Staff paper

Agenda reference: 30

IASB® meeting

Date	**October 2024**
Project	**Second Comprehensive Review of the *IFRS for SMEs®* Accounting Standard**
Topic	**Sweep issues**
Contacts	Helen Lloyd (hlloyd@ifrs.org) Mostafa Mouit (mmouit@ifrs.org)

Purpose of this paper

1. At its July 2024 meeting, the International Accounting Standards Board (IASB) decided to begin the balloting process for the *Third edition of the* IFRS for SMEs *Accounting Standard*.[1]

2. The staff have prepared a draft of the *Third edition of the IFRS for SMEs Accounting Standard*. In doing so, two sweep issues have been identified.

3. The purpose of this paper is to ask the IASB to decide how to address those sweep issues.

4. In this paper, the term SMEs refers to entities that are eligible to apply the *IFRS for SMEs* Accounting Standard (the Standard). The term Exposure Draft refers to the Exposure Draft *Third edition of the* IFRS for SMEs *Accounting Standard*.

[1] At its September 2024 meeting, the IASB decided to finalise the proposals in the Exposure Draft *Addendum to the Exposure Draft* Third edition of the *IFRS for SMEs* Accounting Standard with some minor revisions. IASB members confirmed they were satisfied that the IASB has complied with the applicable due process requirements.

Summary of staff recommendations

5. The staff recommend the IASB:

   (a) specify that the assessment of whether fair value of contingent consideration can be measured without undue cost or effort, proposed in paragraph 19.13 of the Exposure Draft, is made at the acquisition date (initial recognition) and not revisited.

   (b) amend paragraph 5.11 of the Standard as proposed in the Exposure Draft, including the additional clarifying sentence.

Structure of this paper

6. This paper is structured as follows:

   (a) application of the undue cost or effort exemption to contingent consideration (paragraphs 7–19 of this paper); and

   (a) analysis of expenses by nature or function (paragraphs 20–25 of this paper).

Sweep issues

Application of the undue cost or effort exemption to contingent consideration

Background

7. As an example of a contingent consideration arrangement, the consideration for acquiring a business could be:

   (a) a payment of CU1,000 (cash consideration); and

   (b) a further payment that would be calculated as 5% of the profits of the acquired business in the two years following the acquisition (*contingent consideration*).

8. Paragraph 19.12 of the Exposure Draft proposed (emphasis added):

> The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement (see paragraph 19.11). The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree **if it can be measured reliably.**

9. Paragraph 19.13 of the Exposure Draft proposed (emphasis added):

> However, if the acquisition-date fair value of contingent consideration **cannot be measured reliably without undue cost or effort**, the acquirer shall recognise, at the acquisition date, an estimate of the most likely amount of contingent consideration.

10. Paragraph 19.23B of the Exposure Draft proposed (emphasis added):

> ... The acquirer shall account for changes in the amount of contingent consideration that are not measurement period adjustments as follows:
>
> (a) ...
>
> (b) other contingent consideration that:
>
> (i) is **within the scope of Part II of Section 11** *Other Financial Instrument Issues* (**whose fair value can be measured reliably without undue cost or effort**) shall be measured at fair value at each reporting date with changes in fair value recognised in profit or loss.
>
> (ii) is **not within the scope of Part II of Section 11** (whose fair value cannot be measured reliably without undue cost or effort (see paragraph 19.13)) shall be reviewed at each reporting date and adjusted to reflect the current estimate of the most likely amount of the contingent consideration at

that reporting date. Any adjustments to the amounts previously recognised shall be recognised in profit or loss.

Sweep issue

11. A question has been raised on what happens if the acquisition-date fair value of contingent consideration *cannot* initially be measured reliably without undue cost or effort but, in a subsequent period, the fair value of that contingent consideration *can* be measured reliably without undue cost or effort.

12. The staff think the question can be reframed as does an acquirer that becomes able to measure the fair value of contingent consideration without undue cost or effort:

(a) change to applying the requirements in paragraph 19.23B(b)(i) of the Exposure Draft—that is measure the contingent consideration at fair value at each reporting date with changes in fair value recognised in profit or loss; or

(b) continue applying requirements in paragraph 19.23B(b)(ii) of the Exposure Draft—that is continue reviewing the contingent consideration at each reporting date and adjust it to reflect the current estimate of the most likely amount of the contingent consideration at that reporting date, recognising any adjustments to the amounts previously recognised in profit or loss.

Staff analysis

13. Section 2 of the Standard includes an explanation of when it is acceptable for an entity to use the undue cost or effort exemption. Paragraph 2.30 of the Exposure Draft proposed that:

(a) assessing whether a requirement would involve undue cost or effort on initial recognition should be based on information about the costs and benefits of the requirement at the time of initial recognition; and

(b) if the undue cost or effort exemption also applies to a subsequent measurement, a new assessment of undue cost or effort should be made at that subsequent date, based on information available at that date.

14. In developing the proposals in paragraphs 19.13 and 19.23B(b)(ii) of the Exposure Draft, the IASB considered the feedback from comment letters on the Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard.* The feedback provided support for allowing contingent consideration to be measured at fair value at each reporting date, but asked for an undue cost or effort exemption to be in place for those SMEs that found it too difficult to measure fair value.[2]

15. In the staff's view, there are two alternatives to address the sweep issue in paragraph 11 of this paper:

(a) the first alternative is to retain the proposals in paragraphs 19.13 and 19.23B(b)(ii) of the Exposure Draft without adding clarification. In this case SMEs would need to look to paragraph 2.30 of the Exposure Draft which requires a new assessment at each reporting date when the undue cost or effort exemption is applied subsequent to initial recognition. Requiring SMEs to revisit this assessment would mean SMEs would need to make a new assessment of undue cost or effort at each subsequent reporting date, based on information available at that date. This could lead to a change of measurement so that if contingent consideration *can* be measured reliably without undue cost or effort at any subsequent date before settlement, an acquirer would be required to apply the requirements set out in paragraph 19.23B(b)(i) of the Exposure Draft from that point.

(b) the second alternative is to specify that paragraph 19.13 of the Exposure Draft is to be applied only if the fair value of contingent consideration cannot be measured reliably without undue cost or effort at initial recognition, without a requirement to revisit this assessment.

[2] See paragraphs 39–41 of AP30A: Towards an Exposure Draft—IFRS 3 Business Combinations.

16. The staff do not think that the outcome of applying the requirements in paragraph 19.23B(b)(i) would be materially different from the requirements in paragraph 19.23B(b)(ii). This is because:

    (a) the nature of contingent consideration arrangements is that an acquirer would most likely use Level 3 of the fair value hierarchy in applying the requirements in paragraph 19.23B(b)(i); and

    (b) both paragraphs require changes to the amounts previously recognised to be included in profit or loss.

17. In other words, requiring SMEs to make the undue cost or effort assessment at initial recognition would be unlikely to give very different outcomes from requiring that assessment to be reperformed at each reporting date.

18. The staff think that the second alternative in paragraph 15 of this paper would be more aligned with the feedback described in paragraph 14. The effect of this second alternative would be that an SME would assess at the date of a business combination whether it could measure the fair value of contingent consideration reliably without undue cost or effort, and would not then reassess this decision. The contingent consideration would therefore be measured in accordance with either paragraph 19.23B(b)(i) or paragraph 19.23B(b)(ii) until it is settled, without being revisited.

Staff recommendation

19. The staff recommend the IASB specify that the assessment of whether fair value of contingent consideration can be measured without undue cost or effort, proposed in paragraph 19.13 of the Exposure Draft, is made at date of the business combination (initial recognition) and not revisited.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 19 of this paper?

Analysis of expenses by nature or function

Background

20. The Exposure Draft proposed amendments to paragraph 5.11 of the Standard (shown in markup):

> An entity shall provide ~~present~~ an analysis of expenses using a **classification** ~~classification~~ based on either the nature of expenses or the function of expenses within the entity, which ever provides information that is reliable and more relevant. This analysis may be either presented in the statement of comprehensive income or in the notes.

Sweep issue

21. No comments were received on the proposed amendments to paragraph 5.11 of the Standard. However, a suggestion has been made to reject the proposal, and not amend the paragraph in the Third Edition of the Standard. The view expressed is that the proposed amendments would introduce too much freedom to SMEs by providing an option of including an analysis by nature or function only in the notes to the financial statements, instead of in the income statement.

Staff analysis

22. The amendments to paragraph 5.11 were proposed because:

    (a) Section 5 is based on IAS 1 *Presentation of Financial Statements*, which in paragraph 99 states that 'an entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity'. Paragraph 100 of IAS 1 goes on to say 'entities are encouraged to present the analysis in paragraph 99 in the statement(s) presenting profit or loss and other comprehensive income'. The use of 'encouraged' suggests that including the analysis in the income statement is not a requirement. Based on this, the proposed additional sentence would be making explicit the existence of an option that was already available.

(b) The use of 'present' and 'disclose' to refer to the primary statements and the notes respectively is now well established, but the terms were previously used more ambiguously, in IAS 1 and elsewhere. Therefore the exposure draft proposed replacing 'present' with 'provide' so that there would not be a contradiction between the first sentence and the proposed additional sentence.

(c) The explicit requirement to include information either in the primary statement or in the notes might encourage SMEs to disclose useful information in the notes rather than a single line in the income statement.

23. In the staff's view, the proposed amendments to paragraph 5.11 do not introduce a new option that SMEs cannot already apply; instead they offer helpful clarity on the intention of the original words.

24. However, there is an alternative view that the addition sentence could be viewed as relaxing the original requirements and as newly allowing SMEs to prepare income statements with no analysis of expenses. Following this argument, issuing the Third Edition of the Standard without the additional sentence would mean the Standard would be unchanged in this regard and therefore there might be less likelihood of a perceived change in requirements.

Staff recommendation

25. The staff recommend the IASB amend paragraph 5.11 of the Standard as proposed in the Exposure Draft, including the additional clarifying sentence.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 25 of this paper?