EFRAG
European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 1 February 2013 to Commentletters@efrag.org

xx February 2013

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

Dear Sir/Madam,

Re: Exposure Draft *Annual Improvements to IFRSs 2011–2013 Cycle*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft, *Annual Improvements to IFRSs 2011 – 2013 Cycle,* issued by the IASB on 20 November 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.

EFRAG believes that the proposed amendment to IFRS 1 is unnecessary. Furthermore this proposed amendment puts into question the purpose annual improvements should serve.

In addition, EFRAG believes that the IASB should refrain from making amendments to the bases for conclusions of standards, unless it wishes to correct outright errors. In our view, amendments to bases for conclusions cannot take the place of actual standard setting. Furthermore, we would like to note that such amendments do not form part of the standards themselves and hence do not affect IFRSs as endorsed in the European Union.

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 1

EFRAG's responses to the questions raised in the ED

Question 1

Do you agree with the IASB's proposal to amend the Standard 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 understands that the annual improvement process offers a valuable opportunity to change current standards in order to address – on a timely basis – issues raised by constituents of widespread concern and urgency. Therefore, EFRAG agrees that most of the issues addressed by the IASB within the Exposure Draft *Annual Improvements to IFRSs 2011 – 2013 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 notes that the proposed amendment to IFRS 1 appears to be unnecessary; therefore EFRAG is concerned about the purposes for which the annual improvement exercise is currently being used.

3 EFRAG believes that changing the standards bears a cost and therefore IFRSs should only be amended where there is a compelling case to do so and the benefits to be gained outweigh the costs.

4 Furthermore, EFRAG regrets that the IASB is systematically proposing amending the basis for conclusions of the standards to address the issues raised by constituents instead of improving the text within the standards. In fact, EFRAG notes that the basis for conclusions should contain, according to paragraph 3.76 of the proposed new edition of the IASB and IFRS Interpretations Committee Due Process Handbook (issued in May 2012) only '*the rationale for why* (the IASB) *made the decisions it reached in developing or changing an IFRS. The Basis for Conclusions also includes the IASB's responses to comments received when the proposals were exposed*'.

5 Finally, EFRAG is concerned that European constituents will not benefit from the amendments as they will not affect IFRSs as endorsed in the European Union.

Issue 1: IFRS 1 – First-time Adoption of International Financial Reporting Standards: Meaning of effective IFRSs

Notes to constituents

6 The IASB was requested to clarify which version of an IFRS should be applied in an entity's first IFRS financial statements in circumstances where a new or revised IFRS that is not yet mandatory, but that can be adopted early, has been issued.

7 Some noted that paragraph 7 of IFRS 1 implies that a first-time adopter can choose either the current version of an IFRS or early adopt a new version. However, others believe that paragraph BC11 of IFRS 1 implies that an entity *should use the latest version of IFRS. They believe that the 'current version of IFRSs' refers to the latest version of an IFRS.*

8 The IASB is therefore proposing to add an explanatory paragraph to the basis for conclusions of IFRS 1 in order to clarify that a first-time adopter may apply either a new IFRS that is not yet mandatory if that IFRS permits early adoption or the IFRSs that are effective at the end of its first IFRS reporting period.

9 If a first-time adopter chooses to apply a new IFRS early, that new IFRS will be applied for all periods presented in its first IFRS financial statements, unless such IFRS provides an exemption or an exception that permits or requires otherwise.

EFRAG's response

EFRAG believes that the proposed amendment is not necessary.

10 EFRAG believes that changes to standards bring with them standard setting costs for the IASB and due process costs for its constituents. Therefore changes to the standards should only be made if there is a compelling case to do so. In this case, we believe that IFRS 1 is already sufficiently clear and we do not believe that the changes are necessary.

11 EFRAG further notes that amendments to the basis for conclusions of IFRS 1, which is intended as a record of the IASB's thinking at the time a standard is issued, will not affect IFRS as endorsed in the European Union.

12 Finally, EFRAG understands that the IASB has not included an effective date because the proposed amendments only aim to clarify the basis for conclusions in IFRS 1.

Issue 2: IFRS 3 – Business combinations: Scope of exception for joint ventures

Notes to constituents

13 The IASB acknowledged that the scope exclusion in paragraph 2(a) of IFRS 3 for 'the formation of a joint venture' was not consequently amended when IFRS 11 Joint Arrangements *was issued.*

14 IFRS 11 changed the use of the term 'joint venture' from having a general meaning that included 'jointly controlled operations', 'jointly controlled assets' and 'jointly controlled entities', to mean a specific type of joint arrangement, which does not include 'joint operations'.

15 In addition, the IASB was also requested to clarify whether this scope exception only applies to the accounting by the joint arrangements themselves in their financial statements or to the accounting by the parties to the joint arrangement for their interests in the joint arrangement.

16 The IASB noted that paragraph 2(a) of IFRS 3 should exclude the formation of any type of joint arrangement (i.e. joint ventures and joint operations) from the scope of IFRS 3.

17 In addition, they also noted that paragraph 2(a) of IFRS 3 only addresses the accounting by the joint arrangements themselves in their financial statements.

18 *Finally, the IASB proposes that the amendment should be applied retrospectively for annual periods beginning on or after 1 January 2014. Early application is permitted.*

EFRAG's response

EFRAG agrees with the proposed amendments.

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

Question to constituents

20 Do you believe that the IASB should address any further amendments to IFRS 3 before commencement of its planned post-implementation review of the standard? Please explain why.

Issue 3: IFRS 13 – Fair Value Measurement: Scope of paragraph 52 (portfolio exception)

Notes to constituents

21 *The IASB was requested to clarify whether the scope set out in paragraph 52 of IFRS 13 applies to all contracts that are within the scope of IAS 39 or IFRS 9, regardless of whether they meet the definitions of 'financial assets' or 'financial liabilities' in IAS 32* Financial Instruments: Presentation*.*

22 *Paragraphs 48 and 52 of IFRS 13 allow an entity to apply an exception to IFRS 13 when measuring the fair value of a group of financial assets and financial liabilities. An entity that manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risks is therefore permitted to measure that group of financial assets and financial liabilities on a net basis, rather than on an individual instrument basis.*

23 *However, currently paragraph 52 of IFRS 13 refers only to* 'financial assets and financial liabilities*' within the scope of IAS 39* Financial Instruments: Recognition and Measurement *or IFRS 9* Financial Instruments*.*

24 *The IASB proposes to amend IFRS 13 to clarify that the scope set out in paragraph 52 in IFRS 13 includes all contracts that are within the scope of IAS 39 or IFRS 9, regardless of whether they meet the definitions of* 'financial assets*' or* 'financial liabilities*' in IAS 32. Accordingly, the scope exception will also become applicable to contracts to buy or sell non-financial items or to derivatives.*

25 *Finally, the IASB proposes that the amendment should be applied retrospectively for annual periods beginning on or after 1 January 2014. Early application is permitted.*

EFRAG's response

EFRAG welcomes the proposal to clarify that the scope exception applies to all contract within the scope of IAS 39 and IFRS 9.

26 EFRAG welcomes the amendments as we believe they clarify that the scope of the measurement exception in IFRS 13 includes all financial instruments as defined in the relevant standards.

27 However, while agreeing with the proposal of linking IFRS 13 with relevant standards dealing with financial instruments, EFRAG believes that the proposed wording of the basis for conclusions should be improved.

28 EFRAG believes that 'some contracts to buy or sell a non financial item that can be settled net in cash or another financial instrument', defined under paragraph AG 20 of IAS 32, could be in circumstances scoped out from IAS 39 and IFRS 9. Therefore these contracts would also be outside the scope of the proposed amendments.

29 Finally, EFRAG agrees that this amendment should be applied retrospectively.

Issue 4: IAS 40 – Investment Property: Acquisition of investment property: interrelationship with IFRS 3

Notes to constituents

30 The IASB acknowledged that diversity in practice exists regarding scopes of IFRS 3 Business Combinations *and IAS 40* Investment Property *as:*

(a) Some considered both standards as <u>mutually exclusive</u> if an investment property with associated insignificant ancillary services as specified in paragraph 11 of IAS 40 was acquired. Accordingly, property, together with any associated insignificant ancillary services, becomes a single 'unit of account' and therefore this unit of account should be seen as one asset, called 'investment property'; while

(b) Others did not view IFRS 3 and IAS 40 as being mutually exclusive if investment property with associated insignificant ancillary services as specified in paragraph 11 of IAS 40 is acquired, and did not view the definitions of a business as defined in Appendix A of IFRS 3 and investment property as defined in paragraph 5 of IAS 40 as being interrelated. They think that an entity acquiring investment property has to determine <u>whether it meets both definitions</u>.

31 The IASB noted that paragraphs 8 to 14 of IAS 40 were developed to distinguish between investment property and owner-occupied property. In fact, investment property usually falls within the scope of IAS 40; whereas, an owner-occupied property falls within the scope of IAS 16 Property, Plant and Equipment*. In addition, neither IFRS 3 nor IAS 40 contains a limitation in its scope that restricts its application when the other standard applies, i.e. there is nothing within the scope of each standard to suggest that they are mutually exclusive. Therefore, the IASB concluded that that IFRS 3 and IAS 40 are not mutually exclusive.*

32 Accordingly, the IASB proposed to amend current IAS 40 to clarify that judgement is needed to determine whether the acquisition of investment property is the acquisition of an asset, a group of assets or a business combination in the scope of IFRS 3 and that this judgement is not based on paragraphs 7 to 15 of IAS 40 but on the guidance in IFRS 3. However, the distinction between investment property and owner-occupied property is based on paragraphs 7 to 15 of IAS 40.

EFRAG's response

EFRAG welcomes the amendments as it believes they add clarity in IAS 40.

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

34 However, EFRAG believes that the amendments should be applied retrospectively as it believes that the purchase price allocation accounting within IFRS 3 produces more relevant information for users. In EFRAG's view, it is likely that entities that purchased an investment property had already collected relevant information on the fair value of the asset. Therefore, EFRAG believes that the risk of using hindsight in these circumstances is limited and outweighed by the benefit of having comparable and relevant information.

35 Furthermore, EFRAG understands that the objective of these amendments is to provide clarification on how current guidance in IAS 40 and IFRS 3 already applies. Accordingly, we do not see the need for prospective application of these amendments.

36 Therefore, if retrospective application is to be pursued, EFRAG believes that the IASB should carefully explain in its effects analysis how it considered the costs and benefits of this requirement, and why the use of hindsight would not be of concern in this particular case.

37 Finally, EFRAG notes that while this particular amendment is fairly insignificant in its own right, it points at a much more substantive unaddressed issues resulting from the following significant difference in the accounting for asset acquisitions and business combinations:

(a) Treatment of transaction costs should be expensed in business combinations, but should be capitalised for asset acquisitions;

(b) Deferred tax should be recognised in business combinations, but the initial recognition exemption in IAS 12 applies to asset acquisitions;

(c) Purchase price allocation – IFRS 3 requires assets and liabilities to be recognised at fair value, while the purchase price is allocated based on relative fair value for asset acquisitions;

(d) Goodwill is only recognised in case of a business combination;

(e) Treatment of purchase consideration paid in shares – IFRS 3 provides guidance in the case of business combinations, but IFRS 2 applies to all other types of transactions;

(f) Treatment of contingent consideration, which is only defined by IFRS 3 but which is undefined for asset acquisitions; and

(g) Disclosures.

38 EFRAG believes that the IASB should consider the consequences of the distinction between assets and businesses as part of the post implementation review of IFRS 3 rather than as part of a series of separate standard setting initiatives, which currently include the following:

(a) IASB projects on:

   (i) Accounting for Contingent Consideration in a Business Combination within the Annual Improvements to IFRSs 2010 – 2012 Cycle;

   (ii) Scope of application of IFRS 3 and IAS 40, which this annual improvement ED addresses;

   (iii) Sales or contributions of assets between an investor and its associate/ joint venture (Proposed amendments to IFRS 10 and IAS 28); and

   (iv) Acquisition of an interest in a joint operation (Proposed amendments to IFRS 11);

(b) IFRS Interpretations Committee projects on:

   (i) IAS 16, IAS 38 and IFRIC 12 – Variable payments for the separate acquisition of PPE and intangible assets; and