

October 31, 2002

Sir David Tweedie  
Chairman IASB  
30 Cannon Street  
London EC4M 6XH  
UK

Dear David,

Re: ED 1 First-time Application of International Financial Reporting Standards

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of an IFRS dealing with First-time Application of IFRS. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

We support the simplified approach which replaces the former SIC 8 with a more pragmatic and practical solution. However, we believe the standard requires further clarification and modification in certain areas.

The appendix comprises our answers to the questions raised in the draft standard and other comments which we believe require consideration.

If you would like further explanation of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman  
EFRAG, Chairman

## **ED 1 First-time Application of International Financial Reporting Standards**

- Q1. The proposed IFRS would apply when an entity first adopts International Financial Reporting Standards (IFRSs) as its new basis of accounting, by an explicit and unreserved statement of compliance with all IFRSs (paragraphs 1-5 and paragraphs BC4-BC10 of the Basis for Conclusions). Is this an appropriate description of the circumstances when this proposed IFRS should apply? If not, what changes would you suggest, and why?**

### **Response**

Yes, EFRAG in general agrees that it is appropriate to regard the first time of application of IFRSs as being the first time the financial statements include an *explicit and unreserved statement of compliance with all IFRSs*.

We agree with the principle in paragraph 3 that an entity is a first-time adopter when it adopts IFRSs as a new basis of accounting. The Exposure Draft makes that distinction based solely on whether an entity's financial statements previously contained an *explicit and unreserved statement of compliance with all IFRSs*, as required by IAS 1 (paragraph 2 of the Exposure Draft) (see BC 9), or not.

The application of the principle as it stands would result in certain anomalies. Consider the following situations:

1. an entity which was in full compliance with all IFRSs for previous years, but failed to include the formal *explicit and unreserved statement of compliance with all IFRSs* in the financial statements, would be regarded as a first-time adopter (with all the consequences of paragraph 7 and 13 of this Exposure Draft).
2. two entities which have both failed to comply with IAS 14, segment reporting, in their most recent previous financial statements: the first entity made a statement that it complies with all IFRSs, except for IAS 14. The second entity made an *explicit and unreserved statement of compliance with all IFRSs*, but the auditors qualify their report on the basis of non compliance with IAS 14. Despite their financial statements being the same in all respects, the first entity would be regarded as a first time adopter whereas the second entity would not be a first time adopter per paragraph 3 (c) of this Exposure Draft.

In the first situation, we believe the entity should be able to continue to use the accounting previously used and should not be forced to adopt IFRSs for the first time as required by paragraph 7 of the Exposure Draft. We acknowledge that this alternative is already facilitated in paragraph 13 by applying the IFRSs that were effective in each period (SIC 8 approach).

In the second situation we are uneasy about the inconsistent treatment of the two entities based on paragraphs 2 (a) (ii) and 3 (c) of the proposed IFRS.

We believe it is important for every entity already reporting under IFRSs to assess carefully whether IFRSs were really the basis of accounting used and agree with the

thought in BC7 that the test for concluding whether the basis was IFRSs should be similar to an auditor's thought process in deciding whether to issue an 'except for' or an adverse opinion.

We also support the point made in the final sentence of BC7 that if the departures from IFRSs were so pervasive that an auditor would issue an adverse opinion, an entity should conclude that its basis of accounting was not IFRSs.

We support the exemptions provided in paragraph 5 for subsidiaries that have prepared financial statements under IFRSs for consolidation purposes in the past, but for practical reasons we suggest changing the wording in paragraph 5 (b) from "...the owners of the minority interests, including those not otherwise entitled to vote, unanimously agree that the subsidiary is not treated as a first-time adopter..." to "...none of the owners of the minority interests, including those not otherwise entitled to vote, objects to the subsidiary being treated as a first-time adopter...".

**Q2. *The proposed IFRS proposes a requirement that an entity shall prepare its opening IFRS balance sheet using accounting policies that comply with each IFRS effective at the reporting date for its first IFRS financial statements. Paragraphs 13-24 propose limited exemptions from this requirement. Are all of these exemptions appropriate? Should the Board amend any of these exemptions or create any further exemptions (paragraphs BC11-BC89)? If so, why?***

### **Response**

We support the general principle in paragraph 7 that an entity should use the same accounting policies throughout all periods presented in its first IFRS financial statements and that those policies should comply with each IFRS effective at the reporting date. We accept that the intention of the proposed standard is that first-time adopters should be required (rather than permitted) to use all the exemptions in paragraphs 16 - 24 unless they choose to use the approach set out in paragraph 13. We agree that entities should not be permitted to cherry pick which exemption they wish to apply. This improves comparability over all periods presented by entities that issue financial statements for the first time in complete compliance with IFRSs.

Further, we note that paragraph 13 states that if an entity does not use the exemptions "it shall apply the IFRSs that were effective in each period and may therefore need to consider superseded versions of IFRSs if later versions require prospective application." We assume it means all relevant superseded versions of all IFRS and transitional arrangements have to be applied, but we still believe the standard should make it clear whether this really means all or only those IFRSs relating to the exemptions.

However, we believe paragraph 13 is unclear as regards entities that choose not to make use of the exemptions. Logically we believe that the principle set out in paragraph 7 applies since paragraph 13 is based on that principle. Thus an entity would apply the IFRSs effective at the reporting date for its first IFRS financial

statements retrospectively. This also meets the primary objective of comparability between entities applying IFRSs for the first time.

The second part of paragraph 13 suggests that entities that choose not to use the exemptions should use the IFRSs that were effective in each period (SIC 8 approach). Clarification is therefore needed whether it is intended that the paragraph 7 principle should apply in such a case or the SIC 8 approach.

Our view is that the normal basis should be the paragraph 7 principle approach. However, we can envisage circumstances where entities have in the past applied the recognition and measurement principles of IFRSs fully but have failed to give some required disclosures or have simply omitted the *explicit and unreserved statement of compliance with all IFRSs*. In those cases entities should, in our view, be given the option to apply the full “SIC 8 approach”.

**Q3. Paragraphs 28-37 of the proposed IFRS deal with presentation and disclosure requirements (see also paragraphs BC90-BC97). Are all of these disclosures appropriate? Should the Board require any further disclosures or eliminate or amend any of the proposed disclosure requirements? If so, why?**

### **Response**

We regard all of these disclosures as appropriate. However, paragraph 32 requires an entity to explain how the change of basis of accounting has affected the financial statements. The Exposure Draft does not indicate how much detail is required and we therefore suggest including more guidance possibly by way of an example. For instance it may be required to disclose the effects of change before and after tax, and the changes could be required to be disclosed for each group of assets and liabilities – for instance for intangibles, inventory, property, plant and equipment or receivables. Clarification should be provided by giving examples.

**Q4. Do you have any other comments on the Exposure Draft?**

1. Paragraph 2 sets out the criteria for classifying entities as first-time adopters. Amongst other criteria an entity is a first-time adopter if it “prepared financial statements under IFRSs for internal use only, without making them available to the entity’s owners or other external users;...”  
A literal reading of paragraph 2(b) suggests that an entity which provided only its regulators but not other external users with its IFRS financial statements would not qualify as a first-time adopter. We are not convinced that was intended and believe clarification is needed in the standard.
2. BC13 describes the concept of “undue cost or effort”. We agree that determining cost-based measurement under IFRSs for an asset or liability at the date of transition to IFRSs may require undue cost or effort and that in such a case an alternative

measure should be applied. However, we believe that “undue cost or effort” is open to very wide interpretation and therefore its use should be limited. We suggest the Board gives careful consideration to the use of the exemption. Further guidance and examples clarifying the meaning and use of the “undue cost or effort” exemption should be provided in order to avoid conflicting interpretations which would undermine overall reliability and comparability of IFRS financial statements.

3. The treatment of negative goodwill for first-time adopters is described in Appendix B Business Combinations B1(e). We recognise that this prohibition against recognition of negative goodwill in an opening IFRS balance sheet reflects a proposal in phase I of the IASB’s project on business combinations. However, we find the proposals confusing because:

- (i) under paragraph 20 (b) goodwill (presumably both positive and negative) should be shown under the opening IFRS balance sheet at its carrying amount under previous GAAP,
- (ii) under existing standards negative goodwill can be recognised,
- (iii) in the Appendix B1(e) it is said that an entity shall not recognise negative goodwill in its opening balance sheet – based on a proposal for a new standard on Business Combinations not yet published as an Exposure Draft.

We believe that the standard for First-time Application should be based on existing standards and should not anticipate future standards still to be agreed. In addition the treatment of negative goodwill should be dealt with in the standard itself rather than in the Appendix.

4. Appendix B Business Combinations Example 4 shows that, where an entity has acquired a subsidiary and, using its previous GAAP, has written goodwill off to equity, it should not make any adjustment when moving to IFRSs. However, the example is silent as to what happens if the subsidiary is subsequently resold. If it were to be resold for the original acquisition price the group will appear to have made a profit (equal to the amount of goodwill previously charged to equity) if the profit is taken wholly to income rather than to equity. To avoid this distortion a number of national standards have safeguards the effect of which is that only the profit in excess of goodwill previously written off to equity is taken to income.

A similar safeguard against the recognition of artificial profit is needed in the IFRS. (Note that in certain countries it is assumed - for the purpose of the calculation of profit that may be fairly recognised - that goodwill written off to equity would otherwise have been amortised over 5 years so that only a proportion of the profit on sale would be realised in that way.)

5. Paragraph 20 (b) (ii) of the Exposure Draft requires an impairment test for goodwill applying IAS 36. The test is to be done regardless whether there is any indication that goodwill may be impaired or not. EFRAG agrees with the general approach. Whilst we believe that any impairment so revealed should be dealt with in equity (in accordance with paragraph 12) it has been suggested to us that the final words of paragraph 20 (b) (ii) “...and in recognising any impairment loss” suggest that the IAS 36 treatment of losses (taken to income) is intended. It would be useful to clarify the treatment and remove the wording referred to above which is the cause of confusion.