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Comment Letter to ED IFRS for SME

Ladies and Gentlemen,

Please find below my comments on the above mentioned exposure draft.

Regards,

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Comments on ED IFRS for SME:

The draft picks up different concepts for the topics business combination (Section 18), impairment of goodwill (Section 26) and equity (Section 21). The reason for these different concepts might be that for both topics there are ongoing projects for revision for full IFRS and it is not clear yet, which concept will finally be realized.

However, the elements of the different concepts which have been picked up for the Draft IFRS for SMEs are not consistent and as a consequence, the financial statements prepared in accordance with these rules might be not in line with the concepts and pervasive principles as described in Section 2 of the Draft.

Section 18, Business Combination follows the parent entity extension concept. Therefore – if less than 100% of a business is acquired - goodwill is recognised only for the parents share of the acquired business. This is stated in 18.20 where goodwill is defined as the excess of the cost of the business combination over the acquirers interest in the net fair value of identifiable assets, liabilities and contingent liabilities.

Assume the Fair Value of Net Assets of a Company S is 80, the total value of S is 100 and P acquires 80% for 80. According to Section 18, the values recognized for the acquisition are as follows:

| | Parents Interest | Minority Interst |
|------------|------------------|------------------|
| Net Assets | 64 | 16 |
| Goodwill | 16 | |
| Total | 80 | 16 |

According to 26.22, for the impairment test, the fair value of the component is compared with the carrying amount of the component, including goodwill. So, if the Fair Value of S declines from 100 to 96, no impairment would be necessary, because the carrying amount of 96 does not exceed the fair value. (26.23 for minority interest is not applicable here, because Step 2 of the impairment test is not reached).

However, if the fair value of the acquired entity declines from 100 to 96, there is a decrease in economic benefit. According to 2.20 (b) an expense should be recorded if there is a decrease in economic benefit. Therefore, the rule of 26.22 is not consistent with the concepts and pervasive principles.

According to 26.23 an impairment loss for goodwill is apportioned between that attributable to the parent and that attributable to the minority interest, with only the former being recognised as a goodwill impairment loss.

Thus, if the total fair value of S declines to 90 in the above example, there is an impairment loss of 6 (96 carrying value – 90 fair value) according to 26.22 Step 1 (d) resp. Step 2 (a). If this impairment loss is partly attributed to the minority interest in accordance with 26.23, the carrying value after the impairment would still exceed the fair value which seems not to be the intention of the impairment rules.

Therefore, 26.22 and 26.23 should be redrafted and should have a wording similar to IAS 36.92, where the carrying value is adjusted for the minority interest before performing the impairment-test.

Section 21 follows the entity concept. According to IAS 21.11 an entity shall treat changes in a parents controlling interest in a subsidiary that do not result in a loss of control as transactions with equity holders in their capacity as equity holders. An entity shall not recognise gain or loss on these changes in consolidated profit or loss. Also, an entity shall not recognise any change in the carrying amounts of assets (including goodwill) or liabilities as a result of such transaction.

Assume that in the example above, P acquires the remaining 20% of S for 20. According to 21.11, the book entry for this transaction would be:

| | | |
|-------------------|----|----|
| Minority Interest | 16 | |
| Equity (Parent) | 4 | |
| Cash | | 20 |

The values now recognized in the financial statements would be as follows:

| | Parents Interest | Minority Interest |
|------------|------------------|-------------------|
| Net Assets | 80 | 0 |
| Goodwill | 16 | |
| Total | 96 | 0 |

However, if P had acquired 100% of S for 100 in one single transaction, the values would be:

| | Parents Interest | Minority Interest |
|------------|------------------|-------------------|
| Net Assets | 80 | 0 |
| Goodwill | 20 | |
| Total | 100 | 0 |

From the perspective of P, there should be no difference if it acquires S in one or in two steps. Therefore, the different result are a contradiction to the principle of comparability in 2.9 of the Draft.

The problems are getting worse in case of a sale to minorities. Assume that P has acquired 100% of S for 100 at first. Now P sells 20% of S for 20 to minorities.

From 21.11 and 9.8 of the draft, it is not completely clear, which book entry should be made for the sale. 21.11 states that assets including goodwill should not be changed. It is not clear if the new minority interest should be calculated on the basis of the assets including or excluding goodwill:

Alternative 1:

| | | |
|-------------------|----|----|
| Cash | 20 | |
| Minority Interest | | 20 |

This would mean that 20% of goodwill is allocated to minorities.

Alternative 2:

| | | |
|-------------------|----|----|
| Cash | 20 | |
| Equity (Parent) | | 4 |
| Minority Interest | | 16 |

This would mean that only 20% of net assets are allocated to minorities, whereas the complete goodwill remains allocated to the parents share.

In 26.23 it is stated that in case of a minority interest in the component to which goodwill has been allocated, the carrying amount of that component comprises both the parents interest and the minority interest in the identifiable net assets of the component and the parents interest in goodwill. This indicates that the goodwill should not be allocated to minorities and Alternative 2 should be applied. Moreover, Alternative 2 is in line with the book entry for the acquisition of minority interest shown above.

However, I believe that it should be clarified in the Standard (21.11) which Alternative should be applied for the sale of interest to minorities.

In Alternative 2 there is the problem that an immediate impairment is necessary if the value of S has not increased meanwhile: the total value (discounted cashflows) of S is still 100 and 20 goodwill is attributed to the parents interest. If the impairment rules in Section 26 are redrafted in line with the existing rules of IAS 36, this goodwill of 20 would have to be notionally adjusted for the minority interest ($20 / 0,8 = 25$). As a consequence, the carrying value (105) exceeds the fair value (100) by 5 and goodwill has to be impaired by 4 ($5 \times 0,8$).

This impairment does not fulfil the definition of an expense of 2.20 (b) or 2.37, because there is no decrease in economic benefits. In my view, an impairment can only happen if there is a decline of fair value (expected cash flows) or if the entity enters into an unfavourable contract. Neither of these has happened in the above example.

The problems described above are the result of different concepts for consolidation in the Draft. The Board should therefore consider to implement the Full-Goodwill-Method in Section 18 as in the Exposure Draft for IFRS 3 or the acquisition and sale of minority interests in Section 21 recognised in the income statement with according adjustment for additional acquired or sold goodwill. The concept to treat the acquisition and sale of minority interest as transaction with equity holders in their capacity as equity holders is not consistent with the concept of recognising only the parents share of goodwill.