IFRS for SMEs – definition of public accountability
Issues Paper

Objective

1 The objective of this agenda paper is to:

(a) inform EFRAG FRB about the proposed clarifications to the definition of 'public accountability' published in the IASB Exposure Draft: Third edition of the IFRS for SMEs Accounting Standard (ED *IFRS for SMEs*)

(b) to seek the EFRAG FRB views as to whether EFRAG should comment on these proposals included in Question 1 of the IASB ED *IFRS for SMEs*;

(c) if yes, to seek the EFRAG FRB views on key messages to be included in a draft comment letter.

Background of the scope of *Subsidiaries without Public Accountability: Disclosures (SWPA) project*

IASB Proposals for the scope

2 The IASB proposed that the objective of the draft *SWPA* Standard is to permit eligible subsidiaries to use reduced disclosures together with the recognition, measurement and presentation requirements in IFRS Standards.

3 An entity would be permitted to apply reduced disclosure requirements in its consolidated, separate or individual financial statements if, at the end of its reporting period it is:

(a) a subsidiary;

(b) does not have public accountability; and

(c) has an ultimate or intermediate parent that produces consolidated financial statements available for public use that comply with IFRS Standards.

4 An entity has *public accountability* if:

(a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) it holds assets in a *fiduciary capacity* for a broad group of outsiders as one of its primary businesses (most banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks would meet this criterion).

5 An entity may hold assets in a *fiduciary capacity* for a broad group of outsiders because the entity holds and manages financial resources entrusted to it by clients,

customers or members not involved in the management of the entity. However, doing so for reasons incidental to a primary business does not make the entity publicly accountable. Such a situation may arise for travel or real estate agents, schools, charitable organisations, co-operative enterprises requiring a nominal membership deposit, and sellers (such as utility companies) that receive payment before the delivery of goods or services.

6 The definition of public accountability included in the ED is based on the definition included in the IFRS for SMEs Standard.

Feedback on the scope received by the IASB

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8 The respondents to the ED provided mixed views on the proposed scope:

(a) many respondents suggested widening the scope to allow more entities to apply the proposals. However, respondents expressed a variety of different views on how the scope should be widened;

(b) some respondents agreed with the proposed scope but suggested the IASB considers widening the scope at a later stage (e.g., after the draft Standard has been implemented);

(c) a few suggested a narrower scope; and

(d) a few observed that the regulator should determine who could apply the draft Standard.

9 Some respondents sought further guidance on the description of 'public accountability', including 'fiduciary capacity'.

Feedback on the scope received by EFRAG

10 European constituents welcomed the ED and the IASB objective to ease financial reporting for eligible subsidiaries while maintaining relevant information for users. Nevertheless, they expressed concerns on the scope and raised questions on the interaction of the IASB's proposals with EU accounting law.

11 When referring to the scope, respondents expressed mixed views, in particular on whether and to what extent the scope should be widened. Many respondents supported the IASB's proposed scope and the IASB's approach to first test its proposals with subsidiaries without public accountability.

12 By contrast, many European constituents asked the IASB to consider widening the scope and provided different suggestions on how the scope should be expanded. For example, there were requests to include associates, joint ventures and joint operations; non-listed insurance companies that are subsidiaries; non-listed banks that are subsidiaries; ultimate parent entities for their separate financial statements; or all entities without public accountability.

13 In addition, respondents noted that the application of the criterion "it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses", which is derived from *IFRS for SMEs* Standard, raises many questions and may be difficult to be applied in practice. For example, insurers do not in general regard themselves as holding assets in a fiduciary capacity.

14 When referring to the interaction of the IASB's proposals with the EU accounting law, respondents highlighted that the applicability of the ED in the EU depends on whether IFRS Standards were allowed for annual accounts in local jurisdiction, reflecting the different use of the options in Regulation (EC) No. 1606/2002.

15 In addition, respondents highlighted that the IASB's notion of 'Public Accountability' is different from the notion of Public Interest Entities' (PIEs) included in the Accounting Directive and that this could be a potential incompatibility.

EFRAG Final Comment Letter on the scope

16 EFRAG published its final comment letter on 25 February 2022. In its comment letter EFRAG recognised support from constituents to permit eligible subsidiaries to apply IFRS Standards with reduced disclosure requirements. EFRAG also highlighted the feedback received from those that encouraged the IASB to widen the scope and include several additional types of entities.

17 However, EFRAG decided to note that there was no clear consensus on whether and to what extent the scope should be widened. Therefore, EFRAG suggested that the IASB continues with the current scope of the project but in parallel assesses the possibility of scope extension.

18 In addition, to address EFRAG's constituents concerns, EFRAG proposed that the IASB considers:

(a) clarifying the concept of holding assets in a fiduciary capacity before issuing a finalised standard and exploring the applicability of the ED to the insurance sector;

(b) providing further guidance as the project is likely to put pressure on the definitions 'available for public use' and 'public accountability'; and

(c) that its approach to the scope provides a working environment for the standard rather than a legal scope of application as such decisions are normally made in the EU endorsement process.

IASB redeliberations on the scope of the standard

19 In May 2022, the IASB started its redeliberations by discussing the proposed scope of the draft Standard. In that meeting, the IASB tentatively decided to:

(a) confirm the scope as proposed in the draft Standard; and

(b) review that scope after the draft Standard has been finalised, possibly during the post-implementation review.

20 The IASB also tentatively decided to provide guidance to improve understandability of the definition of ‘public accountability’ defined in *IFRS for SMEs* (see ASAF Agenda Paper 8), including clarifying amendments on the notion of holding assets in a fiduciary capacity (e.g. avoid specifying how often the entities listed in paragraph 7(b) of the draft Standard hold assets in a fiduciary capacity for a broad group of outsiders as one of their primary businesses).

Proposals in the ED *IFRS for SMEs* and their impact on the *SWPA* project

Recent IASB decisions on the scope in IFRS for SME Standard

21 In June 2022, the IASB tentatively decided:

(a) not to include guidance on public accountability from Module 1 *Small and Medium-sized Entities* in the *IFRS for SMEs* Accounting Standard;

(b) not to include guidance on public accountability from Module 1 in the proposed Accounting *Standard Subsidiaries without Public Accountability: Disclosures* when it is finalised; but

(c) to make Module 1 separately available on the IFRS Foundation's website as educational material to support the proposed Accounting Standard *Subsidiaries without Public Accountability: Disclosures*, when that Accounting Standard is finalised.

22 Eight of ten IASB members agreed with this decision.

The IASB proposals in the ED IFRS for SMEs

23 On 8 September 2022, the IASB published the ED *Third edition of the IFRS for SMEs Accounting Standard* as part of its second comprehensive review of the Standard.

24 In the ED the IASB is proposing to:

(a) amend paragraph 1.3(b) (rewording);

(b) add paragraph 1.3A to clarify the characteristics of an entity with public accountability.

25 In addition, EFRAG Secretariat notes the IASB tentative decision to make Module 1 separately available on the IFRS Foundation's website as educational material to support the proposed Accounting Standard *Subsidiaries without Public Accountability: Disclosures*, when that Accounting Standard is finalised. (This decision is not reflected in the ED).

26 On Question 1 - *Definition of public accountability* of the ED *IFRS for SMEs,* the IASB refers to the concerns about applying the definition of public accountability expressed by respondents in the feedback to the IASB ED on SWPA*.* The IASB expects that the proposed amendments to paragraphs 1.3 and 1.3A of Section 1 of the ED IFRS for SMEs will add clarity, without changing the intended scope of the Standard*.*

27 During its work, the IASB considered, but decided not to permit exceptions to the definition of public accountability to allow some publicly accountable entities to use the Standard. Feedback received by the IASB showed that such changes would increase the complexity of the Standard and that it would be difficult to clearly define the group of entities with public accountability that should be permitted to apply the Standard.

28 In addition, if the scope of the Standard would be widened to include a sub-group of financial institutions, it will create a need to incorporate additional requirements from IFRS 9 *Financial Instruments* and IFRS 13 *Fair Value Measurement* to cater for more complex financial instruments, and to incorporate risk disclosures from IFRS 7 *Financial Instruments: Disclosures*. In addition, requirements to use the general model in IFRS 9 to calculate expected credit losses and disclose credit risk management practices would have to be added. Therefore, the IASB decided not to propose widening the scope of the Standard to include some publicly accountable entities.

29 The IASB also considered feedback on the Exposure Draft *ED/2021/7 Subsidiaries without Public Accountability: Disclosures* and concerns about the definition of public accountability. In particular, some respondents to ED/2021/7 disagreed with the statement in paragraph 1.3(b) of the Standard that *'most'* banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks hold assets in a fiduciary capacity for a broad group of outsiders as a primary business, and hence have public accountability. These concerns were raised mainly in relation to insurance companies. A few respondents were of the view that premiums collected by an insurance company in exchange for a contractual promise to indemnify the customer for a possible future event belong to the insurance company and are not held and managed in a fiduciary capacity by the insurance company. Some respondents asked for guidance on the term 'fiduciary capacity'.

30 The IASB observed that there is a high degree of public interest in the financial reports of all non-captive insurance companies (insurance companies that insure the risks of parties outside their group of entities) because:

(a) the policyholders risk financial loss if an insured event occurs and the insurance company cannot pay the claim; and

(b) the policyholders are outsiders who cannot demand information for themselves. That is why insurance companies are regulated—like banks, mutual funds, securities brokers and dealers, and other financial institutions.

31 The IASB also noted that the *IFRS for SMEs* Accounting Standard includes no specific requirements for insurance contracts or complex financial instruments and, therefore, may not be suitable for more complex financial institutions. Nevertheless, the IASB agreed with respondents that specifying *how often* the entities in paragraph 1.3(b) of the Standard[1] hold assets in a fiduciary capacity *is unhelpful* within the definition of public accountability and it would be better to clarify why those entities *often have public accountability*. Consequently, the IASB is proposing to amend paragraph 1.3(b) to instead list banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks as examples of entities that *often meet* the second criterion. Nevertheless, the IASB noted that this amendment *is not intended to be a relaxation of the criterion in paragraph 1.3(b)*.

32 Furthermore, to help jurisdictions better understand the basis for the definition of 'public accountability' and apply that definition consistently, the IASB is proposing to clarify *why* the entities in paragraph 1.3(b) would *often* be considered to have public accountability. In particular, the IASB is proposing to clarify that an entity with these characteristics would usually have public accountability:

(a) there is both a high degree of outside interest in the entity and a broad group of users of the entity's financial statements (existing and potential investors, lenders and other creditors) who have a direct financial interest in, or substantial claim against, the entity.

(b) these users depend primarily on external financial reporting as their means of obtaining financial information about the entity. These users need financial information about the entity but lack the power to demand the information for themselves.

33 The IASB's view is that full IFRS Accounting Standards are intended to meet the needs of these users.

34 The IASB expects that the proposed amendments will add clarity, without changing the intended scope of the *IFRS for SMEs* Standard and asks whether respondents agree with this expectation and with the proposed clarification.

35 In relation to the definition of *'fiduciary capacity'*, the IASB noted that it discussed providing guidance on, or defining, this term during the first comprehensive review and concluded that it would be <u>difficult to develop guidance that would be applicable, translatable and capable of being consistently applied across all jurisdictions applying the Standard</u>. The IASB also noted that the Standard is established in many jurisdictions, using the definition of public accountability. Consequently, including a definition of 'fiduciary capacity' in the Standard now could create problems in jurisdictions that have already determined which types of entities in that jurisdiction have public accountability, if such determinations are inconsistent with any new definition.

EFRAG working groups recent discussions

EFRAG IAWG feedback 4 October

36 Members considered that the IASB clarifications were very general. One member was concerned that the changes made potentially have unintended consequences.

[1] Please refer to Appendix 1 for the proposed text of the *IFRS for SMEs* Accounting Standard in relation to the scope.

37 Members noted that the IASB scoped out the insurance companies but considered that it would be beneficial if the reduced disclosures could be applied by some small insurance subsidiaries (e.g., life insurers).

38 Members questioned the IASB not allowing the reduced disclosure requirements for IFRS 17 and noted that even if some of the insurance entities would be scoped in, they would have anyway to provide full disclosures. Therefore, if the insurers are scoped in, the simplifications to IFRS 17 disclosures should be discussed.

39 One member suggested that removing the term 'fiduciary capacity' from the definition of 'public accountability' would allow to scope in the insurance companies.

40 Another member suggested that the question of scope could be handled through the local legislation.

41 One member noted that aligning the definition of 'public accountability' with 'public interest entity' would not solve the issue of scoping in the insurance entities as they are public interest entities under the EU legislation.

42 Some members agreed with the IASB reasoning that insurance and financial entities are of public interest and policy holders should have a right on the full disclosures.

43 Members also noted that scoping in the insurance or financial institutions will require revisiting the disclosure requirements in order to cater for more complex financial instruments.

44 Members suggested that the link between the scope of *IFRS for SME* and *Subsidiaries without a Public Accountability* should not be considered as automatic and implicit.

45 Members agreed that EFRAG could comment on the Question 1 of *IFRS for SMEs* ED and reiterate the points mentioned above.

EFRAG FR TEG feedback 6 October

46 EFRAG FR TEG members generally recommended that EFRAG should comment on the Question 1 of the IASB ED IFRS for SMEs given the extensive debate on the topic of scope.

<u>Decoupling the two scopes</u>

47 One of the options considered by the EFRAG FR TEG members was to decouple the scopes of *IFRS for SMEs* from the scope of SwPA standard to allow more flexibility of scope changes in the latter.

48 Members noted the IASB arguments for keeping the scope and definitions of 'public' accountability and 'fiduciary capacity' the same for both standards. Given that SwPA project evolved from the *IFRS for SMEs* Standard with its existing scope and disclosures, disconnecting the two now would require revisiting the whole approach to develop the disclosure requirements in SwPA project.

49 Members in favour for enlarging the scope of SwPA project by including insurance entities considered the decoupling of two scopes as a possible alternative. Given that currently full disclosure requirements for IFRS 17 are included in SwPA ED the users would receive the information regarding the insurance business they are interested in. Preparers of the insurance industry could benefit from the reduced disclosure requirements in other areas of financial reporting.

<u>Definitions of public accountability and fiduciary capacity</u>

50 The clarifications to the definition of 'public accountability' in paragraph 1.3A are helpful but too loose and will be difficult to enforce. The order of the two conditions and their relationship (should it be a) **and** b) or a) **or** b)?) is not clear. Wording should be more stringent and preferably aligned with the IASB DP *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* published in 2004.

51 Having a fiduciary capacity should be considered as one of the indicators of the public accountability.

52 Members noted that the paragraph 1.4 of the IFRS for SMEs already contains a guidance on what constitutes a 'fiduciary capacity' and it can be interpreted in a way that the insurance subsidiaries are in the scope of the standard. However, the IASB has provided clarifications in the paragraphs 1.3A and BC 15 with the aim to exclude the insurance entities from the scope. Some jurisdictions used their own definition of 'public accountability' when applying the IFRS for SMEs and this could be a possible solution.

53 Members preferred to have a reference to the educational material (explaining definitions of public accountability and fiduciary capacity) within the standard as an application guidance and not outside. In this case this guidance will be endorsed in EU.

54 Members noted that the lack of clarity with the definition of 'public accountability' should not prevent from endorsing the future reduced disclosure standard.

<u>Insurance entities</u>

55 Some EFRAG FR TEG members considered that insurance entities should be in the scope of the reduced disclosure standard. In these members' view it could promote the use of IFRS in Europe and policyholders already had access to the public information about performance and key figures of insurance entities as it is required by EU Solvency regulation.

56 In general, EFRAG TEG members noted that insurance companies meet the 'Public Interest Entity' definition and even if the IASB adapts the definition of fiduciary capacity it will not solve the major question: whether the insurance entities should be entitled to use the reduced disclosure standard. As this is an area regulated by existing EU Law, the views of European Commission and member states in this respect are of high importance.

The EFRAG Secretariat assessment of the impact of the proposed changes

Reasons for comment

57 Given the direct impact on the definitions of 'public accountability' and 'fiduciary capacity' used in the *SWPA* project, the EFRAG Secretariat considers that EFRAG could comment on Question 1 *Definition of public accountability* of the ED, only. This is despite the fact that the *IFRS for SMEs* Standard is not endorsed in the EU. The changes proposed are according to the IASB based on the feedback received on the ED *Subsidiaries without Public Accountability*. The scope of the IASB ED on *SWPA* is directly linked to the definition of 'public accountability' in the *IFRS for SMEs* Standard as the same wording is used. The EFRAG Secretariat considers that any changes to the latter will directly affect the scope of *SWPA* project, unless the IASB decides to disconnect the two scopes.

58 EFRAG requested from the IASB to clarify the terms underpinning to the scope in its comment letter on the ED *SWPA* and, as such, should consider the impact of the proposed changes to the IFRS for SMEs standard (A disclaimer would be provided should EFRAG decide to issue a comment letter.)

Possible ways forward

59 The EFRAG Secretariat considers that the main question to answer is: should the insurance subsidiaries in Europe be permitted to apply the reduced disclosure standard?

60 It should be noted that insurance entities are considered as public interest entities ('PIE') under EU law and thus even if they will be in the scope of the reduced

disclosure standard, they might be forced by local legislation to apply at least the requirements in the Accounting Directive.

61 In the case if a particular jurisdiction requires or permits the application of full IFRS by insurance subsidiaries, it means that the reduced disclosure standard (if endorsed in EU) will also be automatically applicable to them. It could be problematic if the reduced disclosure requirements are less than the requirements in the Accounting Directive for the PIE.

62 Considering this, the EFRAG Secretariat considers the following possible alternative:

(a) Calling for the IASB to decouple the two scopes;

(b) not commenting on the IASB's consultation on IFRS for SMEs.;

(c) calling for further clarifications to the definitions of public accountability and fiduciary capacity in the IFRS for SMEs.

Decoupling the two scopes

63 In this case the scope of IFRS for SMEs standard remains unaffected but the scope of SwPA reduced disclosure standard could be adjusted to include insurance companies. For example, EFRAG could request, in the IASB project SWPA, to the IASB to decouple the scope from the IFRS for SMEs Standard. In such a case, the IASB could considering removing the term of fiduciary capacity from the definition of public accountability. This would mean that both insurance companies and banks would be in the scope of the project.

64 This could also trigger the IASB revisiting its approach and proposals in the reduced disclosure standard to encompass disclosures related to insurance companies and banks.

Not commenting on the IASB's consultation on IFRS for SMEs

65 With this option, EFRAG would not comment on the IASB proposals in the IFRS for SMEs Standard. Any comments on the scope and terminology would be made within the IASB's project *Subsidiary without Public Accountability* to not disrupt any potential improvements to the *IFRS for SMEs* Standard.

66 At the endorsement stage, EFRAG would have to consider the scope and terminology used in the scope and assess whether it would be necessary to make adjustments to align it with current European Accounting Legislation.

Providing further clarifications to the definitions of public accountability and fiduciary capacity in the IFRS for SMEs

67 Another option is to continue to request, in the IASB's consultation on the *IFRS for SMEs* Standard, the IASB to further clarify the definitions of 'public accountability' and 'fiduciary capacity', particularly in regard to insurance companies.

68 However, it is doubtful that any clarifications would result in the insurance subsidiaries being included in the scope. The IASB's intention not to change the scope and hence not to scope in insurance entities is quite clear from the Basis of Conclusions (BC 15) and also from the clarifications added in paragraph 1.3A.

69 However, it might be useful, to include guidance (key elements only) from Module 1 on 'public accountability' and 'fiduciary capacity' as an application guidance to the future *SWPA* Standard.

Questions for EFRAG FRB

70 Does EFRAG FRB consider that EFRAG should comment on the Question 1 of the ED *Third edition of the IFRS for SMEs Accounting Standard*?

71 If yes, which of the options would you suggest exploring in a draft comment letter?

Appendix 1: Section 1 of IFRS for SMEs Accounting Standard

The text below is shown in mark-up. That is: (i) requirements it is proposing to remove or replace are struck through; (ii) requirements it is newly proposing are underlined; and (iii) requirements unaffected by the proposals are shaded in grey.

Intended scope of this Standard

1.1 The *IFRS for SMEs* Accounting Standard is intended for use by entities without public accountability, which are referred to as **small and medium-sized entities** (SMEs) in this Standard. This section describes the characteristics of SMEs.

Description of small and medium-sized entities

1.2 Small and medium-sized entities are entities that:

(a) do not have **public accountability**; and

(b) publish **general purpose financial statements** for external users.

Examples of external users include **owners** who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

1.3 An entity has public accountability if:

(a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (for example, ~~most~~ banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks often ~~would~~ meet this second criterion).

1.3A An entity with the following characteristics would usually have public accountability:

(a) there is both a high degree of outside interest in the entity and a broad group of users of the entity's financial statements (existing and potential investors, lenders and other creditors) outside the entity (other than owner-managers) who have a direct financial interest in or substantial claim against the entity.

(b) the users in (a) depend primarily on external financial reporting as their means of obtaining financial information about the entity. These users need financial information about the entity but lack the power to demand the information for themselves.

1.4 Some entities may also hold assets in a fiduciary capacity for a broad group of outsiders because they hold and manage financial resources entrusted to them by clients, customers or members not involved in the management of the entity. However, if they do so for reasons incidental to a primary business (as, for example, may be the case for travel or real estate agents, schools, charitable organisations, co-operative enterprises requiring a nominal membership deposit and sellers that receive payment in advance of delivery of the goods or services such as utility companies), that does not make them publicly accountable.

1.5 **If a publicly accountable entity applies ~~uses~~ this Standard, its financial statements shall not be described as conforming to the *IFRS for SMEs* Accounting Standard—even if any law or regulation in that entity's ~~its~~ jurisdiction permits or requires this Standard to be used by publicly accountable entities.**

1.6 A **subsidiary** whose **parent** uses **full IFRS Accounting Standards**, or that is part of a consolidated **group** that uses full IFRS Accounting Standards, is not prohibited from using this Standard in its own financial statements if that subsidiary by itself does not have public accountability. If its financial statements are described as conforming to the *IFRS for SMEs* Accounting Standard, it must comply with all of the requirements ~~provisions~~ of this Standard.

1.7 A parent entity (including the ultimate parent or any intermediate parent) assesses its eligibility to use this Standard in its **separate financial statements** on the basis of its own status without considering whether other group entities have, or the group as a whole has, public accountability. If a parent entity by itself does not have public accountability, it may present its separate financial statements in accordance with this Standard (see Section 9 *Consolidated and Separate Financial Statements*), even if it presents its **consolidated financial statements** in accordance with full IFRS Accounting Standards or another set of generally accepted accounting principles (GAAP), such as its national accounting standards. Any financial statements prepared in accordance with this Standard shall be clearly distinguished from financial statements prepared in accordance with other requirements.