EFRAG
European Financial Reporting Advisory Group

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Draft Comment Letter

Comments should be submitted by 22 August 2012 to Commentletters@efrag.org

8 June 2012

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the exposure draft, Exposure Draft *Annual Improvements to IFRSs 2010 – 2012 Cycle,* issued by the IASB on 3 May 2012 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

Our detailed comments and responses to the questions in the ED are set out in the appendix. To summarise we agree with most proposals in the ED and with the objective they are trying to achieve but EFRAG is concerned about the issues explained below.

IFRS 3 Business Combinations: Accounting for contingent consideration in a business combination

EFRAG agrees with the proposed amendments, however it believes that the IASB should also propose consequential amendments to IAS 39 *Financial Instruments: Recognition and Measurement* as entities that are not applying IFRS 9 early may encounter the same issues being addressed by these amendments. In addition, EFRAG believes that the IASB should also align IAS 39 to the requirement in IFRS 9 regarding the accounting for own credit risk on financial liabilities measured at fair value as it believes that users of the financial statements of entities that do not apply IFRS 9 early would also benefit from this improvement in financial reporting.

IAS 12 Income Taxes: recognition of deferred tax assets for unrealised losses on available-for-sale debt securities

EFRAG appreciates the IASB's responsiveness to an issue that has been raised by its constituents and that has given rise to divergence in practice. However, we are concerned about the approach the IASB has taken in drafting the amendments. Rather than addressing the relatively narrow issue of the recognition of deferred tax assets in relation to debt securities that are classified as available-for-sale, these proposed amendments potentially cover a much wider and more complex range of circumstances. As such, we question whether the proposals still meet the criteria, in paragraph 65A of IASB Due Process Handbook, to be addressed as part of the Annual Improvement Project. Even if the IASB were to affirm that these amendments should be part of the annual improvements, we believe that additional outreach work is required to ensure that these amendments will not introduce new problems in areas where none exist to date. This is particularly the case because the interaction between IAS 12 and complex tax legislation in many jurisdictions has the potential to result in some anomalous outcomes.

If you would like to discuss our comments further, please do not hesitate to contact Giorgio Acunzo or me.

Yours sincerely,

Françoise Flores
EFRAG Chairman

APPENDIX

EFRAG's responses to the questions raised in the ED

Question 1

Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose?

Question 2

Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft? If not, why and what alternative do you propose?

1 EFRAG agrees that, with the exception of the proposed amendments to IAS 12 as discussed below, the issues addressed by the IASB within the Exposure Draft *Annual Improvements to IFRSs 2010 – 2012 Cycle* ('the ED') meet the criteria of the IASB Due Process Handbook and therefore they should be resolved as part of the annual improvement project.

2 However, EFRAG has some doubts as to whether the consequences of the proposed amendments to IAS 12 have been considered in sufficient detail as this is not apparent from the Basis for Conclusion. In order for the IASB's constituents to be able to assess the impact of the proposed amendments, we recommend the IASB to analyse whether the proposal will change current practice in situations other than those that the proposed amendments aim to address.

Issue 1: IFRS 2 Share-Based Payment: Definition of vesting conditions

Notes to constituents

3 The IASB identified the need to clarify the definition of a vesting condition in IFRS 2 Share-based Payment *to ensure the consistent classification of conditions attached to a share-based payment as the standard does not separately define a performance condition or a service condition, but instead describes both concepts within the definition of vesting conditions.*

4 In addition, the IASB intended to clarify some issues which had been raised by constituents in applying the definition of vesting condition in IFRS 2, namely:

(a) *<u>the correlation between an employee's responsibility and the performance target</u> – The IASB proposes that the definition of a performance condition should make clear that a performance target may relate either to the performance of the entity as a whole or to some part of the entity, such as a division or an individual employee. The IASB noted that it is reasonable to assume that the performance target set by management for an employee's share-based payment appropriately incentivises the employee to provide an increased quality and/or quantity of service to benefit the entity.*

(b) *<u>whether a share market index target may constitute a performance condition or a non-vesting condition</u> – The IASB proposes that the definition of a performance condition should make clear that a performance target is defined by reference to the entity's own operations (or activities) or its share price because the target within a performance condition needs to be 'within the influence of' the employee and also in the interest of the entity.*

(c) *<u>whether a performance target that refers to a longer period than the required service period may constitute a performance condition</u> – The IASB proposes to make clear that, in order to constitute a performance condition, any performance target needs to have an explicit or implicit service requirement for at least the period during which the performance target is being measured. In their reasoning, the IASB noted that the definition of a vesting condition makes clear that a vesting condition (including a performance condition) must 'determine whether the entity receives the services that entitle the counterparty to receive' the share-based payment. In addition, the IASB noted that a performance condition has an explicit or implicit service requirement while a non-vesting condition does not.*

(d) *<u>whether the employee's failure to complete a required service period is considered to be a failure to satisfy a service condition</u> – The IASB proposes to make clear within the definition of a service condition that if the employee fails to complete a specified service period, the employee fails to satisfy a service condition, regardless of what the reason for that failure is. The accounting consequence is that the compensation expense would therefore need to be reversed if an employee fails to complete a specified service period.*

EFRAG's response

EFRAG supports the proposed amendments.

5 EFRAG agrees with the IASB's assessment of the issues and with its proposed amendments to address them as we believe that they would reduce divergence in the application of IFRS 2.

Issue 2: IFRS 3 – Business combinations: Accounting for contingent consideration in a business combination

Notes to constituents

6 The IASB proposes to clarify that contingent consideration is assessed as either a liability or an equity instrument only on the basis of the requirements of IAS 32 Financial Instruments: Presentation*. The IASB acknowledged that paragraph 40 of IFRS 3* Business Combinations *currently refers not only to IAS 32, but also to 'other applicable IFRSs' in determining whether contingent consideration is classified as a liability or as an equity instrument. Therefore, the IASB believed the issue should be addressed and proposes to delete the reference to other applicable IFRSs.*

7 In addition, the IASB noted that the requirements on subsequent measurement in paragraph 58 in IFRS 3 for contingent consideration that is a financial instrument within the scope of IFRS 9 Financial Instruments *are inconsistent when compared with the accounting requirements of IFRS 9, which allows measurement at amortised cost as well as measurement at fair value. Consequently, the IASB proposes to amend the classification requirements of IFRS 9 so that the subsequent measurement requirements of IFRS 9 that do not require the use of fair value do not apply to contingent consideration that arises from a business combination.*

8 Finally, the IASB addressed the conflict between the subsequent measurement requirements in paragraph 58(b) for contingent consideration that is not a financial *instrument conflict with the measurement requirements in other applicable IFRSs. The IASB, therefore, proposes to delete the reference to IAS 37* Provisions, Contingent Liabilities and Contingent Assets *or other IFRSs as appropriate from paragraph 58(b).*

EFRAG's response

EFRAG welcomes the amendments as they add clarity to IFRS 3, but believes that the IASB should amend IAS 39 correspondingly.

EFRAG reiterates its request to amend IAS 39 to align it to the requirement in IFRS 9 regarding the accounting for own credit risk on financial liabilities measured at fair value.

9 EFRAG agrees with the IASB's assessment of the issues and with its proposed amendments to address them.

10 However, EFRAG believes that the IASB should also propose consequential amendments to IAS 39 *Financial Instruments: Recognition and Measurement* as entities that are not applying IFRS 9 early may encounter the same issues being addressed by these amendments.

11 In addition, EFRAG believes that the IASB should also align IAS 39 to the requirement in IFRS 9 regarding the accounting for own credit risk on financial liabilities measured at fair value. EFRAG believes that users of the financial statements of entities that do not apply IFRS 9 early would also benefit from this improvement in financial reporting.

Issue 3: IFRS 8 – Operating Segments: Aggregation of operating segments and reconciliation of the total of reportable segments' assets to entity's assets

Notes to constituents

12 The IASB proposes to amend paragraph 22 in IFRS 8 Operating Segments *to require entities to disclose those factors that are used to aggregate the entity's reportable segments when operating segments have been aggregated. Accordingly, the amendments propose to require disclosure of a brief description of the operating segments that have been aggregated and the economic indicators that have been assessed to determine that they have similar economic characteristics.*

13 In addition, the IASB proposes to amend paragraph 28(c) of IFRS 8 to clarify that a reconciliation of the total of the reportable segments' assets to the entity's assets should be disclosed, if that amount is regularly provided to the chief operating decision maker in line with the requirements already existing for other mandatory reconciliations (e.g. the total of the reportable segments' liabilities).

EFRAG's response

EFRAG agrees with the amendments to IFRS 8 as these improve the understandability of financial information. However, EFRAG believes that the wording of the amendments should be improved in order to emphasise that entities are required first to comply with the overarching principles in IFRS 8 in providing disclosures on the aggregation of reporting segments.

14 EFRAG agrees with the IASB's assessment of the issues and with its proposed amendments to address them as it believes that they enhance the understandability of financial information.

15 EFRAG believes that in a principles-based accounting system, constituents should always refer to the overarching principles set out in paragraph 12 of IFRS 8 regarding aggregation. Accordingly, EFRAG believes that the wording of the amendments should be improved to make clearer that entities are first required to comply with such overarching principles in providing disclosures on the aggregation of reporting segments.

16 Finally, while EFRAG agrees that the proposed amendments meet the criteria to be part of the annual improvement project, we believe that any future amendments to IFRS 8 would best be considered as part of the IASB's post-implementation review of the standard.

Issue 4: IFRS 13 – Fair Value Measurement: Short-term receivables and payables

Notes to constituents

17 The proposed amendment to the Basis for Conclusions of IFRS 13 Fair Value Measurement *aims to explain the IASB's rationale for amending paragraph B5.4.12 of IFRS 9 and paragraph AG79 of IAS 39* Financial Instruments: Recognition and Measurement *when IFRS 13 was issued.*

18 In particular, the IASB proposes to clarify that, when making those amendments to IFRS 9 and IAS 39, it did not intend to remove the ability of an entity to measure short-term receivables and payables with no stated interest rate at invoiced amounts without discounting, when the effect of not discounting is immaterial. Instead, the IASB deleted those paragraphs in IFRS 9 and IAS 39 because they believed IFRS 13 already contained guidance for using present value techniques to measure fair value and IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors *addresses materiality in applying accounting policies.*

EFRAG's response

EFRAG welcomes the proposal to clarify that the practical expedient for measuring short-term receivables and payables is still available.

19 EFRAG welcomes the proposal as it clarifies the measurement requirements for short-term receivables and payables with no stated interest rate. We support the arguments provided by the IASB as we believe that – under current IFRSs – constituents should already refer to IAS 8. Therefore, constituents should apply the concept of materiality in assessing the need to identify the financial component included in short-term receivables and payables with no stated interest rate and, if immaterial, measure them at their invoice amounts without discounting.

20 However, EFRAG believes that IAS 8 is the only standard governing the materiality concept. Therefore, we believe that the IASB should avoid introducing in other standards specific guidance on how the materiality concept should be applied. In addition, EFRAG believes that it could be helpful to provide constituents with educational materials that further explain the guidance in IAS 8. Such educational materials should provide guidance that allows entities to avoid making a costly evaluation to prove that the financial component in their short-term receivables and payables is immaterial.

21 EFRAG understands that the IASB has not included an effective date because the proposed amendments only aim to clarify rather than change existing practice. However, we believe that the IASB should provide a clear explanation of their reasoning by improving the wording of the proposed amendments to the Basis for Conclusions in IFRS 13.

Issue 5: IAS 1 – Presentation of Financial Statement: Current/non-current classification of liabilities

Notes to constituents

22 The IASB proposes to amend IAS 1 Presentation of Financial Statement *to clarify that a liability is classified as non-current if an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility with the same lender, at the same or similar terms.*

23 In other circumstances indeed the IASB believed that if an entity expects, and has the discretion to refinance, an existing loan on substantially different terms, then classification of the loan as non-current at the reporting date would not be consistent with the derecognition guidance for financial liabilities if this existing loan would be derecognised less than 12 months after the reporting date, and replaced by the new refinanced loan facility at that time.

24 Consequently, the IASB proposes to amend the wording of paragraph 73 of IAS 1 to clarify that, for the paragraph to apply, and for an existing loan that is due within 12 months of the reporting date to be classified as non-current, an entity must expect, and have the discretion to refinance, the loan for at least twelve months after the reporting period with the same lender, at the same or similar terms. In the IASB's view, similar terms would be expected to result in no substantial change to the rights and obligations of the parties to the loan facility.

25 Finally, the IASB proposes that the amendment to IAS 1 be applied prospectively for annual periods beginning on or after 1 January 2014 given the potential impact of the change and given that the proposed clarification may cause entities to choose to renegotiate some loans.

EFRAG's response

EFRAG agrees with the proposal.

26 EFRAG supports the amendments as they provide enhanced guidance on the classification of liabilities. In addition, EFRAG believes that they could reduce diversity in practice by limiting the circumstances when paragraph 73 of IAS 1 applies.

Issue 6: IAS 7 – Statement of Cash Flows: Classification of interest paid that is capitalised as part of the cost of an asset

Notes to constituents

27 The IASB received a request to clarify the classification in the cash flow statement of interest paid that is capitalised into the cost of property, plant and equipment as it seemed that current requirement in paragraph 16 of IAS 7 to classify them as *investing cash flows to be inconsistent with paragraphs 32 and 33, which required interest paid to be classified only as an operating or a financing cash flow.*

28 To address this conflict, the IASB proposes to clarify that capitalised borrowings costs should follow the classification of the underlying asset. This amendment also applies to borrowing costs that have been capitalised as part of operating assets (such as inventory), which should be classified as part of an entity's cash flows from operating activities.

EFRAG's response

EFRAG agrees with the proposal.

29 EFRAG supports the amendments as they reduce diversity in practice and improve the understandability of financial reporting.

Issue 7: IAS 12 – Income Taxes: Recognition of deferred tax assets for unrealised losses

Notes to constituents

30 The IASB received a request to provide guidance in circumstances when an entity:

(a) *has a deductible temporary difference relating to an unrealised loss on available-for-sale debt instruments that are measured at fair value;*

(b) *has the ability and intention to hold the instruments until the loss reverses (which may be at their maturity); and*

(c) *has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise that deductible temporary difference.*

31 The IASB concluded that an action does not qualify as a tax planning opportunity if the action does not create or increase taxable profit, and has proposed to amend IAS 12 accordingly. The IASB also clarified that when an entity assesses whether taxable profits will be available against which it can utilise a deductible temporary difference, the entity considers whether tax law restricts the sources of taxable profit against which the entity may make deductions on the reversal of that deductible temporary difference. However, if tax law restricts the utilisation of losses to deductions against income of a specified type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type. For example, this means that it might be possible to recognise a deferred tax asset regarding capital losses, provided that sufficient future capital gains are expected that would not be offset for tax purposes by losses from other sources.

EFRAG's response

EFRAG appreciates IASB's responsiveness to this practice issue, but has concerns about the wider implications of the proposed amendments in other circumstances.

32 EFRAG appreciates the IASB's responsiveness to an issue that has been raised by its constituents and that has given rise to divergence in practice. However, we are concerned about the approach the IASB has taken in drafting the amendments. Rather than addressing the relatively narrow issue of the recognition of deferred tax assets in relation to debt securities that are classified as available-for-sale, these proposed amendments potentially cover a much wider and more complex range of circumstances. As such, we question whether the proposals still meet the criteria, in paragraph 65A of IASB Due Process Handbook, to be addressed as part of the Annual Improvement Project. Even if the IASB were to affirm that these amendments should be part of the annual improvements, we believe that additional outreach work is required to ensure that these amendments will not introduce new problems in areas where none exist to date. This is particularly the case because the interaction between IAS 12 and complex tax legislation in many jurisdictions has the potential to result in some anomalous outcomes.

Question to constituents

33 Do you believe that the application of the proposed amendments to IAS 12 would have unintended consequences? If so, could you please explain?

Issue 8: IAS 16 and IAS 38 – Property, Plant and Equipment and Intangible assets: Revaluation method – proportionate restatement of accumulated depreciation

Notes to constituents

34 The IFRS Interpretations Committee reported to the IASB that divergence in practice existed in calculating the accumulated depreciation for an item of property, plant and equipment that was measured using the revaluation method in cases where the residual value, the useful life or the depreciation method had been re-estimated before a revaluation.

35 Paragraph 35(a) currently requires that, in instances where the gross carrying amount is revalued, the revalued accumulated depreciation results from applying the same proportionate factor as for the change in the gross carrying amount to the accumulated depreciation before revaluation.

36 The IASB agreed that the restatement of the accumulated depreciation is not always proportionate to the change in the gross carrying amount. In particular, when the revalued amounts for the gross and the net carrying amounts both reflect observable data, it is demonstrated that accumulated depreciation cannot be proportionately restated to the gross carrying amount after revision of the residual value, the useful life or the depreciation method before the revaluation.

37 Accordingly, the IASB proposes changes to IAS 16 and IAS 38 in order to clarify that the determination of the accumulated depreciation does not depend on the selection of the valuation technique; and that the accumulated depreciation is computed as the difference between the gross and the net carrying amounts. Consequently, when the residual value, the useful life or the depreciation method have been re-estimated before a revaluation, restatement of the accumulated depreciation is not proportionate to the change in the gross carrying amount of the asset.

EFRAG's response

EFRAG agrees with the proposed amendments as it reduces divergence in practice.

Issue 9: IAS 24 – Related Parties Disclosure: Key management personnel

Notes to constituents

38 The IASB was asked to address the disclosure of related party transactions that arise when a management entity provides key management personnel services to a reporting entity. The IASB understood that divergence exists, because some reporting entities disclose the compensation paid by the management entity to those employees or directors of the management entity that act as key management personnel of the reporting entity, while others disclose the service fee paid or payable to the management entity that they recognise as an expense.

39 The IASB therefore proposes to clarify that the definition of a related party is extended to include management entities. Moreover, the amendments are intended to clarify that the disclosure requirements on transactions are extended to require the separate disclosures of transactions for the provision of key management personnel services; and finally that the key management personnel compensation that is provided through management entities is excluded from the disclosure requirements on compensation of key personnel management personnel in order to prevent duplication.

EFRAG's response

EFRAG supports these amendments as they result in improved disclosures.

Issue 10: IAS 36 – Impairment of Assets: Harmonisation of disclosure for value in use and fair value less costs to sell

Notes to constituents

40 In May 2008, the IASB amended IAS 36 to address an inconsistency in the disclosure requirements for circumstances in which discounted cash flows were used to determine recoverable amounts for cash-generating units (CGUs) that contain goodwill or intangible assets with indefinite useful lives.

41 Consistent with that amendment, the IASB proposes to clarify that the disclosure requirements in IAS 36 that are applicable to value in use are also applicable to fair value less costs to sell when there has been a material impairment loss or impairment reversal in the period. The disclosures that IAS 36 requires in paragraph 130(f), when value in use is used to determine recoverable amount, currently differ from those disclosures required when fair value less costs to sell is used. These differing requirements appear to be inconsistent when a similar valuation methodology (discounted cash flows) has been used.

EFRAG's response

EFRAG agrees with the proposed amendments, but believes that they should be applied retrospectively.

42 EFRAG agrees with the proposed amendments as they provide a helpful clarification. We also agree that this issue should be resolved as part of the annual improvement project as it removes an existing inconsistency.

43 However, EFRAG believes that the amendments should be applied retrospectively as information about the comparative period is useful in itself and enhances comparability. In addition, the information that would be required to be disclosed already exists and should not be costly to collect. Finally, EFRAG noted that paragraph 140C of IAS 36 which was introduced in May 2008 was also not required to be applied prospectively.