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DSR – öffentliche SITZUNGSUNTERLAGE

DSR-Sitzung:	**143. / 13.04.2010 / 15:15 – 16:45 Uhr**
TOP:	**11 – EFRAG's Draft Advice**
Thema:	**EFRAG's Analyse zur Übereinstimmung des IFRS for SMEs mit den EU-Bilanzrichtlinien**
Papier:	**142_11a DSR_Stellungnahmeentwurf**

1 Der nachfolgende Stellungnahmeentwurf des DSR zu EFRAG's Draft Advice on compatability of the IFRS for SMEs and the EU Accounting Directives basiert auf den Entscheidungen des DSR in seiner 142. Sitzung (März 2010).

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Berlin, 8. April 2010

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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 do not provide a sufficient basis on which to reject the IFRS for SMEs as not being compatible with the EU Accounting Directives. In our view the IFRS for SMEs should therefore be accepted by the EU Commission.

Two aspects confirm this overall impression. For one, 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. Furthermore, some of the requirements might also be subject to the discussion concerning the revision of the EU Accounting Directives. The outcome of

that discussion could further reduce incompatibilities which are now pointed out in EFRAG's analysis.

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

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Appendix

Extraordinary items

2 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.

3 We would suggest to the EU-Commission, however, that the presentation of extraordinary items is discussed in the course of revision of the EU Accounting Directives. In our view there are valid reasons for not allowing extraordinary items to be presented in the income statement.

Financial instruments at fair value

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

5 Firstly, in our opinion EFRAG in its analysis has not 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 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.

6 EFRAG however fails to acknowledge that IAS 39.12-13 provide yet another exception to the exception from the general option to designate an entire hybrid contract 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

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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.

7 It is 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 the SME 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. There would be no incompatibility between the IFRS for SMEs and the EU Accounting Directives.

8 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 companies 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.

9 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

10 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.

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

12 However, to our understanding EFRAG fails to acknowledge 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.

13 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"*.

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

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

15 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 written off within a maximum period of 5 years. Member States may, however, permit companies to write goodwill off over a longer period if the useful economic life is not exceeded.

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

17 To our understanding EFRAG's example does not contribute to an understanding of the incompatibility that might exist: If the company assumes the useful life to be between 2 and 11 years the company is not "unable to make a reliable estimate of the useful life". Similarly, if a company assumes the useful life to be between 2 and 5 years, it is not unable to make a reliable estimate only because it cannot identify the useful life more specifically. In both cases it is therefore unlikely (or even impossible) that under IFRS for SMEs the entity would have to assume the useful life to be 10 years.

18 Along this line of argument, we also question whether the application of the EU Accounting Directives would necessarily result in the useful life being 5 years. Taking the example of a company not being able to specify the useful life of goodwill, but assuming it to be between 7 and 10 years. Following EFRAG's argument, these companies would amortize goodwill over 5 years. However, this company 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 7 and 10 years will be applied; a 5year useful life, however, seems out of the question.

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

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

20 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 would like to add, however, that negative goodwill rarely occurs in practice. Nevertheless, we agree with EFRAG's approach (as set out in par. 6 of EFRAG's draft letter) that the frequency of certain issues does not affect the overall conclusion that there remains a difference between the IFRS for SMEs and the EU Accounting Directives.

Reversal of goodwill impairment losses

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

22 To our understanding EFRAG suggests that according to the EU Accounting Directives goodwill should be accounted for in line with all other fixed assets. Therefore, irrespective of the lack of an explicit requirement on the reversal of goodwill impairment losses, it should be accounted for as all other fixed assets. In our view, however, two aspects are in contrast with the assumption to treat goodwill like all other fixed assets.

23 Firstly, the EU Accounting Directives differentiates between goodwill and other fixed assets when it refers to "formation expenses" (see article 37.2 of the fourth accounting directive) for the subsequent measurement of goodwill (maximum period of five years, instead of useful life as other fixed assets).

24 Secondly, different from other fixed assets the goodwill stands out due to some specific characteristics. Unlike with other fixed assets it is very difficult to distinguish between internally generated goodwill and acquired goodwill in case of an increase in value of a once impaired goodwill. There might be circumstances in which an impairment of goodwill is reversed (acquired goodwill would be recognized). This could be the case for goodwill which was impaired due to the external indicators of 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 very impairment assumed some time ago. However, very often the increase in the value of goodwill will relate to specific business decisions of the entity that once acquired the goodwill. In the end it is very difficult to establish operational principles for this distinction. Both IFRS for SMEs and EU Accounting Directives emphasize that internally generated goodwill should not be recognized.

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25 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). We therefore conclude that the IFRS for SMEs is in line with the EU Accounting Directives regarding the prohibition of reversal of goodwill impairment.

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