

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH

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

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities (the ED). Our responses to the questions in the Invitation to Comment are in Appendix 1 to this letter. We also have various detailed comments on certain of the proposals. These are included in Appendix 2. Our comments on matters of principle and general approach are summarised in the following paragraphs.

Support for the project

We support the Board's project to produce a high quality, more practicable alternative to full IFRS in response to demand from constituents to take account of the needs of small and medium-sized entities and emerging economies. We find much to commend in the proposals contained in the ED. Features we support in particular are set out in the section headed "Features of the document of particular merit" below.

The focus of the project

The term "non-publicly accountable" covers entities ranging from very large multinational groups through to small owner-managed businesses. Within such a wide range, the needs of the users of financial statements and the resources available to the preparer inevitably vary widely. The optimum financial reporting standard (ie that which achieves the best balance of cost to preparers and benefits to users) may be very different for different entities within that range. Accordingly, we believe it is entirely appropriate and indeed necessary for the project to focus on certain types of entity within the broad non-publicly accountable category.

Having said that, we do not think there is a straightforward relationship between the *size* of an entity and the financial reporting requirements that should apply to it. The use of size indicators tends to over-emphasise the ability of the entity to prepare financial statements relative to the needs of the users of those statements. The primary determinant of financial reporting requirements should be the needs of users of the entity's financial statements rather than the size of the entity and/or its capacity to prepare the information. However, smaller entities *tend* to: (i) engage in simpler transactions such that fewer of the subjects covered in full IFRS apply to them; (ii) have fewer external users of their financial statements; and (iii) incur higher *relative* costs in preparing financial information. Accordingly, size of the entity is a pragmatic "proxy" for a fuller analysis of the costs of benefits of financial reporting requirements for different classes of non-publicly accountable entity.

The premise underlying our response is that the proposed IFRS for SMEs is targeted at entities with a user-driven need to prepare general purpose financial statements and reasonable access to the financial expertise needed to achieve compliance. These will generally be larger entities.

Entities within the scope of IFRS for SMEs

We agree that all publicly accountable entities should use full IFRS.

Some larger private entities are economically significant to a wide range of users of their financial statements. However, the needs of users of financial statements of these entities are different from the users of the financial statements of publicly traded markets (as acknowledged by the Board in the Basis for Conclusions paragraph 24 (BC24)). We believe it is appropriate to provide a simplified alternative to full IFRS for private entities that involves lower compliance costs whilst meeting the reasonable expectations of a wide range of users.

Whilst we understand the concerns that underlie the Board's attempt in paragraph 1.3 of the ED (ED1.3) to prescribe which entities can assert conformity with the standard, we do not agree that this is appropriate or desirable. Notions of what is "publicly accountable" will vary from jurisdiction to jurisdiction. It seems illogical to seek to deny a reporting entity the right to assert that its financial statements are 'in conformity with the IFRS for SMEs if that it is indeed the case. We therefore suggest deletion of ED1.3. Further, we suggest that ED1.2 is amended to the effect that jurisdictions may apply their own definitions of what is a publicly accountable entity.

Use of the IFRS for SMEs by small and micro-entities

We believe that the cost of preparing general purpose financial statements using the proposals in the ED would usually outweigh the benefit for most small and micro-entities. Nonetheless, we recognise that many governments and regulators may require such entities to prepare financial statements for specific purposes (such as taxation) or broader public policy reasons. Such circumstances are likely to differ from one jurisdiction to another. We therefore support the Board's approach of not focusing on small and micro-entities at this stage.

This project might lead some jurisdictions which have existing requirements for general purpose financial reporting by small and micro-entities to reconsider the need for such requirements. We encourage the Board to play a part in stimulating a wider debate with local jurisdictions as to the need for general purpose financial statements for small and micro-entities. The IFRS for SMEs could serve a useful purpose as a starting point from which local jurisdictions could develop applicable requirements. Those requirements should reflect the specific circumstances that have led to the jurisdictional decision to impose mandatory financial reporting on this class of entity.

Features of the document of particular merit

We support the considerable reduction in disclosure requirements compared to full IFRS.

We believe the important Section on Concepts and Pervasive Principles is written in an accessible style. We also strongly support the greater focus on stewardship than is found elsewhere in IASB literature and the emphasis on costs and benefits. We believe stewardship is of particular importance to the users of financial statements of SMEs because these users tend to have a greater interest in the stability and security of the business than in making buy, sell or hold decisions. We also welcome the emphasis on substance over form in ED2.6 and the clear discussion of the concept of prudence in ED2.7.

We welcome the omission of a mandatory fallback to full IFRS when transactions are encountered that are not specifically dealt with. As noted below, to maximise the benefit of the simplifications in the ED, the IFRS for SMEs needs to be a stand-alone document. Cross-references back in to full IFRS would require preparers and users of SME financial statements to be familiar with two sets of financial reporting standards. This presents a more onerous burden on SMEs than on those using full IFRS.

We support the efforts made to develop a logical structure that promotes ease of use. The inclusion of all requirements in a single standard is in our view greatly preferable to adding an appendix for SMEs to each full IFRS (for example). The structure of the ED, topic by topic with implementation guidance and examples appended to each Section where relevant, allows preparers to focus on the main requirements without being distracted by unnecessary detail.

The 2-yearly updating cycle allows a period of stability between updates that will promote consistency of application of IFRS. Although the Board should consider whether changes to full IFRS should be reflected in the IFRS for SMEs, they should not incorporate them in the standard as a matter of course. Only changes relevant to improving the quality of SME reporting and increasing the benefit to users of SME financial statements without undue cost and effort should be made.

Summary of suggested improvements

As noted above, we do not believe that the ED is suitable for small and micro-entities. Consequently, our comments reflect only those improvements that we believe are relevant to improving the proposals for larger entities within the scope of the ED.

Although the focus is on larger entities, we consider that some limited further simplifications are appropriate. In offering these suggestions, our intention is to identify areas which we believe add *unnecessary* complexity - in other words areas which we believe add cost for preparers without commensurate benefits. We do not support removing requirements that provide important information for users solely to reduce complexity for preparers. Accordingly, we support retaining the requirements on consolidation and business combinations (for example).

Title of the project

Although the term "small and medium-sized entities" (SMEs) is widely recognised and is used within the IASC Foundation objectives, it does not accurately describe the entities within the intended scope of the ED. Consequently, we do not agree that "IFRS for SMEs" is an appropriate title for this proposed set of financial reporting standards.

We disagree with the assertion that the term "non-publicly accountable entity" (NPAE) implies that smaller entities are not accountable (BC54). The term NPAE might not be widely used at present but that should not preclude its use. The term is clearly defined in the ED and its meaning, if properly communicated, should quickly become widely recognised. We recommend the title reverts back to "IFRS for Non-publicly Accountable Entities". Alternatively, the title could be "IFRS for Private Entities" if a definition of "private entities" was introduced that was consistent with the definition of NPAEs.

Stand-alone document

We strongly believe that making the IFRS for SMEs a fully stand-alone document would greatly enhance its understandability and ease of use. Although this could add to the length of the document we believe that this is preferable to mandatory cross-references to full IFRS.

Where requirements are currently cross-referenced to full IFRS because they are unlikely to apply to entities within the scope of the ED, we recommend that the subject should be omitted (and the cross-reference deleted). For the few entities that do encounter such transactions, the general hierarchy for selecting accounting policies in Section 10 can provide a suitable basis for developing an appropriate policy. This hierarchy would permit, though not mandate, the use of the policy options within full IFRS.

Requirements that are likely to be relevant to sufficient numbers of preparers should in our view be included directly in the IFRS for SMEs rather than by cross-reference. An example of such an area is lessor accounting for finance leases.

Availability of full IFRS options

The Basis for Conclusions outlines some of the Board's reasons for developing a separate IFRS for SMEs rather than introducing additional differential reporting exemptions into full IFRS. We are particularly persuaded by the argument in BC26 that notes "differences in the types and needs of users of SMEs financial statements, as well as limitations in, and costs of, the accounting expertise available to SMEs, suggested that separate accounting standards for SMEs are appropriate." This paragraph goes on to say that the constraints on such standards should include "focus on the needs of users of financial statements of SMEs".

On the basis of these different needs, we do not agree that all options available in full IFRS need to be made available in the IFRS for SMEs. We believe that the primary objective is to deliver reliable and understandable information in SMEs' financial statements at a reasonable cost. We consider that broad comparability between SMEs and publicly accountable entities is a desirable but secondary characteristic. In our view, the benefits of cost-effective simplified measurement and recognition requirements outweigh the cost of reduced comparability between SMEs and publicly accountable entities.

Some commentators argue that an SME that is a subsidiary of a parent entity that reports using full IFRS should have all full IFRS accounting policy options available. This is on the grounds that those subsidiaries need to produce such information to meet the requirements of the parent. However, we believe that the IFRS data produced for consolidation purposes has a different materiality threshold from that required in a subsidiary's separate financial statements. Consequently, we believe it will be less costly for such entities to produce a second set of financial statements that comply with a simplified IFRS for SMEs than it would were they to apply the more complex options available through a cross-reference to full IFRS. If jurisdictions or parent entities believe that subsidiaries have sufficient public accountability or user-driven need, full IFRS can be applied. The number of entities in this category is insufficient to justify complicating the IFRS for SMEs for all entities for which it is intended. Having said this, we consider that the disclosure requirements of full IFRS are burdensome and excessive for many subsidiaries of publicly accountable parents. Accordingly, and as a separate future exercise, the Board might usefully consider providing disclosure exemptions in full IFRS for this class of entity.

Style and structure of the document

We have provided some specific comments and recommendations to improve the style and structure of the ED within our detailed comments on specific Sections in the Appendices to this letter. In summary, our suggested improvements include:

- Within each Section, put the most commonly used principles and requirements at the beginning of the Section, so that those preparing accounts for a business with less complex transactions need read no further. More complex requirements and options could then follow where relevant, presented in such a way that users of the default simple policies do not need to read them (eg through boxing, shading or inclusion at the end of the Section).
- Where more complex requirements or options need more detailed guidance, this guidance should be included as an appendix to the relevant section in the standard, appropriately cross-referenced, or be placed in the separate Implementation Guidance.

- Rephrasing more of the words drawn directly from IFRS to make them easier to understand for the likely users of the SME standard.

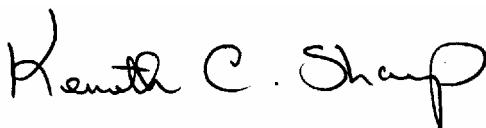
Further recognition and measurement simplifications

We believe that the Board should apply a "bottom up" approach to the recognition and measurement requirements in the IFRS for SMEs. We suggest that that historical cost measurement should be the norm. Fair value measurement should be required only when (i) fair value measurement is considered important for users; and (ii) the cost of providing the information is not excessive when weighed against the benefits to users. This could be achieved by reconsidering the role and expectations of the concepts of "reliably measured", "estimate reliably" and "readily determinable" in the context of fair values and SMEs. We believe that the approach adopted in ED35.1, which suggests using fair values for biological assets when "fair value is readily determinable without undue cost or effort" should be fully explained and expanded. Guidelines should be provided as to when fair values or inputs into valuation models are expected to be readily determinable and so are expected to be used. The approach could be useful in other areas such as sections 11B, 17.9, and 18.14. (This approach may also assist jurisdictions in developing a set of standards for domestic "micro-entities" based on similar principles to the IFRS for SMEs but with a simpler approach.)

We recommend further simplification of specific accounting requirements in the appendices to this letter.

If you have any questions on our response, or wish us to amplify our comments, please contact our Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,



Kenneth C Sharp
Global Leader - Assurance Services
Grant Thornton International

Appendix 1: Responses to Invitation to Comment questions

1. Stand-alone document

With the objective of a stand-alone document in mind, are there additional transactions, other events or conditions that should be covered in the proposed standard to make it more self-contained?

Conversely, is there guidance in the draft standard that should be removed because it is unlikely to be relevant to typical SMEs with about 50 employees?

- 1.1. We believe that the standard should be a stand-alone document with no mandatory cross-references to full IFRS. Cross-referencing obliges the users of the IFRS for SMEs to have knowledge of two sets of standards and to keep fully up to date with developments in full IFRS as well as the IFRS for SMEs.
- 1.2. Generally, where the ED includes transactions only by specific cross-reference to full IFRS, the Board should either delete the cross-reference or replace it with the specific requirements. The decision as to which course to take should be based on (i) the prevalence of the transaction type for entities within the intended scope of the IFRS for SMEs; and (ii) a judgement as to the extent and acceptability of diversity that would result from omission of the topic altogether. If the cross-reference is omitted without replacement by specific requirements, this would allow the few entities that enter into the transactions to follow the general hierarchy for selecting accounting policies in Section 10 (see comment, next paragraph). If the widespread occurrence of the transactions and consequential benefit to users merits inclusion in the IFRS for SMEs, the cross-reference to full IFRS should be replaced by the explicit requirements. These requirements should be simplified where possible and appropriate. Specifically:
 - 1.2.1. Lessor accounting for finance leases is relevant for many SMEs (eg car dealerships). We recommend that this subject is included in the IFRS for SMEs with simplifications similar to those available for lessee accounting for finance leases.
 - 1.2.2. The objective of IAS 29 *Financial Reporting in Hyperinflationary Economies* is as relevant to SMEs as to publicly accountable entities because the problems of a hyperinflationary economy undermine reliability of all general purpose financial reporting. We recommend that the more judgmental indicators of hyperinflation in IAS 29 be included within the IFRS for SMEs instead of the current simple numerical indicator, which is too basic and may not reflect the underlying substance. The calculations required by IAS 29 are complex and costly to determine and are unlikely to adequately reflect the full impact to users of financial statements. We recommend the cross-reference to the requirements of IAS 29 are replaced by a requirement for more narrative disclosures to describe the impact of hyperinflation and the associated risks to the entity.
 - 1.2.3. Segment reporting (IAS 14/IFRS 8); Earnings per share (IAS 33) and Interim financial reporting (IAS 34) are not required for SMEs. Sections 31, 34 and 37 respectively require those SMEs that provide voluntary information in these areas to comply with the applicable requirements of full IFRS. This will add unnecessary cost burdens on preparers and so discourage such voluntary disclosures, to the detriment of users of the financial statements. We recommend deleting Sections 31, 34 and 37. Entities making such disclosures voluntarily might in practice use full IFRS. If they do not, the generic requirements of Sections 2 and 3 of the ED provide adequate safeguards.

- 1.3. The hierarchy contained in ED10.2 forms a good basis for developing accounting policies for transactions not covered by the standard, without mandatory fall back to full IFRS. Although full IFRS is clearly a useful source of guidance on appropriate application of principles to specific transactions, the general hierarchy will provide the flexibility. This will help to ensure that policies better reflect the cost-benefit balance for the entity and the users of its financial statements.
- 1.4. Where transactions are included in the ED, but only the simple option is included and a cross-reference to full IFRS permits a more complex option, we believe the Board should review the need for and suitability of the complexity of these options for SMEs. As noted in the main body of our response, we do not agree that all options available to entities using full IFRS need to be available to SMEs. Where an alternative to the simple treatment is considered appropriate (eg revaluation of property, plant and equipment), it should be included in the IFRS for SMEs and expressed in a simplified form when possible (see our response to question 4 below).
- 1.5. We understand that making the IFRS for SMEs into a fully stand-alone document that includes all the necessary policy options to be available will result in a longer standard. We believe that a stand-alone document is important both to preparers and to users. Offsetting reductions in length would be achieved by deleting or simplifying requirements that are too complex for the requirements of an SME (see our response to question 4 below). The structure of the document could improve ease of use by providing the simple "benchmark" options in the main body of the standard with the more complex options contained in an appendix (see our suggestions on improvements to the style and format of the document in the main body of this letter).
- 1.6. Mandatory cross-referencing to full IFRS also introduces an element of instability into the IFRS for SMEs. If cross-references are retained, the Board needs to make clear the status of IFRIC interpretations and the status of changes to full IFRS where there is a time lag before the IFRS for SMEs is updated. The preface to the ED Draft refers in P16 to changes where there are specific requirements in the IFRS for SMEs but this does not seem to address direct cross-references to full IFRS.

2. Recognition and measurement simplifications adopted

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.**

Section 9: Consolidated and separate financial statements

- 2.1. We support the requirement to prepare consolidated financial statements in which the parent entity consolidates its investments in subsidiaries (ED9.1). Many SMEs are parent entities and consolidated financial statements provide important information. However, we recommend that a subsidiary should be excluded from consolidation when control is intended to be only temporary (ie it was acquired and is held exclusively with a view to its disposal in the near future). Consolidation for one period only requires significant cost and effort and provides very limited informational benefits for users. We believe that the economic substance of a subsidiary over which control is short-term is better captured by treating the investment as a financial asset within the scope of Section 11.

Section 11 Financial assets and liabilities

- 2.2. ED11.8 proposes that all financial instruments are measured at fair value unless the instrument fits the complex criteria in ED11.9 which permits measurement at amortised cost. It would be simpler and less costly to allow amortised cost as the norm or default. Fair value measurement should only be required where fair value is likely to be of more relevance to users and is "readily determinable", as in the case of biological assets in Section 35, (also see our comments below). This would eliminate the need to work through the complexities of ED11.9 in order to designate instruments (including simple instruments) at amortised cost.
- 2.2.1. The ED uses the phrases "measured reliably" and "reliable estimate". Increasingly in full IFRS there is a presumption that fair values will normally be capable of reliable measurement or estimation (eg IFRS 2 *Share Based Payment* states in paragraph 24 that it would be "rare" that an entity could not reliably estimate the fair value of equity instruments granted). Appendix B to Section 11 of the ED includes the same presumption (repeating substantially the same wording as IAS 39 *Financial Instruments: Recognition and Measurement* AG69 - 82). We do not believe that this presumption is suitable for SMEs. Indeed, there is an acknowledgement of this in the share-based payment Section in ED25.4 (and in BC91) that entities may not be able to reliably measure the fair value of equity instruments issued. Although Section 11 Appendix A provides some useful guidance on fair value measurement considerations, it needs to be tailored to reflect the different circumstances and measurement needs of SMEs (and users of their financial statements).
- 2.2.2. We believe the IFRS for SMEs should only require fair values (whether for financial instruments or any other assets or liabilities) when there is a clear need to provide such information to users of SMEs' financial statements. Also, we believe that fair value should only be required where the fair value or the inputs to valuation techniques are "readily determinable without undue cost or effort". This phrase is used in ED35.1 (and BC86 and BC103) relating to biological assets.
- 2.2.3. It would therefore be helpful for the Board to explain when it considers that fair values ought to be "readily determinable without undue cost or effort". This should include an indication of when the inputs need to incorporate observable market values or a professional valuation and when they can be a reasoned internal estimate. Throughout the IFRS for SMEs, cost (less depreciation and impairment) or amortised cost (less impairment) should be the required measurement basis unless fair value is demonstrably more useful to users and is "readily obtainable without undue cost or effort".
- 2.3. The requirements for derecognition of financial assets in ED11.24 *et seq* are expressed more simply than in IAS 39 but are still unduly complicated. It would be better to express the clear examples first and then describe the details to assist with clarity and understanding.
- 2.4. Although the Board has made a not unsuccessful attempt to simplify the provisions for hedge accounting (ED11.29 *et seq*), in this instance we consider that certain of the draft requirements should be strengthened. If entities are engaged in hedging and wish to apply hedge accounting, we suggest that they are likely to be sufficiently well resourced to apply a robust hedge accounting model. Our specific suggestions are as follows.
- 2.4.1. Section 11 paragraph 30 does not specify when the documentation and effectiveness testing should be completed, either initially or subsequently. BC74 states that the ineffectiveness is recognised and measured at the end of the financial reporting period. We agree with this approach but do not believe that this is reflected in the wording within Section 11.
- 2.4.2. Similarly, the clarification in BC74 as to the timing of the discontinuance of hedge accounting should be reflected in Section 11.

- 2.4.3. A recognised problem for entities wanting to use hedge accounting in practice is the lack of clarity as to the level of detailed documentation required. It would be helpful to incorporate some guidance and practical examples of effectiveness testing within the implementation guidance or in an Appendix to Section 11
- 2.5. The draft standard does not address the classification by the issuer of a financial instrument as a liability or equity. We recommend that simplified guidance and definitions are included.
- 2.6. It would also be helpful if the draft standard made specific reference to derivatives, to avoid any uncertainty over their accounting treatment. For example, ED11.2(h) could read "Derivatives such as options ... etc...".

Section 18 Business Combinations and Goodwill

- 2.7. We recommend the introduction of a rebuttable presumption that goodwill has a useful life of (say) 20 years and should be amortised over that period, with recoverable amounts tested only if there are indications of impairment. Notwithstanding the arguments in BC80, we consider that most SMEs will find this approach substantially easier to understand and operate, with little reduction in the value of the financial statements to SME users.

Section 25: Share-based payment

- 2.8. We do not support accounting for equity-settled share-based payment transactions through profit or loss (ED25.1 – 25.4). We are not persuaded by the Board's arguments as set out in BC101 in the context of users of SMEs financial statements; while BC91 implies that the intrinsic value method will be widely used because of the inability to measure fair value reliably, the cross-reference links to the statement in IFRS 2.24 which states that this method will apply only in "rare cases". This inconsistency is confusing to users and preparers and does not reflect the substance of the circumstances. Shares in SMEs are not regularly bought and sold. Hence market prices and transaction based measures of volatility are not available. Accordingly, valuation will be complex and costly for SMEs and (in our view) will not provide sufficiently reliable information to users to justify the cost. We therefore recommend that equity-settled share based payments are addressed through disclosure only.
- 2.9. We agree that cash-settled share-based payment transactions should be recognised through profit or loss. These share-based payments result in cash outflows. We suggest that these type of arrangements are a form of "other long-term employee benefit" and that the requirements of ED27.28 are sufficient to address them.

Section 26: Impairment of non-financial assets

- 2.10. We support the approach proposed in the ED (ie requiring impairment testing for goodwill and intangibles only if there is an indicator that impairment has occurred). However, we consider that impairment should be determined based on value in use compared to carrying amount, not fair value. We consider that value in use is more straightforward to determine and (for operational assets) often more relevant in the context of the business.

Section 28: Income taxes

- 2.11. We broadly support the approach to accounting for current taxes, which is close to full IFRS. While we applaud the Board's attempt to simplify accounting for deferred taxes by basing it on temporary timing differences, we find the analysis and explanations in Section 28 in need of further simplification and restructuring. At it stands this Section is likely to be very confusing for most of its intended audience.

- 2.12. We agree that timing differences are often easier to understand and identify than other temporary differences. However, the substantial emphasis given to timing differences as a subset of temporary differences is distracting and even confusing (ED28.6 - 8). Rather, the examples given would be better described as temporary so as to provide consistent terminology throughout the Section.
- 2.13. The initial recognition exemption allowed in IAS 12 *Income Taxes* (IAS 12) is not available within Section 28. However, it seems ED28.17 is trying to introduce a similar, practical exemption. However, the meaning of this paragraph is unclear and seems to produce an arbitrary result that is not conceptually supported. We recommend this paragraph is rephrased to clarify its intended result or is replaced by the initial recognition exemption contained in IAS 12.

Section 29: Financial reporting in Hyperinflationary Economies

- 2.14. In general, we do not support "bright-line" numerical limits or indicators. We believe the simplified, purely numerical approach to identifying whether there is a hyperinflationary economy (ie 100% in 3 years) may give a different answer to IAS 29's more judgmental approach. We recommend the indicators from IAS 29 be reproduced in the IFRS for SMEs.

Section 36 Discontinued operations and assets held for sale

- 2.15. We believe that with regard to discontinued operations it is sufficient to disclose the effect on profit or loss, including comparative amounts for the previous period, beginning from the point in time when the contract to sell is signed or the operations have actually been abandoned (ED36.1 – 36.4).
- 2.16. The requirements of Section 36 (in particular the measurement model in ED36.5 - 7) lead to only minimal additional information for users. Other requirements within the ED are, in our view, sufficient to deal with assets held for sale and discontinued operations. In particular the following requirements address aspects of this area:
- ED26.6(f) - plans to dispose of an asset before the previously expected date are an indicator of impairment;
 - ED26.11 requires a reduction of the carrying amount of an asset when the fair value less costs to sell is lower than its current carrying amount;
 - ED26.16 requires a reversal of an impairment loss if certain conditions are met;
 - ED16.17 and 17.27 require consideration of the residual value when assets are depreciated or amortised.

In view of these requirements, we consider that the inclusion of specific measurement requirements for assets held for sale is unnecessary.

3. Recognition and measurement simplifications not adopted

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?

- 3.1. See our comments on share based payments at paragraphs 2.8 and 2.9 of this letter.

4. Whether all accounting policy options in full IFRS 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. In six circumstances in which full IFRSs allow accounting policy options, the (ED) IFRS for SMEs include only the simpler option, and the other (more complex) option(s) are 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?

- 4.1. Our response to Question 1 on the need for the IFRS for SMEs to be stand-alone is relevant here. We also explain in the main body of this letter why we do not believe that it is necessary that the IFRS for SMEs includes or facilitates all the accounting policy options in full IFRS.
- 4.2. We believe that accounting policy options should be retained (whether in a simplified form or in the same form as full IFRS) only if necessary for SMEs. In deciding what is necessary, the Board should take account of the extent to which SMEs are likely to use a more complex option in practice. When accounting policy options are judged necessary, the requirements should be simplified where appropriate. We set out below our views on which options should be available to SMEs, which should be available but in simplified form and which should be removed altogether.

Section 7: Cash Flow Statement

- 4.3. The option in ED7.9 to apply the direct method for reporting cash flows from operating activities (via a cross-reference to IAS 7 *Cash Flow Statements*) should be omitted. This method is rarely used in practice and so deletion would not have an adverse impact on SMEs.

Section 11: Financial assets and financial liabilities

- 4.4. We do not support the option in ED11.1 to apply IAS 39 in full as an accounting policy choice. This is too complex to be of use to SMEs (both preparers and users). Instead, the requirements relating to financial instruments should be simplified and dealt with within the IFRS for SMEs (see our specific comments in response to question 2 above).

Section 13: Investments in Associates

- 4.5. For measurement after initial recognition, the ED provides an accounting policy choice from three alternative methods (cost model, equity model and fair value through profit or loss model). Once selected the same method is applied to all investments in associates (ED13.3 – 6). We believe this requirement is too restrictive and is likely to result in cost being selected as the default. This would prevent entities providing relevant information to users that may be readily available for some, though not all, such investments. We do not recommend a completely free choice for each investment but instead recommend a hierarchy be applied in respect of each individual investment, relating to the availability of information:
 - 4.5.1. Each investment should be measured at either fair value (if it can be measured reliably) or using the equity method (if the necessary information required to apply is reasonably expected to be available).
 - 4.5.2. Cost should be used in all other cases.

- 4.6. The cross-reference to IAS 28 *Investments in Associates* in ED13.5 should be deleted and replaced with specific requirements. We recommend a simplified equity accounting approach. Frequently, the information required for a full (ie IFRS 3 *Business Combinations* type) fair value exercise and subsequent adjustments is highly problematic especially in an SME context. A method based on cost plus subsequent share of profits less losses, adjusted to achieve consistency of significant accounting policies, should provide suitable information for users.

Section 14: Investments in Joint ventures

- 4.7. Our comments above with regard to investments in associates are equally applicable to investments in jointly controlled entities in Section 14. The option of proportional consolidation should be included by outlining the specific requirements, not by cross-reference to IAS 31 *Interests in Joint Ventures*.

Section 15: Investment Property

- 4.8. The use of the fair value option is common among entities that hold investment properties and the information provided by this method is relevant to users of SMEs financial statements. We recommend that the cross-reference to IAS 40 *Investment Property* is replaced with material drawn from IAS 40 but simplified. In particular the more general paragraphs on fair value could be deleted. These repeat fair value guidance included elsewhere in the ED (eg ED2.31(b)).

Section 16: Property, Plant and Equipment

- 4.9. Similarly, we support the proposal to require initial recognition of property, plant and equipment at cost, with a choice thereafter between the cost and revaluation models. In line with our comments elsewhere, we recommend that the revaluation requirements of IAS 16 *Property, Plant and Equipment* are incorporated into this Section.
- 4.10. We consider that this Section could be usefully restructured, promoting important principles such as that in ED16.6, and deferring more detailed material such as that found in ED16.2 and 4.

Section 17: Intangible Assets other than Goodwill

- 4.11. The option to measure intangible assets after initial recognition using the revaluation model (ED17.21 and 23) should be deleted. In our experience, the revaluation model for intangible assets is very rarely used in practice.
- 4.12. Consistent with our recommendation to make the IFRS for SMEs stand-alone, we suggest that the relevant requirements of IAS 38 with regard to the capitalisation model for development costs be incorporated in simplified form into the standard instead of the specific cross-reference in ED17.16.

Section 23: Government Grants

- 4.13. We prefer the IFRS for SMEs model in ED23.4 for all government grants and believe this provides better comparability and quality of information for users than IAS 20 *Government Grants*. Consequently, we recommend that the option to fall-back to IAS 20 for all grants not measured at fair value through profit and loss is deleted.

Section 24: Borrowing Costs

- 4.14. As noted in our answer to question 5 below, we strongly support the inclusion of the immediate expensing option as the "benchmark" position for SMEs. However, we accept that for some SMEs, particularly those involved in property development, the option to capitalise some borrowing costs is important and provides more relevant information for users. We therefore recommend that the relevant requirements of IAS 23 *Borrowing Costs* are incorporated into the IFRS for SMEs. Simplification can be achieved by incorporating only a summarised version of the bold type paragraphs in IAS 23.

Section 35: Specialised Industries

- 4.15. Section 35.2 requires that entities engaged in the exploration for, evaluation or extraction of mineral resources shall recognise all exploration expenditure as an expense in the period in which it is incurred. IFRS 6 *Exploration for and Evaluation of Mineral Resources* provides entities with the opportunity to continue to use their existing accounting policy for exploration expenditure within certain constraints. We acknowledge that this is a temporary approach but, for the time being, we recommend that the same broad model should be available for SMEs. This would be achievable by deleting ED35.2 and so permitting SMEs in the extractive industry to fall back on the general hierarchy in ED10.2 - 4 for determining accounting policies.

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 Board 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?

- 5.1. We agree. The expense model is more appropriate and cost-effective for the majority of SMEs and so is a suitable simplification to retain.

6. Topics not addressed in the proposed IFRS for SMEs

Some topics addressed in full IFRSs are omitted from the IFRS for SMEs because the Board believes that typical SMEs are not likely to encounter such transactions or conditions. By cross-reference, the draft standard requires SMEs with 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?

- 6.1. As noted above, we would prefer the IFRS for SMEs to be "stand-alone" and so specific mandatory cross-references to full IFRS should be deleted. We outlined in our response to Question 1 above the areas where we consider that requirements should be included directly in the IFRS for SMEs (preferably in a simplified form).

6.2. Currently the Sections on Segmental Reporting, Earnings Per Share and Interim Financial Statements (Sections 31, 34 and 37) require full compliance with the full IFRS standards via specific cross-reference. There is no option to provide disclosures outside of these full IFRS requirements. This is considered unhelpful and will act as a barrier to useful information being provided on a voluntary basis. Some SMEs may wish to provide some information in these areas, especially relating to segments, but would want flexibility regarding the format and detail of the disclosures. This could be done by presenting the information outside the financial statements, eg in a business review, but we feel that this would reduce reliability and effectiveness of the information. We outline below some suggestions as to how this area could be dealt with:

6.2.1. Delete the specific cross references to full IFRS by deleting Sections 31, 34 and 37.

6.2.2. Require clear disclosure of the basis of preparation of voluntary disclosures so that readers can make an assessment of its reliability and comparability.

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?

7.1. We consider the hierarchy within Section 10 of the ED to be appropriate and useful. As noted above, a mandatory fallback to full IFRS creates added complexity to the IFRS for SMEs. It would also lead to uncertainty as to the status of IFRIC interpretations and changes to cross-referenced full IFRS that are made before the IFRS for SME is updated.

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?

8.1. Some respondents might argue that if the requirements of the IFRS for SMEs are written sufficiently clearly, then no further guidance should be needed. However, we believe that it would be helpful to include some recognition and measurement guidance, demonstrating calculations and accounting entries. These could be based on those currently included in full IFRS but would in some cases benefit from additional explanatory notes. This guidance should be included in the Implementation Guidance Section of the IFRS for SMEs, clearly cross-referenced to the main body of the standard to assist clarity.

8.2. Examples of areas where such guidance would be helpful are as follows:

8.2.1. Accounting for reverse acquisitions. IFRS 3 Illustrative example IE 5 would be a useful basis for guidance in the IFRS for SMEs Application Guidance.

- 8.2.2. Common control transactions, which are more common for private companies than for quoted companies.
- 8.2.3. Effectiveness testing of hedges. If hedge accounting is used ED11.30(d) requires the hedge to be highly effective. Some guidance as to how effectiveness can be tested would be useful and should focus on simple, cost-effective techniques.
- 8.2.4. ED9.21 introduces the idea of 'combined financial statements', which do not feature anywhere else in IFRS. We can see practical difficulties arising in respect of, for example, inter-company items and equity. Consequently, clearer instructions as to how to prepare such combined statements are needed.
- 8.2.5. The appropriate treatment for the acquisition of entities or groups of assets that are not businesses (such as the material in IFRS 3.4).
- 8.2.6. The guidance in IFRS 3 Appendix B16 concerning the allocation of the cost of a business combination to the identifiable assets, liabilities and contingent liabilities (ED18.13) would be equally applicable and useful to SMEs as to those entities using full IFRS. We recommend the guidance is included in the IFRS for SMEs as an Appendix to Section 18 *Business Combinations*.

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?

9.1. We consider the proposed disclosures requirements are appropriate.

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?

10.1. It would be helpful to have more guidance on business combinations, along the lines of the guidance in IFRS 1 *First-Time Adoption of International Financial Reporting Standards*.

10.2. Also, more guidance on "deemed cost" is needed, ie when it can be used and what measure is appropriate.

10.3. More clarity and guidance is needed on deferred tax. It is not clear why an exemption is proposed - in what circumstances would the tax base or carrying value not be identifiable? Does the exemption apply at the transition date or also at each subsequent balance sheet date?

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?

11.1. We agree the proposed approach is appropriate for the reasons stated in BC127.

11.2. However, we agree with the comment in BC126 that the consistency of consideration achieved by contemporaneous consideration of changes to the IFRS for SMEs is a substantial benefit.

11.3. It would be helpful if the Board could publish their views as to how they believe the publication of new or amended standards and interpretations should impact the IFRS for SMEs at the same time such publications are issued. This could take the same form as the IASB Annual Improvements Project. Although comments are only sought from constituents on an annual basis on the "collected proposed amendments", their ongoing publication throughout the year allows for more timely consideration.

11.4. Publication of a basis for conclusions in support of all decisions to include, exclude or amend requirements in new/amended full IFRS from the IFRS for SMEs would be helpful.

Appendix 2: Other detailed comments

The following paragraphs set certain other recommendations on possible improvements to the ED.

Section 2 Concepts and Pervasive Principles

ED2.39 states that the standard “does not allow the recognition of items in the balance sheet that do not meet the definition of assets or of liabilities”. However, we challenge this statement in the light of the inclusion of deferred income and of the approach taken to the treatment of government grants in Section 23. This should be more clearly linked to the definition of liability in ED2.35.

Section 3 Financial Statement Presentation

As we noted in the main body of our letter, we do not agree with the restriction in ED1.3 preventing an entity that is publicly accountable from stating compliance with the IFRS for SMEs, even if permitted to do so by its jurisdictional authority. Consequently, we suggest deletion of ED3.1(b).

ED3.1(a) helpfully notes that application of the [draft] standard is **presumed** to achieve fair presentation in financial statements. ED3.3 - 6 deal with the ‘extremely rare circumstances’ in which an entity departs from the standard because compliance would be misleading. We suggest that locating this material near the start of the Section accords it undue prominence, and that these paragraphs should instead appear towards the end of the Section.

The requirement in ED3.8 to present a complete set of accounts ‘at least annually’ is inconsistent with the preparation of financial statements for a period longer than one year (although we realise that the statement is consistent with IAS 1 *Presentation of Financial Statements*). The statement should be amended accordingly.

Section 7 Cash Flow Statement

Acquisitions and disposals of subsidiaries and business units should be shown as "operating" cash flows according to ED7.10. This is inconsistent with IAS 7.39 which requires them to be classed as investing. There is no explanation of this change. We assume this is a drafting error, particularly as the paragraph is under the heading "reporting cash flows from investing and financing activities".

Section 9 Consolidated and Separate Financial Statements

ED9.21 sets out proposed requirements on combined financial statements, which has no counterpart in full IFRS (at least not explicitly). We believe combined financial statements could provide useful information in some circumstances, such as for entities which are under common control but not part of a group. However, practical difficulties are likely to arise such as the treatment of inter-company items and equity. If the current draft guidance is to be retained, we recommend that the Board considers whether some limited additional guidance is appropriate.

ED9.18 refers to held for sale classification. There is no definition or explanation of the term in this Section. The term should be in bold font (given that there is a definition in the glossary). A cross-reference to Section 36 *Discontinued Operations and Assets Held for Sale* would also be helpful.

Section 10 Accounting Policies, Estimates and Errors

As discussed above, we agree with the non-mandatory fallback to full IFRS outlined in ED10.4. However, experience strongly suggests that regulators and other users often express an expectation to regularly refer back to full IFRS in order to adhere to 'best practice'. The non-mandatory nature of this guidance should be made absolutely clear to prevent uncertainty arising over the need to fallback to full IFRS. The paragraph could start along the lines:

Management are not required to look further for guidance than the sources referred to in paragraph 10.3. However, in making the judgement described in paragraph 10.2, management may, at their discretion, also consider...

Additional guidance as to when departure from full IFRS can be justified in the light of the information needs of users of SMEs' financial statements would be helpful in this context, perhaps along the lines of our comments above supporting our recommendations for simplifications.

If the Board accept our recommendations to delete cross-references to full IFRS and to make the IFRS for SMEs "stand-alone", ED10.9(b) will need to be deleted.

A definition of "measurement basis" and some explanation of the difference between this and an accounting estimate would add clarity and thereby improve compliance with the different treatment required by ED10.8 and ED10.13.

Section 11 Financial Assets and Liabilities

ED11.7(c) requires equity instruments to be measured at cost less impairment if not publicly traded and if their fair value cannot otherwise be measured reliably. ED11.22(b) defines the impairment loss as the difference between the asset's carrying amount and the asset's fair value. This is inconsistent because the fair value cannot be measured reliably. We suggest the Board bases the impairment requirement for such assets on the wording used in ED11.22(a) instead.

Section 18 Business Combinations and Goodwill

The "purchase of all the net assets of another entity" (ED18.2) is not always a business combination under IFRS 3's concepts and under the definition of a business imported into the ED. It would be helpful if this could be clarified and an outline given of the appropriate treatment for the acquisition of entities or groups of assets that are not businesses (such as the material in IFRS 3.4).

Section 19 Leases

The ED does not reproduce the requirements in IAS 17 *Leases* to consider the land and buildings elements of a lease separately for the purpose of lease classification. We welcome this simplification for SMEs, as it may be costly and time consuming to determine reliably the allocation of the minimum lease payments to the two elements. However, it would be helpful if the IFRS for SMEs or the Basis for Conclusions could include wording to clarify that a lease for land and buildings can be considered as a single lease.

The ED proposes that lessees shall initially recognise the rights and obligations under finance leases at amounts equal to the fair value of the leased property, without any reference to the amount of minimum lease payments (ED19.8). Such leased assets should be recognised at the lower of the present value of the minimum lease payments and fair value. Given that the minimum lease payments need to be calculated anyway, this will simplify the standard.

Incentives are common in any kind of operating lease transaction; they are not restricted to those with publicly accountable entities. We believe it would be helpful to include an accounting requirement for such incentives.

Section 21 Equity

ED21.2(a) states that if equity instruments are issued before cash is provided in exchange, the amount receivable should be treated as an offset to equity. In our view, it would normally be treated as an asset (an amount receivable), depending of course on the specific terms and conditions of the issue. While we do not necessarily object to the proposed treatment in context, it would be helpful if the Basis for Conclusions addressed this issue.

We recommend that this Section is relocated next to that on financial assets and financial liabilities (Section 11), given the close connection between the conceptual issues involved.

Section 22 Revenue

ED22.16 (and by cross-reference to this paragraph, ED22.5) requires interest revenue to be recognised using the effective interest method as described in Appendix A of Section 11 Financial Instruments. We recommend an appropriate simplification in this area would be to permit recognition based on the nominal interest earned during the period with straight-line amortisation of any discount, premium and transactions costs if the investment is accounted for at cost. Suitable wording for a non-prescriptive simplification may be "in allocating interest revenue, an entity may use an approximation to simplify the calculation". (This wording is consistent with that used in ED19.10, which allows the allocation of the finance charge under a finance lease to be approximated.)

Section 26 Impairment of Non-financial Assets

ED26.11 usefully explains what an impairment is. This paragraph would be more helpfully placed at the beginning of the Section (suitably modified to encompass value in use).

We also recommend that the Board provides a brief description of the process involved in carrying out an impairment review.

ED26.22 Step 2(b) requires that the allocation of an impairment loss should be carried out on the basis of relative fair values. This is more onerous than the requirement of IAS 36.104, which refers to the carrying amount of each asset in the unit. We recommend that carrying amounts are used as the basis of allocation.

Section 27 Employment Benefits

The exceptions listed in ED27.3(b); 27.13(b) and 27.21 should also cover amounts included in development costs, where the capitalisation model in Section 17 *Intangible Assets other than Goodwill* (amended to incorporate the specific requirements as recommended above) is used.

E27.11 allows entities involved in multi-employer defined benefit plans to account for them as defined contribution under certain conditions. However the definition of multi-employer plans in the glossary excludes plans involving entities under common control. This deprives SMEs of the accounting permitted for group plans by IAS 19 *Employee Benefits*. (paragraphs 34-34B). This accounting treatment should in our view be available in the IFRS for SMEs.

Section 28 Income taxes

We welcome the Board's attempt to simplify accounting for deferred taxes by basing it on timing rather than temporary differences. Unfortunately, however, we believe that Section 28 as drafted is likely to be very confusing for most of its intended audience.

We suggest that the Section should be restructured. As a starting point, we suggest that the summary principle in ED28.2 should be redrafted (from the third sentence), along the lines:

Current tax arises when income taxes are payable to or recoverable from the tax authorities at the period end as a result of taxable profits or losses that have already been earned or incurred.

Deferred tax arises if the future use or sale of assets and the settlement of liabilities at their carrying amounts would lead to higher or lower income taxes in future periods. The use or sale of an asset or settlement of a liability might often result in taxable income being earned and tax deductions being allowed. If the taxable income and related tax deduction are of different amounts, the use or sale of an asset or settlement of a liability will lead to higher or lower income taxes in future periods.

Deferred tax liabilities are generally recognized when the future recovery or settlement of an entity's assets or liabilities at their carrying amounts will result in taxable income that exceeds any related tax deduction. Deferred tax assets are generally recognized when future recovery or settlement of an entity's assets or liabilities at their carrying amounts will result in tax deductions in excess of any related taxable income.

To give effect to this principle, this Section requires a comparison to be made between the carrying amount of assets and liabilities and their **tax base**. The tax base is generally the tax deduction or addback that will be allowed when the asset is used or sold, or the liability is settled. Deferred tax assets and liabilities are recognized when the tax base differs from the carrying amount (with limited exceptions).

The deferred tax sub-section should then start with a summary of the 'mechanics' of deferred tax, dealing with the notions of tax base and temporary difference.

On points of detail:

- we recommend that paragraphs ED 28.13 and 14 appear before the detailed requirements on deferred tax (ie that current tax is dealt with before deferred tax);
- the Section is titled "Income taxes" and begins by defining that term. However, the term is hardly used elsewhere in the Section. Explanations concerning current and deferred tax would be clearer if they are amended to refer to the income tax consequences of transactions;
- we find it unhelpful that the term "tax base" has been replaced by "tax basis";
- the material on temporary differences that are timing differences (ED28.6 - 9) seems likely to confuse more than it clarifies. The Section adopts a temporary difference model, consistent with IAS 12 *Income Taxes*. The material at ED28.6 *et seq* runs the risk of giving a false impression that the ED adopts a timing difference model;
- the purpose of ED28.17 is very unclear and is likely to cause considerable confusion. We suggest it should be deleted or re-written.

Given the extensive changes we believe are necessary, the Board might usefully consider re-exposing this Section (perhaps as a "Staff Draft"). We would be pleased to comment further on a revised section.

Section 33 Related Party Disclosures

The following additional material would be helpful for users of the standard:

- a definition of a close member of the family; and
- an explanation of why disclosure of related parties is important, to augment the principles of disclosure.

Section 38 Transition to IFRS for SMEs

We commend the sympathetic approach to deferred income taxes in ED38.8(f), but suggest that some explanation be given of the approach to be taken by a first time adopter making use of this concession. For example, is the non-recognition of such balances effective at transition date or balance sheet date? And is the subsequent accounting similar to that following an initial recognition exemption? We also suggest that the Board defines the “date of transition”, referred to in ED38.5 and elsewhere.
