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Sir David TWEEDIE
Chairman International Accounting
Standard Board

LONDON

ED 1 on First Time Application of International Financial Reporting Standards

Dear Sir,

ABI welcomes the opportunity to comment on the ED 1 on First Time Application of International Financial Reporting Standards.

ABI warmly welcomes the intention of establishing uniform rules on the occasion of the first application of the International Financial Reporting Standards with the entry into force of European Union Regulation 1606/2002, in view of the impact that it will have on a multitude of operators in many different countries.

ABI also welcomes the proposal to make financial statements as comparable as possible, beginning with the first time application of the standards.

However, it must be borne in mind that the new rules must be placed in the legal and regulatory context currently in force in the various countries. Certainly changes will have to be made in national legal orders, including in areas beyond those strictly connected with the drafting of financial statements. Nevertheless, the changes that will be introduced, whether they relate to financial statements or refer to other matters, must preserve what has been done up to then. Hence, they must not affect the representation of corporate events reflected in financial statements that were already drafted and approved, and drafted under previous rules.

We maintain that this safeguard provision must prevail over the need, important though it is, for comparability expressed in the "exposure draft". In the case of first application of the IFRS, however, this safeguard requirement conflicts with the rigid retroactive application

Segue lettera Oggetto: **ED 1 on First Time Application of International Financial Reporting Standards**

of the new standards. Moreover, such application could result in significant discontinuities in the financial statement values presented over time by companies, which would translate into extreme volatility of shareholders' equity in the first accounts drafted according to the international standards.

These concerns are set forth at greater length in our responses, included in the enclosure, to the individual questions of the IASB.

Since some of these concerns were also raised by EFRAG in its draft comments published on its website (www.efrag.org) and attached for your reference, our comments in the enclosure will take as a point of departure those of EFRAG.

We would ask that our comments be circulated to the Board and included in the published responses to the ED 1 on First Time Application of International Financial Reporting Standards.

Yours sincerely,



Giuseppe Zadra
(General Manager)

Enclosures:

ABI Position Paper
EFRAG Document

LG/

Progetto IAS/Lettera PP ED 1
Ottobre 2002

ED 1 - FIRST TIME APPLICATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Premise

ABI warmly welcomes the intention of establishing uniform rules on the occasion of the first application of the International Financial Reporting Standards with the entry into force of European Union Regulation 1606/2002, in view of the impact that it will have on a multitude of operators in many different countries.

We also welcome the proposal to make financial statements as comparable as possible, beginning with the first time application of the standards.

However, it must be borne in mind that the new rules must be placed in the legal and regulatory context currently in force in the various countries. Certainly changes will have to be made in national legal orders, including areas beyond those strictly connected with the drafting of financial statements. Nevertheless, the changes that will be introduced, whether they relate to financial statements or refer to other matters, must preserve what has been done up to then. Hence, they must not affect the representation of corporate events reflected in financial statements that were already drafted and approved under previous rules.

We maintain that this safeguard provision must prevail over the need, important though it is, for comparability expressed in the "exposure draft". In the case of first application of the IFRS, however, this safeguard requirement conflicts with the rigid retroactive application of the new standards. Moreover, such application could result in significant discontinuities in the financial statement values presented over time by companies, which would translate into extreme volatility of shareholders' equity in the first set of accounts drafted according to the international standards.

These concerns are set forth at greater length in our responses to the individual questions of the IASB.

Answers to questions

Q1. The proposed IFRS would apply when an entity first adopts International Financial Reporting Standards (IFRSs) as its new basis of accounting, by an explicit and unreserved statement of compliance with all IFRSs (paragraphs 1-5 and paragraphs BC4-BC10 of the Basis for Conclusions).

Is this an appropriate description of the circumstances when this proposed IFRS should apply? If not, what changes would you suggest, and why?

We agree with EFRAG's answer, with the sole exception of the last paragraph, on paragraph 5.

On paragraph 5, we believe that the paragraph should be deleted, both because the accounts of subsidiaries drafted by the parent company for purposes of consolidated accounts are not public accounts and are frequently adjusted by the parent company; further, we fail to see the logic of leaving the decision of whether or not the accounts shall be considered compliant with the IFRS up to the minority shareholders. Moreover, the mechanism for obtaining their consent would be difficult and costly (in Italy, a special shareholders' meeting would have to be called). Finally, it would deprive the readers of the subsidiaries' balance sheets of important information. In particular, they would no longer be able to see the reconciliation of the accounts with the financial statements drawn up under local rules.

Q2. The proposed IFRS proposes a requirement that an entity shall prepare its opening IFRS balance sheet using accounting policies that comply with each IFRS effective at the reporting date for its first IFRS financial statements.

Paragraphs 13-24 propose limited exemptions from this requirement.

Are all of these exemptions appropriate? Should the Board amend any of these exemptions or create any further exemptions (paragraphs BC11-BC89)? If so, why?

The question must be answered in three separate points:

- the compliance of the opening IFRS financial statements with the new standards;
- the principle of retroactive application for transactions carried out prior to the application of the IFRS;
- the exemptions provided for by ED1.

Compliance of the opening balance sheet with the new standards

On the first point, paragraph 6 of ED 1 takes the earliest year presented for purposes of comparison as the date of transition to the new standards. Paragraph 7 requires that an entity use the same accounting standards in all periods presented for comparison and that these standards be in compliance with those “effective” at the “reporting date” (i.e., the end of the reference period) for the first IFRS financial statements.

We agree with this approach, as long as standards “effective” at the “reporting date” means those IFRS for which the date of entry into force is earlier than the “reporting date.” This because a “first time adopter”, in drafting the financial statements, will have to apply the new standards from the start of the first reference period of the first IFRS financial statements (in the case of transition to IFRS in 2005, this means January 1st 2005) and cannot intervene subsequently to modify, in the course of that year, accounts already drafted according to previous standards. However, it will be possible to reconstruct the data for the previous year or years presented for comparison, as this would be a reworking of the data outside of the actual accounts.

The principle of retroactive application for transactions carried out prior to the date of first application of IFRS

Paragraph 11 of ED 1 affirms the assumption of compliance with IFRS takes place via:

- (a) recognising all assets and liabilities whose recognition is required by IFRSs;
- (b) not recognising items as assets and liabilities if IFRS do not permit such recognition;
- (c) reclassifying items that entity recognised under previous GAAP as one type of asset, liability or component of equity, but that are a different type of asset, liability or component of equity under IFRSs; and
- (d) applying, IFRSs in measuring all recognised assets and liabilities.

We have no problem with point *c* or with point *d*, which incidentally is in line with current practices regarding changes in valuation criteria. The date on which the valuation criteria are modified is the closing date of the financial year, since these are “adjustments” carried out upon closing of the yearly accounts.

However, points *a* and *b* do give rise to significant problems in their application, especially if there are assets or liabilities that have been derecognized according to national accounting standards but that must be re-recognised in the financial statements, because they lack the requirements for derecognition under IFRS.

Italian law, and certainly the law in other countries, attributes to the accounts and the company's financial statements deriving there from, a definite juridical value. In Italy, the law lays down the obligation to keep certain accounts and books of account, and the entries in these books have legal validity for the recognition of obligations to third parties and for purposes of possible criminal offenses¹.

Our opinion is that legally, the representation of a transaction with a counterpart in the accounts, included in a balance sheet that has been formally approved, cannot be modified after the fact by reason of a change in accounting rules. It should also be noted, furthermore, that the reinstatement of assets or liabilities under this procedure of retroactively aligning old and new accounting standards could entail the derecognition of profits or losses already included in approved accounts and financial statements (charging them to shareholders' equity as is provided for by paragraph 12 of ED 1), and this too is highly debatable.

Accordingly, ABI's view is that the retroactive application of the new rules on recognition and derecognition of balance sheet assets and liabilities is incompatible with existing national legal orders.

On top of these legal problems and in connection with the retroactive application of the new standards, there are problems and difficulties regarding the continuity of the values provided in financial statements and the resulting distortions in their representation in the profit-and-loss account in connection with the derecognition or recognition of assets and liabilities that were respectively recognised or derecognised. Such discontinuities could produce significant volatility in shareholders' equity (the accounting contra account for all realignments) in the first year in which IFRS applies.

The problems in their application involve the possible need to re-examine transactions carried out even a good number of years before the transition to IFRS (since ED 1 sets no time limit to retroactivity). This is very unlikely to be practicable for large firms. Further, the elements needed to reinstate certain entries years after the fact could well be lacking. This is a problem of "undue cost or effort," which ED1 does allow for some types of exemptions, but the types listed are not exhaustive.

The discontinuity in financial statement values and the resulting distortions in their representation in the profit-and-loss accounts would occur in a very large number of cases. The following is a list of a certain items.

1. *Initial recognition of financial instruments:* IAS 39, as regards financial instruments, requires that the initial recognition of an asset or liability including transaction costs. Given that in most national accounting standards most of these costs are charged to the profit-and-loss account, the transition to IFRS would mean, for the items still on the balance sheet, an accounting adjustment, with shareholders' equity as contra account. This would mean that, upon subsequent

¹ Certainly the consolidated financial statements are more flexible, with a primarily informational function. Even so, it does seem likely that the provision of retroactive application is to be applied only to consolidated financial statements and not to individual company financial statements.

sale of the instrument or as an effect of the immediate downward value adjustment of an accessory cost taken to equity, firms would have a lower profit (or a larger loss) than they would under the national standards (the profit-and-loss account would be charged twice for the same item).

2. *Capitalisation of intangible fixed assets in financial statements drawn up according to national standards and subsequent derecognition with the transition to IFRS (because the charges do not meet IFRS requirements for recognition as intangible fixed assets):* on 1 January 2005, a company must make an accounting adjustment of the previous financial statements (drawn up according to national standards) and then derecognise the residual portion (suspended in intangible fixed assets) of the costs, which according to IFRS should have been charged to the profit-and-loss account for the year in which they were incurred. This residual portion of costs must be charged directly to equity (probably through a reduction in some unencumbered reserve, if there is no reserve for retained earnings; and if there are no free reserves, then the charge cannot even be made) and hence does not flow through the profit-and-loss account.
3. *Allocations to risk and loss provisions in balance sheets drawn up according to national accounting standards and subsequent derecognition with the transition to IFRS (because they lack the latter's requirements for earlier recognition):* on 1 January 2005 the firm must make an accounting adjustment of the previous financial statements (drawn up according to national standards) and then derecognise the provision for liabilities that under IFRS could not be set aside in advance. The amount must be charged directly to shareholders' equity (in a specially created reserve). If in a subsequent year, costs are incurred under which the old national accounting principles would have been covered by the loss provision, the cost would have to be charged to the profit-and-loss account again (as the provision upon which to draw no longer exists). Alternatively, the firm would have to use the reserve created upon transition to IFRS, but this would be a deviation from the application of the international standards and would amount, in substance, to the reinstatement of the situation described in the financial statements drawn up under national standards.

These problems, in our view, suggest there is a need to rethink the general principle of retroactive application of the standards as regards the figures in past financial statements already approved. It must be possible to safeguard the accounts as reflected in financial statements that are closed and approved. We must not forget that transactions and contracts are entered into, in part, on the basis of the accounting rules in effect at the time, so that retroactive change in these rules is hard to justify. The same request was made in the recent letter commenting on IAS 39, in the answer to question 10 on the retroactive application of the rules on derecognition.

In order to give the reader of the accounts a framework of comparability for the first few years of application of the new standards (where there could remain some changes in the accounting representation of transactions concluded prior to the transition to IFRS), a company could be required to indicate the changes and their effects on individual items.

Alternatively, considering at the very least the problems that retroactive application of the international standards could raise for the reconstruction of historical data series, we suggest that the exemption for "undue cost or effort" apply to all the cases envisaged in paragraph 11, as in the existing approach of SIC No. 8. For there could be further problems of application beyond those cited in the list of exemptions (such as the problem mentioned above, of the initial valuation of financial instruments), so that list cannot be considered, initially, to be exhaustive.

Use of exemptions under ED 1

As for the use of exemptions, the precise meaning of the phrase “if an entity uses the exemptions it shall use them all, to the extent that they are applicable” set in para. 14, is not clear.

Our interpretation is that a company must use exemptions only if the conditions are met, i.e. if it is not in a position to come into line with the international standards. Thus if a company must use the exemption for “business combinations” but is capable of reconstructing the cost of the items, it must not also apply the exemption for the latter.

Finally, there is a contradiction between paragraph 13, which requires the adoption of all the previous versions of the standards, even if superseded, in the case that the firm does not avail itself to the exemptions, and paragraph 7 (in boldface), which requires the adoption of the IFRS in effect at the “reporting date.”

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

We agree that the “disclosures” are appropriate.

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

We agree with the various points made by EFRAG in its paper, save only for point 6 on hedge accounting. The provisions of ED 1, in our view, do not appear to extend the application to improvements proposed in ED IAS 32 and 39 (in particular on continuing involvement). As for the retroactive application of IFRS (hence, retroactive application also of continuing involvement), see our remarks on question 2 above.