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European Financial Reporting Advisory Group

# DRAFT LETTER

**Comments should be sent to commentletter@efrag.org by 19 April 2010**

**(Questions related to the draft letter are included in the appendix)**

Pierre Delsaux
Director
European Commission
B-1049 Brussels

XX May 2010

Dear Mr. Delsaux

**Advice on compatibility of the IFRS for SMEs and the EU Accounting Directives**

In November 2009, the European Commission asked EFRAG to provide it with advice detailing on exactly which points the IFRS for SMEs (International Financial Reporting Standard for Small and Medium-sized Entities) is incompatible with the EU Accounting Directives (78/660/EC and 83/349/EEC).

EFRAG would like to highlight that this analysis has been performed from a technical accounting perspective. Accordingly, the purpose of this analysis is to provide input to the wider policy considerations about the role of the IFRS for SMEs within EU as well as to the European Commission's review of the EU Accounting Directives.

EFRAG has completed its analysis under its due process procedures, including the issuance of a draft letter for comment.

In accordance with the guidelines provided in your letter dated 24 November 2009, 'incompatibility' has been defined to mean that an accounting treatment required by the IFRS for SMEs is not permitted under the EU Accounting Directives. When the IFRS for SMEs includes options for the accounting treatment of a transaction, other event or condition, an 'incompatibility' is considered to only exist if none of these options is permitted under the EU Accounting Directives. Accordingly, application of some of the options included in the IFRS for SMEs would be in conflict with the EU Accounting Directives even though these options are not mentioned in this document. In relation to its review of the Accounting Directives, the European Commission may consider whether these options should be allowed or required under the EU Accounting Directives.

EFRAG notes that Directive 2003/51/EC of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/349/EEC and 91/674/EEC in its preamble states: "The amendments will remove all inconsistencies between Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the one hand and IAS in existence at

1 May 2002, on the other". Accordingly, EFRAG has not considered requirements of the IFRS for SMEs that are the same as those in IAS at 1 May 2002.

As the basis for its analysis, EFRAG has used the English versions of the EU Accounting Directives.

The Appendix includes the details and the reasoning behind EFRAG's analysis. EFRAG's conclusion is that the following requirements of the IFRS for SMEs are incompatible with the EU Accounting Directives:

1 The prohibition to present or describe any items of income and expense as 'extraordinary items' in the statement of comprehensive income (or in the income statement, if presented) or in the notes (IFRS for SMEs par. 5.10) (see Appendix par. 3 - 6).

2 The requirement to measure financial instruments within the scope of section 12 of the IFRS for SMEs (non-basic financial instruments) at fair value (IFRS for SMEs par. 12.7 and 12.8) (see Appendix par. 7 - 16). (Par. 11.2 IFRS for SMEs includes an option for entities to choose to apply the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement*. As the option does not refer to a specific version of IAS 39, EFRAG has not been able to assess whether this option would be compatible with the EU Accounting Directives or not. Accordingly, EFRAG has disregarded the option when assessing whether or not the requirements of the IFRS for SMEs regarding financial instruments are compatible with the EU Accounting Directives or not.)

3 The requirement to measure associates for which there is a published price quotation using the fair value model (IFRS for SMEs par. 14.7 and 14.10) (see Appendix par. 17 - 29).

4 The requirement to measure investments in jointly controlled entities for which there is a published price quotation using the fair value model (IFRS for SMEs par. 15.12 and 15.15) (see Appendix par. 17 - 29).

5 The requirement to presume the useful life of goodwill to be ten years if an entity is unable to make a reliable estimate of the useful life (IFRS for SMEs par. 19.23) (see Appendix par. 30 - 34).

6 The requirement to recognise immediately in profit or loss any negative goodwill (IFRS for SMEs par. 19.24) (see Appendix par. 35 - 37).

7 The prohibition to reverse an impairment loss recognised for goodwill (IFRS for SMEs par. 27.28) (see Appendix par. 38 - 42).

Please do not hesitate to contact me, if you have any questions about our advice.

Yours sincerely

Stig Enevoldsen
**EFRAG, Chairman**

# Appendix
# Basis for Conclusion

1 This appendix sets out the basis for EFRAG's advice on the compatibility of the IFRS for SMEs with the EU Accounting Directives. It includes the reasoning for the conclusions reached where a paragraph of the IFRS for SMEs has been identified as being incompatible with the EU Accounting Directives. Although this appendix includes quotations from both the EU Accounting Directives and the IFRS for SMEs, it may be necessary to refer to these documents in order to be able to follow the reasoning behind EFRAG's conclusions.

2 The IFRS for SMEs as issued by the IASB on 9 July 2009 and the EU Accounting Directives as of 26 February 2010 have been assessed. This analysis does not consider how the EU Accounting Directives have been applied in the national law of EU Member States.

**Requirements of the IFRS for SMEs assessed to be incompatible with the EU Accounting Directives**

*Extraordinary items*

3 According to paragraph 5.10 of the IFRS for SMEs:

> An entity shall not present or describe any items of income and expense as 'extraordinary items' in the statement of comprehensive income (or in the income statement, if presented) or in the notes.

4 According to article 29.1 of the Fourth EU Accounting Directive:

> Income and charges that arise otherwise than in the course of the company's ordinary activities must be shown under 'Extraordinary income and extraordinary charges'.

<u>EFRAG Conclusion</u>

5 EFRAG has concluded that:

(a) as the IFRS for SMEs specifically prohibits items to be presented or described as 'extraordinary items'; and

(b) as the Fourth EU Accounting Directive specifically requires certain items to be presented under 'Extraordinary income and extraordinary charges';

the requirement of paragraph 5.10 of the IFRS for SMEs is incompatible with the EU Accounting Directives.

6 EFRAG notes that the EU Accounting Directives do not specify what items should be considered to be income and charges that do not arise in the course of a company's ordinary activities, and hence presented as extraordinary. Accordingly, it may be that the EU Accounting Directives only require very few items to be presented as 'extraordinary'. It could therefore be argued that the incompatibility issue seldom would arise in practise and that the issue could therefore be neglected. However, EFRAG is of the view that the frequency by which an issue would arise in practice cannot be taken into account when assessing whether or not a requirement is compatible with the EU Accounting Directives.

*Financial instruments at fair value*

7 According to paragraph 12.8 of the IFRS for SMEs:

At the end of each reporting period, an entity shall measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss, except as follows: equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.

8 Financial instruments within the scope of Section 12 includes according to paragraph 12.3 of the IFRS for SMEs all financial instruments except the following:

(a) those covered by Section 11.

(b) interests in subsidiaries (see Section 9 Consolidated and Separate Financial Statements), associates (see Section 14 Investments in Associates) and joint ventures (see Section 15 Investments in Joint Ventures).

(c) employers' rights and obligations under employee benefit plans (see Section 28 Employee Benefits).

(d) rights under insurance contracts unless the insurance contract could result in a loss to either party as a result of contractual terms that are unrelated to:

(i) changes in the insured risk;

(ii) changes in foreign exchange rates; or

(iii) a default by one of the counterparties.

(e) financial instruments that meet the definition of an entity's own equity (see Section 22 Liabilities and Equity and Section 26 Share-based Payment).

(f) leases (see Section 20 Leases) unless the lease could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to:

(i) changes in the price of the leased asset;

(ii) changes in foreign exchange rates; or

(iii) a default by one of the counterparties.

(g) contracts for contingent consideration in a business combination (see Section 19 Business Combinations and Goodwill). This exemption applies only to the acquirer.

9 According to paragraph 11.7 of the IFRS for SMEs:

A debt instrument that satisfies all of the conditions in (a)–(d) below shall be accounted for in accordance with Section 11:

(a) Returns to the holder are

(i) a fixed amount;

(ii) a fixed rate of return over the life of the instrument;

(iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR); or

(iv) some combination of such fixed rate and variable rates (such as LIBOR plus 200 basis points), provided that both the fixed and variable rates are positive (eg an interest rate swap with a positive fixed rate and negative variable rate would not meet this criterion). For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.

(b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

(c) Contractual provisions that permit the issuer (the debtor) to prepay a debt instrument or permit the holder (the creditor) to put it back to the issuer before maturity are not contingent on future events.

(d) There are no conditional returns or repayment provisions except for the variable rate return described in (a) and prepayment provisions described in (c).

10 Article 32 of the Fourth EU Accounting Directive states:

The items shown in the annual accounts shall be valued in accordance with Articles 34 to 42, which are based on the principle of purchase price or production cost.

11 Article 42a of the Fourth EU Accounting Directive states:

1. By way of derogation from Article 32 and subject to the conditions set out in paragraphs 2 to 4 of this Article, Member States shall permit or require in respect of all companies or any classes of companies valuation at fair value of financial instruments, including derivatives.

Such permission or requirement may be restricted to consolidated accounts as defined in Directive 83/349/EEC.

...

3. Paragraph 1 shall apply only to liabilities that are:
(a) held as part of a trading portfolio; or
(b) derivative financial instruments.

4. Valuation according to paragraph 1 shall not apply to:
(a) to non-derivative financial instruments held to maturity;
(b) to loans and receivables originated by the company and not held for trading purposes; and
(c) to interests in subsidiaries, associated undertakings and joint ventures, equity instruments issued by the company, contracts for contingent consideration in a business combination as well as other financial instruments with such special characteristics that the instruments, according to what is generally accepted, should be accounted for differently from other financial instruments.

5a. By way of derogation from the provisions of paragraphs 3 and 4, Member States may, in accordance with international accounting standards as adopted by Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, as amended until 5 September 2006, permit or require valuation of financial instruments, together with the associated disclosure requirements which are provided for in international accounting standards adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

12 EFRAG notes that according to the Fourth EU Accounting Directive, all financial instruments can be measured at cost. However, when disregarding financial liabilities arising on the transfer of a financial asset and hedged items, financial

liabilities not mentioned in article 42a(3) can only be measured at fair value if this is allowed by article 42a(5a). That is, if the financial liabilities can be measured at fair value according to international accounting standards as adopted by Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, as amended until 5 September 2006.

13 According to (full) IFRS, financial liabilities can be measured at fair value if one of the following conditions (IAS 39.9 as endorsed as of 5 September 2006 and including Commission Regulation (EC) No 1864/2005) are met:

(a) It is classified as held for trading. A financial liability is classified as held for trading if it is:

(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

(iii) a derivative (except for a derivative that is designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IAS 24 Related Party Disclosures (as revised in 2003)), for example the entity’s board of directors and chief executive officer.

14 In cases where a financial liability is not held for trading, measurement at fair value does not eliminate an accounting mismatch and it is not managed on a fair value basis, the liability can only be measured at fair value if the requirements of IAS 39.11A are met. According to IAS 39.11A (as included in Commission Regulation (EC) No 1864/2005):

Notwithstanding paragraph 11, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:

(a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

15 For example, a financial liability could include an embedded derivate – for example a leverage feature – that does not significantly modify the cash flows that otherwise would be required by the contract. According to the IFRS for SMEs paragraph 11.9 this instrument cannot be considered as a basic financial instrument and should therefore be measured at fair value. However, this instrument cannot be measured at fair value according to (full) IFRS or other criteria included in the EU Accounting Directives.

<u>EFRAG Conclusion</u>

16 EFRAG has concluded that

(a) as some financial instruments (for example a financial liability including a leverage feature that does not significantly modify the cash flows that otherwise would be required by the contract) should be measured at fair value according to the IFRS for SMEs; and

(b) as some of these instruments (for example a financial liability including a leverage feature that does not significantly modify the cash flows that otherwise would be required by the contract) cannot be measured at fair value according to the EU Accounting Directives(full) IFRS or other criteria included in;

EFRAG is of the opinion that the requirements of paragraphs 12.7, 12.8 and related references are not compatible with the EU Accounting Directives.

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

17 The IFRS for SMEs uses the terms: consolidated and separate financial statements. As financial statements of an entity that does not have a subsidiary are not separate financial statements, these financial statements are in the following termed non-separate financial statements. Non-consolidated financial statements are separate as well as non-separate financial statements.

18 Paragraph 14.7 of the IFRS for SMEs states:

> An investor shall measure its investments in associates for which there is a published price quotation using the fair value model (see paragraph 14.9).

19 Paragraph 14.10 of the IFRS for SMEs states:

> At each reporting date, an investor shall measure its investments in associates at fair value, with changes in fair value recognised in profit or loss, using the fair valuation guidance in paragraphs 11.27–11.32. An investor using the fair value model shall use the cost model for any investment in an associate for which it is impracticable to measure fair value reliably without undue cost or effort.

20 Similarly, paragraphs 15.12 and 15.15 of the IFRS for SMEs state:

> A venturer shall measure its investments in jointly controlled entities for which there is a published price quotation using the fair value model (see paragraph 15.14).

> At each reporting date, a venturer shall measure its investments in jointly controlled entities at fair value, with changes in fair value recognised in profit or loss, using the fair valuation guidance in paragraphs 11.27–11.32. A venture using the fair value model shall use the cost

model for any investment in a jointly controlled entity for which it is impracticable to measure fair value reliably without undue cost or effort.

21 In relation to the consolidated financial statements, article 33 of the Seventh EU Accounting Directive states:

1. Where an undertaking included in a consolidation exercises a significant influence over the operating and financial policy of an undertaking not included in the consolidation (an associated undertaking) in which it holds a participating interest, as defined in Article 17 of Directive 78/660/EEC, that participating interest shall be shown in the consolidated balance sheet as a separate item with an appropriate heading. An undertaking shall be presumed to exercise a significant influence over another undertaking where it has 20 % or more of the shareholders' or members' voting rights in that undertaking. Article 2 shall apply.

2. When this Article is applied for the first time to a participating interest covered by paragraph 1 above, that participating interest shall be shown in the consolidated balance sheet either:

(a) at its book value calculated in accordance with the valuation rules laid down in Directive 78/660/EEC. The difference between that value and the amount corresponding to the proportion of capital and reserves represented by that participating interest shall be disclosed separately in the consolidated balance sheet or in the notes on the accounts. That difference shall be calculated as at the date as at which that method is used for the first time; or

(b) at an amount corresponding to the proportion of the associated undertaking's capital and reserves represented by that participating interest. The difference between that amount and the book value calculated in accordance with the valuation rules laid down in Directive 78/660/EEC shall be disclosed separately in the consolidated balance sheet or in the notes on the accounts. That difference shall be calculated as at the date as at which that method is used for the first time.

(c) A Member State may prescribe the application of one or other of (a) and (b) above. The consolidated balance sheet or the notes on the accounts must indicate whether (a) or (b) has been used.

(d) In addition, for the purposes of (a) and (b) above, a Member State may require or permit the calculation of the difference as at the date of acquisition of the shares or, where they were acquired in two or more stages, as at the date on which the undertaking became an associated undertaking.

3. Where an associated undertaking's assets or liabilities have been valued by methods other than those used for consolidation in accordance with Article 29 (2), they may, for the purpose of calculating the difference referred to in paragraph 2 (a) or (b) above, be revalued by the methods used for consolidation. Where such revaluation has not been carried out that fact must be disclosed in the notes on the accounts. A Member State may require such revaluation.

4. The book value referred to in paragraph 2 (a) above, or the amount corresponding to the proportion of the associated undertaking's capital and reserves referred to in paragraph 2 (b) above, shall be increased or reduced by the amount of any variation which has taken place during the financial year in the proportion of the associated undertaking's capital and reserves represented by that participating interest; it shall be reduced by the amount of the dividends relating to that participating interest.

5. In so far as the positive difference referred to in paragraph 2 (a) or (b) above cannot be related to any category of assets or liabilities it shall be dealt with in accordance with Articles 30 and 39 (3).
…

7. The eliminations referred to in Article 26 (1) (c) shall be effected in so far as the facts are known or can be ascertained. Article 26 (2) and (3) shall apply.

8. Where an associated undertaking draws up consolidated accounts, the foregoing provisions shall apply to the capital and reserves shown in such consolidated accounts.

9. This Article need not be applied where the participating interest in the capital of the associated undertaking is not material for the purposes of Article 16 (3).

22 Article 32 of the Seventh EU Accounting Directive states:

1. Where an undertaking included in a consolidation manages another undertaking jointly with one or more undertakings not included in that consolidation, a Member State may require or permit the inclusion of that other undertaking in the consolidated accounts in proportion to the rights in its capital held by the undertaking included in the consolidation.

2. Articles 13 to 31 shall apply mutatis mutandis to the proportional consolidation referred to in paragraph 1 above.

3. Where this Article is applied, Article 33 shall not apply if the undertaking proportionally consolidated is an associated undertaking as defined in Article 33.

23 In relation to non-consolidated financial statements, article 32 of the Fourth EU Accounting Directive states:

The items shown in the annual accounts shall be valued in accordance with Articles 34 to 42, which are based on the principle of purchase price or production cost.

24 Article 42a of the Fourth EU Accounting Directive states:

1. By way of derogation from Article 32 and subject to the conditions set out in paragraphs 2 to 4 of this Article, Member States shall permit or require in respect of all companies or any classes of companies valuation at fair value of financial instruments, including derivatives.

Such permission or requirement may be restricted to consolidated accounts as defined in Directive 83/349/EEC.

4. Valuation according to paragraph 1 shall not apply to:
…

(c) to interests in subsidiaries, associated undertakings and joint ventures, equity instruments issued by the company, contracts for contingent consideration in a business combination as well as other financial instruments with such special characteristics that the instruments, according to what is generally accepted, should be accounted for differently from other financial instruments.
....

5a. By way of derogation from the provisions of paragraphs 3 and 4, Member States may, in accordance with international accounting standards as adopted by Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, as amended until 5 September 2006, permit or require valuation of financial instruments, together with the associated disclosure requirements which are provided for in international accounting standards adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

EFRAG Conclusions

25 In relation to measurement of associates in the consolidated financial statements, EFRAG has concluded that:

(a) as the IFRS for SMEs requires that associates for which there is a published price quotation should be measured using the fair value model; and

(b) as the EU Accounting Directives would require associates to be measured using the equity method

paragraphs 14.7 and 14.10 of the IFRS for SMEs are not compatible with the EU Accounting Directives.

26 In relation to measurement of associates in non-separate financial statements, EFRAG has concluded that:

(a) As the IFRS for SMEs requires that associates for which there is a published price quotation should be measured using the fair value model;

(b) as the EU Accounting Directives would only allow measurement of associates at fair value if this is allowed by (full) IFRS as endorsed as of 5 September 2006;

(c) as (full) IFRS as endorsed as of 5 September 2006 would generally not allow associates to be measured at fair value in non-separate financial statements

paragraph 14.7 and 14.10 of the IFRS for SMEs are not compatible with the EU Accounting Directives.

27 In relation to measurement of jointly controlled entities (that would otherwise be associates) in the consolidated financial statements, EFRAG has concluded that:

(a) as the IFRS for SMEs requires that jointly controlled entities for which there is a published price quotation should be measured using the fair value model; and

(b) as the EU Accounting Directives would require jointly controlled entities to be measured using the equity method or pro-rata consolidation;

paragraphs 15.12 and 15.15 of the IFRS for SMEs are not compatible with the EU Accounting Directives.

28 In relation to measurement of jointly controlled entities (that would otherwise be associates) in non-separate financial statements, EFRAG has concluded that:

(a) as the IFRS for SMEs requires that jointly controlled entities, for which there is a published price quotation, should be measured using the fair value model;

(b) as the EU Accounting Directives would only allow measurement of jointly controlled entities at fair value if this is allowed by (full) IFRS as endorsed as of 5 September 2006;

(c) as (full) IFRS as endorsed as of 5 September 2006 would generally not allow jointly controlled entities to be measured at fair value in non-separate financial statements

29 paragraphs 15.12 and 15.15 of the IFRS for SMEs are not compatible with the EU Accounting Directives.

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

30 Paragraph 19.23 of the IFRS for SMEs states:

> After initial recognition, the acquirer shall measure goodwill acquired in a business combination at cost less accumulated amortisation and accumulated impairment losses:
>
> (a) An entity shall follow the principles in paragraphs 18.19–18.24 for amortisation of goodwill. If an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall be presumed to be ten years.
>
> (b) An entity shall follow Section 27 Impairment of Assets for recognising and measuring the impairment of goodwill.

31 Article 30 of the Seventh EU Accounting Directive states:

> 1. A separate item as defined in Article 19 (1) (c) which corresponds to a positive consolidation difference shall be dealt with in accordance with the rules laid down in Directive 78/660/EEC for the item 'goodwill'.
>
> 2. A Member State may permit a positive consolidation difference to be immediately and clearly deducted from reserves.

32 Article 34.1 (a) of the Fourth EU Accounting Directive states:

> Where national law authorizes the inclusion of formation expenses under 'Assets', they must be written off within a maximum period of five years.

33 Article 37.2 of the Fourth EU Accounting Directive states:

> Article 34 (1) (a) shall apply to goodwill. The Member States may, however, permit companies to write goodwill off systematically over a limited period exceeding five years provided that this period does not exceed the useful economic life of the asset and is disclosed in the notes on the accounts together with the supporting reasons therefore.

EFRAG Conclusion

34 EFRAG has concluded that:

(a) as the IFRS for SMEs deems the useful life of goodwill to be ten years if an entity is unable to make a reliable estimate of its useful life (if, for example, an entity assumes the useful life of goodwill to be between 2 and 11 years, the IFRS for SMEs would require 10 years to be used as the useful life); and

(b) as the Fourth EU Accounting Directive would require goodwill to be written off within five years unless a longer useful life can be supported (if, for example, an entity assumes the useful life of goodwill to be between 2 and 11 years, the Fourth EU Accounting Directive would require 5 years to be used as the useful life);

paragraph 19.23.a of the IFRS for SMEs is not compatible with the EU Accounting Directives.

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

35 Paragraph 19.24 of the IFRS for SMEs states:

If the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities recognised in accordance with paragraph 19.14 exceeds the cost of the business combination (sometimes referred to as 'negative goodwill'), the acquirer shall:

(a) reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination, and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

36 Article 31 of the Seventh EU Accounting Directive states:

An amount shown as a separate item, as defined in Article 19 (1) (c), which corresponds to a negative consolidation difference may be transferred to the consolidated profit-and-loss account only:

(a) where that difference corresponds to the expectation at the date of acquisition of unfavourable future results in that undertaking, or to the expectation of costs which that undertaking would incur, in so far as such an expectation materializes; or

(b) in so far as such a difference corresponds to a realized gain.

<u>EFRAG Conclusion</u>

37 EFRAG has concluded that:

(a) as the IFRS for SMEs require immediate recognition in profit or loss negative goodwill; and

(b) as the EU Accounting Directives would not allow negative goodwill to be recognised immediately in profit or loss if the negative goodwill for example relates to expectation of unfavourable future results

paragraph 19.24 of the IFRS for SMEs is not compatible with the EU Accounting Directives.

*Reversal of goodwill impairment losses*

38 According to paragraph 27.28 of the IFRS for SMEs:

An impairment loss recognised for goodwill shall not be reversed in a subsequent period.

39 Article 35 of the Fourth EU Accounting Directive states:

(a) Fixed assets must be valued at purchase price or production cost, without prejudice to (b) and (c) below.

(b) The purchase price or production cost of fixed assets with limited useful economic lives must be reduced by value adjustments calculated to write off the value of such assets systematically over their useful economic lives.
(c) (aa) Value adjustments may be made in respect of financial fixed assets, so that they are valued at the lower figure to be attributed to them at the balance sheet date.
(bb)Value adjustments must be made in respect of fixed assets, whether their useful economic lives are limited or not, so that they are valued at the lower figure to be attributed to them at the balance sheet date if it is expected that the reduction in their value will be permanent.
….
(dd)Valuation at the lower of the values provided for in (aa) and (bb) may not be continued if the reasons for which the value adjustments were made have ceased to apply.

EFRAG Conclusion

40 EFRAG has concluded that:

(a) as the IFRS for SMEs specifically prohibits reversal of goodwill impairment; and

(b) as the Fourth EU Accounting Directive specifically requires goodwill impairment losses (valuation at the lower of the values provided for in article 35 (c) (aa) and (bb)) to be reversed if the reasons for which they have been recognised have ceased to apply;

41 the requirement of paragraph 27.28 of the IFRS for SMEs is incompatible with the EU Accounting Directives.

42 EFRAG acknowledges that in some cases it could be difficult to distinguish between recognition of internally generated goodwill and reversal of goodwill impairment losses. The EU Accounting Directives would not allow internally generated goodwill to be recognised. It could, therefore, be argued that in order not to recognise internally generated goodwill, goodwill impairment losses could not be reversed. However, it is EFRAG's view that in some cases it could be clear that reversal of goodwill impairment losses is not recognition of internally generated goodwill. Accordingly, in these cases the EU Accounting Directives would require reversal of goodwill impairment losses.

**Questions to constituents**

*Paragraphs of the IFRS for SMEs that are not incompatible with the EU Accounting Directives*

| Q1 | Do you think that some of the paragraphs of the IFRS for SMEs, EFRAG has identified as being incompatible with the EU Accounting Directives, are compatible with the EU Accounting Directives? (If so, why?) |
|---|---|

*Paragraphs of the IFRS for SMEs that may be incompatible with the EU Accounting Directives*

A minority of EFRAG members have identified these additional paragraphs of the IFRS for SMEs they think may be incompatible with the EU Accounting Directives:

Potential voting rights

(a) In relation to when an entity should include another entity in the consolidated financial statements, paragraph 9.6 of the IFRS for SMEs states:

> Control can also be achieved by having options or convertible instruments that are currently exercisable or by having an agent with the ability to direct the activities for the benefit of the controlling entity.

Article 1.1 of the Seventh EU Accounting Directive states:

Member State shall require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking):

(a) has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); or

(b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; or

(c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for each contracts or clauses shall not be required to apply this provision; or [...]

Article 1.2 of the Seventh EU Accounting Directive states:

Apart from the cases mentioned in paragraph 1 the Member States may require any undertaking governed by their national law to draw up consolidated accounts and a consolidated annual report if:

(a) that undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking); or [...]

According to the minority of EFRAG members, the EU Accounting Directives do not allow entities to take options and convertible instruments into account when determining whether or not to include an entity in the consolidation.

The majority of EFRAG members either think that

(i) The EU Accounting Directives are silent on the issue and accordingly do not prohibit entities to take options and convertible instruments into consideration when determining whether or not to consolidate an entity. Accordingly, paragraph 9.6 of the IFRS for SMEs cannot be said to be incompatible with the EU Accounting Directives.

or

(ii) The EU Accounting Directives use the word ‘right’ (right to) in many places where control is discussed. This implies that also options and convertible instruments shall be taken into consideration when assessing whether or not to include an entity in the consolidation.

‘Less likely than not’ liabilities

(b) Paragraph 21.4 of the IFRS for SMEs states:

An entity shall recognise a provision only when:

(a) the entity has an obligation at the reporting date as a result of a past event;
(b) it is probable (ie more likely than not) that the entity will be required to transfer economic benefits in settlement; and
(c) the amount of the obligation can be estimated reliably.

Paragraph 19.14 of the IFRS for SMEs states:

The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets and liabilities and a provision for those contingent liabilities that satisfy the recognition criteria in paragraph 19.20 at their fair values at that date [...]

Paragraph 29.24 of the IFRS for SMEs states:

Uncertainty about whether the tax authorities will accept the amounts reported to them by the entity affects the amount of current tax and deferred tax. An entity shall measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will review the amounts reported and have full knowledge of all relevant information. Changes in the probability-weighted average amount of all possible outcomes shall be based on new information, not a new interpretation by the entity of previously available information.

Article 20.1 of the Fourth EU Accounting Directive states states:

Provisions are intended to cover liabilities the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise.

A minority of EFRAG members think that 'likely' in article 20.1 of the Fourth EU Accounting Directive should either:

(i) Be interpreted as 'probable' in paragraph 21.4 of the IFRS for SMEs. In that case it would not be compatible with the EU Accounting Directives to recognise contingent liabilities acquired in a business combination (paragraph 19.14 of the IFRS for SMEs) and current tax and deferred tax using the probability-weighted average amount (paragraph 29.24 of the IFRS for SMEs) when it is not probable that these liabilities will arise.

(ii) Or be interpreted as a very low probability. In that case it would be incompatible with the EU Accounting Directives only to recognise probable provisions (paragraph 21.4 of the IFRS for SMEs).

The majority of EFRAG members do not think the requirements of the IFRS for SMEs on the issues are incompatible with the Council Directives, although they do not agree on the reasons.

(i) Some think that 'likely' in article 20.1 of the Fourth EU Accounting Directive should be interpreted as a very low probability. However, as article 20.1 of the Fourth EU Accounting Directive only defines provisions, but does not include any recognition criteria, the recognition criteria of the IFRS for SMEs can be applied. Accordingly, it would be compatible with the EU Accounting Directives only to recognise probable provisions.

(ii) Some think that 'likely' in article 20.1 of the Fourth EU Accounting Directive should be interpreted as 'probable' in paragraph 21.4 of the

IFRS for SMEs. However, the Council Directives are silent on how to account for contingent liabilities acquired in a business combination and on how to account for uncertainty about whether the tax authorities will accept the amounts reported to them by the entity. Accordingly, paragraphs 19.14 and 29.24 of the IFRS for SMEs would not be incompatible with the EU Accounting Directives.

and

(iii) Some think that 'likely' in article 20.1 of the Fourth EU Accounting Directive should be interpreted as 'probable' in paragraph 21.4 of the IFRS for SMEs. However, it would be in accordance with the 'prudence principle' of the EU Accounting Directives also to recognise contingent liabilities acquired in a business combination (paragraph 19.14 of the IFRS for SMEs) and current tax and deferred tax using the probability-weighted average amount (paragraph 29.24 of the IFRS for SMEs) when it is not probable that these liabilities will arise.

| Q2 | Do you think that paragraphs 9.6, 19.14, 21.4 and/or 29.24 are incompatible with the EU Accounting Directives? (If so, which and why?) |
|---|---|

*Paragraphs of the IFRS for SMEs that are incompatible with the EU Accounting Directives*

| Q3 | Do you think there are other paragraphs of the IFRS for SMEs that are incompatible with the Council Directives? (If so, why?) |
|---|---|

*Different language versions of the EU Accounting Directives*

| Q4 | Are you aware of situations where the conclusions reached by EFRAG would have been different had another language version than the English version been applied in the analysis? (If so, what conclusion would be different and why?) |
|---|---|

*Other issues*

To stimulate the discussion, EFRAG has on its website published its working paper, comparing each paragraph of the IFRS for SMEs with the requirements of the EU Accounting Directives.

| Q5 | Do you have other comments in relation to EFRAG's conclusions and their bases (including conclusions stated in EFRAG's working paper)? |
|---|---|