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Our ref: ICAEW Rep 40/10

Your ref:

Ms Françoise Flores
Chair
Technical Expert Group
European Financial Reporting Advisory Group (EFRAG)
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By email: commentletter@efrag.org

Dear Ms Flores

COMPATIBILITY OF THE IFRS FOR SMEs AND THE DIRECTIVES

The ICAEW is pleased to respond to your request for comments on *Draft advice on compatibility of the IFRS for SMEs and the EU Accounting Directives.*

Please do not hesitate to contact me or my colleague Pablo Portugal at the ICAEW Office in Brussels (pablo.portugal@icaew.com; 022303272), should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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EFRAG CONSULTATION ON DRAFT ADVICE ON COMPATIBILITY OF THE IFRS FOR SMEs AND THE EU ACCOUNTING DIRECTIVES

Memorandum of comment submitted in April 2010 by The Institute of Chartered Accountants in England and Wales in response to EFRAG's consultation on *Draft advice on compatibility of the IFRS for SMEs and the EU Accounting Directives*, published in March 2010

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INTRODUCTION

1. The ICAEW welcomes the opportunity to comment on the consultation on *Draft advice on compatibility of the IFRS for SMEs and the EU Accounting Directives* published by EFRAG.

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the ICAEW, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms.

5. The ICAEW has been present in Brussels for over a decade, facilitating dialogue among stakeholders on key public policy issues and providing technical advice across a broad range of topics including financial reporting, audit, business law, ethics, corporate governance, financial services, tax, enterprise, skills and sustainability. The ICAEW is listed in the European Commission's Register of Interest Representatives (identification number: 7719382720-34).

OVERALL VIEW

6. We welcome the opportunity to comment on EFRAG's draft advice to the European Commission on incomptabilities between the IFRS for SMEs and the EU Accounting Directives. We commend the rigorous analysis undertaken and the efforts of EFRAG to engage with its stakeholders through this consultation.

7. We note that the analysis has identified a small number of incompatibilities, which would arise in rare circumstances. It should thus be possible for Member States who wish to use IFRS for SMEs as the basis of their national GAAP to do so, having taken account of the issues identified. The analysis should also aid the ongoing revision of the Directives, which are in any event overdue for review and updating.

RESPONSES TO SPECIFIC QUESTIONS

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?)

The prohibition to present or describe any items of income and expense as 'extraordinary items'

8. We agree that technically there seems to be an incompatibility with the definition, but note that the IFRS for SMEs only allows a separate line item for large or unusual items and a subtotal of profit or loss before such items. Thus the prohibition in reality is using the word ‘extraordinary’.

The requirement to measure financial instruments within the scope of section 12 of the IFRS for SMEs (non-basic financial instruments) at fair value

9. We agree that there are circumstances, as illustrated in the EFRAG working paper, where a conflict exists as the IFRS for SMEs requires certain liabilities that do not qualify as ‘basic financial instruments’ to be accounted for at fair value through profit or loss in some circumstances where this is not permitted by IAS 39. Such circumstances will be rare in practice and most SMEs applying the financial instruments requirements of the standard will also comply with the requirements of the Directives.

10. We are mindful that EFRAG’s analysis has not sought to assess whether the option to follow the requirements of IAS 39 would result in incompatibilities with the Accounting Directives. We note that this incompatibility would disappear if an entity were to follow IAS 39, but acknowledge that it is unlikely that most SMEs would chose to do this.

The requirement to measure associates for which there is a published price quotation using the fair value model

11. In our view there is no incompatibility on the issue of the treatment of associates and joint ventures in *non-separate* financial statements as such accounts are not dealt with by the Directives. The 7th Directive is addressed to companies with a subsidiary, not companies that have only associates or joint ventures. The 4th Directive concerns separate accounts, not non-separate accounts. Whilst some Member States might require non-separate accounts under certain circumstances or may specify that non-separate accounts are to be regarded as consolidated accounts, these are not required by EU law and hence there can be no incompatibility with the IFRS for SMEs on this topic.

12. We think, regardless of the above rationale, that EFRAG’s conclusion that the IFRS for SMEs is incompatible with the Directives in this area is incorrect. EFRAG reaches this conclusion because FVTPL is not permitted by the Directives for investments in associates either in consolidated accounts or individual accounts. However, paragraph 14.7 of the IFRS for SMEs is grouped together with 14.5 and 14.6 under the heading “Cost model”. Under the standard, only those electing to apply the cost model need to consider applying 14.7. If they elect to apply equity accounting under 14.4, they do not have to consider 14.7. In other words, a company is always free to choose a policy of equity accounting in both consolidated and “non-separate” financial statements even if there is a published price for the investment. As this is also permitted by the Directives, there is no incompatibility.

13. A contrary view might be reached through considering BC117. BC117 states that *any* investment in an associate or jointly controlled entity for which there is a published price quotation must be measured at fair value through profit or loss. This is unhelpful but cannot override the clear requirements of the standard itself. Also, the disclosure requirement in paragraph 14.12(c) envisages the disclosure of the fair value of investments in associates that have been accounted for using the equity method for which there is a published price quotation.

14. We also note the following in support of our analysis:

(i). In relation to the separate financial statements of a parent, investments in associates must be stated at either cost or FVTPL (see 9.26). EFRAG concludes that both of the alternatives are consistent with the Directives. The reason that the answer re FVTPL is different from that for individual accounts is that IAS 27 permits FVTPL in the case of separate financial statements of a parent. IAS 28 does not permit FVTPL. The Directives permit financial assets to be accounted for at FVTPL where this is permitted by full IFRSs provided that the “related disclosures” of full IFRSs are made.

(ii). 14.4 says that "an investor shall account for *all* of its investments in associates using one of the following [models]." Thus having chosen a model a reporting entity then follows those rules without considering the rules given under other models. 14.7 is merely a signpost to those following the cost model to use fair value for listed associates.

(iii). Finally, BC 117 itself does refer to the Board opining that "fair values are more relevant than cost-based measurements" - which we take to refer to the cost model and not to equity accounting.

Therefore we conclude that there is good evidence to support the view that there is no incompatibility, that listed associates (and jointly controlled entities) can be equity accounted, and that BC 117 is unfortunately worded.

The requirement to measure investments in jointly controlled entities for which there is a published price quotation using the fair value model

15. Please see our answer above regarding associates. On the same grounds, we do not think there is any incompatibility regarding jointly controlled entities.

The requirement to presume the useful life of goodwill to be ten years if an entity is unable to make an estimate of the useful life

16. We doubt that there is a real incompatibility here. It seems likely that any incompatibility could be avoided in practice by the entity involved deciding that the short economic life of its goodwill could be reliably estimated. If this is not the case, paragraph 18.18 refers to amortisation and to impairment testing, and 8.24 provides for annual reviews of useful lives. Therefore, if an entity used too long a life, this should soon be identified and rectified.

17. An entity is most likely to be unable to make a reliable estimate of the useful life of goodwill when that life is long, but uncertain. It is unclear how a reporting entity applying the Directives should deal with such uncertainty. However, it seems reasonable to make a prudent estimate, at the shorter end of the range, and this is the practical effect of the requirement in the IFRS for SMEs.

The requirement to recognise immediately in profit or loss any negative goodwill

18. We agree with EFRAG’s analysis that there is a possible conflict.

The prohibition to reverse an impairment loss recognised for goodwill

19. We agree that this is a conflict, and that the 'may not' means 'must not'. However, it would only be a problem when the impairment review supported a value of goodwill that was indisputably the same goodwill that was previously written down - if it were

internally generated goodwill it could not be recognised on the balance sheet.

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?)

20. No, we do not believe that any of paragraphs 9.6, 19.14, 21.4 and/or 29.24 are incompatible with the Directives.

    We have considered at some length the possible incompatabiity with paragraphs 21.4/29.24 of the IFRS for SMEs. Our thinking on this issue is set out below:

    - Article 20 of the 4th Directive appears in Section 4 of the Directive. Items in this section do not relate to recognition or measurement, but rather to where types of items are to be presented in the formats. So Article 20 does not define any particular accounting for provisions, but only where the amounts would be presented if they were recognised.

    - Measurement rules for provisions in the 4th Directive are to be found in Section 7, Valuation Rules, where Article 31 requires a prudent basis and that account must be taken of all liabilities arising. We read this as meaning that an entity should not omit from consideration anything that qualifies as a liability. Article 42 requires that provisions may not exceed in amount the sums that are necessary.

    - 'Likely to be incurred' follows the normal English rendering of likely, to include probabilities of less than 50%. This is illustrated by the equivalence, in the IFRS for SME Glossary, of 'probable' with 'more likely than not'. Probable is thus more than 50% probability, whereas by contrast there are things that are likely, but are not probable.

    - What the IFRS for SMEs calls contingent liabilities (ie, provisions where the likelihood of an outflow of economic benefits is less than 50%) are therefore included in Article 20's definition of the scope of provisions. Because provisions are also liabilities in Article 20, entities complying with the Directive are required by Article 31(1) (c) (bb) to take account of them, and therefore consider at what amounts they should be recognised.

    - Application of IFRS for SMEs 2.39 and 21.4 results in considering contingent liabilities and determining that such liabilities should be accounted for at an amount of zero.

    - In application of IFRS for SMEs 14.8 and 19.7 (applying the purchase method), the contingent liabilities of the acquiree are considered and determined to be accounted for at an amount greater than zero, ie their fair value.

    - Application of IFRS for SMEs 29.24 gives rise to considering a probability-weighted amount, in a way not dissimilar to that for provisions.

21. A challenge to the above approach would be that it results in contingent liabilities being measured differently when they arise from different circumstances. However, that is not contrary to the Directive (for example purchased goodwill and internally generated goodwill are measured differently).

    The consequence of the above logic would be that there would be no incompatibility between the Directive and IFRS for SMEs around the issue of 'likely to be incurred'.

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

22. No, we do not believe that there are any additional incompatibilities.

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?)

23. We do not offer any views on this question.

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

24. We have no further comments.

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