EFRAG
European Financial Reporting Advisory Group

Pierre Delsaux
Director
European Commission
B-1049 Brussels

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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 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).

The European Commission has requested that incompatibility, for the purpose of the analysis, is considered to mean that an accounting treatment required by the IFRS for SMEs is not permitted under the EU Accounting Directives. EFRAG has completed its analysis under its due process procedures, including the issuance of a draft letter for comment. A feedback statement on the comment received is provided as appendix to this letter.

EFRAG's overall conclusions should not be read independently from the detailed working paper explaining how every detailed conclusion has been reached. The complete set of documents (letter, feedback statement and detailed working paper) will be available to the public on the EFRAG's website in the "Other projects" section.

In order to avoid any possible misunderstanding of how its analysis was conducted or of how its conclusions have been reached and in the light of the comments received, EFRAG wishes to emphasise the following:

(a) The Directive 2003/51/EC of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/349/EEC and 91/674/EEC states in its preamble: "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". After discussing and consulting with European Commission staff it was decided that EFRAG should not challenge this statement. Accordingly, EFRAG has not carried out any assessment of the requirements of the IFRS for SMEs that are identical to the requirements of IAS at 1 May 2002.

(b) Where the IFRS for SMEs provides different possible options, no incompatibility is deemed to exist as long as at least one of those possible options is compatible with the EU Accounting Directives. Accordingly, the list of incompatibilities identified below does not include options in the IFRS for SMEs which are incompatible with the EU Accounting Directives, as long as at least one alternative option is compatible with the EU Accounting Directives.

(c) EFRAG has compared the detailed requirements of the IFRS for SMEs with those of the EU Accounting Directives (that is the Fourth and Seventh EU Company Law Directives) only. As a result, any possible incompatibility between the IFRS for SMEs and other EU Directives are not listed below.

(d) When assessing whether the requirements of the IFRS for SMEs were incompatible with the EU Accounting Directives, EFRAG has not taken into account whether the incompatibilities would arise in practice.

(e) In some cases, EFRAG has assessed that the EU Accounting Directives were not clear and therefore could be interpreted in different ways. If one of these interpretations would result in the IFRS for SMEs not being incompatible with the EU Accounting Directives, the requirement has not been included in EFRAG's list of incompatible requirements. The appropriate justification is provided in the document labelled "Compatibility issues – EFRAG working paper". EFRAG wishes to emphasise that this working paper as well as its feedback statement are integral to the analysis.

(f) EFRAG has performed its assessment from a technical accounting perspective only. For this reason and because of the limitations identified above, EFRAG's assessment is not an assessment of the outcome of a potential EU court case.

(g) In its analysis EFRAG has not considered how the EU Accounting Directives have been implemented in the EU Member States.

(h) 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. 4 -7).

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. 8 - 18). (Par. 11.2 of the 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 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. 19 - 23).

4 The requirement to recognise immediately in profit or loss any negative goodwill (IFRS for SMEs par. 19.24) (see Appendix par. 24 - 26).

5 The requirement to present the amount receivable from equity instruments issued before the entity receives the cash or other resources, as an offset to equity and not as an asset (IFRS for SMEs par. 22.7(a))(see Appendix par. 27 - 29).

6 The prohibition to reverse an impairment loss recognised for goodwill (IFRS for SMEs par. 27.28) (see Appendix par. 30 - 33).

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

Yours sincerely

Françoise Flores
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

2 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.

3 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.

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

Extraordinary items

4 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.

5 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>

6 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.

7 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 practice and that the issue could therefore be neglected. However, the frequency by which an issue would arise in practice has not been taken into account in this assessment.

Financial instruments at fair value

8 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.

9 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.

10 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).

11 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.

12 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.

13 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.

14 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.

15 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.

16 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 unless:

(a) the economic characteristics and risks of the leverage feature (the embedded derivative) are not closely related to the economic characteristic, and

(b) risks of the host contract and that an entity is unable to determine reliably the fair value of an embedded derivative.

EFRAG Conclusion

17 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 always 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.

18 EFRAG notes that the IFRS for SMEs includes an option to apply IAS 39 instead of the requirements in the IFRS for SMEs for financial instruments. It could therefore be argued that if the requirements of IAS 39 would be compatible with the EU Accounting Directives, there would not be an incompatibility issue. However, as the IFRS for SMEs does not refer to a specific version of IAS 39, EFRAG has not been able to assess whether 'IAS 39' would be 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

19 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.

20 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.

21 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.

22 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

23 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; 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;

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

24 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.

25 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.

EFRAG Conclusion

26 EFRAG has concluded that:

(a) as the IFRS for SMEs requires immediate recognition in profit or loss of 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.

Presenting unpaid capital as an offset to equity

27 Paragraph 22.7 of the IFRS for SMEs states:

An entity shall recognise the issue of shares or other equity instruments as equity when it issues those instruments and another party is obliged to provide cash or other resources to the entity in exchange for the instruments.

(a) If the equity instruments are issued before the entity receives the cash or other resources, the entity shall present the amount receivable as an offset to equity in its statement of financial position, not as an asset.

28 In the layout schemes related to the balance sheet (article 9 and 10) of the Fourth EU Accounting Directive the following items should be shown separately:

A. Subscribed capital unpaid

of which there has been called

(unless national law provides that called-up capital be shown under 'Liabilities'. In that case, the part of the capital called but not yet paid must appear as an asset either under A or under D (II) (5)).

…

D. Current assets

II. Debtors

5. Subscribed capital called but not paid (unless national law provides that called-up capital be shown as an asset under A).

…

Liabilities

A. Capital and reserves

I. Subscribed capital

(unless national law provides for called-up capital to be shown under this item. In that case, the amounts of subscribed capital and paid-up capital must be shown separately).

EFRAG Conclusion

29 EFRAG has concluded that:

(a) as the IFRS for SMEs requires unpaid called-up capital to be presented as an offset to equity and not as an asset; and

(b) as the EU Accounting Directives would require unpaid called-up capital to be presented as an asset

paragraph 22.7 of the IFRS for SMEs is not compatible with the EU Accounting Directives.

Reversal of goodwill impairment losses

30 According to paragraph 27.28 of the IFRS for SMEs:

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

31 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

32 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;

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

33 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.