact me.

Kind regards,

Liesel Knorr