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Dear Francoise,

EFRAG's Draft Letter Advice on compatibility of the IFRS for SMEs and the EU Accounting Directives

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on EFRAG's Draft Letter Advice on compatibility of the IFRS for SMEs and the EU Accounting Directives. We appreciate the opportunity to comment on this Draft Letter.

EFRAG provided a very thorough analysis on the compatibility of the IFRS for SMEs and the EU Accounting Directives. EFRAG's conclusion is that seven requirements of the IFRS for SMEs are incompatible with the EU Accounting Directives. Our overall impression is that these remaining differences between IFRS for SMEs and the EU Accounting Directives are rather minor incompatibilities. The GASB does not believe that these differences provide a sufficient basis on which to reject the application of the IFRS for SMEs for entities of the European member states. This is also justified by our valid assumption that the transactions for which the IFRS for SMEs and the Directives provide different requirements are not likely to often occur in SMEs. Furthermore, after careful consideration of EFRAG's analysis we concluded that some of the “incompatible requirements” might in fact be in line with the EU Accounting Directives which further reduces the number of incompatibilities.

In our view the EU Commission should therefore take the necessary steps to allow entities to apply the IFRS for SMEs.

Please find our arguments and further comments on EFRAG’s analysis and conclusion on the incompatibilities in the appendix enclosed with this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix

Extraordinary items

We agree with EFRAG's conclusion that there is an incompatibility between the IFRS for SMEs and the EU Accounting Directives regarding the presentation of extraordinary items.

We would suggest to the EU-Commission, however, that the presentation of extraordinary items is discussed in the course of the revision of the EU Accounting Directives. In our view there are valid reasons for not allowing items to be presented as extraordinary in the income statement, i.e. such items should be presented as part of ordinary activities as well as before income taxes.

Financial instruments at fair value

We generally agree with EFRAG's analysis regarding accounting requirements for certain financial instruments. However, in assessing the issue on hand two further aspects need to be considered which result in a conclusion different from EFRAG's, i.e. in our view there is no incompatibility between the IFRS for SMEs and the EU Accounting Directives in respect of these financial instruments.

Firstly, in our opinion EFRAG in its analysis has not sufficiently considered all relevant requirements of IAS 39. After laying out the applicable requirements in the IFRS for SMEs and the EU Accounting Directives EFRAG concludes (para. 14 of EFRAG's draft letter) that based on IAS 39.11 A (a) an entity may not designate the entire hybrid (combined) contract at fair value through profit or loss if the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract. Therefore the general option to designate the entire hybrid contract as at fair value through profit or loss does not apply for these circumstances. As a result, the embedded derivative needs to be separated and measured separately from the host contract.

EFRAG however appears to not consider that IAS 39.12-13 provide yet another exception to the exception from the general option to designate an entire hybrid contract as at fair value through profit or loss (IAS 39.11 A (a), cited by EFRAG). IAS 39.12 states that "if an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. […]". IAS 39.13 specifies when an entity is unable to determine the fair value of the embedded derivative. As a result the entire hybrid contract would have to be measured at fair value through profit or loss.

It is oftentimes very likely, especially for SMEs, that entities will be unable to determine the fair value of an embedded derivative which does not significantly modify the cash flows otherwise required by the contract. Ultimately the entity applying the IFRS for SMEs would just like an entity applying the EU Accounting Directives (specified in IAS 39 and more specifically IAS 39.12) measure the entire hybrid contract at fair value through profit or loss. Consequently, in such scenarios there would be no incompatibility between the IFRS for SMEs and the EU Accounting Directives.

Secondly, applying the definition of an incompatibility as laid out in EFRAG's draft letter (page 1) a conflict does not exist at all: SMEs can always opt to apply IAS 39 instead of section 11 and 12 (as allowed by IFRS for SMEs.11.2 (b)). As EFRAG points out, the EU Accounting Directives ultimately refer to IAS 39. Hence, the incompatibility between IAS 39 and the IFRS for SMEs is the basis for the incompatibility between the IFRS for SMEs and the EU Accounting Directives. However, by allowing entities to apply the IAS 39 in full, the IFRS for SMEs provides an option which is in line with the EU Accounting Directives. While we acknowledge that it seems unlikely that SMEs opt to apply IAS 39 in full, formally the existence of the option results in a compatibility of the IFRS for SMEs and the EU Accounting Directives.

Furthermore, we would suggest including a different example. The example of a leverage feature as suggested by EFRAG (para. 15 of EFRAG's draft letter) does not necessarily represent an embedded derivate that does not significantly modify the cash flows that otherwise would be required by the contract.

Measurement of investments in associates and joint ventures for which there is a published price quotation at fair value in non-separate financial statements

We do not agree with EFRAG's conclusion regarding the incompatibility of measurement of investments in associates and joint ventures for which there is a published price quotation.

EFRAG analyses correctly that entities that choose the cost model for investments in associates or jointly controlled entities (IFRS for SMEs.14.5 et seq. and .15.10 et seq.) might ultimately be required to use the fair value model in the case of investments in associates or jointly controlled entities for which there is a published price quotation.

However, to our understanding EFRAG appears not to consider that all entities have the option to apply either the cost model, the equity model or the fair value model (see IFRS for SMEs.14.4 and .15.9). Only after the entity chose the cost model does the "published-price-quotation-exemption" apply. Therefore, if an entity chooses the equity model this particular "published-price-quotation-exemption" does not become effective. Irrespective of the existence of a published price quotation the entity would apply the equity method and not the fair value model. The equity method is provided for in the EU Accounting Directives as well.

Overall, the IFRS for SMEs provides an option that is compatible with the EU Accounting Directives (equity method), which the entities are always allowed to choose irrespective of a published price quotation. Following EFRAG's definition of incompatibility the existence of one option which is in line with the EU Accounting Directives satisfies the criterion of compatibility. Therefore, the published-price-quotation-exemption within one particular measurement model (cost model) does not result in an incompatibility since there is always one option to choose by the entity that results in an accounting treatment analogue to the EU Accounting Directives. As EFRAG stated (page 1 of the draft letter): *„an incompatibility is considered to only exist if none of these options is permitted under the EU Accounting Directives"*.

Amortisation of goodwill over ten years when an entity is unable to make a reliable estimate of the useful life

While we concur with EFRAG's conclusion that there might be cases in which the amortisation period of goodwill differs between IFRS for SMEs and EU Accounting Directives, we do not agree with the result of EFRAG's analysis.

EFRAG concludes that the IFRS for SMEs (19.23 (a)) requires the useful life to be presumed to be 10 years if an entity is unable to make a reliable estimate of the useful life of goodwill. EFRAG further reasons that the EU Accounting Directives require goodwill to be amortised over a maximum period of 5 years. Member States may, however, permit entities to amortise goodwill over a longer period not exceeding the useful economic life.

EFRAG also chooses an example to demonstrate the assumed incompatibility: If the useful life of goodwill is assumed to be between 2 and 11 years the IFRS for SMEs would require the amortisation over 10 years, while the EU Accounting Directives would require the useful life to be 5 years.

To our understanding EFRAG's example does not fully match the case described and as it is set the example is slightly extreme. If the entity assumes the useful life to be between 2 and 11 years the entity is not automatically "unable to make a reliable estimate of the useful life". We acknowledge that a range of possible useful lives can be so wide as to be equal to be "unable to make a reliable estimate of the useful life". However, just because the entity assumes a range of possible useful lives this does not necessarily result in the entity being unable to make a reliable estimate. If an entity for example assumes the useful life to be between 3 and 5 years, it is not unable to make a reliable estimate just because it cannot identify the useful life more specifically. At least in our example it is therefore unlikely that under IFRS for SMEs the entity would have to assume the useful life to be 10 years, i.e. the entity in our example would be expected to amortise the goodwill over 4 years.

Along this line of argument, we also question whether the application of the EU Accounting Directives would necessarily result in the amortisation period being 5 years. Take the example of an entity not being able to specify the useful life of goodwill, but assuming it to be between 8 and 10 years. Following EFRAG's argument, this entity would amortise goodwill over 5 years. However, this entity is obviously able to support a useful life longer than 5 years and the assumed useful life does not exceed the economic life. The question remaining is which useful life between 8 and 10 years will be applied; a 5year useful life, however, does not seem appropriate.

Overall, we suggest that EFRAG revises its argumentation in order to explicitly lay out where these requirements are incompatible.

Immediate recognition in profit or loss of negative goodwill not related to a realised gain

We agree with EFRAG's conclusion that there is an incompatibility between the IFRS for SMEs and the EU Accounting Directives regarding the immediate recognition in profit or loss of negative goodwill not related to a realised gain. Regarding the impact of this difference we question, however, whether negative goodwill regularly occurs in small and medium-sized entities.

Reversal of goodwill impairment losses

We do not concur with EFRAG's analysis and conclusion regarding the reversal of goodwill impairment losses.

To our understanding EFRAG suggests that according to the EU Accounting Directives goodwill should be accounted for under the same rules as all other fixed assets.

Therefore, due to the lack of an explicit requirement on the reversal of goodwill impairment losses, such losses should be accounted for as they would for other fixed assets. In our view, however, two aspects are in contrast with the assumption to treat goodwill like all other fixed assets.

Firstly, while the EU Accounting Directives view the goodwill as a fixed asset, they differentiate between goodwill and other fixed assets regarding the subsequent measurement. Unlike other fixed assets the goodwill has not to be amortised over its useful economic life: instead the Directives provide for a special requirement by referring to the subsequent measurement of "formation expenses" (see article 37.2 of the fourth accounting directive: maximum period of five years).

Secondly, also unlike other fixed assets the goodwill stands out due to some specific characteristics. Different than for other fixed assets it is very difficult to distinguish between internally generated goodwill and acquired goodwill in case of an increase in value of goodwill that once has been impaired. There might be rare circumstances in which an impairment of goodwill is reversed (and as a result acquired goodwill would be recognised again). This could be the case for goodwill which was impaired due to the external indicators such as the financial and economic crisis. These indicators might have changed now resulting in a different assessment of the goodwill and in fact a reversal of the impairment recorded in an earlier reporting period. However, very often the increase in the value of goodwill will relate to specific business decisions of the entity that once acquired the goodwill. Even in the case of external indicators which cease to exist it is most likely that the entity has initiated additional activities to act upon these external effects. In the end it is very difficult if not impossible to establish operational principles for the distinction between the (prohibited) recognition of internally generated goodwill and a mere reversal of acquired goodwill. Both IFRS for SMEs and EU Accounting Directives emphasize that internally generated goodwill should not be recognized.

Overall, it therefore seems reasonable to conclude that goodwill should be treated differently than other fixed assets when it comes to increases of the value of goodwill (which has been impaired before). The EU Directives with the different requirement for the subsequent measurement of goodwill and its strict prohibition to recognise internally generated assets provide room for this assumption. In light of the fact that it is very difficult to differentiate between internally generated goodwill and acquired goodwill we conclude that the EU Directives also allow for the prohibition of reversal of goodwill impairment. The IFRS for SMEs would then be in line with the EU Accounting Directives regarding the prohibition of reversal of goodwill impairment.