EFRAG
European Financial Reporting Advisory Group

October xx, 2002

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

DRAFT

Dear David,

Re: Exposure Draft 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.

This is the first Exposure Draft IASB has published in the new three part format comprising the Standard, the Basis for Conclusions and Implementation Guidance. We find this format helpful and congratulate IASB on the clarity of presentation.

We understand that the First-time Application project has two main objectives: the first is to secure the greatest comparability between all entities which issue financial statements in full compliance with IFRS; the second is to make the implementation of IFRS for first adopters as practical as possible without compromising the basic concepts and accounting principles which form the Framework of IFRS. These objectives may to some extent conflict. We support the pragmatic and rational approach which has guided IASB in many respects in this project by proposing sensible solutions whilst minimising departures from the underlying concepts and principles of IFRS.

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 clarification 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

Exposure Draft 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?

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

Paragraph 3(c) indicates that an entity does not adopt a new basis of accounting when the entity “presented financial statements in the previous year that contained an explicit and unreserved statement of compliance with IFRS, but the auditors qualified their audit report on those financial statements.” We believe that where the auditor’s qualification relates to a disagreement with management about the explicit and unreserved statement of compliance with IFRS (meaning “all IFRS”) the entity should be treated as a first-time adopter of IFRS. For that reason the standard should draw a distinction between an auditor’s qualification in respect of non-compliance with IFRS and a qualification for other reasons.

We are aware that in certain countries it is not uncommon for financial statements to include an explanation that they have been prepared in accordance with national requirements which “are consistent with” IFRS. This may be regarded locally (but not always internationally) as being an explicit and unreserved statement of compliance with IFRS. The difference may lie in incomplete disclosure under IFRS whilst meeting national requirements, for example. It would therefore be useful to clarify within the proposed standard that such wording can only be accepted as having that meaning if in fact all IFRS have actually been fully applied.

We support the exceptions provided in paragraph 5 for subsidiaries that have prepared financial statements under IFRS for consolidation purposes in the past.

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?

A. 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 also agree that entities should be permitted to use the exemptions set out in paragraph 16 to 24 but that if they choose to make use of the exemptions they should use them all (to the extent that they are applicable) rather than cherry pick which ones they wish to apply. This minimises the number of options and improves comparability.
Further we note that paragraph 13 states that if an entity does not use the exemptions "it shall apply the IFRS that were effective in each period and may therefore need to consider superseded versions of IFRS if later versions require prospective application." We believe the standard should make it clear whether this means all relevant superseded versions of all IFRS and transitional arrangements have to be applied or only those IFRS relating to the exemptions. (We assume it means all.)
We believe that the information would be more transparent for users and comparable for the periods presented if the fallback position when not using the exemptions were to be the use of the general rule in paragraph 7 (as explained in paragraph 13) – namely to use the same accounting policies throughout all periods presented and those policies comply with each IFRS effective at the reporting date. However this would mean full retrospective application. There could be practical difficulties in that it would mean recalculating all the existing IFRS compliant information on a new basis (IFRS in force at 2005 rather than earlier) but if this is onerous the entity can always make use of the exemptions in paragraphs 14 to 27 in the same way as other first-time adopters.

(NOTE: We may wish to delete the last subparagraph of this answer in the final version but comments would be welcome.)

Please consider our additional comment to the exceptions under paragraph 8 in our answer to Q4.

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?

A. We regard all of these disclosures as appropriate.

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 might be required to disclose the effects of change before and after tax, and the changes might be required to be disclosed for each group of assets and liabilities – for instance for intangibles, inventory, property, plant and equipment or receivables.

We understand that no specific disclosures are required in the notes to for instance property, plant and equipment in accordance with IAS 16 paragraph 60.

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

1. We regard the explanations in the Introduction under "Objective" (I1.) as very important for the first-time adopters and the users of financial statements. For this reason we recommend including this paragraph in the Standard itself rather than in the Introduction.

2. Paragraph 2 sets out the criteria for classifying entities as first-time adopters. Among 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 that paragraph 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. Equally a 100% subsidiary providing its owner with IFRS financial statements but not making it more widely available would according to paragraph 2 not qualify as a first-time adopter.
   We are not convinced that was intended and believe clarification is needed in the standard.

3. Concept of "undue cost or effort":
   BC 13 describes the concept of "undue cost or effort". We agree that determining cost-based measurement under IFRS for an asset or liability at the date of transition to IFRS may require undue cost or effort and that in such a case an alternative measure should be applied. However, we consider that "undue cost or effort" is very subjective and may lead to inconsistent interpretations, even inappropriate applications. In order to avoid too broad an interpretation of the concept of "undue cost or effort", we recommend that a high threshold be required by the standard so that this expression would have much the same meaning as "impracticable", but limited to matters concerned with the administrative cost of compliance.

4. Business combinations:
   We support the pragmatic approach adopted by the IASB in paragraph 20 (Business combinations) whereby entities retain in their opening IFRS balance sheet the same classification of business combinations as in their financial statements under previous GAAP. Nevertheless IASB will be aware that the concept of "acquisition" and/or of "uniting of interests" is not commonly and consistently defined and applied in different countries and that some inconsistent treatments will result from that situation. We do not suggest changing the proposed approach since it would be difficult for practical reasons to reconsider each case but we believe that an option might be given (or an exception provided) for entities who consider it more appropriate to reclassify as acquisitions business combinations which under their previous GAAP were treated as

“uniting of interests”. Generally, we favour encouragement of the treatment of past business combinations as purchases rather than poolings if it is practical to do so.

(NOTE: We may wish to delete this answer in the final version but would welcome views.)

5. Negative goodwill:
   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. Under existing standards negative goodwill can be recognised in the opening IFRS balance sheet; but that may change by 2005 if the standard is adopted according to the proposal. Changes to the proposal should be carefully considered

   We suggest placing this statement within paragraph 20 of the standard and not in Appendix B Business Combinations, if it is included in the final standard.

6. Hedge accounting:
   Paragraph 24 requires an entity to apply the hedging requirements of IAS 39 prospectively from the date of transition to IFRS. We assume that the consequences of that, described in Appendix C hedge Accounting, include the improvements of the current improvements project on IAS 32 and 39 (concerning the designation continuing involvement approach and the derecognition requirements as well as the categorisation).

7. We can envisage situations when the primary financial statements have in the past been prepared under national GAAP but that secondary statements using IFRS (or IAS) had been prepared for consolidation purposes but not made available to the wider body of shareholders or other users. We believe that in such cases there is a need for reconciliation and disclosure provisions similar to those in paragraph 29 to 37 but which form a reconciliation link between primary and secondary financial statements.

8. The exemptions set out in paragraph 14 to 27 are designed to avoid the need to go back and restate amounts which cannot be reliably restated because the entity is unlikely to have the necessary information. Similar considerations suggest exemptions may be needed for long term contracts if the entity used the completed contract method for long term contracts prior to transition date.

9. 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 reserves, it should not make any adjustment when moving to IFRS. 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 reserves) if the profit is taken wholly to income rather than to reserves. To avoid this distortion UK GAAP has safeguards the effect of which is that only the profit in excess of goodwill previously written off to reserves is taken to income. A similar safeguard against the recognition of artificial profit is needed in the IFRS.
   We do recognise that once integrated into the group the goodwill relating to an individual subsidiary becomes difficult to identify so that there may be practical problems if a requirement similar to that suggested is introduced in the standard.

10. Throughout the Exposure Draft there are references to both “IFRS” and “IFRSs”. However, it is not always clear why one is used and not the other. For example, see paragraph 30: there is no logic to the use of “IFRS” in the first line and “IFRSs” in the second. We suggest using “IFRS” throughout, on the basis that it is a collective noun that can be used in both the singular and plural. (In the past, “IASs” was never used.)