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RE: Staff Questionnaire on Possible Recognition and Measurement Modifications for
Small and Medium-sized Entities (SMEs) - 5 April 2005

Dear Paul,

We are pleased to provide our comments with respect to the IASB staff questionnaire. We trust that this will prove useful in your deliberation. If you have any questions regarding our submission please contact Rita Marnoch, Director of Standards at rmarnoch@cga-canada.org.

Regards,

[Original signed by:]

Anthony Ariganello, FCGA, CPA (Delaware)
President & CEO

Issues related to reporting by small and medium-sized enterprises

The Certified General Accountants Association of Canada has reviewed the IASB *Staff Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities (SMEs)* [the “questionnaire”], and we are pleased to offer these comments. In doing so, we will draw from the experience of Canada in its implementation of a similar regime for SMEs.

General

It is worth noting that when the Canadian Accounting Standards Board (AcSB) implemented *Handbook* section¹ 1300, *Differential Reporting*, for use by SMEs in Canada, it focused on the “who” and then the “how.” The IASB appears to have the “who” resolved to the satisfaction of respondents, and we concur with the approach being taken. This is understandable since the parameters are much the same for both jurisdictions.

What is at issue now is the “how.” Respondents are being asked to provide input on a number of topics related to SME reporting. Before providing comments on these topics, it may be beneficial to review the criteria used by the AcSB to make such decisions. While it is generally agreed that the underlying premise is based on “costs and benefits,” the application of that notion is more difficult than a simple exposition. The excerpt below is taken from the *Basis for Conclusions* document that accompanies section 1300.

Comparing the costs and benefits of an accounting standard, or of a requirement within a standard, is a complex task. Despite several efforts to rationalize the approach, it remains a judgmental process ... The benefits to the users were assessed in relation to three of the four fundamental qualitative characteristics of financial information set out in [the Canadian equivalent of the IASC *Framework*]: understandability, relevance, and reliability. Comparability was not used as a criterion because it fundamentally conflicts with providing accounting alternatives.

When a conflict arises between the characteristics of relevance, reliability, comparability and understandability, a trade-off needs to be found that enables the objective of financial statements, i.e., decision usefulness, to be met. The assessment of benefits was made in relation to the two identified groups of users of the financial statements of non-publicly accountable enterprises: the non-managing owners and the creditors.

The costs of complying with individual accounting requirements were broken down into the following categories: preparation costs, communication costs (when appropriate), specialized expertise costs and related audit or review costs. Costs and users’ benefits were weighted on a three-point scale (low, moderate, high).

- Low benefits and low, moderate or high costs of compliance call for a differential treatment.
- Moderate benefits and moderate or high costs of compliance call for a differential treatment.
- High benefits and high costs of compliance at most lead to a simplified treatment producing not significantly different results.

¹ References to “section xxxx” means reference to the relevant section in the Canadian Institute of Chartered Accountants’ *Handbook – Accounting*.

Under this framework, “high benefits” is a necessary condition if an SME entity is required to comply with a “full” standard. Moreover, in the absence of high benefits, “high costs of compliance” will usually lead to differential treatment. Therefore, it is against this backdrop that the Working Party should assess the alternatives on the agenda. Further, it would be prudent to give considerable weight to the experience of Canada in implementing a system that is, in many respects, the precursor of what the IASB is reviewing.

One last caveat: this response focuses on SMEs. The 2004 IASB Discussion Paper also focused on SMEs, but it chose to define them as “non-publicly accountable entities.” While this is a position supported by CGA-Canada, it is crucial to bear in mind that while *all SMEs are non-publicly accountable entities, it is much more difficult to assert that all non-publicly accountable entities are SMEs*. Therefore, when reviewing the comments below, it is critical that care be taken when extending the arguments to all entities being considered by the IASB.

Question 1

Question 1 asked respondents to identify possible areas for simplification by reference to Attachment A of the questionnaire. Given below is CGA-Canada’s assessment of the issues associated with the standards identified in Attachment A.

IAS 2: Inventories (revised 2003)

Small enterprises often use a periodic system rather than a perpetual system to keep track of inventory. Many use FIFO rather than weighted average to simplify the process for determining cost of goods sold; with FIFO, cost of goods sold is to opening inventory plus purchases minus ending inventory. Still other SMEs do not bother with net realizable value; items tend to stay in inventory until they are written off. Many SMEs may not properly track or allocate all plant overheads to cost of inventory. They allocate direct materials and labour and either make an estimate of overhead or make no direct overhead allocation at all to the cost of inventory. Using a lower inventory cost also tends to result in not having net realizable value adjustments because unless the product is out of date or obsolete, any discounted price likely exceeds cost.

From a *theoretical* perspective, one can argue that there should be no difference in the manner of dealing with inventories. From a *practical* perspective, the issue depends on the sophistication of the entity and the extent to which inventory is a significant asset on the balance sheet or cost of goods sold is a key income statement item. Many SMEs tend to get aggressive one way or another with inventory valuations based on their tax positions or need for financing. Therefore, emphasizing consistency of application may be just as important as the measurement used.

IAS 11: Construction contracts (revised 1993)

IAS 18: Revenue (revised 1993)

From a *theoretical* perspective, one can argue that there should be no difference in the manner of dealing with these contracts. The substance of the transaction should dictate the manner in which it is recorded; the size of the entity is not a factor in assessing the substance of the transaction.

From a *practical* perspective, the issue depends on the sophistication of the entity, its ability to capture the information necessary to perform the percentage calculations (or even to determine

whether the contract will ultimately be profitable), and the extent to which the revenue is a key income statement item. Perhaps the best way to deal with this is to suggest that there is a rebuttable presumption that the necessary information is available to follow IAS 11 and IAS 18.

In the absence of such data, one could fall back to IAS 11's requirement that if the outcome cannot be reliably estimated, no profit should be recognized; instead, contract revenue should be recognized only to the extent that contract costs incurred are expected to be recovered, and contract costs should be expensed as incurred. Finally, one must be cognizant of what tax authorities permit and not overlook that differences between accounting policies and tax treatment of those items is a major source of SME reconciliation.

IAS 12: Income Taxes (revised 2000)

Many small enterprises ignore deferred income taxes. They usually apply tax-based depreciation rates, so the single biggest source of tax deferrals is eliminated. For many non-public enterprises, it is argued that the costs of reporting future income tax liabilities or assets under IAS 12 would clearly exceed the benefits of the information provided.

The basis for such a position lies in the assessment of users' needs. It has been suggested that many, perhaps most, financial institutions ignore future income tax information when analyzing SME reports. Anecdotal evidence suggests that the information relevant for lenders is limited to income tax assets and liabilities that have an effect on future cash flows in the short term. Moreover, profit analysis is usually done at the EBITDA level, and so future income tax liabilities are generally ignored in cash flow analysis. Given that significant costs are incurred on a recurring basis for the computation of future income taxes — with no clearly observable benefit — the provision of future income taxes fails to meet the tests specified in the cost/benefit matrix.

In Canada, the outcome is a differential reporting option permitting qualifying enterprises to use the taxes payable method on the condition that they also provide certain disclosures. These disclosures include a reconciliation of the current tax expense to the amount that would be due if the statutory rate were applied to accounting income. Through the identification of the most significant reconciling items, the reconciliation provides financial statement users with information about the entity's tax filing practices that helps in predicting future cash flows. This contrasts with the New Zealand approach where taxes payable can be used with no reconciling disclosures. Note that both Canada and New Zealand contrast with the UK approach where FRSSE 3 mandates that full provision be made for deferred tax assets and liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in tax computations.

From a *theoretical* perspective, one can argue that there should be no difference in the manner of accounting for income taxes. Ultimately, the issue must come down to cost/benefit, and it is on this basis that theory must yield to practicality. In this regard, the Canadian and New Zealand approaches are preferable. That is, the IASB should permit SME entities to use the taxes payable method (with or without additional disclosures).

IAS 17: Leases (revised 2003)

As with income tax issues, many small entities ignore lease accounting requirements. Unless the amount is material to the enterprise, all lease costs will be treated as an expense — essentially

treating finance leases as operating leases. This approach can be supported from two perspectives: the cost/benefit consideration (similar to those for income tax accounting) and tax considerations. Just as many SMEs use tax-based depreciation rates, they also rely on tax legislation for guidance in this area. For example, the Canadian *tax* treatment of leases is to allow the entire payment as a tax-deductible expense. In order to eliminate any deferred tax issues, SMEs follow the tax treatment of deeming all leases as operating rather than capitalizing and expensing under the finance lease category.

The difference between this category and deferred income taxes is that lease expenses *are* a factor in EBITDA. Consequently, the amount of the expense does have a bearing on a lender's consideration. However, one way to deal with this issue is to mandate disclosures similar to those required under finance leases, namely expected cash payments for a five-year (or even longer) period.

Perhaps the deciding factor to consider is the tax treatment accorded leases. Accounting for leases under IAS 17 may be a topic where local jurisdictions dictate the outcome: if leases must be treated as finance leases for tax purposes, it makes sense to require the same treatment for accounting purposes since the necessary data is readily available. If, however, a jurisdiction permits expensing all lease payments (like Canada), then accounting for the lease as an operating lease makes sense, provided disclosure is made of cash payment required by the lease.

IAS 19: Employee Benefits (revised 2000)

Most small entities do not have arrangements that would be subject to IAS 19. Those that do tend to ignore the accounting requirements unless the amount is material to the entity. As with *all* of the SME issues, one can argue that there should be no difference in the manner of accounting from a *theoretical* perspective. It is the substance of the transaction that matters, not the entity that undertakes the transaction. A counter-argument might be related to the cost/benefit criterion — the application of IAS 19 would fail to meet the tests specified in the cost/benefit matrix.

However, unlike future income taxes, it cannot be claimed that there is no clearly observable benefit. While post-employment benefits can be deemed estimates, they are *contractual* obligations and the entity is obligated to meet them. This differs from deferred income taxes where circumstances may change to the point that the future taxes are no longer payable. Put another way, an entity can avoid recapture of future income tax by replacing the equipment; an entity cannot avoid paying post-employment benefits by hiring new employees.

Therefore, there should be no divergence from this standard.

IAS 27: Consolidated and Separate Financial Statements (revised 2003)

Many SMEs have subsidiaries. Typically there are two or more entities organized in a holding/operating arrangement. That is, there is one entity that is effectively a holding company, controlling one or more operating entities. Under IAS 27, these operating entities need to be consolidated with the parent holding company.

When section 1300 was implemented in Canada, the AcSB took the position that such subsidiaries could be accounted for using either the cost or the equity methods. It based its decision on research

that suggested that lending institutions often ignored consolidated financial statements, as their claims are mostly against the assets of the individual legal entities to which they have advanced credit. When loans are guaranteed by other legal entities within a related group, creditors request the financial statements of the debtor and all of the guarantors rather than consolidated financial statements of the entire group.

In addition, consolidated financial statements may be useful to unrelated shareholders in assessing management stewardship, but SME shareholders typically have access to all pertinent information concerning the resources and results of operation of the group without the need for consolidated financial statements. Therefore, the AcSB concluded that in the absence of users' interest in consolidated financial statements, the cost of providing such information exceeds the benefits. Accordingly, it decided to permit the use of the equity method or the cost method to account for subsidiaries, and not require consolidation.

As with income taxes, the cost/benefit argument is persuasive; consequently, SMEs should not be required to consolidate their subsidiaries, but instead should be permitted the use of the equity method or the cost method to account for their subsidiaries.

IAS 28: Investments in Associates (revised 2003)

IAS 31: Investments in Joint Ventures (revised 2003)

Before any comments are made, it should be noted that in Canada, accounting standards make the same distinctions as does IAS 31; however, the Canadian treatment is to require proportionate consolidation for all "joint ventures" — irrespective of whether "it" is jointly controlled operations, assets or entities.

The issue here is similar to that of IAS 27 — is the cost of providing the required information greater than the benefit derived from it being presented? The Canadian analysis concluded that the cost was too high. Accordingly, it permitted the use of the cost method to account for investments in enterprises subject to significant influence (the analogue of associates in IAS 28), and the use of the equity method or the cost method to account for interests in joint ventures. The reasoning was the same as for investments: lending institutions often ignored consolidated financial statements, as their claims are mostly against the assets of the individual legal entities to which they have advanced credit.

Research indicated that when loans are guaranteed by other legal entities within a related group, creditors request the financial statements of the debtor and all of the guarantors rather than consolidated financial statements of the entire group. Therefore, the AcSB concluded that in the absence of users' interest in what would otherwise be required, the cost of providing such information exceeds the benefits. Consequently, SMEs should be permitted to use the cost method to account for their associates (IAS 28) or either the cost or equity method for joint ventures (IAS 31).

IAS 36: Impairment of Assets (revised 2004)

There are two key issues under consideration here. First, should there be any relief regarding the impairment approach to goodwill and intangibles, for indefinite life assets under IAS 36? Second,

should the provisions regarding the impairment of property, plant and equipment under IAS 36 be carried forward for SMEs?

As with the previous two standards, the first issue comes down to a cost/benefit decision. Moreover, like the previous standards, it is almost certain that the limited users of SME financial statements will already know if an asset is impaired.

The Canadian position allows a qualifying enterprise to elect to test goodwill for impairment only when an event or circumstance occurs that indicates that the fair value of a reporting unit may be less than its carrying amount. Without the availability of this election, goodwill would have to be tested on an annual basis. An identical provision exists for assets with indefinite lives: they need be tested for impairment only when circumstances occur that suggest the asset is impaired.

From a theoretical perspective, one gets into the form over substance debate. It is the asset that matters, not the enterprise that holds it. However, the conceptual framework posits that decision-usefulness must be an over-riding characteristic. Thus, requiring information that is not desired or deemed useful (or necessary) fails the decision-usefulness test. One could also add that very few SMEs have purchased subsidiaries with goodwill recognition an issue; even fewer have significant intangible assets with indefinite lives. When combined with the cost/benefit assessment, it makes sense to adopt a position similar to that of Canada, namely that impairment need only be tested when circumstances suggest impairment has occurred.

Note: some may suggest that this is a circular argument — test for impairment only when impairment is thought to have occurred. However, it is not. The impairment test *confirms* the existence of a condition. It does not, in and of itself, *signal* the condition. Signalling is left to the characteristics identified in the standards.

On the impairment issue, current Canadian standards provide no relief for SME financial statements. Should the *nature* of an asset affect its treatment? The fact that intangible assets with indefinite lives are treated differently from tangible assets with definite lives seems inconsistent. However, here one can argue that the difference is warranted.

Most SME financial statements will report property, plant and equipment. As a percentage of assets, this category is often significant relative to total assets. Moreover, if one examines lenders' views, it is often these assets that are pledged as security for borrowings. Accordingly, it is critical that the amount reported under historical cost not exceed realizable value. Further, unless one is participating in a specialized industry, it is not unreasonable to presume that an organized market exists to provide a proxy for fair value. This ties to the notion that differential reporting requires high costs as the first hurdle. Here we have high benefits with moderate or low costs. Accordingly, it is recommended that no exemption be granted for impairment of property, plant and equipment.

A final comment that applies to both issues: the key aspect for an SME is valuation. This is where complexity and cost become issues for an SME, especially in the area of intangible assets or asset for which comparable sales are not available or the assets are costly to appraise. The test for impairment will almost always require some outside involvement. In an audit, the involvement needs to be either independent or well documented to be useful.

IAS 37: Provisions, Contingent Liabilities, and Contingent Assets

The issues under IAS 37 are much like the second issue of IAS 36. The key factors are cost/ benefit and decision-usefulness. Like the earlier assessment of property, plant and equipment, a decision to provide differential treatment relies on the fact that such reporting requires high costs as the first hurdle. In this situation there is high benefits with moderate or low costs. Further, lenders need to know whether unforeseen circumstances potentially affect their collateral. Hence, the reporting of provisions and contingent liabilities is critical to that understanding. Accordingly, no special treatment is recommended for SME reporting.

IAS 38: Intangible Assets (revised 2004)

IAS 38 requires that all expenditures incurred from when the recognition criteria are met until the asset is available for use should be accumulated to form the cost of the asset. Presumably, this is what the issue is related to — given that development of “something” will result in commercial viability, an entity would normally capitalize its expenditures on that “something.” In turn, this raises the issue of when is the asset ready for use. However, it is not obvious what the SME issue is — and absent more information, it is difficult to ascertain.

Further, the enterprise should test for impairment, at least annually, an intangible asset that is not yet available for use. If the cost recognized for the asset exceeds its recoverable amount, the enterprise has to recognize an impairment loss. This impairment loss should only be reversed if the conditions for reversals of impairment losses under IAS 36 are met. Again, it is not obvious what the issue is here.

IAS 38 requires consideration of residual values in determining the depreciable amount of an intangible asset. IAS 9 prohibited the consideration of residual values. However, IAS 38 sets criteria that make it highly unlikely that an asset that arises from development expenditures would have a residual value above zero. As before, it is unclear what the issue is.

Previous issues have referred to the notion of cost/benefit in order to reach a decision. Here, one can easily argue that the costs of obtaining the required data will be considerable. It is less obvious that the benefits will be. However, like IAS 19, this is something one would expect few SMEs will have to deal with. Moreover, this may also be an issue where decision-usefulness becomes the key criterion, and one can certainly argue that having this information is critical if one is to assess the future prospects of an organization. On balance, this may be another standard from which no deviations are allowed.

IAS 39: Financial Instruments — Recognition and Measurement (revised 2003 and 2004)

The questionnaire raises four key issues related to IAS 39:

1. Use of the effective interest method
2. Fair value measurements
3. Accounting for foreign currency forward contracts
4. Derecognition and/or hedge accounting provisions

Given the pervasive nature of financial instruments, the resolution of these issues is key for SMEs.

1. Use of the effective interest method under IAS 39

According to the definition included as paragraph 9 of IAS 39, the effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Paragraph 46 of IAS 39 states that after initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for loans and receivables held-to-maturity investments, which are to be measured at amortized cost using the effective interest method, and investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, which are to be measured at cost.

Paragraph 47 goes on to say that after initial recognition, an entity shall measure all financial liabilities at amortized cost using the effective interest method, except for a limited number of specific liabilities.

Currently, the effective interest method is required for items such as long-term investments, long-term debt, notes receivable, and instalment sales receivables. The requirements of IAS 39 do not impose a new or onerous requirement on entities. Essentially, assets and liabilities that have a fixed term and a fixed interest rate are accounted for using that method. IAS 39 simply defines such assets and liabilities as financial instruments and classifies them typically as “held to maturity” or “loans and receivables.”

Therefore, the question becomes “is the retention of this policy appropriate for SMEs?” That is, are there any compelling reasons to change the accounting and reporting requirements from current practice? Before answering this question, it would be useful to know the extent to which SMEs engage in activities that give rise to such assets and liabilities.

Most SMEs will have accounts receivable and payable, but these accounts are carried at face value (ignoring allowance for doubtful accounts). Many will have demand loans or similar debt instruments, but as these typically call for floating interest rates, the loan itself will be valued at face value. Others *will* have fixed term and/or fixed rate loans, but it is doubtful that they have accounted for them using the effective interest rate. Why would these SMEs not follow required practice? It comes down to the same criteria as other issues: cost/benefit and decision-usefulness.

Here, the cost/benefit trade-off is irrelevant. The cost of following the “correct” treatment is negligible. The benefit may also be negligible, but the criterion is not a factor. Rather, it is the decision-usefulness assessment that matters. Most SMEs concern themselves with cash flows. It

can be argued that for many SMEs, cash flow is more important than income, at least in the short run. Therefore, it follows that showing the rate-adjusted balance of a financial instrument is *less* useful than not, since a quick calculation of expected cash flows (based on balance sheet value and the effective interest rate) would misrepresent “real” cash flows.

Since the effective interest rate method *is* current practice, and since there has been no significant outcry against the application of this requirement, one could conclude that its retention is appropriate. On the other hand, anecdotal evidence suggests that the effective interest rate method is ignored by SMEs, and provides no benefit by way of decision-usefulness. Therefore, SMEs should be permitted to account for, and report, financial instruments at cost that would otherwise be accounted for and reported by means of the effective interest method. Accordingly, a decision on this issue will depend on the feedback received from respondents.

2. Fair value measurements under IAS 39

The fundamental notion underlying IAS 39 is that all financial instruments should be measured and reported at fair value, unless fair value cannot be reliably determined. Even the effective interest method can be construed as a form of fair value measurement, since it reports a financial instrument based on current interest rates. IAS 39 requires that any gains or losses arising from subsequent re-measurement at fair value be accounted for depending on the classification accorded a financial instrument.

IAS 39 requires that an entity classify its financial instruments into one of the four categories cited earlier: held for trading, loans and receivables, available for sale, or held to maturity. Moreover, that classification is critical since *all* gains and losses are reported in the current period’s profit and loss *except* for instruments classified as “available for sale.” Here the gain or loss is deferred in comprehensive income until such time as the instrument is disposed of.

Therefore, there are really two aspects to the issue. Should SMEs be required to measure their financial instruments at fair value, and if so, should they be required to follow the requirements of IAS 39 with respect to gains and losses?

On the first issue, one must fall back again on the two key tests: cost/benefit and decision-usefulness. IAS 39 notes that one criterion for fair value measurement is the existence of an active market. IAS 39 further provides alternatives in the absence of an active market. Perhaps an SME “compromise” would be to require fair value measurement when an active market exists. Of course, what constitutes an “active market” may give rise to debate, but it would be difficult to argue that it would be costly to obtain the data. Less obvious is the benefit of using fair values. However, if one considers that lenders are the most common users of SME statements (aside from the owners), then there is merit in using fair value: a lender would have a much more “accurate” picture of the “value” of the assets (and liabilities) on an SME balance sheet. In the absence of an active market, one could fall back on cost. It is likely that lenders do the same.

What about the gains and losses? This aspect is partly tax-driven. Many jurisdictions ignore holding gains and losses when determining taxable income. The notion is that tax is not

impacted until the instrument is sold or otherwise disposed of. Certainly, lenders will ignore holding gains and losses when determining income. As noted earlier, they tend to focus on EBITDA. Given that holding gains and losses are *not* part of EBITDA, it is uncertain what is added, in a decision-usefulness context, by requiring gains and losses to flow through profit and loss. Accordingly, it is recommended that for those instruments measured at fair value, SMEs should be permitted to defer all gains and losses until such time as the instrument is sold or otherwise disposed of.

3. Accounting for foreign currency forward contracts under IAS 39

As noted earlier, hedge accounting recognizes the offsetting effects of fair value changes of both the hedging instrument and the hedged item in the same period's profit or loss. It requires that the hedging relationship be clearly defined, measurable, and actually effective. Foreign currency hedges are the most likely type of hedge entered into by an SME. Unlike Canadian treatment, IAS 39 allows a hedge of foreign currency risk to be accounted for as either a fair value hedge or as a cash flow hedge. Section 3865 requires that it be treated as a cash flow hedge.

The main difference between the two types of hedges relates to what happens to the changes in fair value of the hedging instrument: under a fair value hedge, the change in fair values of both the hedging instrument and the hedged item are recognized in profit or loss when they occur. This differs from the treatment accorded a cash flow hedge: the change in fair value of the hedging instrument is recognized in equity until such time as those future cash flows occur. That is, it does not hit the profit and loss statement until the hedge is settled.

It should be noted that all of the issues associated with hedging only matter if a hedge straddles a reporting period. That is, if a firm has to pay \$100,000 US on 1 December and it chooses to hedge that transaction on 3 October, it really doesn't matter which treatment is followed (or even if any hedge is recognized in the first place), since all the effects will wash out in the quarter ending 31 December. Even if the hedge is put in place on 3 May rather than 3 October, the effects will wash out in the annual statements. Since most (all?) SMEs do not have to issue *formal* interim reports, the quarterly effects are ignored.

What happens if the hedge straddles a year-end? It can be argued that the impact *ought* to be reported, but one must assess the decision-usefulness and cost/benefit of applying IAS 39. While these hedges may be material to the entity, the effect of the change often is not. For example, suppose a Canadian entity has to hedge \$250,000 US forward six months. Assuming we do not see changes similar to those of 2003, it is not unreasonable to expect modest changes between spot rates and forward rates. For the sake of argument, assume that the rate changes by 500 basis points. That is a non-trivial change. But on \$250,000, it amounts to \$12,500.

The question one has to ask then is how material is \$12,500 to that entity. One would assume that any organization dealing in \$250,000 sales/payable would likely not consider such an amount material. They may not be happy about it (if the entity is on the wrong side of the rate change), but it is doubtful it would lead to the collapse of the entity. Even if we increase the transaction by an order of magnitude, the relative impact remains the same. Therefore, it could be argued that it fails the decision-usefulness criterion.

What about the cost/benefit trade-off? This criterion is likely to be a “failure” as well. IAS 39 imposes considerable burden on an entity when it enters into a hedging relationship. Paragraph 71 of IAS 39 states that “if there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 85-88 and Appendix A paragraphs AG102-AG104, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 89-102.” This implies that the entity must first explicitly designate the hedge. Paragraph 88 identifies the conditions which must be present if hedge accounting is to be followed.

It is not unreasonable to expect multinational oil companies (for instance) to be hedging their foreign currency exposure, especially as they are dealing in billions of dollars (or euro or yen). Notwithstanding the cost and effort required to comply with IAS 39, investors expect, and rightly so, to see the impact of these decisions. However, it is difficult to demonstrate that the investors in an SME are shielded from the data necessary to understand the actions of the SME. That is, these investors have access to the critical actions of the SME and they are capable of assessing hedging decisions made by the SME. Given the significant costs associated with satisfying IAS 39, it is difficult to demonstrate that the benefits exceed those costs. Accordingly, SMEs should be permitted to account for foreign currency forward contracts at cost until settlement.

4. Derecognition and/or hedge accounting provisions of IAS 39

This issue is linked to the previous issue. If one exempts SMEs from the more onerous requirements related to hedging, does this undermine the applicability of IAS 39? It can be argued that the answer is “no,” since the extent of hedging by SMEs is limited. As noted for issue 3, foreign currency hedges are the most likely type of hedge entered into by an SME.

IAS 39 defines “derecognition” as “the removal of a previously recognized financial asset or financial liability from an entity’s balance sheet.” While that definition sounds reasonably straightforward, the process is anything but. One need only review the applicable paragraphs (included as Appendix 1 to this response) to appreciate the complexity of the matter.

It is doubtful that many SMEs would be able to fully comprehend the requirements, let alone apply them. While the requirements related to derecognition of financial liabilities are more readily dealt with, the entire topic will fail the cost/benefit test cited in the introduction to this response. Clearly we have high costs with, at best, moderate benefits. In keeping with the assessment in the introduction, a simplified approach to derecognition is preferred for SMEs. Likewise, the requirements of hedging could be simplified if there is a desire to have the hedging requirements apply to SMEs.

IAS 41: Agriculture

IAS 41 presumes that fair value can generally be determined for biological assets and produce as it assumes a market for these items. As was discussed under IAS 39, the determination of fair value in cases where an active market exists should not be an unreasonable requirement. One would expect that produce would not be planted in the first place if there were no expectation of being able to sell

it. Further, one would expect that produce, having been planted, would not be harvested if there were no expectation of sale. Therefore, it is reasonable to expect that a market price for produce can be established. Consequently, if a market exists, then an SME should be expected to use that price as a proxy for fair value.

The problem many SMEs face is that sometimes the “market” is not free. Often a quota system exists, or some other marketing board system exists where price is set and the seller is not free to “shop around” for a better price. Nonetheless, this is still an external price and it represents the most realistic expectation of what the seller will receive for the produce.

On the other hand, biological assets are more troublesome. It can be argued that the marketing of biological produce is no different than for other produce. A quota system exists, for example for beef, and a seller can sell only so much beef at a specific price. Or the seller can choose not to sell. In either case, there is a proxy for market and fair value. Therefore, as with produce, under normal circumstances, a market price can be determined which meets the fair value requirement.

IFRS 2: Share-based Payments

The topic of share-based payments has been a controversial one for more than a decade. The FASB recently released a revised version of statement 123, which requires the expensing of stock options. The CICA changed Canadian recommendations in 2004 to require the expensing of stock options. Add IFRS 2 to the mix, and virtually all major standard-setting bodies converged on a single standard — expense the cost of share-based payments.

For SMEs, the issue breaks down into two sub-issues: should SMEs be required to expense share-based payments in the first place, and if they are, how should those costs be measured?

The first issue is similar to that of IAS 19 — if an organization has transactions or contracts that meet the definition of share-based payments, then IFRS 2 should apply. As with post-employment benefits, here the decision-usefulness test is “passed,” as is the cost/benefit test (grudgingly no doubt). The nature of these future obligations is sufficiently important to the long-run viability of an enterprise that recognition is mandated.

The second issue is how these costs should be measured. Presumably, that is what the Working Party is to address, given the issue posed. Generally, the biggest problem for SMEs is that their stock does not trade in an active market (if at all). This begs the question of how one determines a fair value for the share-based payment. Option-pricing models are not helpful since there is no measure for volatility. Beta is missing since there is no market to generate the beta.

To use the Black-Scholes option-pricing model for a call, one must have data regarding a stock’s volatility. If the volatility is zero (which is the case for private companies with no market for their stock), then two of the key terms in the model will equal zero. This begs the question: is there an easier way to deal with private company options? The answer is yes. The value of a call option (which is what this is) when volatility is zero is simply the current stock price minus the present value of the exercise price.

Therefore, SMEs should be required to recognize the cost of share-based payments, but in the absence of active markets for their stock, they should also be permitted a simplified measurement model.

Question 2

Question 2 requested that respondents consider issues that might be omitted from SME standards, as they would be unlikely to occur. In the event that the standard was applicable, SMEs would be directed to comply with the appropriate IFRS. Respondents were directed to Attachment B for a list of standards where SME transactions were unlikely to occur.

The underlying premise that the IASB appears to have adopted is that SME reporting would be simplified to recognize the limited application of certain standards as they applied to SMEs. Attachment B provides such a list. Now we are being asked to identify standards (or aspects thereof) that would not be included in the separate SME standards publication, in order to reduce the size of the volume. While there is merit in such an approach, it assumes that a separate volume is appropriate. It is CGA-Canada's contention that such a decision has yet to be made, and, in any case, it has not been demonstrated that a separate volume is appropriate.

The Canadian approach has been to include specific guidance within the applicable standard relating to differential reporting. For example, the section dealing with subsidiaries includes specific paragraphs providing relief for non-public entities. It seems counter-productive to publish a large book for SMEs and an even larger book for non-SMEs — especially as an SME will have to have the full set of IFRSs if there is a fallback situation. Would it not be more practical to expand the current set of IFRSs by a modest amount rather than have two major publications?

Notwithstanding, below is our assessment of the issues raised in Attachment B.

IFRS 2 SMEs generally do not enter into share-based payment transactions. The SME equivalent of IFRS 2 should simply refer back to IFRS 2.

Agreed. Our comments on IFRS 2 recommend that IFRS 2 apply, with the exception that the option-pricing model be amended to recognize the lack of volatility.

IFRS 3 SMEs seldom enter into business combinations. The SME equivalent of IFRS 3 should simply refer back to IFRS 3.

We do not agree. While it may be true that SMEs seldom enter into business combinations with *unrelated* entities, combinations with *related* entities occur frequently. Company A and Company B jointly start Company C. Eventually, Company A buys Company B and/or absorbs Company C. This issue then becomes, should SMEs have to comply with IFRS 3 rather than assume that it does not apply.

IFRS 4 Because companies that issue insurance contracts hold assets in a fiduciary capacity, they have public accountability. IASB standards for SMEs would not be intended for them. Therefore, an SME version of IFRS 4 is not needed.

Agreed.

IAS 11 Combining and Segmenting Construction Contracts

It is not obvious why SMEs would not have to comply with the requirements of IAS 11 if the circumstances require such treatment. As we noted in our comments regarding applicability of the percentage of completion method, there is no reason not to require its use. If an entity is sophisticated enough to engage in a contract that calls for the percentage of completion approach, then it should be sued. Likewise, if an entity is engaged in circumstances which call for combining or segmenting of construction contracts, then that information is significant enough to pass the decision-usefulness test and ought to be provided.

IAS 12 Temporary differences arising from investments in subsidiaries, branches, associates, and interests in joint ventures

If an entity is permitted to use the taxes payable method (as recommended in our comments on IAS 12), then temporary differences will not be a factor and this issue can be ignored. If, however, entities are required to use the liability method of IAS 12, then temporary differences should also be recognized.

IAS 16 Revaluation model for property, plant and equipment

As noted in our comments related to Attachment A, lenders tend to rely more on the personal wealth and guarantees of the principals of an SME organization rather than the entity itself. Moreover, it can be argued that the decision-usefulness of revaluing property, plant and equipment is high; the problem is, so is the cost of obtaining the necessary information. In the absence of compelling evidence that following this aspect of IAS 16 would enhance SME statements, CGA-Canada suggests that this could be an optional treatment permitted for SMEs. Alternatively, the Canadian approach could be adopted insofar as the frequency of a test is concerned: unless there is evidence that the asset has been impaired, it should continue to be carried at cost.

IAS 17 Sale and leaseback transactions

Few SMEs would engage in sale and leaseback transactions. CGA-Canada agrees that for those that do, compliance with IAS 17 is appropriate.

IAS 19 Defined benefit employee benefit programs

As we noted in our comments related to IAS 19, it is CGA-Canada's position that few, if any, SMEs would have circumstances that would require compliance with IAS 19.

However, our view is that if such circumstances occur, compliance with IAS 19 should be required due to the critical nature of the information associated with post-employment benefits. Here the SME owes a duty to its employees and, irrespective of whether an entity is “public” or not, the duty remains the same. Therefore, there should be no relief from the requirements of IAS 19. In other words, SMEs should be referred to the full version of IAS 19.

IAS 23 Capitalization model for borrowing costs

In the absence of compelling evidence that compliance with IAS 23 would impose an onerous burden on SMEs, CGA-Canada’s position is that if the standard applies, it should be followed. Therefore, like IAS 19, SMEs should be referred to the full IAS 23.

IAS 26 Because retirement benefit plans hold assets in a fiduciary capacity, they have public accountability. IASB standards for SMEs would not be intended for them. Therefore, an SME version of IFRS 26 is not needed.

Agreed.

IAS 27 SMEs generally do not have subsidiaries. The SME equivalent of IAS 27 should simply refer back to IAS 27.

Not so. Please see our comments related to IAS 27 under Attachment A and IFRS 3, above. CGA-Canada believes an SME version of (parts of) IAS 27 is necessary.

IAS 30 The entities to which IAS 30 applies are, by definition, entities with public accountability and, therefore, IFRSs apply to such entities.

Agreed.

IAS 32 Split accounting for compound financial instruments

It depends on the circumstances giving rise to the issuance of the financial instrument. We make this comment as Canada permits the issuance of “preferred” shares in tax planning arrangements — shares that require split accounting if IAS 39 is followed. The Canadian approach has been to exempt such shares from the purview of the standards. Accordingly, we suggest that financial instruments that require split accounting likewise be required to follow split accounting unless they are issued as part of tax planning arrangements.

IAS 36 Because SMEs generally do not enter into business combinations, the material on impairment of goodwill in IAS 36 could be omitted from the SME standard on impairment of assets.

Agreed.

IAS 38 Revaluation model for intangibles

As with many aspects of IFRSs, the applicability to SMEs depends on the size and sophistication of the entity. It is true that few SMEs will hold intangibles; however, for those that do, the question is much the same as for IAS 16: if appropriate, then IAS 38 is appropriate. Therefore, it would be reasonable to suggest that when an SME holds intangibles, it apply the revaluation model of IAS 38. However, perhaps the Canadian approach could be adopted insofar as the frequency of the test is concerned: unless there is evidence that the asset has been impaired, it should continue to be carried at cost.

IAS 39 Derecognition

As we noted in our comments to IAS 39 with respect to Attachment A, the entire topic of derecognition will fail the cost/benefit test cited in the introduction to the response. Clearly we have high costs with, at best, moderate benefits. In keeping with the assessment in the introduction, a simplified approach to derecognition is preferred for SMEs.

IAS 39 Hedge Accounting

The requirements of hedging could be simplified if there is a desire to have the hedging requirements apply to SMEs. As mentioned in our question 1 comments, it is probable that the only hedge SMEs will utilize is one related to foreign currency.

Appendix 1: Excerpts from IAS 39

16. Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.
- (a) Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions:
 - (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.
 - (ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of all cash flows of a debt instrument, paragraphs 17-23 are applied to 90 percent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.
 - (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of interest cash flows from a financial asset, paragraphs 17-23 are applied to 90 percent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.
 - (b) In all other cases, paragraphs 17-23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 percent of cash collections from a financial asset (or a group of financial assets) or (ii) the rights to 90 percent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 percent of the principal amount of the receivables, paragraphs 17-23 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 17-26, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

17. An entity shall derecognise a financial asset when, and only when:
- (a) the contractual rights to the cash flows from the financial asset expire; or
 - (b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20. (See paragraph 38 for regular way sales of financial assets.)

18. An entity transfers a financial asset if, and only if, it either:
- (a) transfers the contractual rights to receive the cash flows of the financial asset; or
 - (b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.

Application Guidance paragraph 36 lays out a flowchart:

AG36. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.

