EFRAG

European Financial Reporting Advisory Group

29 January 2008

ED of Proposed Improvements to International Financial Reporting Standards
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir/Madam,

Re: ED of Proposed Improvements to International Financial Reporting Standards

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the *IASB Exposure Draft of Proposed Improvements to International Financial Reporting Standards*. 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 amendments on the issues.

In the annex to this letter, we set out our detailed comments on the proposals in the ED. In this letter we make a few higher level comments.

- EFRAG welcomes the IASB's decision to devise a streamlined process for dealing efficiently with a collection of miscellaneous, non-urgent but necessary, minor amendments to IFRSs. Although one has to be careful when making very detailed changes to what is after all supposed to be a principles-based set of standards written at a fairly high level, there is no doubt that some very detailed aspects of existing standards are causing problems and need to be addressed. We broadly support the idea of bringing these changes together in an omnibus ED and an omnibus standard.

- Having said that, it is very important that the Annual Improvements Process is used only for the right kind of amendments. Amendments should not be so minor that they create the impression that IFRS are rules based standards written at a detailed level. Nor should the amendments be ones that are likely to result in significant changes in practice or which need really to be evaluated in a broader context. We think there are several proposals in this ED that should not be dealt with in the Annual Improvements Project. We recognise that it could be argued that it is of no great significance what sort of amendments are dealt with in the project, because the IASB is following a full due process in any event. However, our understanding is that the annual improvements have been discussed in a relatively narrow context and, placed amongst 40 other amendments, it is inevitable that they will not get the attention during the consultation phase that they would have got as standalone amendments. We think it is necessary to discuss the following items more broadly and in a wider context because they are not 'minor' amendments:

(a) Issue 4: IAS 1 – Statement of compliance with IFRSs. As explained more fully in paragraphs 9 – 13 of the annex, we think the IFRS branding issue is too big an issue to be dealt with as an annual improvement. It is a proposal that will affect many companies and it raises important issues that go beyond standard-setting.

(b) Issue 7: IAS 8 – Status of implementation guidance. In our view this amendment seeks to clarify something that was not really open to misinterpretation. We are concerned that extremely minor amendments of this kind could encourage those who use IFRS to think of them as a set of rules rather than as a set of high-level principles-based standards. See paragraph 21 of the annex.

(c) Issue 10: IAS 16 – Sale of assets held for rental. The IASB is proposing to amend IFRS to require the sale of assets held for rental to others that are routinely sold in the course of its ordinary activities to be treated as revenue. In EFRAG's view, it is not appropriate, in a set of principles-based standards, to limit such an amendment to a narrow range of entities. If the principle is right, it should be applied generally and that is too big a change to be made through this project. Our detailed comments can be found in paragraphs 29 – 31 of the annex.

(d) Issue 28: IAS 38 – Advertising and promotional activities. EFRAG is not comfortable about this amendment being made through the Annual Improvements Project, for two reasons. Firstly, the proposed amendment touches on a very fundamental issue—the distinction between an asset and an expense. Secondly, it would appear from the letters we have received that constituents believe the amendment proposed might change practice significantly for some entities; we believe that, if a proposed amendment is likely to change practice significantly, it is better for it to be dealt with on a standalone basis rather than in an omnibus ED with forty other proposed amendments. Our detailed comments can be found in paragraphs 89 – 90 of the annex.

(e) Issue 30: IAS 39 – Definition of a derivative. We are concerned that this proposed amendment could have implications that might not have been fully considered when developing the proposal. (For example, we think it could have implications for the accounting treatment of service concessions.) We think the proposal should therefore be removed from this project and dealt with in a standalone project. For further explanations we refer to paragraphs 97 – 98 of the annex.

(f) Issue 35: IAS 40 – Property under construction or development for future use as investment property. We think this issue raises an important consideration that deserves also to be considered in a wider context: whether existing IFRS (ie IAS 16 and 40) permit revaluations of assets under construction. Our detailed comments can be found in paragraphs 114 – 117.

- Putting that issue to one side, we agree with most of the proposals in the Exposure Draft (although we sometimes see a need for a rewording or an additional amendment to make the issue clearer). Our main areas of disagreement are as follows:

  (a) Issue 4: IAS 1 – Statement of compliance with IFRSs. The IASB is proposing to amend IAS 1 to require entities to provide a specific disclosure about the extent to which the financial statements have been prepared in accordance with full

IFRS and a description of how the reported financial position and financial performance would have differed if IFRS had been complied with in full. We do not believe it is appropriate, or even necessary, for the IASB to in effect say "you must comply with our standards but, if you do not, you must provide the following disclosure." The IASB should focus its efforts on developing standards that it envisages will be fully complied with. For further comments we refer to paragraphs 9 – 13 of the annex.

(b) Issue 5: IAS 1 – Current/non-current classification of convertible instruments. The proposal here is to amend the criteria used to determine whether an instrument is a current or non-current instrument to focus on when there will be an outflow of cash or other assets. Although we do not disagree with the thinking underlying the proposal, we think more thought needs to be given to its implications for instruments settled by the provision of services or by replacement with another obligation. See paragraphs 15 – 16 of the annex.

(c) Issue 6: IAS 1 – Current/non-current classification of derivatives. The IASB's concern is that the current wording of IAS 1 means that all derivatives will be classified as current instruments, which may not be appropriate. Again, although we do not disagree with the thinking underlying the proposal, we think the actual amendments proposed will not achieve the desired purpose. Please read paragraphs 18 – 19 for our full explanation.

(d) Issue 16: IAS 19 – Replacement of term 'fall due'. EFRAG agrees with the IASB that this is an inconsistency in IAS 19 that needs to be addressed. However, we do not believe that introducing the notion "wholly entitled" will improve the current situation very much. We think the amendment would create other uncertainties and could have implications that have not been thoroughly thought through. We therefore believe that the IASB should take more time to fully consider the issue. We suggest moving the issue to the next Annual Improvements Project to allow the IASB sufficient time to investigate any consequences on the areas mentioned above. Please read paragraphs 54 – 55 for our full explanation.

(e) Issue 30: IAS 39 – Definition of a derivative. The IASB is proposing to revise the definition of a derivative to exclude the current reference to non-financial variables. However, although the IASB is right when it says that the reason why this reference was originally inserted no longer applies, EFRAG believes that the reference has wider implications nowadays and those implications have not been fully considered. For further explanations we refer to paragraphs 97 – 98 of the annex.

(f) Issue 38: IAS 41 – Point-of-sale costs. The IASB is proposing to replace the reference in IAS 41 to 'point of sale costs' with the more widely used 'costs to sell'. The IASB argues that currently the two terms describe the same notion, and it is desirable to use one term to describe each notion. However, EFRAG does not agree that the two terms *do* describe the same notion. Our detailed comments can be found in paragraphs 124 – 126.

If you would like further clarification of the points raised in this letter, either Sven Morich or I would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Annex: Responses to the invitation to comment

IFRS 1 First-time Adoption of International Financial Reporting Standards

Issue 1: Restructure of IFRS 1

1 The IASB proposes to restructure IFRS 1. The main change proposed is to remove certain transitional provisions relating to particular IFRSs from the main body of the IFRS 1 to appendices. The restructuring is not supposed to alter the technical content of IFRS 1. However, some transitional provisions have been removed as they are no longer relevant. This means that the proposal is to move the specific exceptions to the mandatory application of IFRSs retrospectively and the exemptions from other IFRSs from the body of the Standard and instead place them in appendixes.

IASB Q1: *Do you agree with the Board's proposed restructuring of IFRS 1? If not, why?*

2 EFRAG supports the proposed restructuring of IFRS 1 and agrees that it makes the standard clearer and easier to navigate. EFRAG also agrees that the amended IFRS 1 should have an effective date of 1 January 2009 so that part of the present, date specific, transitional provisions can be deleted.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

Issue 2: Plan to sell the controlling interest in a subsidiary

3 This issue relates to an uncertainty as to how IFRS 5 should be applied when an entity is committed to a plan to sell the controlling interest in a subsidiary and retain a non-controlling interest in that subsidiary. The uncertainty arises because IFRS 5 is not clear on "how much" of a non-current asset or a disposal group needs to be disposed of for the asset or group to be considered "recovered principally" through a sale and therefore classified as held for sale. In practice it seems that the term "principally" in paragraph 5 of IFRS 5 is being interpreted in different ways, for instance:

(a) Some believe being committed to a plan involving loss of control over a subsidiary is the triggering event for the classification as held for sale.

(b) Some believe the majority of the interest in the subsidiary has to be disposed of to meet the criteria for classification as held for sale.

4 The IASB believes (a) above is the appropriate interpretation and is proposing that IFRS 5 should be amended accordingly.

IASB Q2: *IASB Q2: Do you agree with the proposal to add paragraph 8A to IFRS 5 to clarify that assets and liabilities of a subsidiary should be classified as held for sale if the parent has a sale plan involving loss of control of the subsidiary? If not, why?*

5 EFRAG agrees that there is uncertainty on this issue and it agrees with the amendment proposed, which it believes is consistent with the definitions in IFRS 5 and with recent decisions taken by the IASB on other revised standards.

IFRS 7 Financial Instruments: Disclosures

Issue 3: Presentation of finance costs

6 The IASB proposes to amend the implementation guidance in IFRS 7 *Financial Instruments: Disclosures* because there is a potential conflict between that guidance and IAS 1 *Presentation of Financial Statements* (as revised in 2007). IAS 1 prohibits the presentation of *net* finance costs (or a similar term) in the statement of comprehensive income unless the finance costs and finance revenue included in the net total are disclosed. Paragraph IG13 of IFRS 7 indicates that total interest income and total interest expense could be included as a component of finance costs. The IASB proposes to resolve the potential conflict by amending paragraph IG13.

IASB Q3: The Board proposes to amend paragraph IG13 of IFRS 7 Financial Instruments: Disclosures *to resolve the potential conflict with IAS 1. Do you agree with the proposal? If not, why?*

7 EFRAG agrees that there is a potential conflict between IAS 1 and IFRS 7 and it agrees with the amendment proposed.

IAS 1 Presentation of Financial Statements

Issue 4: Statement of compliance with IFRSs

8 The IASB has noted that some entities are referring to IFRS in describing the basis on which their financial statements are being prepared without describing those statements as complying with IFRSs. For example, some are stating simply that their financial statements are prepared "in accordance with IFRSs as adopted/modified for use in [country X]". The IASB believes this is unhelpful and potentially misleading. It has therefore proposed that IAS 1 *Presentation of Financial Statements* should be amended to require entities to provide a specific disclosure on the extent to which the financial statements have been prepared in accordance with full IFRS and a description of how the reported financial position and financial performance would have differed if IFRS had been complied with in full.

IASB Q4: Do you agree with the proposal to require an entity that cannot make an unreserved statement of compliance with IFRSs to describe how its financial statements would have been different if prepared in full compliance with IFRSs? If not, why?

9 EFRAG agrees that it is fundamentally important for entities to disclose in their financial statements the accounting policies that have been used to prepare those financial statements in sufficient detail to enable users to understand the policies that have been used. Although IAS 1 already requires disclosures about accounting policies, there is evidence to suggest that the disclosures currently being provided are often not sufficiently detailed. For example, it can be difficult to determine whether an entity is applying a hedge accounting policy that is consistent with IFRS as issued by the IASB or IFRS as adopted for use in the EU. EFRAG would support all reasonable steps to rectify this situation. It seems to us however that the starting point for this ought to be to consider whether the existing requirements on accounting policy disclosure are being implemented correctly and, if they are, whether those specific requirements need to be enhanced. We are not in favour simply of adding a new—and different—disclosure requirement without ensuring the existing ones are working properly first.

10 We understand that some believe the amendment proposed is needed because users are seeing the reference to IFRS in statements such as “these financial statements have been prepared in accordance with IFRS as modified for use in XXX” and assuming that, because IFRS is referred to, it follows that the financial statements will be similar to fully-compliant IFRS financial statements. We see this as an educational issue rather than an issue for standard-setters.

11 For the above reasons we see no need for the amendment proposed.

12 We would also make two further observations:

(a) We think it damages the credibility of the IASB and the status of its standards to incorporate in IFRS a statement that in effect says “you must comply with IFRS but if you do not do so you must provide the following disclosure”. The IASB should focus its efforts on developing standards that it envisages will be fully complied with.

(b) It is important, when considering proposals like this one, to bear in mind the position of entities in jurisdictions that have an endorsement procedure. Endorsement takes time and, as a result, it will from time-to-time be impossible for an entity that wishes to comply fully with IFRS to do so because a standard has not yet been endorsed. Thus, under the proposal in this paper, that entity would in some years state that it has prepared its financial statements in accordance with IFRS and in some other years would have to state that it has not prepared its financial statements in accordance with IFRS. There is a danger that such a disclosure could in itself be misunderstood.

13 For the above reasons we think that the issue is too big to be dealt with within the Annual Improvements Process.

Issue 5: Current/non-current classification of convertible instruments

14 IAS 1 requires a liability to be classified as current if the entity does not have an unconditional right to defer settlement for at least twelve months from the end of the reporting period. The Framework states that ‘settlement’ includes conversion of the liability into equity. Consequently, the liability component of a convertible instrument that the entity could be required to settle in shares at any time would be classified as current. The IASB believes this is inappropriate – the focus of the current/non-current classification should be on settlement by transfer of cash or other assets – and therefore proposes to amend IAS 1.

<u>IASB Q5:</u> Do you agree with the proposal to clarify that the potential settlement of a liability by the issue of equity is not relevant to its classification as current? If not, why?

15 EFRAG agrees that the potential settlement of a liability by the issue of equity is not relevant to its classification as current, because such a settlement is not an outflow of resources and we agree that the focus of the current/non-current classification should be on the outflow of cash or other assets of the entity.

16 One implication of the amendment as currently proposed is that some financial instruments that are not convertible instruments would also no longer be classified as current liabilities. For example, instruments that are settled through the provision of services or the replacement of an obligation with another obligation would always be classified as non-current liabilities under the amended IAS 1.60(d):

(a) We think this would be inappropriate for a liability settled through the provision of services, so we suggest amending IAS 1.60(d) so it refers to ‘transfer of cash or other benefits’ rather than ‘cash or other assets’.

(b) We are concerned that, under the revised wording, an instrument that is to be settled within the next twelve months by being replaced with another obligation would be classified as non-current even if the replacement obligation would be classified as a current obligation. We think such a classification would be inconsistent with IAS 1.73, which seems to suggest that such an obligation is a current obligation.

Issue 6: Current/non-current classification of derivatives

17 The IASB identified an inconsistency in IAS 1 *Presentation of Financial Statements* regarding the current/non-current classification of derivatives. The IASB is concerned that the guidance in paragraphs 68 and 71 of IAS 1 might be read to imply that all financial assets and financial liabilities classified as held for trading in accordance with IAS 39 are required to be presented as current. The IASB reasons that this would be in contradiction to the criteria for the differentiation of current assets and liabilities from non-current assets and liabilities set out in paragraphs 66 and 69 in IAS 1.

IASB Q6: Do you agree with the proposal to amend the examples in paragraphs 68 and 71 of IAS 1 to remove the potential implication that financial assets and financial liabilities that are classified as held for trading in accordance with IAS 39 are required to be presented as current? If not, why?

18 EFRAG agrees that the guidance in IAS 1 regarding current assets and liabilities suggests that all held-for-trading derivatives should be classified as current irrespective of how long they may be outstanding. However:

(a) we do not think deleting references to IAS 39 in paragraphs 68 and 71 is sufficient to resolve the issue because criterion (b) in paragraphs 66 and 69 of IAS 1 states that, because assets and liabilities that are held primarily for the purpose of being traded should be treated as current (and ‘held primarily for the purpose of being traded’ is presumably the equivalent to the held-for-trading category in IAS 39). We suggest that the IASB should add the following text:

> “However financial assets and financial liabilities that are required to be classified as held-for-trading in accordance with IAS 39, that have a maturity of more than twelve months and are expected to be held for at least twelve months (for example derivatives or obligations to deliver financial assets borrowed by a short seller) should be presented as non-current financial assets or non-current financial liabilities.”

(b) We think a similar inconsistency arises in respect of obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own) which are required to be classified as held-for-trading under IAS 39 even though such contracts might have maturity longer than 12 months.

19 We also think it would be helpful to have some clarification as to how to treat derivatives with staggered settlement dates.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Issue 7: Status of implementation guidance

20 The IASB has been told that paragraph 7 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* could be misinterpreted as requiring the mandatory application of Implementation Guidance. It is therefore proposing to amend a few paragraphs of IAS 8 to clarify the status of implementation guidance.

<u>IASB Q7:</u> Do you agree with the proposal to amend paragraphs 7, 9 and 11 of IAS 8 to clarify the status of implementation guidance? If not, why?

21 EFRAG is not convinced that the existing material was really open to misinterpretation, but agrees that the amended text is very clear about the status of the Implementation guidance.

IAS 10 Events after the Reporting Period

Issue 8: Dividends declared after the end of the reporting period

22 The IASB identified a potentially unclear explanation in the guidance in IAS 10 *Events after the Reporting Period*. The explanation relates to why a dividend declared after the balance sheet date does not result in the recognition of a liability. That explanation (given in paragraph 13 of the standard) is that dividends declared after the balance sheet date but before finalisation of the financial statements are not recognised as a liability at the balance sheet date because 'they do not meet the criteria of a present obligation in IAS 37'.

23 The IASB's concern is that some may read the above explanation as implying that a liability should be recognised for dividends not declared until after the balance sheet date if there is an established pattern of paying a dividend. The IASB believes it would not be appropriate to recognise a liability in such circumstances, and is therefore proposing to amend IAS 10 so that it cannot be read in that way.

<u>IASB Q8:</u> Do you agree with the proposal to amend paragraph 13 of IAS 10 to clarify why a dividend declared after the reporting period does not result in the recognition of a liability at the end of the reporting period? If not, why?

24 EFRAG shares the IASB's concern and agrees with the IASB's proposal to eliminate this potential conflict between paragraph 13 of IAS 10 and paragraph BC4 of the standard's Basis for Conclusions by incorporating into the standard BC's explanation.

IAS 16 Property, Plant and Equipment

Issue 9: Recoverable amount

25 In IAS 16 Property, Plant and Equipment, 'recoverable amount' is defined as the higher of an asset's net selling price and its value in use. However:

(a) IAS 36 *Impairment of assets* defines the same term differently. Its definition is "the higher of its <u>fair value less costs to sell</u> and its value in use".

(b) The IASB has also noted that paragraph 15 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires entities to measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

There is perceived to be some inconsistency between these definitions and requirements. The IASB is therefore proposing to amend IAS 16's definition to bring it into line with IAS 36 and IFRS 5.

IASB Q9: Should the definition of recoverable amount in IAS 16 be amended to remove the perceived inconsistency with 'recoverable amount' used in other IFRSs? If not, why?

26 EFRAG questions whether this amendment is really needed because, since IAS 36 *Impairment of Assets* was issued, the definition in IAS 16 has become redundant because IAS 16 does not itself require the use of recoverable amount (except when it is discussing IAS 36 in IAS16.63). For that reason, EFRAG believes that a more appropriate amendment would have been simply to delete the definition in IAS 16. Having said that, the proposed amendment does not appear to be wrong.

Issue 10: Sale of assets held for rental

27 In various industries - such as car rental, aircraft manufacturing, heavy equipment, shipping, property industry - some entities manufacture or acquire assets with the intention of first renting them out to third parties under an operating lease, then selling them. Currently, there is a diversity of practice as to how the sales of such dual intention assets are presented in the financial statements.

28 The Board proposes to amend IAS 16 to require the sale of assets held for rental to others that are routinely sold in the course of its ordinary activities to be treated as revenue. The Board proposes consequential amendments to IAS 7 *Statement of Cash Flows* in respect of this issue.

IASB Q10: Do you agree with the proposal to amend paragraph 68 of IAS 16 and paragraph 14 of IAS 7? If not, why?

29 Although EFRAG supports what the IASB is trying to do by proposing this amendment, assets held for rental are just one example of assets that are acquired/constructed by an entity with the dual intention to sell the asset as part of its business model and we do not believe that it is appropriate to deal with the issue narrowly (by focusing just on assets held for rental).

30 In our view, the issue needs to be addressed in a broad context and comprehensively; and the best thing to do would be to address the issue on a standalone basis (ie outside of the Annual Improvements Project) and in a principle-based way.

31 Subject to the above comment, EFRAG shares the IASB's concerns that the current IAS 7 would result in a dissymmetry of the presentation of the cash in- and outflows and we agree with the IASB's proposal to classify both cash flows as operating.

IAS 17 Leases

Issue 11: Classification of leases of land and buildings

32 IAS 17 *Leases* requires that in certain situations leases of land and buildings should be bifurcated and accounted for separately. The main circumstance when this is necessary is when, if the lease of the land and the lease of the building were to be classified separately, one (usually the lease of the building) would be classified as a finance lease and the other (usually the lease of the land) would be an operating lease.

33 The IASB is concerned that the material in IAS 17 might be read to suggest that all leases of land are operating leases. For example, when a lease that is a 999 year lease of land and buildings is assessed using the criteria in paragraphs 8 to 12 of IAS 17, the IASB believes the conclusion should usually be, depending of course on the specific terms of the lease, that the entire lease is a finance lease (because the lessee will typically be in an economically similar position to an entity that has purchased the land and buildings). However, the guidance in paragraph 14 would be viewed by many as requiring the lease to be bifurcated and the land lease component to be classified as an operating lease.

34 The IASB proposes to amend IAS 17 to address this perceived inconsistency between the specific classification guidance for leases of land and buildings (in paragraph 14) and the general lease classification guidance (in paragraphs 8 to 12). It is proposing to do this by amending the specific classification guidance (ie paragraph 14).

IASB Q11: *Do you agree with the proposal to amend paragraphs 14 and 15 of IAS 17 to eliminate a perceived inconsistency between the specific classification guidance for leases of land and buildings and the general lease classification guidance in IAS 17? If not, why?*

35 EFRAG agrees with the proposed amendment. We suggest however adding in paragraph 15 an “of” before second “buildings” to ensure that readers would still understand that bifurcation of land and building might be necessary. The paragraph would read then:

“The land and buildings elements of a lease of land and of buildings are considered separately for the purposes of lease classification.”

Issue 12: Contingent rents

36 The IFRIC referred to the IASB for consideration the question of whether an estimate of contingent rentals payable / receivable under an operating lease should be (a) included in the total lease payments / lease income to be recognised on a straight-line basis over the lease term or (b) expensed as incurred (as is done for finance lease contracts). However, in referring the matter to the IASB the IFRIC noted that there seemed to be little divergence in practice on the issue.

37 The IASB proposes that contingent rent relating to an operating lease should be recognised as incurred. It noted that this would achieve consistency in the treatment of contingent rent for finance and operating leases – even though IFRIC did not think there was any diversity. It is also worth noting that the proposal would appear to involve a change in practice for most entities involved in these sort of transactions.

<u>IASB Q12:</u> Do you agree with the proposal that contingent rent relating to an operating lease should be recognised as incurred? If not, why?

38 EFRAG agrees with the proposed amendment.

39 We are concerned though that the proposed wording ("Contingent rent shall be recognised as an expense in the periods in which it is incurred.") could allow entities to structure lease arrangements so that significant parts of the actual payments are classified as contingent (although virtually certain) and are as a result not recognised as an expense until the end of the agreement. EFRAG therefore suggests refining the drafting to prevent such structuring opportunities arising. For example, it could require the substance of the contingency to be considered.

IAS 18 Revenue

Issue 13: Costs of originating a loan

40 The IASB has identified an inconsistency between the guidance in the Appendix accompanying IAS 18 *Revenue* and IAS 39 *Financial Instruments: Recognition and Measurement*. Paragraph 14 (a) (i) of the Appendix to IAS 18 discusses origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IAS 39 is classified as a 'financial asset at fair value through profit or loss'. It states that "…these fees are an integral part of generating an involvement with the resulting financial instrument and, together with *the related direct costs* are deferred and recognised as an adjustment to the effective interest rate." (Emphasis added). The IASB has concerns about the words "related direct costs": IAS 18 does not seem to require such costs to be incremental while IAS 39 uses the term "transaction costs" and defines them as related incremental direct costs.

41 The IASB thinks the result is that standards are inconsistent as to the identification of costs incurred in originating a financial asset that should be deferred and recognised as an adjustment to the effective interest rate. It is therefore proposing to eliminate this inconsistency.

42 The IASB believes that the definition of transaction costs in IAS 39 is more appropriate and should be used to determine the costs that are deferred in accordance with IAS 18 on the origination of a loan. As a result, it is proposing to amend IAS 18 by replacing the phrase "related direct costs" in the above sentence with "related transaction costs (as defined in IAS 39)".

<u>IASB Q13:</u> Do you agree with the proposed amendment to the guidance on IAS 18 to explain that the definition of the transaction costs to be applied to the accounting for financial asset origination fees are those defined in IAS 39? If not, why?

43 In our view, the difference between IAS 18 and IAS 39 with regard to the definition of costs incurred in originating a financial asset that should be deferred and recognised as an adjustment to the effective interest rate is not intentional.

44 The method to calculate the effective interest rate is defined in IAS 39 and the definition contains the following requirement: "The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS18 revenue), transaction costs, and all other premium and discounts." This requirement is clear in that costs that are included in the calculation of

the effective interest rate are transaction costs and these are defined in IAS 39 as related incremental direct costs.

45 Therefore, EFRAG agrees with the proposal to include a reference to the definition of transaction costs under IAS 39 in paragraph 14(a)(i) of the Appendix to IAS 18.

46 However, in addition to the inconsistency in paragraph 14 (a) (i) identified by the IASB as explained in the preceding paragraphs, we note that paragraph 14(a)(ii) in the Appendix to IAS 18 that discusses commitment fees received by the entity to originate a loan seems to be inconsistent with IAS 39 too because it also uses the words "related direct costs" when describing costs that should be deferred and recognised (together with the commitment fee) as an adjustment to the effective interest rate.

47 At the same time paragraph 14(a)(iii) in the Appendix to IAS 18 that discusses origination fees received on issuing liabilities uses the term "related transaction costs" in relation to costs that should be deferred and recognised as an adjustment to the effective interest rate, i.e. is consistent with IAS 39.

48 We believe therefore that a similar amendment to the one proposed needs also to be made to paragraph 14(a)(ii), and for consistency to paragraph 14 (a) (iii) even though the latter is already clear in this respect.

IAS 19 Employee Benefits

Issue 14: Curtailments and negative past service cost

49 The IASB is proposing to amend IAS19 in respect of plan amendments because it believes the definitions of negative past service costs and curtailments are ambiguous and are resulting in diverse accounting for plan amendments that reduce existing benefits. The proposed amendment clarifies that, when a plan amendment reduces benefits for future service, the reduction relating to future service is a curtailment and any reduction relating to past service is a negative past service cost. The Board also proposes to delete a reference to materiality in paragraph 111 of IAS 19.

<u>IASB Q14:</u> (a) Do you agree that IAS 19 should be amended to clarify that when a plan amendment reduces benefits for future service, the reduction relating to future service is a curtailment and any reduction relating to past service is negative past service cost? If not, why?

<u>IASB Q14:</u> (b) Do you agree that the Board should delete the following sentence from paragraph 111 of IAS 19: 'An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements.'? If not, why?

50 EFRAG agrees that the existing guidance in IAS19 on the subject of plan amendments is somewhat ambiguous and therefore open to different interpretations, and it also agrees that the amended text improves IAS19 by clarifying when plan amendments (which reduce existing benefits) should be accounted for as a curtailment or as negative past service costs. Finally, EFRAG agrees with the Board's decision to eliminate the references to 'materiality'.

Issue 15: Plan administration costs

51 The IASB believes it has identified an inconsistency in IAS19 between the definition of 'return on plan assets' and the way in which that term is used. It is proposing to eliminate this inconsistency by amending the definition of 'return on plan assets' to require the deduction of plan administration costs only to the extent that such costs have not been reflected in the measurement of the defined benefit obligation.

IASB Q15: Do you agree with the proposal to amend the definition of return on plan assets in paragraph 7 of IAS 19 to require the deduction of plan administration costs only to the extent that such costs have not been reflected in the measurement of the defined benefit obligation? If not, why?

52 EFRAG agrees with the above proposal; deducting such costs in the calculation of the return on plan assets and including the same costs in the actuarial assumptions used to measure the defined benefit obligation would effectively result in double counting. For that reason it is reasonable to require the deduction of plan administration costs only to the extent that such costs have not been reflected in the measurement of the defined benefit obligation. Nevertheless EFRAG thinks that it would be helpful to determine on which side of the equation such items should be measured.

Issue 16: Replacement of term 'fall due'

53 The IASB is proposing to replace the term "fall due" in the definitions of 'short-term employee benefits' and 'other long-term employee benefits' with "employee becomes wholly entitled" in order to address a perceived inconsistency between the definition of short-term employee benefits in IAS 19.7 and examples thereof in IAS 19.8(b). The term "wholly entitled" focuses on the timing of the entitlement of the employee rather than the expected timing of the use of the benefit by the employee.

IASB Q16: Do you agree with the proposal to replace in IAS 19 the term 'fall due' with the notion of employee entitlement in the definitions of short-term employee benefits and other long-term employee benefits? If not, why?

54 EFRAG agrees with the IASB that this is an inconsistency in IAS 19 that needs to be addressed. However, it is not clear whether the reference to entitlement is intended to be a reference to "vesting". We also think that in preparing the appropriate amendment, the IASB should ensure that the dividing line between short-term and long-term will be consistent with the measurement difference, ie taking into account the lack of discounting in the measurement of short-term employee benefits.

55 We therefore believe that the IASB should take more time to fully consider the issue. We suggest moving the issue to the next Annual Improvements Project to allow the IASB sufficient time to investigate any consequences on the areas mentioned above.

Issue 17: Guidance on contingent liabilities

56 The IASB has proposed removing references in IAS 19 *Employee Benefits* to recognising contingent liabilities (for example, paragraph 32B of IAS 19 states that contingent liabilities are required to be recognised under IAS37 *Provisions*) because such references are inconsistent with IAS37 which states that contingent liabilities should not be recognised.

<u>IASB Q17:</u> Should the reference in IAS 19 to recognising contingent liabilities be removed? If not, why?

57 EFRAG agrees with this proposed amendment.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

Issue 18: Consistency of terminology with other IFRSs

58 The IASB has identified that IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* uses some terms that are inconsistent with defined terms or with more widely used terms for equivalent items in other standards. The IASB believes that the consistency of IFRS would be improved if the terms used by IAS 20 were changed to the equivalent defined or more widely used terms. The inconsistencies are that IAS 20 uses:

(a) 'taxable income' instead of 'taxable profit or tax loss';

(b) 'as income' instead of 'in profit or loss'; and

(c) 'revision to an accounting estimate' instead of 'change in accounting estimate'.

59 The IASB has also noted that these inconsistencies are repeated in the discussion about government grants in IAS 41 *Agriculture*.

<u>IASB Q18:</u> Do you agree with the proposal to conform terminology used by IAS 20 to the equivalent defined or more widely used terms? If not, why?

60 EFRAG agrees that IAS 20 and IAS 41 use inconsistent terminology and that it would be better were this inconsistency to be eliminated. We also agree with the other minor wording changes being proposed; they improve the standard's readability without changing the meaning. This includes the deletion of the statement in IAS 20, paragraph 12 that grants shall not be credited directly to shareholders' interests; EFRAG agrees that the statement is unnecessary because paragraph 12 states that government grants shall be recognised in profit or loss.

Issue 19: Government loans with a below-market rate of interest

61 The Board proposes to amend IAS 20 *Government Grants* to remove an inconsistency with IAS 39 *Financial Instruments: Recognition and Measurement*. The amendment proposed would require the benefit of a loan received from a government with a below-market rate of interest to be quantified by the imputation of interest in accordance with IAS 39.

<u>IASB Q19:</u> Do you agree with the proposed amendments to IAS 20 to clarify that the benefit of a loan received from a government with a below-market rate of interest should be quantified by the imputation of interest in accordance with IAS 39? If not, why?

62 EFRAG agrees with the proposed amendment.

63 However, we would like the IASB to consider providing guidance on how this requirement should be applied by entities hat receive financial support from government in the

form of a low interest loan. We understand that imputation of market interest rate would reveal that the company is only viable because of the government subsidised interest rate – which is indeed the case - but we can also envisage difficulties for such entities in determining a market interest rate for their borrowings under such circumstances. In addition, if an entity receives support from government in the form of a guarantee at non-market rates that enables it to borrow at market rates, would the entity have to impute additional interest under this amendment?

IAS 23 Borrowing Costs

Issue 20: Components of borrowing costs

64 The IASB is proposing to amend paragraph 6 of IAS23 *Borrowing Costs* (which provides a list of components of borrowing costs) to refer to the guidance in IAS39 *Financial Instruments: Recognition and Measurement* on effective interest rate when describing the components of borrowing costs. In particular, the IASB believes that consistency between the standards would be improved, with respect to the components of borrowing costs, if paragraph 6(a) to (c) of IAS 23 (as listed below) were replaced with a cross reference to interest expense calculated in accordance with the 'effective interest method' as defined in IAS 39. The Board noted that components of borrowing costs in paragraph 6(a) -(c) of IAS 23 are broadly equivalent to the components of interest expense calculated using the effective interest rate method under IAS 39.

65 Paragraph 6(a) – (c) of IAS 23 states that Borrowing costs may include :

(a) Interest on bank overdrafts and short term and long term borrowings;

(b) Amortisation of discounts or premiums relating to borrowings;

(c) Amortisation of ancillary costs incurred in connection with the arrangements of borrowings.

<u>IASB Q20:</u> Do you agree with the proposal to amend paragraph 6 of IAS 23 to reference to the guidance in IAS 39 Financial Instruments: Recognition and Measurement relating to effective interest rate when describing the components of borrowing costs? If not, why?

66 EFRAG agrees that consistency between IFRSs will be improved as a result of the proposed amendment. However, we are a bit concerned that there might now be inconsistencies (and perhaps were already inconsistencies) between IFRS and US GAAP on how origination fees and placement fees should be dealt with in the effective interest rate calculation.

IAS 27 Consolidated and Separate Financial Statements

Issue 21: Measurement of subsidiary held for sale in separate financial statements

67 This issue relates to an inconsistency between IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 27 *Consolidated and Separate Financial Statements* on the measurement of a subsidiary classified as held for sale when a parent applies a policy of accounting for subsidiaries in accordance with IAS 39 in its separate financial statements. A similar issue also exists when a parent entity ac-

counts for associates and joint ventures under IFRS in its separate financial statements.

68 Paragraph 37 of IAS 27 requires a parent to account for investments in subsidiaries, jointly-controlled entities and associates in its separate financial statements either at cost or in accordance with IAS 39, unless such investments are classified as held for sale, in which case IAS 27 requires them to be accounted for under IFRS 5. However, IFRS 5 excludes from the scope of its measurement requirements financial assets accounted for in accordance with IAS 39.

69 The IASB is proposing to resolve this issue by eliminating the reference in IAS 27.37 to such investments being accounted for in accordance with IFRS 5; henceforth, even if they are being held for sale they will be accounted for either at cost or in accordance with IAS 39. The underlying issue here is whether such investments should be measured at fair value less costs to sell (IFRS 5) or fair value (IAS 39).

<u>IASB Q21:</u> *Do you agree with the proposal to require investments in subsidiaries that are accounted for in accordance with IAS 39 in the parent's separate financial statements to continue to be accounted for on that basis when classified as held for sale (or included in a disposal group that is classified as held for sale)? If not, why?*

70 EFRAG agrees that there is an issue here that needs to be resolved. It notes also that the proposed amendment is in line with the accounting for other assets that are accounted for at fair value. For that reason EFRAG agrees with the proposed amendment to IAS 27.

IAS 28 Investments in Associates

Issue 22: Required disclosures when investments in associates are accounted for at fair value through profit or loss

71 The IASB has identified an apparent inconsistency in the disclosure requirements for entities that are eligible to and elect to account for investments in associates at fair value in accordance with IAS 39. These entities are excluded from the scope of IAS 28 and, therefore, are not required to give the disclosures that this standard would otherwise require. However, IAS 32 and IFRS 7 both require entities that account for investments in associates in accordance with IAS 39 to give the disclosures required by IAS 28 in addition to the disclosures required by IAS 32 and IFRS 7.

72 The IASB is proposing to address this inconsistency by removing from IAS 32 and IFRS 7 the general requirement to give the IAS 28 disclosures, and instead specifying in IAS 28 the specific disclosures that should be given. In particular, the proposal is that entities would provide the disclosures required by IAS 28.37(f) (re significant restrictions on the ability of associates to transfer funds to the investor).

<u>IASB Q22:</u> *Do you agree with the proposal to clarify the disclosures required of an investor in an associate that accounts for its interest in the associate at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss? If not, why?*

73 EFRAG agrees that there is an apparent inconsistency and it agrees that such inconsistencies should generally be eliminated. For that reason it agrees with the proposal subject to one important caveat: we would wish the IASB to ensure that the benefits to

be derived from these additional disclosures justify the costs involved in providing them.

Issue 23: Impairment of investment in associate

74 Under IAS 28 *Investments in Associates* associates within the scope of IAS 28 are accounted for using the equity method; in other words, the investment is initially recognised at cost and the carrying amount is subsequently increased or decreased to recognise the investor's share of the profit or loss of the associate. Goodwill arising upon the acquisition is thus included within the carrying amount of the investment and is not amortised within the books of the investor, nor is amortisation of the goodwill taken into account in determining the investor's share of the profit or loss of the associate.

75 One implication of this accounting is that, because the goodwill is not separately recognised, it is not tested for impairment separately as would be required by IAS 36 Impairment of Assets, but rather treated as part of the carrying amount of the investment as a whole. The question arises as to whether the same principle applies when an impairment loss or a reversal of a previously recognised loss occurs, i.e. no allocation of the impairment loss is made between the part of the impairment loss that relates to the goodwill element of the investment and the rest of the investment. The IASB is proposing to clarify that no such allocation is made and that consequently any subsequent reversal of impairment losses should also be recognised in full.

IASB Q23: Do you agree with the proposal to amend paragraph 33 of IAS 28 to clarify the circumstances in which an impairment charge against an investment in an associate should be reversed? If not, why?

76 EFRAG agrees with the clarification made by the IASB. This is consistent with the existing requirement of IAS 28.33 not to test separately the goodwill that is subsumed within the cost of the investment in the associate. EFRAG notes that IAS 28.23 requires that under the equity method appropriate adjustments be made to the investor's share of the post-acquisition profits or losses of the associate, and that this would include goodwill impairment losses to be recognised by the associate. Any further impairment loss to be recognised by the investor would therefore be expected to reflect elements other than goodwill, and reversals would also relate to elements other than goodwill.

IAS 29 Financial Reporting in Hyperinflationary Economies

Issue 24: Consistency of terminology with other IFRSs

77 The IASB has identified that paragraph 6 of IAS 29 *Financial Reporting in Hyperinflationary Economies* contains an out-of-date description of the measurement basis used in financial statements. For example, it says assets and liabilities are at cost except "to the extent that property, plant and equipment and investments may be revalued". In other words, it does not reflect that there are now several other balance sheet categories that may or must be measured on the basis of a current value (such as fair value) rather than a historical value. The IASB also believes the standard uses some out-of-date or inconsistent terminology. In particular, it:

(a) uses the term 'market value' in IAS 29 to describe existing measurement practice instead of the defined term 'fair value';

(b) uses the terms ‘results of operations’ and ‘net income’ when other standards use the term ‘profit or loss’ and

(c) refers to ‘investments’ as non-monetary assets carried at cost. Most investments are now measured at fair value in accordance with IAS 39.

IASB Q24: Do you agree with the proposal to update the description of historical cost financial statements in paragraph 6 IAS 29 and to conform terminology in IAS 29 to the equivalent defined or more widely used terms? If not, why?

78 EFRAG agrees with what the IASB is trying to do here and how it is proposing to do it. EFRAG particularly welcomes the IASB’s proposal that paragraph 6 should simply give examples, rather than a definitive list, of items not measured at cost. Regarding replacing the term ‘market value’ with ‘fair value’ EFRAG thinks that this improves consistency with other standards. The places the IASB wants to use the term are places where IAS 29 is in effect referring to what existing IFRS requires.

IAS 31 Interests in Joint Ventures

Issue 25: Required disclosures when interests in jointly controlled entities are accounted for at fair value through profit or loss

79 The IASB has identified an apparent inconsistency in the disclosure requirements for entities that are eligible to and elect to account for investments in jointly controlled entities at fair value in accordance with IAS 39. These entities are excluded from the scope of IAS 31, and, therefore, are not required to give the disclosures that those standards would otherwise require. However, IAS 32 and IFRS 7 both require entities that account for investments in jointly controlled entities in accordance with IAS 39 to give the disclosures required by IAS 31 in addition to the disclosures required by IAS 32 and IFRS 7.

80 The IASB is proposing to address this inconsistency by removing from IAS 32 and IFRS 7 the general requirement to give the IAS 31 disclosures, and instead specifying in IAS 31 the specific disclosures that should be given. Those disclosures are:

(a) the IAS 31.55 disclosures about the aggregate amount of the venturer’s commitments relating to its own, and its jointly incurred share of, capital commitments in respect of the joint ventures; and

(b) the IAS 31.56 disclosures about a listing and description of interests in significant joint ventures and its proportion of ownership of jointly controlled entities.

IASB Q25: Do you agree with the proposal to clarify the disclosures required of a venturer in a jointly controlled entity that accounts for its interest in the jointly controlled entity at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss? If not, why?

81 EFRAG agrees with the IASB’s decision to eliminate these inconsistencies, although it questions whether the specific disclosures required are useful to users of the financial statements of the venture capital organisations and mutual funds that are the object of this scope exception. For that reason, EFRAG believes it is important that the IASB ensures the benefits to be derived from these additional disclosures justify the costs involved in providing them.

IAS 34 Interim Financial Reporting

Issue 26: Earnings per share disclosures in interim financial reports

82 Paragraph 11 of IAS 34 *Interim Financial Reporting* requires the disclosure of basic and diluted earnings per share in an interim report. However, it does not make it clear that this disclosure is required only if the entity falls within the scope of IAS 33 *Earnings per share*.

83 The IASB proposes to amend IAS 34 to require the presentation of basic and diluted earnings per share only when the entity is within the scope of IAS 33.

IASB Q26: Do you agree with the proposal to amend paragraph 11 of IAS 34 to require the presentation of basic and diluted earnings per share only when the entity is within the scope of IAS 33? If not, why?

84 EFRAG agrees with the proposed amendment but believes the IASB should also require the actual calculations to be done in accordance with IAS 33. Therefore, in our view the amended paragraph 11 of IAS 34 should read:

"In the statement that presents the components of profit or loss for an interim period, an entity shall present basic and diluted earnings per share for that period when the entity is within the scope of and shall do so in accordance with IAS 33 Earnings per Share."

IAS 36 Impairment of Assets

Issue 27: Disclosure of estimates used to determine recoverable amount

85 IAS 36 *Impairment of Assets* defines the recoverable amount of an asset or cash generating unit (CGU) as "the higher of the asset's or CGU's fair value less costs to sell and its value in use". When recoverable amount is to be used in the absence of a binding sales contract or an active market, fair value less costs to sell would, like value in use, be derived from estimates of future cash flows. Yet the disclosures required by IAS 36 in this case are very different from those required when value in use is used,

86 The IASB wishes to address this inconsistency and is therefore proposing to amend IAS 36 to require the same disclosures to be given when an asset is measured at fair value less costs to sell, with that amount being estimated using discounted cash flows, as are already required when an asset is measured at value in use.

IASB Q27: Do you agree with the proposal to amend paragraph 134(e) of IAS 36 to require the same disclosures to be given for fair value less costs to sell as are required for value in use when discounted cash flows are used to calculate fair value less costs to sell? If not, why?

87 EFRAG agrees that there is an inconsistency and it agrees the inconsistency should be eliminated by requiring the same disclosures in both cases.

IAS 38 Intangible Assets

Issue 28: Advertising and promotional activities

88 IAS 38 requires expenditure on advertising or promotional activities, training activities and start-up activities, and on relocating or reorganising part or all of an entity to be recognised as an expense as incurred. Divergent interpretations have developed about when such expenses are incurred. This proposed amendment clarifies the meaning of 'as incurred' in this context. It also makes clear that an entity may recognise the prepayment of such expenditure as an asset only until the reporting entity has access to the goods or has received the services.

IASB Q28: (a) Do you agree that IAS 38 should emphasise that an entity should recognise expenditure on an intangible item as an expense when it has access to the goods or has received the services? If not, why?

IASB Q28: (b) Do you agree that paragraph 70 of IAS 38 should be amended to allow an entity to recognise a prepayment only until it has access to the related goods or has received the related services? If not, why?

89 EFRAG is not comfortable about this amendment being made through the Annual Improvements Project, for two reasons. Firstly, the proposed amendment touches on a very fundamental issue—the distinction between an asset and an expense—and we think fundamental issues of this kind need to be addressed broadly and in a principle-based way, rather than in a very narrow context. Secondly, it would appear from the letters we have received that constituents believe the amendment proposed might change practice significantly for some entities; we believe that, if a proposed amendment is likely to change practice significantly, it is better for it to be dealt with on a standalone basis rather than in an omnibus ED with forty other proposed amendments.

90 EFRAG agrees that paragraph 70 of IAS 38 should be amended to allow an entity to recognise a prepayment only until it has access to the related goods or has received the related services.

Issue 29: Unit of production method of amortisation

91 When finalising IFRIC 12 *Service Concession Arrangements*, the IASB noted that the wording used in IAS 38.98 when discussing when to use depreciation methods that involve low levels of depreciation initially ("rarely, if ever") was interpreted by many to mean "never". As a result, commentators were arguing that the use of the unit of production amortisation method could not be used under IFRIC 12's intangible asset model, even though it might reflect the expected pattern of consumption.

92 The IASB decided that this was not the intention of the words in IAS 38.98. It is therefore proposing to clarify things by deleting the relevant sentence of paragraph 98.

IASB Q29: Do you agree with the proposal to remove the last sentence of paragraph 98 of IAS 38 regarding the amortisation method used for intangible assets? If not, why?

93 EFRAG agrees with the amendment. However, we think it would be helpful if the Basis for Conclusion could explain why the IASB decided that merely deleting the words "if ever" would not be sufficient. We think this might be due to possible conclusions

reached in future projects (such as extractive industry), but think things would be clearer were this to be explained in more detail. It was further noted that BC5 refers only to service concessions; this reference could be misinterpreted to mean that this is the only circumstance where a departure may be merited.

IAS 39 Financial Instruments: Recognition and Measurement

Issue 30: Definition of a derivative

94 The IASB proposes to amend the definition of a derivative. The current definition excludes contracts linked to non-financial variables that are specific to a party to the contract. The IASB concluded that the exclusion is not necessary for its original purpose – which was that contracts within the scope of IFRS 4 would not also be in the scope of IAS 39 – because it eventually included in IAS 39 (in paragraph 2(e)) a specific exemption from the scope of IAS 39 for the relevant types of contracts that are also within the scope of IFRS 4. Therefore, the IASB proposes to remove the exclusion relating to non-financial variables that are specific to a party to the contract.

95 As a result, contracts linked to non-financial variables specific to a party to the contract that are within the scope of IAS 39 would be classified as derivatives.

96 The definition of financial risk in IFRS 4 mirrors the definition of a derivative in IAS 39. However, the IASB is not proposing to change IFRS 4 because it believes a distinction based on exposure to non-financial variables is relevant in determining whether a contract is an insurance contract.

IASB Q30: Do you agree with the proposal to amend IAS 39 by removing from the definition of a derivative the exclusion relating to contracts linked to non-financial variables that are specific to a party to the contract? If not, why?

97 EFRAG does not support this proposal. Although we recognise that the words are not needed to achieve the purpose for which they were originally included, we have found the words useful in other contexts – for example, considering where the line should be drawn between the financial asset model and the intangible asset model under IFRIC 12. We also understand that constituents believe the amendment might also have implications for some other types of executory contracts (see list in the paragraph below). We therefore would not want a change made without all the possible implications of the change being considered. For that reason, EFRAG's view is that this issue should not be dealt with in the Annual Improvements Process.

98 We understand that constituents note the following as examples of contracts that could be affected by the proposed amendment:

- Real estate management fees where the fees are based on income generated by the underlying property

- Lease contracts where payments are based on performance measures specific to the lessee (e.g., earnings performance)

- Loans with variable interest rates that are based on the performance of the borrower (e.g., an interest step up feature in the event that the borrower failed to meet liquidity ratios such as interest cover)

- Loans with repayment or interest schedules that are linked to earnings performance of the borrower

- Loans where the interest rate is linked to profit from the sale of assets held by the borrower

- Property development loans where the interest rate is linked to profit on or the ultimate sale of the development

- Residual value guarantees (e.g., where a leasing company guarantees the value of a car at the end of the lease term)

- Pharmaceutical industry contracts (e.g., where payments to be received for providing a new drug are dependent on the success rate of that drug)

- Mobile phone service provider arrangements (e.g., where distributors are compensated by service providers dependent on the length of contract term agreed with the end customer)

- Service concession arrangements where lease payments are dependent on performance of the infrastructure asset

- Debt instruments which are indexed to non-financial variables (“covenants”)

- Royalty schemes where a percentage of the turnover is handed over in royalty

- Employee bonus schemes where employees are promised a percentage of the company’s profit.

Issue 31: Reclassification of derivatives into or out of the classification of at fair value through profit or loss

99 The IASB has identified an inconsistency within IAS 39: *Financial Instruments: Recognition and Measurement.* Paragraph 50 of IAS 39 prohibits the classification of financial instruments into or out of the fair value through profit or loss category after their initial recognition. However, IAS 39 subsequently appears to contradict this prohibition without including specific exceptions from paragraph 50. These cases are:

(a) A possibility to move a derivative *in and out* of the profit or loss category any time while the derivative is outstanding if an entity designates a derivative as a hedging instrument or stops such a designation. This is because IAS 39 allows a derivative be designated as a hedging instrument any time while the derivative is outstanding; the entity might also have to stop hedge accounting if the hedge relationship is no longer effective or it might elect to stop hedge accounting any time.

(b) A requirement in IAS 39 to reclassify a portfolio of financial assets and financial liabilities *into* the fair value through profit or loss category for which evidence arises for the first time of a recent actual pattern of short-term profit taking; and

(c) A requirement in IAS 39 to reclassify a financial instrument into the fair value through profit or loss category if the instrument is transferred into a portfolio for which there is evidence of a recent actual pattern of short-term profit taking.

100 The IASB proposes to amend definitions of a financial instrument classified as held for trading to make it clear that the classification into the held-for-trading category is made on initial recognition.

101 The IASB further proposes to clarify in what circumstances specific financial instruments start or cease to be accounted for at fair value through profit or loss. In this respect, the IASB concluded that the circumstances when a derivative starts or stops being designated as a hedging instrument were not exceptions from the principle that there should be no reclassifications because they were changes in circumstances and not reclassifications.

IASB Q31: (a) Do you agree with the proposal to amend IAS 39 to clarify definitions of a financial instrument classified as held for trading? If not, why?

102 EFRAG agrees with the proposed amendments.

IASB Q31: (b) Do you agree with the proposal to insert in IAS 39 paragraph 50A to clarify the changes in circumstances that are not reclassifications into or out of the fair value through profit or loss category? If not, why?

103 EFRAG agrees that the general principle in paragraph 50 should not apply to those cases when a derivative starts or stops being designated as a hedging instrument in accordance with the respective requirements in IAS 39. However, we do not agree with the IASB's reasoning that these changes in circumstances are not reclassifications. We think they are reclassifications that IAS 39 requires as an exception to the general requirement in paragraph 50. We therefore suggest the following amendment to the IASB's tentative proposal:

> 50 An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued, unless
>
> ~~50A The following changes in circumstances are not reclassifications for the purposes of paragraph 50:~~
>
> (a) a derivative that was previously a designated and effective hedging instrument no longer qualifies as such;
>
> (b) a derivative becomes a designated and effective hedging instrument.

104 Finally, we think there is another exception that should be added as (c) to the above list of exceptions: under paragraph 45 of IFRS 4, an insurance company is allowed to redesignate into the fair value through profit or loss category assets when changing its accounting policies in accordance with IFRS 4.22 to improve the measurement of insurance liabilities.

Issue 32: Designating and documenting hedges at the segment level

105 The IASB believes there is a conflict between paragraph 73 of IAS 39 and the requirements of IFRS 8 *Operating Segments*. Paragraph 73 of IAS 39 refers to the need for hedging instruments to involve a party external to the reporting entity. In doing so, it uses a segment as an example of such a party. IFRS 8 requires the identification of the segments and the information provided in respect of each of those identified segments to be based on the information that is reported to the chief operating decision maker – meaning that there is no requirement that the hedge accounting used in the segment information shall be IFRS-compliant. Therefore, the two IFRSs appear to be

in conflict and the IASB proposes to remove from paragraph 73 references to the designation of hedging instruments at the segment level.

<u>IASB Q32:</u> Do you agree with the proposal to amend paragraph 73 of IAS 39 to remove the references to segments and segment reporting? If not, why?

106 EFRAG agrees with the proposed amendments.

Issue 33: Applicable effective interest rate on cessation of fair value hedge accounting

107 The IASB proposes to amend IAS 39 to clarify that the revised effective interest rate calculated on cessation of fair value hedge accounting in accordance with paragraph 92 should be used for the remeasurement of the hedged item when paragraph AG8 is applicable.

<u>IASB Q33:</u> Do you agree with the proposal to amend paragraph AG8 of IAS 39 to clarify that the revised effective interest rate calculated in accordance with paragraph 92 shall be used, when applicable, for the purposes of the remeasurement of the financial instrument in accordance with paragraph AG8? If not, why?

108 EFRAG agrees with the proposed amendment.

Issue 34: Treating loan prepayment penalties as closely related embedded derivatives

109 The IASB proposes to remove an inconsistency between paragraphs AG30(g) and AG33(a) in IAS 39 *Financial Instruments: Recognition and Measurement* with respect to embedded prepayment options. The proposed amendment clarifies that prepayment options, the exercise price of which compensates the lender for loss of interest by reducing the economic loss from reinvestment risk, are closely related to the host debt contract.

<u>IASB Q34:</u> Do you agree with the proposal to amend paragraph AG30(g) of IAS 39 to clarify that prepayment options, the exercise price of which compensate the lender for loss of interest by reducing the economic loss from reinvestment risk, as described in paragraph AG33(a), are closely related to the host debt contract? If not, why?

110 EFRAG agrees in principle with this proposed amendment. There is a concern that it might create structuring opportunities—because the amendment does not specify to what extent such reduction has to occur—but we see no easy way of addressing that, and anyway we do not believe that concerns about the potential for abuse should determine the content of IFRS.

IAS 40 Investment Property

Issue 35: Property under construction or development for future use as investment property

111 When IAS 40 was being developed, the IASC was concerned about difficulties in estimating reliably the fair value of investment property under construction. It decided as a result that revaluations of investment property under construction should not be permitted, and it excluded such property from the scope of IAS 40 and instead included it

within the scope of IAS 16 because it believed that that would have the effect of prohibiting such revaluations (see IAS 40 BC 17-18).

112 The IASB has several concerns about this:

(c) It thinks that the IASC was wrong to believe that IAS 16 prohibited revaluation of investment property under construction. In its view, both IAS 16 and IAS 40 permit entities to choose either a fair value model or a cost model for revaluation of property under construction.

(d) The IASB believes that the valuation difficulties that the IASC was concerned about no longer exist. Modern valuation techniques mean that the fair value of investment property under construction can nowadays be reliably estimated. The International Valuations Standards Committee supports the IASB in this because it has indicated that it is not substantially more difficult to value investment property under construction at fair value than to fair value completed investment property. Therefore, the reason for the exclusion no longer exists.

(e) The IASB is concerned that, as long as investment property under construction remains within the scope of IAS 16, there will be an inconsistency with the accounting of investment property under redevelopment, which has to be accounted for in accordance with IAS 40.

113 The IASB is therefore proposing to remove from the scope of IAS 16 property under construction or development for future use as an investment property and to include it within the scope of IAS 40. As part of the amendments needed to achieve this, investment property under construction will be within the definition of investment property; and one implication of this is that, where an entity uses the fair value model in IAS 40, changes in the fair value of such property will be included in the statement of comprehensive income. The Board proposes consequential amendments to IAS 16 in respect of this issue.

<u>IASB Q35:</u> The exposure draft proposes to include property under construction or development for future use as an investment property within the scope of IAS 40. Do you agree with the proposal? If not, why?

114 EFRAG agrees with the IASB's assessment that, since the publication of IAS 40, valuation techniques have become more robust and, as a result, there are not the same reliability concerns about fair valuing investment property under construction that there once were. As a result, we would support IFRS being amended to permit such assets to be measured at fair value, as long as IFRS also recognises that there will continue to be circumstances in which it will not be possible to determine the fair value of investment property under construction reliably (as IAS 40 does).

115 EFRAG also agrees that there might be an inconsistency in the accounting for the redevelopment of an existing investment property and the construction or development of a future investment property. We would therefore support this potential inconsistency being addressed by bringing both types of asset within the scope of the same standard.

116 However, we would note that there seems to be considerable uncertainty as to whether IFRS (even with the amendments proposed) would permit assets under construction to be measured at fair value. And, if the IASB takes the view that IAS 40 does permit assets under construction to be measured at fair value, there seems to be a widely held view that, because IAS 16 and IAS 40 are similarly structured in this re-

gard, it should also take the view that IAS 16 permits assets under construction to be measured at fair value—which would be a significant change to existing accounting.

117 Therefore, although we support the IASB's objectives in proposing these amendments, we believe the issues it raises are best addressed comprehensively outside the scope of the Annual Improvements Project.

Issue 36: Consistency of terminology with IAS 8

118 The IASB has noted that IAS 40 does not reflect the updated wording of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. In particular, when IAS 8 was revised as part of the last improvements project, a consequential amendment should have been made to align IAS 40.31 with IAS 8. The Board is therefore proposing to amend paragraph 31 of IAS 40 to ensure consistency with the text of IAS 8.

<u>IASB Q36:</u> Do you agree with the proposal to conform terminology used in paragraph 31 of IAS 40 to the terminology used in IAS 8? If not, why?

119 EFRAG agrees with the proposed amendment.

Issue 37: Investment property held under lease

120 The IASB has noted that there is ambiguous wording in IAS 40 regarding the fair value of investment property held under a lease. In particular, paragraph 50(d) seems to imply that by simply adding back any recognised lease liabilities one arrives at the fair value of an investment property held under a lease. The IASB realises that this suggests that the fair value of an investment property asset held under a lease is equal to the net fair value plus the carrying amount of any recognised lease liability; and that is not correct. The IASB therefore proposes to amend IAS 40 to make clear how an investment property under lease should be recorded.

<u>IASB Q37:</u> Should paragraph 50(d) of IAS 40 be amended to clarify the accounting for investment property held under a lease? If not, why?

121 EFRAG agrees with the proposed amendment. However, it is unsure why the reference to the fair value model has been retained even in the revised wording, as paragraph 50 is obviously relating to the application of the fair value model for investment property and a similar question would not arise in the cost model.

IAS 41 Agriculture

Issue 38: Point-of-sale costs

122 IAS 41 requires a biological asset to be measured at its fair value less estimated point-of-sale costs unless its fair value cannot be measured reliably. The term "point-of-sale costs" is not used by other Standards. On the other hand, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 36 *Impairment of Assets* use the term "costs to sell".

123 The IASB believes these two terms describe the same notion, and it wants to avoid using two terms to describe the same notion. It is therefore proposing to replace the

term “point-of-sale costs” with “cost to sell”. The IASB is proposing consequential amendments to IFRS 5, IAS 2 *Inventories* and IAS 36 in respect of this issue.

IASB Q38: Do you agree with the proposal to replace the terms ‘point-of-sale costs’ and ‘estimated point-of-sale costs’ in IAS 41 with ‘costs to sell’? If not, why?

124 EFRAG does not support the proposed amendment because it is not apparent to us that the two terms do indeed describe the same notion.

(a) Our understanding is that “costs to sell” would normally include transportation costs, while such costs are explicitly excluded from the “point-of-sale” costs. We think the IASB argues that the word “incremental” in the definition of “costs to sell” excludes costs already included in the fair value measurement, but we do not think this is clear.

(b) We think the term “point-of-sale costs” was explicitly introduced in the IFRS literature to distinguish from costs to sell and in order to consider the specific circumstance in relation to agriculture assets. It therefore seems appropriate to use different definitions, as they are supposed to mean different things.

125 Having said that, we hope that when the fair value measurement and measurement debates are finished it will be possible to develop some principles on the treatment of these various costs. Until then though, we would not support any attempt to align what are different notions through the Improvements Project.

126 Finally, EFRAG would have preferred the IASB to have tried to improve the definition of “transaction costs”.

Issue 39: Discount rate for fair value calculations

127 The IASB has noted that the existing wording of paragraph 20 of IAS 41 *Agriculture* requires the use of a pre-tax discount rate to estimate the fair value of a biological asset. In its view that wording unnecessarily restricts the valuation methodology that may be applied. The IASB therefore proposes to amend IAS 41 to remove the restriction. The proposed amendment requires a current market-determined rate to be used but permits this to be a pre-tax or post-tax rate according to the valuation methodology used to determine fair value.

IASB Q39: Do you agree with the proposed amendment to IAS 41 to permit either a pre-tax or a post-tax discount rate to be used according to the valuation methodology used to determine fair value? If not, why?

128 EFRAG agrees with this proposed amendment. Many valuation approaches use a post-tax discount rate applied to expected after-tax cash flows to determine fair value.

Issue 40: Additional biological transformation

129 IAS 41 currently does not permit ‘additional biological transformation’ (ie “the processes of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset”) to be taken into consideration when calculating fair value using discounted cash flows. The reason such transformations are excluded, paragraph 21 of IAS 41 explains, is because the objective is to determine the fair value of a biological asset in its present location and condition, and that present

condition excludes any increases in value from additional biological transformation and future activities of the entity.

130 However, the IASB is now proposing to amend IAS 41 to remove the prohibition on taking ‘additional biological transformation’ into consideration when calculating fair value using discounted cash flows. There are several reasons for making this proposal:

(a) Apparently there is diversity in practice resulting from different interpretations of the existing prohibition requirement, and the IASB wishes to eliminate this diversity.

(b) Having reconsidered the matter, the IASB has concluded that not including these cash flows results in a carrying amount that is not representative of the asset’s fair value. Presumably what the IASB means here is that the market-determined prices or values referred to earlier would take into account the biological asset’s potential for additional biological transformation, so the cash flows used in a DCF estimate of fair value should to.

(c) The IASB also observes that the risks associated with cash flows from ‘additional biological transformation’ would be considered in determining the discount rate.

<u>IASB Q40:</u> Do you agree with the proposal to remove the exclusion of ‘additional biological transformation’ from paragraph 21 of IAS 41? If not, why?

131 EFRAG agrees with the proposal to amend paragraph 17 (by inserting the words “in its present location and condition” into the sentence “If an active market exists for a biological asset or agricultural produce in its present location and condition, the quoted price in that market is the appropriate basis for determining the fair value of that asset”) because it is consistent with other standards and because focussing on the present condition of an asset is the appropriate basis for determining fair value under IFRS.

132 EFRAG also agrees with the proposal to amend paragraph 21. It does not believe this will contradict the general principle above. Measurement of biological assets should take into account the potential to transform.

133 Finally, we have been considering what if any implications this proposed amendment might have for the measurement of present values of other assets. We think the same principle should apply. Therefore, when trying to fair value an investment property using DCF techniques one should be able, where appropriate, to take into account its development potential, e.g. land with or without a planning permission have different values. EFRAG suggests that this could be made clearer in paragraph 51 of IAS 40.

134 We note that the IASB is also proposing to insert the words “and harvest” into the definition of ‘biological transformation’. Although this proposed amendment is not explained in the accompanying material, we can see that its effect would be to treat the harvesting of a biological asset as a type of biological transformation. We agree with the IASB that, in a number of places in which the term ‘biological transformation’ is currently used in IAS 41, it would make sense for that reference to be extended to include harvesting. However:

(a) we believe the terminology in IFRS is most easily understood and applied if wherever possible standards define terms that are commonly used outside of accounting in a way that is consistent with their meaning in common usage. In our view the common use of the term ‘biological transformation’ does not include harvesting the biological asset;

(b) in some of the places in which the term ‘biological transformation’ is used in the standard it may not make sense for the term’s meaning to be extended to include harvesting the biological asset. For example, several paragraphs continue to talk of biological transformation in terms of “growth, degeneration, production and procreation”.

135 We therefore wonder whether it might be clearer to insert the words “and harvest” in the half dozen or so places in which it is appropriate to extend the reference to ‘biological transformation’ to include harvesting.

Issue 41: Examples of agricultural produce and products

136 The IASB proposes to revise the examples of agricultural produce and products that are the result of processing after harvest. Under IAS 41 it is very important to be able to differentiate a biological asset and agricultural produce from products that are the result of processing that agricultural produce. For that reason, in paragraph 4 of IAS 41 there is a table that provides examples of biological assets, the agricultural produce that results from harvesting those biological assets, and products that are the result of processing that harvested produce.

137 The IASB believes that one of the examples in that table is incorrect: logs are described as the agricultural produce of trees, when in fact felled trees are the agricultural produce and logs (and other forms of lumber) are the products that result from processing that agricultural produce. The IASB is therefore proposing to amend the table.

IASB Q41: *Do you agree with the proposed amendments to the examples in paragraph 4 of IAS 41? If not, why?*

138 EFRAG agrees with the proposed amendment.