

**International Headquarters**

KPMG Building  
Burgemeester Rijnderslaan 20  
1185 MC Amstelveen  
The Netherlands

**Correspondence Address**

1-2 Dorset Rise  
London  
EC4Y 8AE  
United Kingdom  
Telephone +44 (20) 7694 8087  
Fax +44 (20) 7694 8429  
Email mark.vaessen@kpmg.co.uk

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

Your ref

Our ref jo/813

Contact Mark Vaessen  
+44 (20) 7694 8089

31 October 2002

Dear Sir David

**Exposure Draft of First-Time Application of International Financial Reporting Standards**

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed IFRS *First-Time Application of International Financial Reporting Standards*. This letter represents the views of KPMG International.

We recognise the challenges inherent in promoting consistency and transparency across First-Time Adopters. We therefore regard this IASB project as an extremely important contribution to the process of complying with the EU regulation passed in June 2002.

We consider that there is an urgent need to finalise this project as quickly as possible.

**Executive summary of views**

This section highlights our views on the key issues we have identified in this Exposure Draft.

We agree with the Board's conclusions that comparability of an entity's results over time should be given priority over the secondary objective of comparability among enterprises adopting at the same time. Whilst the secondary objective is desirable it must be weighed against focusing the limited resources available to get IFRS compliant financial statements in time. Mindful that the proposed FTA IFRS is not aimed solely at companies converting to IFRS within the EU timetable but is also intended for the long term, overall we believe that the standard proposed by the IASB achieves an appropriate pragmatic outcome.



KPMG International Headquarters is the  
administrative headquarters of  
KPMG International, a Swiss association

We disagree strongly with the IASB's choice of form over substance in defining the scope of the proposed IFRS. We believe that the proposal will provide an unexpected opportunity for entities that currently use IFRS as their basis of accounting, but with some reservations to rewrite history because they would qualify as a First-time Adopter under the proposed standard as currently drafted. We consider that an objective assessment can be made by an entity of whether or not IFRS is its basis of accounting. Where there is any reservation in the statement of compliance, we believe that the auditors will also be able to assess whether this is a matter of substance or form and be in a position to conclude. Accordingly, we believe that the word '*unreserved*' is not required in the prior year compliance statement.

The proposed exemptions for business combinations, employee benefits, undue cost and effort in respect of property plant and equipment and currency translation adjustments achieve a good balance between a pragmatic approach and maintaining as much consistency as possible.

We support the objective to reduce the burden on subsidiaries which are First-Time Adopters at a date different from the parent. However, we believe that the exemptions could go further and be clearer and we have offered suggestions in our comment letter on this.

Comparability between First-Time Adopters would be improved, in our opinion, if the currency translation adjustment is set to zero at transition, rather than following previous GAAP.

The proposal to require hedges that were designated as such under previous GAAP to be accounted for as hedges on transition seems not practical nor always possible. If hedge accounting is to be discontinued at the date of transition to IFRS, then making transitional adjustments in respect of such previously designated hedges may create an unnecessary burden on companies in tracking the reversal of those adjustments in subsequent periods. In our view it will be practical to allow companies who do not apply hedge accounting prospectively not to make transitional adjustments if doing so would lead to undue cost and effort. In all other cases the transitional adjustments for previously designated hedges should be required. If an entity does not make transitional adjustments, the normal transition requirement in respect of (non-hedging) derivatives would apply.

We think that there is scope for confusion in the application of the guidance on IAS 10 in conjunction with the estimates principle in paragraph 25. We suggest ways in which this could be clarified.

It is the Board's intention that all future standards will be applied retrospectively unless it is concluded by the Board to be inappropriate in which case the proposed FTA IFRS will be amended. In the run up to 2005 the Board expects companies to plan on a timely basis and to collect information for the date of transition as soon as possible. The proposed implementation date of the standard envisages dates of transition as early as 1 January 2001 (with two years of comparatives). The Board's intentions in relation to retrospective applications of any standards expected to be issued between now and 2005 should be made clear as soon as practicable in order to minimise difficulties in implementation.

**Detailed comments on the exposure draft**

The remainder of our comments are organised as 4 appendices to this main letter in the order noted below:

<u>Appendix</u>		<u>Page</u>
A	Responses to invitation to comment Question 1-3	4
B	Response to invitation to comment Question 4	16
C	Comment on Implementation Guidance	19
D	Drafting comments	22

Please contact Mark Vaessen at 020 7694 8089 or Joanna Osborne at 020 7694 8659 if you wish to discuss any of the issues raised in this letter.

Yours sincerely



KPMG

## Appendix A

### Responses to invitation to comment Question 1-3

#### 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 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?*

We disagree strongly with the IASB's choice of form over substance in defining the scope of the proposed IFRS. Our principal concern is the scope offered to entities that currently use IFRS as their basis of accounting, but with disclosed exceptions, to rewrite history because they would qualify as a First-Time Adopter under the proposed standard. We consider that an objective assessment can be made by an entity of whether or not IFRS is its basis of accounting. Where there is any reservation in the statement of compliance, we believe that the auditors also will be able to assess whether this is a matter of substance or form and be in a position to conclude whether the entity is a First-Time Adopter or not.

For example, we think that a company that complied with all IFRS except for disclosing the remuneration of management in accordance with IAS 24 should not be forced or allowed to be a First-Time Adopter. Our view is reinforced by the arbitrage opportunities that a form-based definition provides. If any company with an "except for", however minor, was permitted to be a First-Time Adopter, we think that the scope for using the proposed FTA IFRS to achieve the desired result is increased because that company's statement of compliance could be modified deliberately the year before it aims for First-Time Adoption to include a clearly trifling example of non-compliance.

The exemptions provided under the proposed FTA IFRS provide a particular opportunity for desired results in the current economic environment. For example such an entity may have a substantial amount of actuarial losses under its employee benefit arrangements which it would be required to recognise in the income statement in future periods. Under the exemptions these losses will be recognised in full in retained earnings at the date of transition. By adopting the proposed FTA IFRS early, such an entity could avoid ever recognising these actuarial losses in its income statement from as early as 31 December 2002.

It seems to us that the only way to avoid such potential manipulation is to use a definition of First-Time Adopter which is based on substance. We note the Board's concern that it is difficult to draw the line in the proposed standard between acceptable and unacceptable reservations. However, we are convinced that this kind of judgement both by the entity and its auditors is part of the normal process of determining appropriate accounting policies and reaching audit

opinions. If the Board believes that an entity is capable of exercising judgement in selecting accounting policies according to the existing IAS 1.20 and the proposed IAS 8 (improved), why should the judgement of whether or not in substance IFRS is an entity's existing basis of accounting be any different? In our view the risk of both management's and the auditors' judgements being in error on this point is significantly lower than the risk of an entity being wrongly included in the scope of the proposed standard and thereby achieving a desired result in particular by being able to apply the exemptions provided under the proposed FTA IFRS. Accordingly we propose that the scope should be amended to delete the word "unreserved" throughout the Exposure Draft. Appropriate commentary explaining the approach could also be provided.

### **Paragraph 2**

It appears to us that there are circumstances in which an entity could claim to be a First-Time Adopter twice. The general statement that forms the first sentence of paragraph 2 could apply twice to an entity which followed IFRS and then stopped. This might occur, for example where an entity previously prepared US GAAP financial statements and also claimed compliance with IAS but dropped the IAS compliance when it became impossible to accomplish both in one set of financial statements. If this entity now switches to IFRS, we understand that it is the IASB's intention that the first-time application rules should apply to these entities, and we agree with this intention. We suggest that this could be clarified by adding 2(d) to the Exposure Draft *'previously presented financial statements with an explicit statement of compliance with IFRS, but ceased to do so and its most recent previous financial statements fall within paragraph 2(a)'*.

### **Paragraph 5**

We strongly support the exemption in paragraph 5 for subsidiaries because we agree that this will avoid a significant burden for example in Europe as the Regulation is likely to be extended to most EU legal entities, probably on a different timetable to consolidated entities.

Generally we have found it difficult to analyse this paragraph. We think it could be read in two ways, one way is that it would only apply to subsidiaries that fully comply with all IFRS and only need to add the necessary disclosures to accomplish a full set of IFRS financial statements. Our experience is that there are certain differences between the reporting package to the parent and the subsidiary's financial statements. Examples are group materiality vs. subgroup/single entity materiality (e.g. unconsolidated subsidiaries, estimates), the need to update under IAS 10 for subsequent events between the package submission date and the date the financial statements of the subsidiary are authorised for issue, and adjustments made at group level only (e.g. for pensions, associates, hedge accounting). This leads to the second possible interpretation of paragraph 5 that a subsidiary in preparing its first IFRS financial statements should address and correct such differences from the financial statements reported to its parent. In our opinion the first interpretation would lead to a very restrictive use of this paragraph. Therefore we recommend that the paragraph is generally redrafted to make it clear the second interpretation is

the right one. In particular to clarify the position on differences we suggest to add the following sentence:

“...An entity is permitted to use this paragraph even if its IFRS report to the parent company is different from full IFRS financial statements on a stand-alone basis.”

On the basis that this suggestion is accepted we do not think it is clear what principles should be followed in determining the adjustments for such differences. It would be possible to apply the principles of IAS 8 and treat them as errors. However, we are uncomfortable with the notion that these adjustments are errors and we do not think that the disclosures in relation to errors would be appropriate.

Furthermore, we are not sure that following IAS 8 would achieve the objective of minimising the differences between the subsidiary's financial statements and the parent's consolidated financial statements. For example, if a subsidiary had not recorded actuarial gains and losses under IAS 19, in applying IAS 8 it would be required to go back and work out the effect of the corridor. In contrast, the parent would have recognised all such gains and losses at transition. We can see additional benefits in the subsidiary being able to utilise the business combinations exemption in circumstances where it publishes consolidated financial statements. Accordingly we suggest that minimal differences will occur if the subsidiary is required to apply the proposed standard in making its adjustments, using the transition date and paragraph 13 option chosen by its parent.

It is unclear from the drafting whether the IASB also intends the subsidiary to include disclosures of these adjustments, although we assume not because it would look strange to disclose adjustments in respect of an unpublished reporting package.

Associates may have implemented IFRS only to report to their investor to fulfill the requirements in IAS 28 to conform their accounting standards with those of the investor. Therefore we suggest extending the exemption for subsidiaries to associates with the same restrictions included in paragraph 5 namely that the other owners agree.

## 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 BC 11 – BC 89)? If so, why?*

**Paragraph 13-24: General comments on exemptions from requirements in other IFRS.**

### Paragraph 13

We agree that all exemptions should be used if applicable. We support the objective of comparability between entities adopting IFRS at the same time (from the same previous GAAP). We agree with the extent to which the Board has limited the use of exemptions by, in general, narrowing them down to the areas in practice where difficulties are often encountered. We have some comments on specific aspects of the exemptions which we discuss further below.

Sentence 3 of paragraph 13 states that an entity which elects not to use the exemptions has to consider superseded versions of IFRS. We note that this is not the same as using SIC-8 as for example the “impracticability exemption” is not included. Although this could lead to different results and more work for the entity compared to SIC-8, we agree with the outcome, but suggest that an explanation is given in the Basis of Conclusion.

In our view the standard would be more readily understood if the two alternatives included here were clearly shown as equal alternatives from which the adopter has a free choice. We therefore recommend wording this paragraph as follows:

“Under this standard a First-Time Adopter has two choices to convert to IFRS

- (a) The First-Time Adopter uses the principles set out in paragraph 7 that require full retrospective application of all IFRSs effective at the reporting date for an entity’s first IFRS financial statements together with all the limited exemptions set out in paragraphs 14-24, to the extent that they are applicable.
- (b) The First-Time Adopter does not use those exemptions in which case the entity shall apply the IFRSs that were effective in each period and may therefore need to consider superseded versions of IFRS if later versions required prospective application.

If the entity chooses alternative (a) it shall only apply the latest version of IFRSs (paragraph 8).”



***Paragraph 14-15***

We support the limitation of the “undue cost and effort” exemption to the determination of the cost of property, plant and equipment or investment property (accounted for at cost). We think that the Board’s proposals for fair value and detailed disclosure of the reasons why determining the information would have caused undue cost and effort are workable in practice.

***Paragraph 16-18: Property, plant and equipment***

We agree that these exemptions are necessary and appropriate. We agree with defining the benchmark in paragraph 17 as ‘broadly comparable’ as a principle without detailed rules, because we think this will avoid interpretive issues and practical difficulties in determining how this paragraph should be applied. We suggest that it might be helpful to give an example of a valuation which would fail the ‘broadly comparable’ test in the Implementation Guidance.

***Paragraph 19: Event driven fair value measurement as deemed cost***

We support the “event-driven” measurement basis as we recognise the need for pragmatic relief in this area, especially as all amounts will be subject to impairment testing. However we think that it will be hard to apply because there may be differing views of what an appropriate event is. We believe that a negative example - of an event which does not meet the definition - will help users to judge in which cases the exemption can be used.

We note that paragraph 19 implies that the event-driven fair value measurement has taken place before the transition to IFRS takes place by using the past tense. In our opinion the sequence of events may not always be historical for example when the transition occurs in connection with a planned initial public offering. We suggest that the exemption can be used for this case as well and therefore sentence 1 of paragraph 19 needs to be written in a positive tense.

***Paragraph 20: Business combinations***

*General*

We support strongly the proposal to carry forward into the IFRS opening balance sheet the previous national GAAP classification of business combinations, and the adjustment of retained earnings to account for any assets and liabilities recognised in the business combination that do not meet the IFRS definition, recognition and measurement criteria. We support also the proposal that the amounts assigned to the assets and liabilities in a business combination are “deemed cost”, meaning that IFRS measurement rules apply to those assets and liabilities subsequently and that these adjustments are recorded against retained earnings. However, we have some specific comments on the application of this proposal below.

The business combination exemption paragraph 20(a) only covers assets and liabilities; it is unclear if the exemption includes minority interests as well. We think that minority interests



should be dealt with in the same way as assets and liabilities and therefore we suggest 20(a) is rephrased to say '*...carrying amounts under previous GAAP of assets and liabilities acquired in a business combination and minority interests, shall be...*'.

In paragraph 20(b)(i) there is a requirement to calculate the minority interest in an intangible asset transferred to goodwill. We assume it is the intention of the IASB that this calculation is recorded following the treatment of minority interests under IAS 22. It may be helpful to clarify this because as it is currently written it seems that the calculation should be done under previous GAAP.

As the business combinations exemption is written at the moment it does not include associates and joint ventures. We believe that the same issues arise on acquisition of an associate or joint venture and therefore we suggest that the exemption be extended.

#### *Goodwill*

Appendix B1(e) states that an entity shall not recognise negative goodwill in its opening IFRS balance sheet. In our opinion this is an important principle and should be included in the main text of the standard perhaps in the business combination exemption as paragraph 20(c). Furthermore no guidance is being given on how the write-off of existing negative goodwill at the date of transition has to be accounted for. In our opinion it should be booked against retained earnings. In addition, we believe that there are a few areas concerning goodwill for which some further implementation guidance should be included:

- Consider a business combination that took place before the transition where the purchase agreement included contingent consideration, and the contingency is resolved only after the date of transition to IFRS. For example if previous GAAP, in contrast to IAS 22.65 seq., does not require probable contingent consideration to be included in the cost of acquisition, there will be a payment of consideration after the date of transition for which there is no provision or liability. We believe that goodwill should be adjusted at the date of transition to recognise the contingent consideration in accordance with IAS 22, and any subsequent adjustments also should be made in accordance with IAS 22. We recommend that guidance on this point is included in Appendix B.
- Consider the situation where according to previous GAAP adjustments are made to goodwill subsequent to the business combination, for example in relation to subsequent adjustment to acquired assets and liabilities that would not be permitted under IAS 22. We think that it is the IASB's intention that such adjustments should be retained in goodwill, and we agree with this. It would be helpful if the examples in Appendix B could be extended to cover this issue or if the clarification could be included in the standard itself.
- Suppose that at the date of transition an entity has an intangible that is required to be reclassified to goodwill. The entity's goodwill had been written off to retained earnings under previous GAAP. It is unclear whether paragraph 20(b)(i) requires a company to create

goodwill in this case or if the intangible should be written off to retained earnings since that is where the goodwill is. In our view the intangible should be written off to retained earnings because this is consistent with the previous GAAP, either because it allowed an immediate write-off of goodwill, or because goodwill had been amortised fully.

- Previous GAAP may not have required amortisation of goodwill. Our understanding of paragraph 20 is that no adjustment is made, but we note that the treatment for property, plant, equipment and intangibles differs. In our view amortisation adjustments should be required from transition date to the effective date of the new business combination standard (assuming that the proposals are passed). This should also be pointed out in IG41 where it is unclear if amortisation of intangibles includes goodwill or not.

*Business combinations not qualifying for the exemption*

We have identified a number of circumstances in which previous GAAP would not have accounted for a business combination where IAS would:

- An entity has potential voting rights that under SIC-33 would result in control over another entity where previous GAAP does not consider these and an investment is recognised instead;
- A subsidiary was not consolidated under previous GAAP which prohibited consolidation of subsidiaries which had different activities [eg insurance]; or
- Subsidiaries were not consolidated because they were minor and previous GAAP did not require it.

Our understanding of paragraph 20 is that these investments would not qualify for the exemption because they are not "...business combinations that the entity recognised under previous GAAP...". Accordingly IAS 22 would be applied retrospectively in requiring consolidation. However there may be undue cost and effort in ascertaining the fair value of the acquired assets and liabilities under previous GAAP at the date of acquisition. We think there are two ways this could be addressed. The acquired assets and liabilities could be recognised at the date of acquisition at the carrying amount in the subsidiary's financial statements. Alternatively the entity could be required to record the acquisition under IAS 22 as if it occurred at transition date, which effectively results in a fair value alternative. On balance we prefer an approach which requires recognition at previous carrying amount, because we think that this reflects greater consistency with the general business combination exemptions.

Previous GAAP may not have accounted for special purpose entities in a manner similar to SIC-12. Our understanding is of paragraph 20 is that this investment would not qualify for the exemption because it is not a "...business combination that the entity recognised under previous GAAP...". Accordingly IAS 22 would be applied retrospectively in requiring consolidation of

the special purpose entity. We suggest that this situation be illustrated. In our opinion this should not lead to an exemption.

If an entity accounted for an investment as a business combination, but would not have done under IFRS perhaps through different definitions of control under previous GAAP we would expect this to be deconsolidated at transition. The same issue arises for associates which under previous GAAP were consolidated. Guidance should be provided on this point.

*Exemption for subsidiaries where group adopts IFRS later*

We think that there is a problem with subsidiaries where the group's First-Time Application occurs after that of the subsidiary; in other words the opposite circumstances to those in paragraph 5. Consider a group, which does not follow IFRS, that includes three subsidiaries as follows.

- Subsidiary A has always followed IFRS,
- subsidiary B adopted IFRS using all the exemptions in an earlier year and
- subsidiary C adopted IFRS using none of the exemptions according to paragraph 13 sentence 3 in a different earlier year.
- Other group companies do not follow IFRS.

Because previous GAAP in this case is not IFRS, but is the GAAP of the parent, the group will follow the proposed FTA IFRS in determining its IFRS opening balance sheet.

Due to the differing history of IFRS experienced by each subsidiary, we expect that there will be differences between their financial statements, which contain a statement of compliance with IFRS, and the IFRS reporting pack that they send to the parent. Maintaining these differences in financial information would incur the same degree of cost and effort as the subsidiary in paragraph 5. It is unclear to us how this should be resolved because we can see practical difficulties in either requiring a change to the subsidiary financial statements to comply with the group, or in redefining *previous GAAP* to give an exemption where the subsidiary already applies IFRS, because of the inconsistencies that would bring.

*Appendix B: Business Combinations is dealt with here as reference is made to points mentioned in connection with the exemption in paragraph 20 of FTA IFRS*

**General**

In our opinion it would be helpful if the examples could be expanded to include some of the more complex circumstances highlighted above, for example, subsequent adjustment to

goodwill, contingent consideration, potential voting rights, investments treated as business combinations etc. .

***Paragraph B1(d)***

The sentence "...The same applies to adjustments resulting from the recognition of an asset or liability not recognised under previous GAAP..." implies that an entity retrospectively goes back and recognises intangible assets on its balance sheet. The concept in IG38 is that an intangible was not recognised previously is deemed to be recognised at nil amount following the past business combination (see also BC41). In our view this concept should be included in Appendix B as well.

***Paragraph B2***

In the example 1(h) it is stated that the deductible temporary difference is 30 (30 less nil). However, it is not clear from the facts that the tax base was zero. This fact should be added to 1(d)(ii).

Example 3 includes the calculation of minority interest in relation to the adjustment to intangible assets. The example explains that minority interest is measured by entity F in accordance with IAS 22, however paragraph 20 of the standard prohibits the retrospective application of IAS 22. In our view the calculation of minority interest should be under previous GAAP stated at the date of acquisition. As stated earlier (see comments on para. 20, general, 3<sup>rd</sup> paragraph), it is unclear how the adjustment would be made, under previous GAAP or IFRS if it is at the date of transition. We suggest that the date at which the adjustment is calculated should be made clearer. We also think that this would be a good place to illustrate more clearly what the treatment of minority interests is, perhaps by including more facts relating to previous GAAP treatment and illustrating an adjustment at transition to the treatment under IAS 22.

***Paragraph 23: Cumulative translation difference***

According to paragraph 23, if the determination of an IFRS-compliant cumulative translation adjustment for an investment in a foreign operation would require undue cost or effort, the previous GAAP cumulative translation adjustment amount is deemed to have been determined properly under IFRS. However, this raises two issues since IAS 21 requires the to be recycled to the income statement on disposal of a foreign entity, thus impacting the gain or loss recognised. Firstly, an entity that has a cumulative translation adjustment under previous GAAP may not be able to analyse its cumulative translation adjustment by foreign operations without undue cost and effort. Secondly, this creates a difference in the subsequent accounting for those entities that have a cumulative translation adjustment under previous GAAP and those who do not. We suggest that the proposals are amended to require all First-Time Adopters to reset their cumulative translation adjustment to zero by transferring the previous GAAP cumulative translation adjustment balance to retained earnings in the opening IFRS balance sheet.

If the IASB does not agree with the method above we alternatively would suggest to recognise the cumulative translation adjustment only to the extent it can be analysed. If an unanalysed element is included, it will not be possible to recycle this adjustment on disposal of the foreign operation. This creates a balance in equity which cannot be recycled because it cannot be identified.

#### ***Paragraph 24 Financial Instruments***

We suggest that this paragraph should clarify that full retrospective application of IAS 39 is in fact required, but there are special transitional rules to cater for the fact that hedge accounting under the IAS 39 requirements cannot be applied retrospectively.

As follows from Appendix C, an entity will have to apply the transition rules stated therein to all derivatives that were designated as hedging instruments under previous accounting principles without regard to whether or not an entity will continue application of hedge accounting. Although we note that the guidance is consistent with the Questions and Answers 172-2 and 172-6 we wonder whether this retrospective element to hedge accounting is always justifiable or practical.

We see some complications in the application of this transition rule to all hedges designated under previous GAAP (i.e. including those for which an entity does not intend to continue hedge accounting prospectively). These are:

- Hedge accounting under IAS 39 is voluntary and based on designation. Some entities choose not to apply hedge accounting under IFRS to avoid the complex accounting adjustments that result from partial fair value adjustment of the hedged item (for a fair value hedge, particularly for interest rate hedges) and from tracking amounts deferred in equity. By forcing "hedge accounting" transition adjustments on these entities, it forces them to track the reversal of those adjustments in subsequent periods or adjust for example the effective interest rate to take into account prior hedging results. This would be especially difficult where the hedged position cannot be specifically identified.
- It may be difficult to identify what was designated as a hedge under previous GAAP, depending upon whether previous GAAP required formal documentation, just an intention, or some other form of designation of hedge accounting.
- For hedges of net positions designated under previous GAAP it will not be possible to apply the requirement of paragraph C3 to adjust the hedged item in a fair value hedge, or to transfer accumulated gains or losses from equity to the income statement at the same time as the hedged item affects income in a cash flow hedge.
- It is not clear how to apply the requirements in paragraph C3 when hedging instruments used do not qualify as hedging instruments under IAS 39, for example internal derivatives or written options.

Therefore we propose to amend the transitional adjustments in respect of previously designated hedges as follows.

Transitional adjustments in respect of previously designated hedges should be:

- recorded if hedge accounting is applied prospectively under IAS 39 for a hedging relationship (assuming that the above complications do not exist if a hedge relationship under IAS 39 can be documented); and
- recorded for hedge relationships that are not continued prospectively under IFRS unless applying the transitional arrangements would lead to undue cost and effort. Situations in which this may happen are described above.

If an entity does not make transitional adjustments, the normal transition requirement in respect of (non-hedging) derivatives would apply.

We agree with the proposal that sales of held-to-maturity assets before the date of transition to IFRS do not result in tainting. However, we think that this proposal is an exemption from the general principle and therefore should be identified as such in the body of the standard.

***Appendix C: Hedge accounting*** is included here as it is part of paragraph 24

We believe that the introduction to Appendix C should emphasise that hedge accounting is not allowed as of the date of transition unless the hedge documentation and effectiveness testing is in place as of that date. This is implicit, but not directly stated.

***Paragraph C3:***

We note that the proposal to adjust the carrying amount of the hedged assets and liabilities in fair value hedges is different from the current IAS 39 requirements. In accordance with the proposal, the adjustment is equal only to the portion of the fair value of the hedging instrument at transition date that reflects the risk hedged, while in accordance with the current transitional requirements in IAS 39, the amount of adjustment is equal to the total fair value of the hedging instrument. We support the proposal because the adjustment done in this way will reflect appropriately the effect of the hedge at the transition date, and suggest to add a clarification in this respect in this paragraph.

### **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?*

#### **Paragraph 32**

We agree with the Board's proposals as to how the material adjustments should be explained, and in particular we agree that this reconciliation does not need to be line by line in the financial statements. We assume that it is the IASB's intention that the reconciliation is post tax, and propose to state this.

We wonder if it is the Board's intention that the use of valuations which are more relevant than cost in accordance with paragraph 14(b) are not disclosed. We believe that this will aid users in making comparisons between entities.



## **Appendix B**

### **Question 4** *Do you have any other comments on the Exposure Draft?*

#### ***General comments on structure of documents***

We note that the proposed standard assumes that the Improvements Exposure drafts are finalised as drafted. The proposed FTA IFRS may need to be updated depending on the final version. In particular, in our comment letter on the IAS 39 amendments we proposed to retain the exemption from restatement for securitisation and other derecognition transactions entered into before 1 January 2001, which would be consistent with the original transition requirements in IAS 39. If our suggestion is accepted in relation to IAS 39, on practical grounds we would support the inclusion of the same exemption in this standard. We also note that the references to IAS 32 and IAS 39 may need to be updated.

The statement in the box on page 7 of the proposed FTA IFRS makes no mention of the status of bold paragraphs which are described as containing the main principles in paragraph 14 of the Preface.

We find the requirement to read the standard in the context of the Framework in the preamble to the exposure draft confusing. Specific requirements of applicable standards cannot be overridden by the Framework.

Bold type has been used very restrictively. In our view there are a number of paragraphs that contain key principles, and therefore should be in bold type; for example paragraphs 2, 11 and 13.

Generally there seems to be duplication between the standard, the Appendices and the Implementation Guidance e.g. paragraph 20 in the Standard is duplicated in Appendix B, IG 7 and 9 are duplicated in paragraph 16-18 of the Standard. We recommend that duplicated guidance be eliminated generally from the document with less authority.

#### ***Paragraph 8***

In the example following paragraph 8 the final paragraph addresses the early adoption of IFRS that are not effective at 31 December 2005, but have been issued and permit early application. We think that this is a point of principle that should be included in the standard, for example in paragraph 8.

#### ***Paragraph 9***

We note the Board's intention that all future standards will be applied retrospectively unless it is concluded by the Board to be inappropriate in which case the proposed FTA IFRS will be amended. In the run up to 2005 the Board expects companies to plan on a timely basis and to

collect information for the date of transition as soon as possible. The proposed implementation date of the standard envisages dates of transition as early as 1 January 2001 (with two years of comparatives). The Board's intentions in relation to retrospective applications of any standards expected to be issued between now and 2005 should be made clear as soon as practicable in order to minimise difficulties in implementation.

### ***Paragraph 12***

The paragraph states that an entity shall recognise all adjustments from its previous GAAP to IFRS directly in equity rather than in its income statement. It is unclear if this means that the adjustments should be recognised against the appropriate item in equity (such as retained income, revaluation reserve, etc...). We suggest to amend the paragraph "...An entity shall recognise those adjustments directly in equity against retained earnings (or, if appropriate another category of equity) rather than in its income statement."

### ***Paragraphs 25-27***

In general we support the proposals concerning estimates because they prohibit the use of hindsight in cases where the previous GAAP provided the information, but accept that the use of hindsight is likely to affect estimates made from scratch in cases where no previous GAAP information exists. We have some concerns on specific aspects of the proposals which are set out below.

The principle that IAS 10 is followed, with certain modifications, is important. Whilst it is referred to in paragraph 26 in relation to estimates not previously made, we think that the general principles discussed in the Implementation Guidance should be included in the standard because the modifications to the principle appear to have broad implications.

Reading paragraphs 25 to 27 in conjunction with the implementation guidance as a whole we understand the modifications to this principle to be as follows. Where a similar estimate was '*...made for the same date under previous GAAP...*' adjustments are only required for differing accounting policies. We would expect '*made for the same date*' to take account of post balance sheet events under previous GAAP. This may have allowed adjustments between the balance sheet date and the date of authorisation of the previous GAAP financial statements on a basis different to IAS 10. Our interpretation is that where a judgement needs to be made regarding conditions which existed at transition or the comparative balance sheet date, no account is taken of any IAS 10 adjusting events even though the authorisation date of the first IFRS financial statements is much later. In effect IAS 10 is applied prospectively from the date of authorisation of the previous GAAP financial statements. If we have understood the position correctly, we agree with the concept of freezing the previous GAAP treatment of post balance sheet events and applying IAS 10 prospectively

We do not think that the principles behind the modification of IAS 10 is stated sufficiently simply. On the basis that we have correctly understood the IASB's intention, we suggest that paragraph 25 is be modified as follows:

*"An entity's estimates under IFRSs shall be consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any differences in accounting policies or methodology), Therefore the estimates for all comparative periods are not adjusted, unless there is objective evidence that those estimates were in error. IAS 10 is applied prospectively for such estimates from the date of authorisation of the previous GAAP financial statements and any resulting adjustments are recognised in the entity's first IFRS financial statements."*

We are unclear if there has been any other modification to the principles in IAS 10. Where no similar estimate was made for a specific item, if a judgement has to be made regarding conditions which existed at transition or the comparative balance sheet date, full account is taken of all adjusting events up to the date of approval of the entity's first IFRS financial statements. The proposed standard notes that in some cases evidence exists of conditions such as market prices in which case we think no judgement needs to be made and IAS 10 would not be referred to. Furthermore, no change is made in the implementation guidance to existing exceptions to the IAS 10 requirements in other IFRS such as the equity/liability classification, lease classification at inception (but see comment later) and the IAS 38 restrictions on the use of hindsight for capitalising internally generated intangibles.

We think that the examples in IG2 could be more helpful to the user. Firstly they could give a worked example of a complex estimate such as a pension calculation with elements which fall into each category in paragraphs 25/26. For example an estimate of the liabilities may be consistent with IAS 19, but the assets may be inconsistent. Secondly they could cover more specifically some of the more difficult practical issues such as calculating for the first time a restoration provision which is capitalised under IAS 16; lease classifications where there is no information contemporaneous with lease inception; treatment of previous GAAP post-balance sheet adjustments, which would be non-adjusting under IFRS.

## **Appendix C**

### **Matters not addressed specifically – Implementation Guidance**

#### ***General comment***

The implementation guidance seems to be prepared on the basis that an entity will apply the principle in paragraph 7 rather than use the paragraph 13 option to apply the IFRSs that were effective in each period. For example, paragraphs IG15 and IG14 state that the specific transitional provisions in standards are not relevant. We suggest this general principle be clarified, perhaps in an introduction to the appendix.

#### ***IG4***

It is confusing that this paragraph provides guidance not to restate the previous GAAP accumulated depreciation and amortisation unless it ‘differs materially’ from IAS. [This guidance is repeated in *paragraph B 2 Example 1 APPLICATION OF REQUIREMENTS - (e)*]. Whilst we understand that the intention of this guidance is to encourage the entity to retain previous GAAP estimates in line with the principles in paragraph 25, we are concerned at the possibility of a new definition of materiality being introduced to IFRS through this proposed standard. If the IASB decides to keep this guidance we suggest to use the wording in BC 70.

#### ***IG5***

This paragraph does not indicate how an entity reconstructs cost data for each component if an entity has not identified components before. It seems to us that the IASB’s intended solution is based on paragraph 16 of the proposed FTA IFRS which states that if the entity is not able to determine a cost-based measurement because this involves undue cost and effort it uses the fair values of these assets. We suggest that the guidance in IG5 would be more useful if this solution is explicitly included, or a reference is made to paragraph 16.

#### ***IG11***

Following our comments regarding paragraphs 25-27, we note that the criteria in IAS 17 contain some fairly subjective tests – reasonable certainty of options being exercised and the reasonable certainty of renewals. If an entity entered into a lease before the balance sheet date, potentially it could use all the evidence up to the date of authorising its first IFRS financial statements in order to classify the lease under IAS 17 in accordance with IAS 10. In the absence of such tests being made under previous GAAP, it may not be practical to determine what would have been the position at inception, which is how we understand the guidance in the first sentence.

We recommend that the guidance be amended to require application of IAS 10 on first-time application where there was no previous lease classification. This would mean that a company

would use all the evidence relating to the first-time classification of pre-transition leases up until the date of approval of its first IFRS financial statements.

### **IG31-35**

An impairment loss may have been recognised under previous GAAP in relation to property, plant or equipment (or in relation to other assets under paragraph 19) which are recognised at deemed cost following the exemptions in the proposed standard. Either at transition or subsequently IAS 36 may require the reversal of that impairment loss. It is unclear whether the reduction in carrying amount that reflects the impairment is available for reversal when deemed cost has been used. It would seem from BC28 that the IASB does not permit reversals when fair value is deemed cost at the time of transition, and we propose to state this.

With respect to the application of IAS 37 in interaction with IAS 16 this is a complicated area where questions are often raised in practice. We think it would be helpful for the Board to illustrate with an example some of the complications of the calculation from initial recognition to the date of transition covering:

- the estimation of the cost of removing or dismantling an asset (current prices vs historic; inflation adjustments);
- changes in discount rates and the unwinding of the discount;
- depreciation;
- changes in the estimated cash flows due to both changes in estimates and changes in circumstances; and
- accounting for costs incurred after the date the asset is acquired.

### **IG 36**

In (b) the description “*separately acquired*” is used. While separate acquisition is clearly distinguished in IAS 38 from acquisition as part of a business combination, we wonder if the guidance would be more helpful in its own right if this distinction was repeated here.

### **IG38**

We have found the guidance on internally generated intangibles confusing. We think that clearer guidance on the circumstances in which intangible assets should be recognised is needed. The discussion in BC 74 would be suitable for this purpose.

We do not think it is apparent from the guidance that there is a different treatment of internally generated intangible assets depending on which element of paragraph 13 is followed. An entity

which chooses sentence 3 would have to use the transitional provisions of IAS 38 which has different requirements in relation to intangible assets recognised prior to 1 July 1999. In contrast an entity that uses paragraph 7 and 13 first two sentences is allowed to recognise these intangible assets if it had documented and assessed all the information at that time. We propose to state this.

## **Appendix D**

### **Drafting comments**

#### **Exposure Draft**

##### ***Paragraph 3(c)***

We believe that it would be helpful to clarify what kind of qualification the audit report has to include and therefore suggest to alter paragraph 3(c) as follows "...qualified their audit report with respect to IFRS compliance on those...".

##### ***Paragraph 20(b)(ii)***

This paragraph contains a requirement to apply impairment testing to goodwill. In our view it is not clearly stated if a resulting impairment loss is part of the adjustment of the IFRS opening balance sheet or booked through the profit and loss statement of the comparative year. IG34 states that the transition provisions of IAS 36 and 37 do not apply, which in our view means that the impairment loss is adjusted through opening retained earnings at the date of transition. We suggest to clarify this by adding "...any resulting impairment loss in opening retained earnings."

##### ***Paragraph 21***

In order to avoid suggesting that all changes from the date of transition up to the balance sheet at the reporting date have to be booked through equity the first sentence in paragraph 21 should be altered "...restate the asset or liability on that basis at the date of transition to IFRS..."

##### ***Paragraph 22***

We agree with this paragraph but suggest that for the avoidance of doubt it may be clearer to say "...in accordance with IAS 19 Employee Benefits paragraph 155, except that the option to amortise the transition obligation over five years provided in IAS 19.155(b) is not available..."

## **Appendix B**

##### ***Paragraph B1(a)***

The clarity of B1(a) would be improved if it was altered as follows "if an entity recognised a business combination under its previous GAAP, an entity shall keep the same classification (as an acquisition,... , a reorganisation of entities under common control, or a uniting of interest) as in its previous GAAP financial statements."



***Paragraph B1(c)***

The parenthetical of B1(c)(i) should be altered as follows "... (and net of, if any, the related tax and minority interest) ..."

B1(c)(ii) should be altered as follows "... regardless of whether or not there is any indication ..."

**Basis for conclusion**

***BC40 footnote 1***

In our view the use of "... any of the exemptions ..." sends a confusing signal implying that use of the exemptions is optional on an exemption by exemption basis. We suggest to delete the "... any of ..." also to conform to paragraph 13 in the IFRS. The same applies to paragraph BC47, which uses the "... any of ..." as well.

***BC56***

We wonder if the statement in the first sentence "It is unlikely that most entities would have adopted IAS 39's criteria for... before they adopt IAS 39..." is consistent with the assumption that people are preparing for First-Time Adoption as mentioned in BC13.