ICAC's Comments on EFRAG's Draft Comment Letter on the Request for information: Comprehensive review of the IFRS for SMEs

Comment Letters
European Financial Reporting Advisory Group
35 Square de Meeûs
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Belgium

Dear Madam/Sir,

In the present letter ICAC gives its view on some specific issues raised on EFRAG's Draft Comment Letter on the *"IASB's Request for information: Comprehensive review of the IFRS for SMEs"*.

First of all, we would like to highlight that we are of the view that any change to the Standards should be argued and justified enough.

Nevertheless, we will support the IASB on changes that will solve any possible deficiencies detected in the current standards in order to improve accounting practice.

Question to EFRAG's constituents

EFRAG TEG members agree that the IFRS for SMEs should be based on the same conceptual framework as full IFRS taking into account the different user needs. They also agree that factors such as stability, changes in users' needs, and alignment with full IFRS should be considered when reviewing the standard. However, they do not agree on the weight to be attached to each of these factors.

What factors do you think should be considered when reviewing the IFRS for SMEs, what should be the weight of each of these factors, and to what extend should amendments to full IFRS be considered when reviewing the IFRS for SMEs?

ICAC's response:

The most important factor is the stability. Notwithstanding the above, the starting point of the IFRS for SME's should be, as far as possible, full IFRS. If the latter change then it is best not to change the IFRS for SME's until it has reached a level of consistent application by all countries that choose to implement these standards.

Question S1: Use by publicly traded entities (Section 1)

The *IFRS for SMEs* currently prohibits an entity whose debt or equity instruments are traded in a public market from using the *IFRS for SMEs* (paragraph 1.3(a)). The IASB concluded that all entities that choose to enter a public securities market become publicly accountable and, therefore, should use full IFRSs.

Some interested parties believe that governments and regulatory authorities in each individual jurisdiction should decide whether some publicly traded entities should be eligible to use the *IFRS for SMEs* on the basis of their assessment of the public interest, the needs of investors in their jurisdiction and the capabilities of those publicly traded companies to implement full IFRSs.

Are the scope requirements of the *IFRS for SMEs* currently too restrictive for publicly traded entities?

(a) No—do not change the current requirements. Continue to prohibit an entity whose debt or equity instruments trade in a public market from using the *IFRS for SMEs*.

(b) Yes—revise the scope of the *IFRS for SMEs* to permit each jurisdiction to decide whether entities whose debt or equity instruments are traded in a public market should be permitted or required to use the *IFRS for SMEs*.

(c) Other—please explain.

Please provide reasoning to support your choice (a), (b) or (c).

- EFRAG is split on this issue and asks its constituents for input.

ICAC's response:

The IFRS for SME's are developed for the individual financial statements of small and medium sized enterprises, theses statements will likely be the only ones they prepare, because these entities do not often have investments in subsidiaries or they may benefit it from the exemptions regulated because of size in the 7th Directive.

Whereas in accordance with Regulation 1606/2002, of July 19, Member States are competent to determine the scope of IFRS in the individual financial statements, then the question is irrelevant.

It will ultimately be each Member State the one that will conduct an analysis on whether or not to apply IFRS for SMEs in the event that any application arose. Neither the IASB and EFRAG should analyse this issue as competence, to date, is of Member States.

Question S2: Use by financial institutions (Section 1)

The *IFRS for SMEs* currently prohibits financial institutions and other entities that hold assets for a broad group of outsiders as one of their primary businesses from using the *IFRS for SMEs* (paragraph 1.3(b)). The IASB concluded that standing ready to take and hold funds from a broad group of outsiders makes those entities publicly accountable and, therefore, they should use full IFRSs. In every jurisdiction financial institutions are subject to regulation.

In some jurisdictions, financial institutions such as credit unions and micro banks are very small. Some believe that governments and regulatory authorities in each individual jurisdiction should decide whether some financial institutions should be eligible to use the *IFRS for SMEs* on the basis of their assessment of the public interest, the needs of investors in their jurisdiction and the capabilities of those financial institutions to implement full IFRSs.

Are the scope requirements of the *IFRS for SMEs* currently too restrictive for financial institutions and similar entities?

(a) No—do not change the current requirements. Continue to prohibit all financial institutions and other entities that hold assets for a broad group of outsiders as one of their primary businesses from using the *IFRS for SMEs*.

(b) Yes—revise the scope of the *IFRS for SMEs* to permit each jurisdiction to decide whether any financial institutions and other entities that hold assets for a broad group of outsiders as one of their primary businesses should be permitted or required to use the *IFRS for SMEs*.

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

- EFRAG is split on this issue and asks its constituents for input.

ICAC's response:

Please see the answer to the preceding question.

Question S3: Clarification of use by not-for-profit entities (Section 1)

The *IFRS for SMEs* is silent on whether not-for-profit (NFP) entities (eg charities) are eligible to use the *IFRS for SMEs*. Some interested parties have asked whether soliciting and accepting contributions would automatically make an NFP entity publicly accountable. The *IFRS for SMEs* specifically identifies only two types of entities that have public accountability and, therefore, are not eligible to use the *IFRS for SMEs*:

- those that have issued debt or equity securities in public capital markets; and
- those that hold assets for a broad group of outsiders as one of their primary businesses.

Should the *IFRS for SMEs* be revised to clarify whether an NFP entity is eligible to use it?

(a) Yes—clarify that soliciting and accepting contributions does not automatically make an NFP entity publicly accountable. An NFP entity can use the *IFRS for SMEs* if it otherwise qualifies under Section 1.

(b) Yes—clarify that soliciting and accepting contributions will automatically make an NFP entity publicly accountable. As a consequence, an NFP entity cannot use the *IFRS for SMEs*.

(c) No—do not revise the *IFRS for SMEs* for this issue.

(d) Other—please explain.

Please provide reasoning to support your choice of (a), (b), (c) or (d).

- EFRAG agrees with alternative c).

<u>ICAC's response:</u>

Please see the answer to the preceding question.

Question S4: Consideration of recent changes to the consolidation guidance in full IFRSs (Section 9)

The *IFRS for SMEs* establishes control as the basis for determining which entities are consolidated in the consolidated financial statements. This is consistent with the current approach in full IFRSs.

Recently, full IFRSs on this topic have been updated by IFRS 10 *Consolidated Financial Statements*, which replaced IAS 27 *Consolidated and Separate Financial Statements* (2008). IFRS 10 includes additional guidance on applying the control principle in a number of situations, with the intention of avoiding divergence in practice. The guidance will generally affect borderline cases where it is difficult to establish if an entity has control (ie, most straightforward parent-subsidiary relationships will not be affected). Additional guidance is provided in IFRS 10 for:

- agency relationships, where one entity legally appoints another to act on its behalf. This guidance is particularly relevant to investment managers that make decisions on behalf of investors. Fund managers and entities that hold assets for a broad group of outsiders as a primary business are generally outside the scope of the *IFRS for SMEs*.
- control with less than a majority of the voting rights, sometimes called 'de facto control' (this principle is already addressed in paragraph 9.5 of the *IFRS for SMEs* but in less detail than in IFRS 10).
- assessing control where potential voting rights exist, such as options, rights or conversion features that, if exercised, give the holder additional voting rights (this principle is already addressed in paragraph 9.6 of the *IFRS for SMEs* but in less detail than in IFRS 10).

The changes above will generally mean that more judgement needs to be applied in borderline cases and where more complex relationships exist.

Should the changes outlined above be considered, but modified as appropriate to reflect the needs of users of SME financial statements and cost-benefit considerations?

(a) No—do not change the current requirements. Continue to use the current definition of control and the guidance on its application in Section 9. They are appropriate for SMEs, and SMEs have been able to implement the definition and guidance without problems.

(b) Yes—revise the *IFRS for SMEs* to reflect the main changes from IFRS 10 outlined above (modified as appropriate for SMEs).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

- EFRAG is not able to provide a view on the issue, alternative c).

ICAC's response:

The reform package on consolidation standards (except in regard to the elimination of the optional nature of the proportionate method) is an example of what the future should not be international standardization. IFRS 10 does not change essentially the factual that triggers consolidation, which is still "control". IFRS10 is a simple interpretation or guidance to identify when control exists basically focused on the accounts of financial institutions, in view of the examples included in the application guidance.

If the aim is to approve a new standard because the one in force is not applied, the efforts will be fruitless. The new standard will neither be applied. To avoid this behavior it is more useful to highlight the failure to comply with the existing standards in the audit report.

In summary, in our opinion, if someone applies IFRS for SME's somewhere in the world, it is best not to change the current requirements. Otherwise, the starting point, as mentioned above, should be the closest to full IFRS.

Question S5: Use of recognition and measurement provisions in full IFRSs for financial instruments (Section 11)

The *IFRS for SMEs* currently permits entities to choose to apply either (paragraph 11.2):

- the provisions of both Sections 11 and 12 in full; or
- the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of Sections 11 and 12.

In paragraph BC106 of the Basis for Conclusions issued with the *IFRS for SMEs*, the IASB lists its reasons for providing SMEs with the option to use IAS 39. This is the only time that the *IFRS for SMEs* specifically permits the use of full IFRSs. One of the main reasons for this option is that the IASB concluded that SMEs should be permitted to have the same accounting policy options as in IAS 39, pending completion of its comprehensive financial instruments project to replace IAS 39. That decision is explained in more detail in paragraph BC106.

IAS 39 will be replaced by IFRS 9 *Financial Instruments*. Any amendments to the *IFRS for SMEs* from this comprehensive review would most probably be effective at a similar time to the effective date of IFRS 9. The *IFRS for SMEs* refers specifically to IAS 39. SMEs are not permitted to apply IFRS 9.

How should the current option to use IAS 39 in the *IFRS for SMEs* be updated once IFRS 9 has become effective?

(a) There should be no option to use the recognition and measurement provisions in either IAS 39 or IFRS 9. All SMEs must follow the financial instrument requirements in Sections 11 and 12 in full.

(b) Allow entities the option of following the recognition and measurement provisions of IFRS 9 (with the disclosure requirements of Sections 11 and 12).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Note: the purpose of this question is to assess your overall view on whether the fallback to full IFRSs in Sections 11 and 12 should be removed completely, should continue to refer to an IFRS that has been superseded, or should be updated to refer to a current IFRS. It does not ask respondents to consider whether any of the recognition and measurement principles of IFRS 9 should result in amendments of the *IFRS for SMEs* at this stage, because the IASB has several current agenda projects that are expected to result in changes to IFRS 9 (see paragraph 13 of the Introduction to this Request for Information).

- EFRAG agrees with alternative b). It thinks that entities should be given the option of following the recognition and measurement provisions of IFRS9. However, post-implementation reviews should consider whether the options could be removed.

ICAC's response:

The main differences between the accounting standards that were applied in Europe and IFRS as approved by the IASB, were regarding business combinations (IFRS3) and financial instruments (IAS39). In recent years these pronouncements have introduced radical changes. So, before changing the current requirements it would be prudent to check if the new criteria will be amended again.

If someone applies IFRS for SME's somewhere in the world, it is best not to change the current requirements. Otherwise, the starting point, as mentioned above, should be the closest to full IFRS. Currently, IFRS 9.

Question S6: Guidance on fair value measurement for financial and non-financial items (Section 11 and other sections)

Paragraphs 11.27–11.32 of the *IFRS for SMEs* contain guidance on fair value measurement. Those paragraphs are written within the context of financial instruments. However, several other sections of the *IFRS for SMEs* make reference to them, for example, fair value model for associates and jointly controlled entities (Sections 14 and 15), investment property (Section 16) and fair value of pension plan assets (Section 28). In addition, several other sections refer to fair value although they do not specifically refer to the guidance in Section 11. There is some other guidance about fair value elsewhere in the *IFRS for SMEs*, for example, guidance on fair value less costs to sell in paragraph 27.14.

Recently the guidance on fair value in full IFRSs has been consolidated and comprehensively updated by IFRS 13 *Fair Value Measurement*. Some of the main changes are:

- an emphasis that fair value is a market-based measurement (not an entity-specific measurement);
- an amendment to the definition of fair value to focus on an exit price (fair value is defined in IFRS 13 as "the price that would be received to sell an asset or

paid to transfer a liability in an orderly transaction between market participants at the measurement date"); and

- more specific guidance on determining fair value, including assessing the highest and best use of non-financial assets and identifying the principal market.

The guidance on fair value in Section 11 is based on the guidance on fair value in IAS 39. The IAS 39 guidance on fair value has been replaced by IFRS 13.

In straightforward cases, applying the IFRS 13 guidance on fair value would have no impact on the way fair value measurements are made under the *IFRS for SMEs*. However, if the new guidance was to be incorporated into the *IFRS for SMEs*, SMEs would need to re-evaluate their methods for determining fair value amounts to confirm that this is the case (particularly for non-financial assets) and use greater judgement in assessing what data market participants would use when pricing an asset or liability.

Should the fair value guidance in Section 11 be expanded to reflect the principles in IFRS 13, modified as appropriate to reflect the needs of users of SME financial statements and the specific circumstances of SMEs (for example, it would take into account their often more limited access to markets, valuation expertise, and other cost-benefit considerations)?

(a) No—do not change the current requirements. The guidance for fair value measurement in paragraphs 11.27–11.32 is sufficient for financial and non-financial items.

(b) Yes—the guidance for fair value measurement in Section 11 is not sufficient. Revise the *IFRS for SMEs* to incorporate those aspects of the fair value guidance in IFRS 13 that are important for SMEs, modified as appropriate for SMEs (including the appropriate disclosures).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Note: an alternative is to create a separate section in the *IFRS for SMEs* to deal with guidance on fair value that would be applicable to the entire *IFRS for SMEs*, rather than leaving such guidance in Section 11. This is covered in the following question (question S7).

- EFRAG is not aware of problems arising from the fair value guidance included in IFRS for SME's, and is seeking for input from its constituents.

  Are you aware of any problems resulting from the guidance on fair value measurement currently included in the IFRS for SMEs that could be solved by expanding the guidance to reflect the principles in IFRS 13, modified as appropriate to reflect the needs of users of SME financial statements and the specific circumstances of SMEs?

ICAC's response:

SMEs will never apply section 11 or IFRS 13 because they do not have the infrastructure/resources to do so. This is what reality shows; consider any other possibility is a mere intellectual entertainment.

An example of the above is what it is stated in paragraph 11.30, which sets the criteria to identify the fair value of the equity instruments that do not have a quoted market price. If this section had been drafted by someone who was truly thinking of harmonizing accounting for these entities and provide them with feasible rules, criteria to value these assets, in any case, should have been the "cost method". At this point, the same can be said for IFRS 9.

Question S7: Positioning of fair value guidance in the Standard (Section 11)

As noted in question S6, several sections of the *IFRS for SMEs* (covering both financial and non-financial items) make reference to the fair value guidance in Section 11.

Should the guidance be moved into a separate section? The benefit would be to make clear that the guidance is applicable to all references to fair value in the *IFRS for SMEs*, not just to financial instruments.

(a) No—do not move the guidance. It is sufficient to have the fair value measurement guidance in Section 11.

(b) Yes—move the guidance from Section 11 into a separate section on fair value measurement.

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Note: please answer this question regardless of your answer to question S6.

- EFRAG agrees with alternative b).

<u>ICAC's response:</u>

When a transaction between unrelated parties does not exist, the application of fair value in SMEs should be limited to financial instruments admitted to trading. Therefore, it seems unnecessary to go beyond what Section 11 says.

However, the relevant issue which should be clarified is who will be the recipients of these IFRS for SME's. Listed companies, large, medium or small and medium-sized and large unlisted companies (on its individual and consolidated accounts), should apply IFRS, or at least similar standards. That's what happens in Spain where local Gaap (applicable in the individual accounts of all kind of companies, and optionally in the unlisted consolidated annual accounts) have been modified to align with full IFRS. For all these companies, fair value requirements and standards applicable should be similar.

That is, in the above situation, IFRS for SME's would never apply. In the particular case of the European Union, each Member State shall, within the framework of Regulation 1606/2002, of 19 July, require, permit or adapt their legislation harmonized with IFRS.

In conclusion, the first thing that should be clarified is who will be the recipients of this standard. Henceforth it will be assumed to be small businesses.

Question S8: Consideration of recent changes to accounting for joint ventures in full IFRSs (Section 15)

Recently, the requirements for joint ventures in full IFRSs have been updated by the issue of IFRS 11 *Joint Arrangements*, which replaced IAS 31 *Interests in Joint Ventures*. A key change resulting from IFRS 11 is to classify and account for a joint arrangement on the basis of the parties' rights and obligations under the arrangement. Previously under IAS 31, the structure of the arrangement was the main determinant of the accounting (ie establishment of a corporation, partnership or other entity was required to account for the arrangement as a jointly-controlled entity). In line with this, IFRS 11 changes the definitions and terminology and classifies arrangements as either joint operations or joint ventures.

Section 15 is based on IAS 31 except that Section 15 (like IFRS 11) does not permit proportionate consolidation for joint ventures, which had been permitted by IAS 31. Like IAS 31, Section 15 classifies arrangements as jointly controlled operations, jointly controlled assets or jointly controlled entities. If the changes under IFRS 11 described above were adopted in Section 15, in most cases, jointly controlled assets and jointly controlled operations would become joint operations, and jointly controlled entities would become joint ventures. Consequently, there would be no change to the way they are accounted for under Section 15.

However, it is possible that, as a result of the changes, an investment that previously met the definition of a jointly controlled entity would become a joint operation. This is because the existence of a separate legal vehicle is no longer the main factor in classification.

Should the changes above to joint venture accounting in full IFRSs be reflected in the *IFRS for SMEs*, modified as appropriate to reflect the needs of users of SME financial statements and cost-benefit considerations?

(a) No—do not change the current requirements. Continue to classify arrangements as jointly controlled assets, jointly controlled operations and jointly controlled entities (this terminology and classification is based on IAS 31 *Interests in Joint Ventures*). The existing Section 15 is appropriate for SMEs, and SMEs have been able to implement it without problems.

(b) Yes—revise the *IFRS for SMEs* so that arrangements are classified as joint ventures or joint operations on the basis of the parties' rights and obligations under the arrangement (terminology and classification based on IFRS 11 *Joint Arrangements*, modified as appropriate for SMEs).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Note: this would not change the accounting options available for jointly-controlled entities meeting the criteria to be joint ventures (ie cost model, equity method and fair value model).

- Currently EFRAG is not able to provide a view on this issue, alternative c).

ICAC's response:

No changes should be introduced with respect to the separate financial statements. Applying the technique of consolidation when the joint venture is structured through a legal form (usually a corporation) will introduce a lot of complexity. IFRS 11 has gone beyond what it should; and should not repeat the mistake in the IFRS for SME's.

Question S9: Revaluation of property, plant and equipment (Section 17)

The *IFRS for SMEs* currently prohibits the revaluation of property, plant and equipment (PPE). Instead, all items of PPE must be measured at cost less any accumulated depreciation and any accumulated impairment losses (cost-depreciation-impairment model—paragraph 17.15). Revaluation of PPE was one of the complex accounting policy options in full IFRSs that the IASB eliminated in the interest of comparability and simplification of the *IFRS for SMEs*.

In full IFRSs, IAS 16 *Property, Plant and Equipment* allows entities to choose a revaluation model, rather than the cost-depreciation-impairment model, for entire classes of PPE. In accordance with the revaluation model in IAS 16, after recognition as an asset, an item of PPE whose fair value can be measured reliably is carried at a revalued amount—its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluation increases are recognised in other comprehensive income and are accumulated in equity under the heading of 'revaluation surplus' (unless an increase reverses a previous revaluation decrease recognised in profit or loss for the same asset). Revaluation decreases that are in excess of prior increases are recognised in profit or loss. Revaluations must be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

Should an option to use the revaluation model for PPE be added to the *IFRS for SMEs*?

(a) No—do not change the current requirements. Continue to require the cost-depreciation-impairment model with no option to revalue items of PPE.

(b) Yes—revise the *IFRS for SMEs* to permit an entity to choose, for each major class of PPE, whether to apply the cost-depreciation-impairment model or the revaluation model (the approach in IAS 16).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

- EFRAG is split on this issue and asks its constituents for input.

ICAC's response:

In many countries laws on revaluation of balances are periodically approved. For example, in Spain a revaluation law was approved in 1996 and another revaluation law may be approved in 2012 or 2013. The IFRS for SME's should consider this possibility (in the terms provided in the 4th Directive), revaluations as regulated in IAS16 are very expensive and difficult to implement for SMEs.

Question S10: Capitalisation of development costs (Section 18)

The *IFRS for SMEs* currently requires that all research and development costs be charged to expense when incurred unless they form part of the cost of another asset that meets the recognition criteria in the *IFRS for SMEs* (paragraph 18.14). The IASB reached that decision because many preparers and auditors of SME financial statements said that SMEs do not have the resources to assess whether a project is commercially viable on an ongoing basis. Bank lending officers told the IASB that information about capitalised development costs is of little benefit to them, and that they disregard those costs in making lending decisions.

In full IFRSs, IAS 38 *Intangible Assets* requires that all research and some development costs must be charged to expense, but development costs incurred after the entity is able to demonstrate that the development has produced an asset with future economic benefits should be capitalised. IAS 38.57 lists certain criteria that must be met for this to be the case.

IAS 38.57 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:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale.
- its intention to complete the intangible asset and use or sell it.
- its ability to use or sell the intangible asset.
- 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.