

GEFIU
GESELLSCHAFT FÜR FINANZWIRTSCHAFT
IN DER UNTERNEHMENSFÜHRUNG E.V.

„Financial Accounting Working Group“

5 November 2002

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir David,

Comments on Exposure Draft ED 1 First-time Application of International Financial Reporting Standards

The Members of the GEFIU Financial Accounting Working Group are pleased to comment on the Exposure Draft ED 1 *First-time Application of International Financial Reporting Standards*.

The GEFIU (Gesellschaft für Finanzwirtschaft in der Unternehmensführung e. V.) is the German Financial Executives Institute. It has some 160 members who are chief financial officers or finance directors of German industrial and trading companies as well as insurance companies, banks, and other financial services. GEFIU is a member of the International Association of Financial Executives Institutes (IAFEI). As a member of the international Group of Treasury Associations (IGTA), GEFIU also cooperates with other treasure associations.

1. Structure of the exposure draft

Before dealing with the individual questions we would like to make preliminary comments on the structure of the draft. Based on our reading, we believe that the exposure draft sets out two alternative methods for first-time adoption of IFRS (par. 13). The first method allows certain departures or exemptions from retrospective application whilst the second method requires full retrospective application. We understand that an entity can choose which option it

applies. We also understand that this choice can only be for either the first or second method but not a mix of the two.

As the second method is only described in the second sentence of paragraph 13, we see the risk of an entity believing that it can only use full retrospective application where it cannot apply the exemptions contained in the first method.

We recommend that each method be described in separate paragraphs to clearly highlight their existence and parity.

2. IFRS effective of the transition date

We favour the preferred approach set out in the draft that the entity should not apply the IFRSs that were effective in each period. This also avoids the noted complication of having to consider superseded versions of IFRSs where later versions required only prospective application. This approach will significantly reduce the workload for first-time adopters.

In our opinion however, the first-time adopter should be required to apply those IFRSs which were effective at the transition date (rather than a retrospective application of the Standards effective at the reporting date). This is because some entities must publish comparative figures for several years, meaning a longer time period between the transition and reporting dates. These entities will no doubt need to start much earlier with the preparation of their IFRS comparative figures – probably annually, parallel to local GAAP. During this preparation period, both these first-time adopters and those entities which have already converted to IFRS, would use the effective Standards, treating any changes in the Standards in a consistent manner. It is also virtually certain, that the Standards will change further in the coming years. If our suggested approach is not adopted, first-time adopters will be faced with the additional burden, in the reporting year, of retrospectively adjusting their IFRS comparative figures to comply with the Standards effective in the reporting year.

3. Structure of the exemptions

Based on our reading, we believe that some of the exemptions set out in paragraphs 14 - 24 are compulsory (e.g. IAS 19, IAS 39). Others only apply however where “undue cost or effort” would otherwise be required to determine a cost based measurement. Whilst the compulsory exemptions are aimed at enhancing comparability of financial statements, the latter exemptions appear aimed at reducing the burden of first time application.

We believe that these different types of exemptions must be clearly differentiated, particularly in light of the requirement to apply all or none of the exemptions.

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.

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?

We find the general presentation of the exemptions unclear and believe that the phrase “undue cost or effort” needs clear and detailed definition to ensure consistency of approach between entities and thus comparability of financial statements.

We also set out below proposed amendments to the exemptions regarding business combinations and the valuation of intangible assets.

Undue cost or effort

The exemptions set out in the exposure draft are based on “undue cost or effort”. We understand that the move from “impracticability” was made to cover situations where retrospective application is practicable but the costs exceed any benefit to users of financial statements. We thus see the change as a slackening of the previous approach. The phrase “undue costs or effort” however is widely drafted and will doubtless lead to varying interpretations which will reduce the comparability of financial statements. We believe that the existing discussion in BC 13 does not go far enough to ensure consistency of approach.

As the phrase “undue cost and effort” is also contained in other Standards we propose that a detailed and clear guidelines are drafted.

We also noted that the phrase is not always consistently used - “undue cost or effort” in paragraph 16, “undue cost *and* effort” in paragraph 23. These inconsistencies need to be clarified or corrected.

Retrospective accounting for business combinations

We believe that the exemption for business combinations was agreed under the belief that the information is not readily available and would thus cost more to determine than any benefits to the users. There are however circumstances where retrospective application will not cause undue cost or effort. At the same time, prospective application is contrary to the board's objective of ensuring that financial statements contain high quality and transparent information. Where an entity has recognised goodwill as an immediate write-off to equity, the entity will have all the data needed to apply IAS 22 retrospectively. In other areas however, retrospective application could cause the entity undue cost or effort, e.g. property, plant and equipment. The entity faces the option of applying all or none of the exemptions and would probably favour applying all the exemptions. This would lead to a reduction in the quality and transparency of the published financial statements where information is actually available.

In view of the importance attached to high quality and transparent information we would propose that entities be allowed a choice of whether to apply IAS 22 retrospectively or prospectively. This choice should not have any impact on the application or otherwise of the other exemptions.

Fair value as deemed cost for intangible assets other than goodwill

In some countries, local accounting standards do not allow the recognition of intangible assets, e.g. internally generated software. In such cases, entities will generally not have any historical cost information available. As collection of this information, if at all possible, is likely to be costly, an entity may well decide not to capitalise the costs. Where the IFRS requires recognition as an intangible asset however, the true and fair view of the entity's financial statements could be distorted.

We agree in general with the IASB's view to limit the exemptions to defined transactions, using "undue cost or effort" as the underlying principle. Important however is the consistent application of this principle. We believe that intangibles should be treated consistently with property plant and equipment, allowing fair value measurement as deemed cost at the date of transition. The fair value measurement should only be permitted where it can be determined by reference to a strictly defined active market. This restriction should be added to paragraph 16.

This approach should not apply to goodwill.

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 of the exposure draft requires a first-time adopter to explain the material adjustments to the cash flow statement arising from the transition to IFRS. It does not however give details on the adjustments that need to be explained. We believe that the change to IFRS impacts on the cash flow statement in two ways.

1. Changes in the balance sheet and income statement arising from the adoption of IFRS.
2. Changes in the structure and presentation due to preparation under IAS 7.

The effects arising from changes in the balance sheet and income statement are already set out in the reconciliation of equity and the profit or loss reconciliation (paragraph 31 of the exposure draft). We thus believe that only an explanation of the changes in structure and presentation would provide additional information to users. As the exposure draft also aims to balance costs with benefits, we recommend amending paragraph 32 to clearly specify the required explanations.

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

Listed entities in the EU must publish their first IFRS financial statements by 2005. In light of this challenging deadline, entities need clear direction on whether they are required to prepare interim reporting in accordance with IAS 34 in the year they present their first IFRS financial statements. Although neither the draft standard nor IAS 34 require interim reporting in accordance with IAS 34, we see the risk, that the current proposal may lead to stock exchanges or the legislator to believe that IAS 34 interim reporting must be applied in the first IFRS-reporting period. This interpretation would further increase the pressure on first time adopters, as it effectively shortens the transition deadline by 9 months.

In addition, the published interim reports would not be audited (according to the current requirements of IAS 34). The year-end audit however could lead to changes in IFRS accounting policies and principles adopted by the entity. This would mean that the quarterly reporting contains incorrect information. As these errors would have to be corrected (to ensure in the next year that the prior year figures are comparable), it would lead to an additional burden on the entities.

We therefore recommend that the exposure draft requires no interim reporting 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 set out our reservations below:

a) Definition of "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 believe this can only mean the publishing or filing of financial statements but see the danger of differing interpretations. We thus propose that the word "presented" be replaced by "published".

In this case paragraph 2 (b) is no longer required.

b) 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. Where the audit qualification was made due to the non-application of IFRS, an entity should be treated as a first-time adopter. Accordingly, paragraph 3 (c) should state that a entity with a audit qualification due to the non-application of IFRSs is a first-time adopter.

Estimates

We have 2 reservations regarding the wording of paragraphs 25-27.

At present these paragraphs cannot be understood without reference to the implementation guidance. We believe however that the Standard itself must contain sufficient information for users. The guidance should only act as a reference.

Our second concern regards the proposal itself. We understand that estimates made under the previous GAAP may only be revised where objective evidence has subsequently come to light showing the estimates to be wrong. Based on this understanding we believe that these paragraphs could lead to financial statements which are not prepared using the most recent information. Accordingly they do not present a true and fair view at the time of preparation under IFRS. We believe it is critical that the comparative figures, which forms an integral part of the financial statements, include all adjusting events after the balance sheet date.

Negative goodwill

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

Equity reconciliation

Paragraph 31a 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.

One of the aims in the exposure draft is to ensure that the first IFRS financial statements are not generated at costs that exceed the benefits to the users. We believe that the costs exceed the benefit to users if an entity must reconcile the equity twice. We understand that the draft requires the presentation of the following information to users:

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

If our understanding is correct, we believe that an entity can provide the required information with only one equity reconciliation. The entity must reconcile the profit or loss of the transition period. This reconciliation, together with one equity reconciliation, at either the transition date or end of the transition period, provides the same information to the user as two equity reconciliations.

Accounting for Goodwill

The IASB decided that the carrying amount of goodwill under previous GAAP should be adopted in an entity's IFRS opening balance sheet. Where the goodwill has been written-off directly to equity, no goodwill would be recognised in the opening IFRS balance sheet. We believe it would be helpful to provide guidance on the accounting treatment for the disposal of goodwill previously written-off directly to equity.

Inconsistencies

Paragraph 12 of the exposure draft requires the recognition of adjustments directly in *equity*. Paragraph 21 however refers more specifically to *retained earnings*. We ask the board to clarify this apparent inconsistency.

Yours sincerely,

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Chairman Financial Accounting Working Group