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Dear Francoise

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

I am responding on behalf of the Accounting Standards Board (ASB) to the above letter setting out EFRAG's draft advice on the compatibility of the IFRS for SMEs and the EU Accounting Directives. The ASB would like to express its appreciation of the very thorough approach adopted by EFRAG in preparing its advice, as set out in the accompanying working paper comparing each paragraph of the IFRS for SMEs with the requirements of the Directives.

The ASB notes that EFRAG has undertaken its analysis from a technical accounting, rather than any wider policy, perspective and has not taken into account the frequency by which an issue would arise in practice. While we acknowledge and understand the approach taken by EFRAG, the ASB hopes that the analysis will provide a useful input to the European Commission's review of the Accounting Directives and the role that the IFRS for SMEs might play in the future reporting requirements for EU entities. As the ASB made clear in its response of 25 February to the Commission's consultation paper on the IFRS for SMEs[1], any incompatibilities identified between the IFRS for SMEs and the Accounting Directives should be removing by revising the Directives.

The responses to EFRAG's questions are attached in the appendix to this letter. As you will see from the appendix, we do not agree with EFRAG's conclusions on a number of the incompatibilities identified and a number of the others, in our view, will occur rarely – if ever – in practice.

[1] The response can be accessed at: http://www.frc.org.uk/asb/publications/other.cfm?cat=76.

Should you have any queries regarding our response please contact me or David Loweth, Technical Director, on 020 7492 2420 or by email d.loweth@frc-asb.org.uk.

Yours sincerely

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Appendix

Compatibility of the EU Accounting Directives and the IFRS for SMEs

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?)

Incompatibility 1: Extraordinary items:

We agree that, technically, this is an incompatibility. While we acknowledge that EFRAG has not taken into account the frequency by which an issue would arise in practice, the ASB's view is that this is, in practice, not an incompatibility. UK GAAP has had an effective prohibition on extraordinary items for many years which is achieved by defining 'ordinary activities' so broadly that it is not possible to envisage a company undertaking any other activities.

Incompatibility 2: Financial Instruments at Fair Value.

As with the issue above, we acknowledge that this is an incompatibility, but one which again is unlikely to occur in practice. The IFRS for SMEs requires certain liabilities that do not qualify as 'basic financial instruments' to be accounted for at fair value through profit and loss in circumstances where this is not permitted by IAS 39. However, the advice we have had would suggest that such circumstances will be rare and most SMEs will be able to apply the financial requirements of the IFRS for SMEs while remaining compliant with the Directives.

Incompatibilities 3 & 4: Measurement of investments in associates and joint ventures for which there is a published price quotation at fair value in non-separate financial statements.

We do not believe that these are incompatibilities. Paragraphs 14.5 to 14.7 of the IFRS for SMEs are only relevant when the cost model is applied. This is clear from the heading above those paragraphs. The effect of paragraph 14.7 is therefore to require an associate for which there is a published price to be accounted for at fair value when the cost model has been selected as an accounting policy choice. The IFRS permits the use of equity accounting in both consolidated and 'non-separate' financial statements. This is also permitted by the Directives so there is no incompatibility.

The ASB is aware of some confusion over this point brought about by the drafting of paragraph BC 117 of the IFRS for SMEs. However, paragraph 14.12(c) requires 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. Such a policy must therefore be permitted within the IFRS for SMEs.

Incompatibility 5: Amortisation of goodwill over ten years when an entity is unable to make a reliable estimate of the useful life.

We do not believe that this is an incompatibility. Paragraph 18.18 of the IFRS for SMEs refers to amortisation and to impairment testing. Therefore it is to be hoped that if an entity used too long a life it would be caught by the need for an impairment test. Furthermore paragraph 18.24 provides for annual reviews of useful lives. So any misuse should be short-lived.

In our view, the IFRS for SMEs does not intend ever to allow amortisation in excess of useful estimated life. That would seem to us to be in line with the provisions of Article 37.2 of the 4th Directive which permits Member States to 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". Under UK GAAP, there is a rebuttable assumption that the useful economic life of purchased goodwill and intangible assets is limited to a period of 20 years or less.

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 there is uncertainty about how long. It is unclear how a company applying the Directives should deal with such uncertainty but the ASB believes that it is appropriate to make a prudent estimate (i.e. at the shorter end of the range). This is the practical effect of the requirement in the IFRS for SMEs.

Incompatibility 6: Immediate recognition in profit or loss of negative goodwill not related to a realised gain.

The ASB agrees that this is an incompatibility, although negative goodwill arises only rarely in practice.

Incompatibility 7: Reversal of goodwill impairment losses.

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The ASB acknowledges there is an incompatibility on this issue, given that Article 35 (1(c(dd))) of the 4th Directive states that the reduction in value 'may not be continued' if the reasons for which the adjustments were made have ceased to be applied. However, for the reasons explained in paragraph 42 of the Appendix to the draft letter, it is difficult to distinguish between the recognition of internally generated goodwill and the reversal of goodwill impairment losses. For this reason, UK GAAP limits the reversal of impairment losses on goodwill.

This incompatibility would, however, 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 different 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?)

No. The ASB supports the views of the majority of EFRAG members.

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

No.

Q4 Are you aware of situations where the conclusions reach 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?)

The ASB has considered only the English language versions of the Directives, so cannot comment on this question.

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

No.