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Dear David

Exposure Draft of First-time Application of International Financial Reporting Standards

This letter is in response to the request for comment on the International Accounting Standards Board (IASB) Exposure Draft ED 1 *First-time Application of International Financial Reporting Standards*. We appreciate the opportunity to comment on this proposal.

In general we are in agreement with the IASB's fundamental approach of retrospective application and thus the valuation of all assets and liabilities as though they had always been accounted for under those IFRS in force at the time of adoption. We also agree with the modification of this general rule where retrospective accounting is burdensome and the information necessary for restatement may not be available. The following comments, therefore, are intended to suggest ways of improving this modification rather than expressing disagreement with the fundamental approach. In this context, our comments are as follows:

Structure of the exposure draft concerning two methods for retrospective application of IFRS (paragraph 13)

Prior to our comments on the individual questions we would like to comment on the structure of the exposure draft as we have reservations regarding the clarity and definition of the draft's objectives. We understand that the exposure draft sets out two alternative methods for first-time adoption of IFRS (par. 13). One method represents exemptions from the general principle in that it does not require retrospective accounting in certain areas. The other proposed method follows the general principle for first-time adoptions, i.e. entities using this method must apply the standards that were effective in each period. If our understanding is correct, entities may choose

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which of the alternatives they apply. Once a decision is made however, the entity must fully apply this alternative. It may not make selective application. We believe that paragraph 13 should be drafted more clearly. As the second alternative is only set out in the second sentence of paragraph 13, it may lead entities to believe the alternative to be only applicable if they are not able to use the exemptions. It would appear more appropriate to emphasise the existence and equality of both alternatives. We recommend that each method is dealt with in separate paragraphs in the section "OVERVIEW OF THE TRANSITION TO IFRSs". This could be achieved by the following amendment.
Add new paragraphs after paragraph 6 as follows:

A. There are two alternatives for first-time adoption of IFRS

- a) The principle in paragraph 7 requires full retrospective application of all IFRSs effective at the reporting date for an entity's first IFRS financial statements. Paragraphs 14 – 24 permit limited exemptions from that principle.*
- b) An entity may also retrospectively adopt IFRS without using any exemptions. If so the entity shall apply the IFRS that were effective each period and may, therefore, need to consider superseded versions of IFRSs if later versions required prospective application. Thus, paragraph 8 is not applicable.*

Structure of the section "exemptions from requirements in other IFRSs"

We understand that some exemptions set out in par. 14 - 24 are mandatory (e.g. Financial Instruments, IAS 19 in case of corridor-approach) whereas others only apply if determining a cost based measurement would involve "undue cost or effort". If our understanding is correct, the exemptions have different qualities and should therefore be distinguished. This is important in the light of the requirement that all exemptions must be applied or none of them. We believe that the mandatory exemptions generally represent exceptions from retrospective application rather than exemptions. They principally exist to avoid cherry picking and to improve comparability for the users of financial statements. By contrast, the exemptions in cases of undue cost or effort represent "relief" for First-time adopters. We therefore recommend emphasizing that there are two types of exemptions. It may then be appropriate to change the structure of the draft and set out the mandatory exemptions on a more prominent level. An overview of our proposed amendment including our proposals on the exemptions is set out in appendix 1.



Question 1:

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?

Yes, this is an appropriate description. However, we would like to address a concern regarding the word “presented” in the scope section where we see a potential risk for misunderstanding (refer to Question 4).

Question 2:

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?

No, we generally have objections regarding the structure of the exemptions in the exposure draft. We are also of the opinion that the underlying principle “undue cost or effort” needs clarification. Furthermore, we believe that the exemption concerning business combinations should be amended and that an additional exemption regarding intangible assets be created.

Restructure of the accounting policies and exemptions section (paragraphs 14 – 24)

We refer to our comments above regarding the structure of the exposure draft.

Undue cost or effort

Throughout the exposure draft the exemptions to the general rule are based upon the principle of “undue cost or effort”. We understand that the board decided to replace the former principle of impracticability by “undue cost or effort” as in some cases retrospective application may not be impracticable, but the cost incurred would exceed the benefit to users. Accordingly, the requirements for undue cost or effort appear to be less strict than the requirements for impracticability. However, we are concerned that in the absence of further guidelines on the requirements for undue cost or effort, entities may adopt varying interpretations. This could erode the comparability of financial statements. In extreme cases, entities may consider almost any cost as undue. We are well aware that the board states in BC 13 that undue cost or effort has to be seen in conjunction with timely planning of the transition to IFRS.



However, this criterion is very subjective. We therefore suggest that specific guidelines defining undue cost or effort are developed. This may also be seen in the broader context that undue cost or effort has been implemented in other standards subject to the improvements' project.

We also observed inconsistencies in the use of the phrase "undue cost or effort". In paragraph 16 for example, the term "undue cost or effort" is used. In paragraph 23 the term "undue cost *and* effort" is used. We therefore propose to the board to clarify this.

Retrospective accounting for business combinations (paragraph 20)

We generally support the board's decision to exempt IAS 22 *Business Combinations* from retrospective application. However, we do not agree that retrospective application be prohibited, thus rendering prospective application of IAS 22 mandatory. We understand the prohibition of retrospective accounting has been set up because the board assumes that gathering the information retrospectively could reduce the relevance and reliability of the first IFRS financial statements and hence, the cost of restatement would be likely to exceed the benefits. However, we believe that there are scenarios where retrospective application does not cause undue cost or effort and prospective application is contrary to the board's objective. Assume an entity has recognised goodwill as an immediate deduction from equity. For the IFRS opening balance sheet the entity has all the data needed to apply IAS 22 retrospectively. In other areas however, retrospective application would cause the entity undue cost or effort, e.g. property, plant and equipment.

Currently, the exposure draft would leave the entity in a situation where a decision is either against transparent and high quality information to users (in case IAS 22 is applied prospectively) or against practical relief (in case the alternative method in paragraph 13 is used) as the exposure draft requires the entity to use all exemptions or none of them.

Thus, if the entity wants to provide a true and fair view of its business combinations in the financial statements, it would no longer be able to apply any of the exemptions and would thus face additional burdens. The entity would have to use all standards that were effective in each period and not only the standard versions that are effective at the reporting date.

The entity's decision therefore is likely to be in favour of using all the exemptions set out in par. 14 - 24.

As a result the entity would not present high quality and transparent information on business combinations even though it may have the information available.

We therefore recommend following the underlying principle of the exposure draft and using "undue cost or effort". This means that retrospective application of IAS 22 should be generally required and prospective application is only permitted if retrospective application causes undue cost or effort.

From our point of view this would support the exposure draft's objective to ensure that entities are presenting financial statements that contain high quality and



transparent information. It would also enhance comparability of first-time adopters with entities that already apply IFRS.

Fair value as deemed cost for intangible assets other than goodwill

In some countries, legal requirements prohibit entities to capitalise cost incurred from intangible assets, e.g. internally generated software. Hence, those entities may not have previously collected the data of such projects. If it is costly or burdensome to collect or estimate the data retrospectively, entities may decide not to capitalise the cost although this could be contrary to the regulation of IFRSs. As a result, the true and fair view of the financial statements could be distorted.

We agree in general with the IASB's view to limit the exemptions to specific transactions and use "undue cost or effort" as an underlying principle. However, we feel that this principle should be applied consistently. It would also appear reasonable that those intangibles should not be dealt with in a different way than property, plant and equipment. Therefore, we recommend that fair value measurement as deemed cost should be permitted at the date of transition for intangible assets other than goodwill if fair value is determinable by reference to a strictly defined active market. In the same context we also propose to amend paragraph 16 with the additional term "if fair value can be determined in a strictly defined active market". This makes clear that fair value can only be accepted if a strictly defined active market exists.

Question 3:

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?

Explanation of material adjustments to the cash flow statement (paragraph 32)

Paragraph 32 of the exposure draft requires a first-time adopter to explain the material adjustments to the cash flow statement resulting from the transition to IFRS. However, the exposure draft does not elaborate on the specific cash flow adjustments that need to be explained. We think that the cash flow statement is affected in different ways by the adoption of IFRS. Firstly, due to changes in the balance sheet and income statement arising from the implementation of IFRS. These effects will already be explained in the reconciliation of equity and the profit or loss reconciliation as set out in paragraph 31 of the exposure draft. Secondly, the changes in the structure and presentation resulting from the conversion of a cash flow statement under national GAAP to a cash flow statement that is prepared in compliance with IAS 7. If our understanding is correct, only an explanation of the latter changes would provide additional information to users. In light of the exposure draft's objective to balance cost and benefit, we therefore recommend that entities should only be required to explain material adjustments resulting from changes



derived from different regulations concerning the preparation of cash flow statements. Accordingly, paragraph 32 should specify the required explanations.

No interim financial reporting prior to the first annual IFRS financial statements

Listed entities in the EU will have to publish their first IFRS financial statements by 2005 and thus, face an ambitious timetable. In light of this tight deadline a crucial question is whether first-time adopters will be required to prepare interim reporting in accordance with IAS 34 in the year they present their first IFRS financial statements. Neither the draft standard nor IAS 34 require entities to present interim financial reporting in accordance with IAS 34. This requirement can only be set through legislation or on the basis of private agreements between a stock exchange and listed entities. Some European stock exchanges have not yet decided whether first-time adopters are required to prepare their interim reporting under IAS 34 prior to their first IFRS reporting date. We are concerned however, that the current proposal may lead stock exchanges or the legislator to believe that IAS 34 interim reporting must be applied in the first IFRS-reporting period. This, from our point of view, exacerbates the already tight deadline as it would effectively compel entities to adopt IFRS 9 months (3 quarters) earlier.

Important is also the fact that no audit opinion is currently required on interim financial reports under IAS 34. This could mean that figures are published in the quarters which have to be changed at the year-end following discussions with auditors. This effectively means that the quarterly reporting contains incorrect (and inconsistent) information.

We therefore recommend that the exposure draft should suggest that no IFRS-interim reporting is required prior to the presentation of the first IFRS financial statements.

Question 4:

Do you have any other comments on the Exposure Draft?

Scope

The exposure draft's approach refers solely to an explicit and unreserved statement of compliance with IFRSs as required by IAS 1. We agree with the proposed scope in general, but have the following concerns:

a) Use of the word "presented"

The draft standard provides in paragraph 2 (a) that an entity shall apply this standard if it has "presented" its most recent previous financial statements. We are concerned that the word "presented" may lead to flawed interpretations. We understand that presented can only be seen in the context of making financial statements available to the public, for instance filing the financial statements in the companies house register. If our understanding is correct, it may be more appropriate to use a clearer word such as "published", "filed" etc.



Importantly we also note, that in this case paragraph 2 (b) may be redundant.

b) Distinction of qualified audit reports

Paragraph 3 (c) sets out that an entity is not considered a first-time adopter if its previous year's financial statements contained an explicit and unreserved statement of compliance with IFRS even though the auditors have qualified the audit report. However, we are of the opinion that in cases where the qualified opinion is due to the non-application of IFRS, an entity should be regarded as a first-time adopter. We therefore recommend specifying in paragraph 3 (c) that an entity with a qualified opinion due to the non-application of IFRSs is considered as a first-time adopter.

Estimates (paragraph 25 – 27)

With regard to the approach set out for estimates, we express concern on two issues. The current wording of paragraph 25 – 27 cannot be understood without implementation guidance explaining different scenarios. We are of the opinion, however, that the standard should include sufficient information for users, thus rendering the use of the guidance optional rather than necessary.

More important is our concern regarding the regulation. We understand that in most cases the estimates made under previous GAAP will be adopted in the opening IFRS balance sheet unless there is objective evidence that those estimates were in error. If our understanding is correct we are concerned that the proposed regulation leads to presentation of financial statements that do not reflect a true and fair view at the time they are prepared in accordance with IFRS. Thus the financial statements may be presented with flawed information although the entity has most recent information available. Our main objection with this approach is that the financial statements of the comparative period are an integral part of the reporting period to be presented. Accordingly it appears crucial to include all adjusting events after the balance sheet date.

Treatment of negative goodwill

We recommend that the provision concerning accounting treatment of negative goodwill should be included in paragraph 20 rather than in Appendix B (e).

Requirements for equity reconciliation

Paragraph 31 a requires an entity to reconcile its equity

- (i) at the date of transition; and
- (ii) at the end of the latest period presented under previous GAAP.

We understand that reconciliations must be drawn up to explain the differences between the previous year as originally published, and the IFRS restatement. However, as stated in the objectives of the exposure draft, an entity's first IFRS financial statements should be generated at costs that do not exceed the benefits to users.



We are of the opinion that the costs exceed the benefit to users if entities have to reconcile equity twice. We understand that the information provided for the users should reflect:

- the effects at the transition date to provide information of the impact of the transition from local GAAP to IFRSs; and
- the effects in the most recent period published under local GAAP.

If our understanding is correct, entities that only need to present one comparative period provide the information required without performing equity reconciliations at two points in time. The information is already available on the grounds that the reconciliation of the profit or loss of the transition period together with an equity reconciliation provides the same information as an additional equity reconciliation. It is therefore irrelevant at which date (transition date or end of transition period) the equity has to be reconciled, and it only needs to be reconciled once.

Accounting for Goodwill

The board decided that the carrying amount of goodwill under previous GAAP should be its carrying amount in an entity's IFRS opening balance sheet. Accordingly, if the goodwill has been deducted from equity no goodwill has to be recognised in the opening IFRS balance sheet. It might be helpful to provide requirements regarding the treatment of the disposal of goodwill previously deducted from equity.

Inconsistencies or misleading wording that need clarification

In par. 12 the exposure draft mentions to recognise adjustments directly in *equity*. In par. 21 it is mentioned to recognise any resulting change against *retained earnings*. We ask the board to clarify this apparent inconsistency.

Yours sincerely

Liesel Knorr



Proposed structure

Appendix 1

