

Memorandum of comment submitted to the International Accounting Standards Board in October 2002 concerning Exposure Draft 1, 'First Time Application of International Financial Reporting Standards', published in July 2002

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding Exposure Draft 1, 'First Time Application of Financial Reporting Standards', published by the Board for comment in July 2002.
2. We have reviewed the exposure draft and set out below a number of comments. We deal first with significant matters before commenting on the specific issues raised in the exposure draft and then on points of detail.

MAJOR POINTS

Support for the Proposals

3. We congratulate the Board on producing a high quality draft standard. In general, the proposals deal with the complexities of first time adoption in a pragmatic and rational manner, whilst ensuring that departures from the key accounting principles of International Financial Reporting Standards (IFRS) are kept to a minimum. However, we have a number of significant concerns regarding the proposals, particularly the clarity of the principal options available to first time adopters.

Undue Cost or Effort

4. We recognise that adoption of a flexible, pragmatic approach to first time application of IFRS is only possible by comparing the cost to the reporting entity of providing information to the resultant benefits to users. We also agree that in some circumstances determining cost-based measurements under IFRS at the date of transition is likely to involve considerable cost and effort. However, the concept of 'undue cost or effort' appears to be a less demanding test than 'impracticality', which it replaces, and in our view may lead to conflicting interpretations. This may undermine the comparability of financial statements and the credibility of IFRS.
5. The Board should ensure that the meaning of 'undue cost or effort' is as certain and unambiguous as possible. For example, a clear, concise and prominent explanation of the Board's thinking on this issue might be provided in IAS 1 or in the Board's 'Framework', with a cross-reference included in each standard that provides exemptions on this basis. We anticipate that the explanation would be on the lines of the comments in the draft Basis of Conclusions, paragraph BC13.

Options for First Time Adopters

6. Subject to our comments regarding hedge accounting, we support the proposal that first time adopters should prepare an opening IFRS balance sheet using accounting policies that comply with IFRS effective at the 'reporting date'. We also agree with the proposed exemptions. However, we consider that the requirements could be expressed more clearly. It should not be necessary to have to analyse in great detail paragraphs 7,8 and 13 of the draft standard to establish that a first time adopter has two principal options when preparing its first IFRS financial statements:

- full retrospective application of a single version of IFRS - IFRS effective at the reporting date. All of the individual exemptions described in paragraphs 14-24 must, where applicable, be used (except where application is stated to be optional or is subject to cost:benefit considerations)
 - preparation of initial IFRS financial statements as if the reporting entity had always applied IFRS - applying superseded and amended versions of IFRS if later versions require prospective application, and providing the same disclosures as other first time adopters regarding the effect of the transition from previous GAAP.
7. We consider that these options could be set out far more clearly and coherently in the draft standard. In addition, we note that the proposals do not require the use of all of the concessions provided to first time adopters, contrary to the assertion in the exposure draft. We discuss these issues in more detail below.

Withdrawal of SIC 8

8. At present, issues that arise when an entity adopts international standards are dealt with by SIC-8, *First Time Application of IASs as the Primary Basis of Accounting*. SIC 8 differs from the proposed new standard in some significant respects. As the standard will encourage early adoption, entities preparing their first IFRS financial statements for a period beginning before 1 January 2003 will be able to apply either the provisions of the new standard or SIC-8.
9. To minimise uncertainty and negate any opportunities for accounting arbitrage, we suggest that SIC-8 is withdrawn shortly after publication of the new standard. The new standard should take effect from the date of withdrawal.

Implementing Changes to Other IFRS

10. The Board has announced its intention to implement significant changes to IFRS in advance of their adoption by European listed companies in 2005. We consider that greater clarity is required regarding the impact of such changes on first time adopters. For example, changes to IAS 21 may require the application of new measurement rules to goodwill recorded in the opening IFRS balance sheet in accordance with paragraph 20 (b) of the proposed standard. We recommend that the Board clarifies its thinking regarding the timing of this and other adjustments arising from changes to IFRS in 2003/2004.

Hedge Accounting

11. In principle, we believe that first time adopters should prepare their opening IFRS balance sheet in full compliance with IAS 39 to ensure that comparative information is produced on a comparable basis. However, we recognise that full retrospective application from the date of transition of the hedge accounting requirements of IAS 39 may be impractical, particularly for US-registered EU listed companies required to prepare opening IFRS balance sheets as at 1 January 2003. We also note that transitional provisions in the original version of IAS 39 meant that implementation

of the new standard did not necessitate the reversal of hedge accounting policies followed in prior years when comparative financial information was prepared.

12. The implications of first time adoption for hedge accounting are discussed in Appendix C to the proposed standard, but lack clarity due to the complicated use of many sub-clauses. We interpret paragraph 3 as permitting the relaxation for comparative periods of the IAS 39 requirements relating to designation, documentation and effectiveness for hedges that were properly designated under previous GAAP. Although such prospective application from the date of transition of the full rigour of IAS 39 might encourage a view that preparatory work for adoption of IFRS in 2005 can be delayed until late in 2004, on balance we support this relaxation on pragmatic grounds. However, in our view this concession should not extend to the checking of effectiveness.
13. The Board should review the drafting and contents of Appendix C to ensure that the requirements relating to this complex area of accounting are as logical, understandable and unambiguous as possible. In this connection, we would point out that the first step in the conversion process is recognition of all derivatives and other financial assets and liabilities in accordance with IAS 39 before consideration is given to the hedge accounting implications. We discuss this issue in more detail below in paragraph 19.

RESPONSES TO SPECIFIC QUESTIONS

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?

14. We agree that that the proposed standard should apply when the adoption of IFRS for the first time is evidenced by an explicit and unreserved statement of compliance with IFRS.
15. Paragraph 3(c) of the exposure draft provides that an entity which presented financial statements in the previous year that contained the required statement of compliance with IFRS falls outside of the scope of the proposed standard whether or not the auditors' qualified their opinion on those financial statements. Whilst we believe that this approach is appropriate, the current wording is unclear and could be misinterpreted, perhaps as the whole paragraph is expressed in the negative. We therefore suggest that the Board reviews the drafting of this important provision.

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?

General

16. We support the proposal that first time adopters should prepare an opening IFRS balance sheet using accounting policies that comply with IFRS effective at the 'reporting date'. We also agree that the proposed exemptions reduce the complexities of first time adoption in a pragmatic and rational manner, whilst keeping departures from the key accounting principles of IFRS to a minimum. However, we consider that the requirements could be expressed more clearly. It should not be necessary to have to analyse in great detail paragraphs 7,8 and 13 of the draft standard to establish that a first time adopter has two principal options when preparing its first IFRS financial statements:
 - full retrospective application of a single version of IFRS - IFRS effective at the reporting date. All of the individual exemptions described in paragraphs 14-24 must, where applicable, be used (except where application is stated to be optional or subject to cost:benefit considerations)
 - preparation of initial IFRS financial statements as if the reporting entity had always applied IFRS - applying superseded and amended versions of IFRS if later versions require prospective application, and providing the same disclosures as other first time adopters regarding the effect of the transition from previous GAAP.
17. We consider that these two options could be set out far more clearly and coherently in the draft standard. We recommend that paragraphs 7, 8, 13 and 14 be redrafted to express clearly and consistently the available options and the implications of adopting them, drawing on the explanations provided in the draft Basis of Conclusions (paragraphs BC59-61 and BC79-80).
18. In addition, we are not convinced that the stated 'all or nothing' approach to use of the exemptions is appropriate. Although *prima facie* this approach might provide a greater level of comparability, we note that use of most of the individual exemptions is in practice optional or subject to cost:benefit considerations. This approach also appears to be inconsistent with the Board's recent proposals for improving a number of existing standards, which contain many individual exemptions on the grounds of 'undue cost or effort', any of which may be taken advantage of individually.

Hedge Accounting

19. We have discussed above in paragraphs 11 to 13 our views on the concessions provided in Appendix C and in particular the need for greater clarity in paragraph C3 due to its many sub-clauses. The meaning of paragraph C3 (a) also causes confusion. It appears to mean that the opening IFRS balance sheet should be

obtained by restating a closing old GAAP balance sheet before any change has been made to old GAAP hedge accounting. In many cases, old GAAP hedge accounting may not have involved the recognition of a derivative used for hedging that had no initial cost. This derivative may or may not qualify for hedge accounting under IAS 39, but it needs to be recognised at fair value in the opening balance sheet before consideration is given to whether it no longer qualifies as a hedge, or is a fair value or cash flow hedge. The first step in this conversion would be recognition of all derivatives and other financial assets and liabilities in accordance with IAS 39 before consideration is given to whether hedge accounting is available under IAS 39 for any of the old GAAP hedges. It would be helpful if this were made explicit. The Board should review the drafting and contents of the Appendix to ensure that all of the requirements relating to this complex area of accounting are as logical, understandable and unambiguous as possible.

Drafting

20. We note that paragraph 14(b) refers to paragraphs 17-19 permitting entities to use some valuations as deemed cost, whereas paragraph 19 in fact mandates the use of event-driven fair values as deemed cost.

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?

21. We strongly agree that clear reconciliations to previous GAAP should be required to help users to understand the effect and implications of the transition to IFRS.
22. Paragraph 32 of the proposed standard requires reconciliations to be sufficiently detailed to permit users to assess material adjustments to the balance sheet and income statement. It should be clear in the standard that that this should include narrative description and explanation where appropriate, as is suggested in paragraph BC94 of the draft Basis for Conclusions.

Question 4

Do you have any other comments on the Exposure Draft?

23. Yes. Please see the other points set out below and our major points concerning:
 - undue cost or effort;
 - withdrawal of SIC 8;
 - implementing changes to other IFRS; and
 - hedge accounting.

OTHER POINTS

Repetition

24. The appendices to the draft standard duplicate a substantial amount of the text of the main standard. We consider that repetition of the requirements of standards in appendices or explanatory material is generally unhelpful and should be kept to a minimum. We therefore suggest that the Board considers how the structure of the draft standard might be modified to achieve this objective.

Implementation Guidance

25. The draft implementation guidance usefully explains how the requirements of the proposed standard interact with the requirements of other IFRS. However, the status of the guidance may not be entirely clear to preparers. We suggest that the Board clarifies the status of implementation guidance provided in relation to new IFRS before issuing the first time adoption standard.

Profit on Sale of Subsidiaries

26. Example 4 of Appendix B, 'Business Combinations', confirms that no adjustment is required on first adoption of IFRS in respect of goodwill deducted from equity under previous GAAP at the time of acquisition. If the subsidiary is subsequently resold at the original acquisition price and the profit is taken to income, the group will report a profit equal to the amount of goodwill deducted from equity. This outcome is misleading and lacks transparency. We suggest that the Board requires that only the profit in excess of goodwill written off to reserves should be recognised as income.

Impairment of Goodwill

27. Paragraph 20 (b) (ii) of the draft standard refers to the recognition of impairment losses relating to goodwill at the date of transition to IFRS. We assume that such losses should be recognised within the reconciliations required by paragraph 31. This should be made clear in the new standard.

Cumulative Translation Differences

28. We agree with the proposed approach proposed in paragraph 23 to cumulative translation differences relating to net investments in foreign operations. We note that the requirement in IAS 21 to classify such differences as a separate component of equity may become redundant in the near future, depending on the outcome of the Board's review of the concept of recycling.

IAS 10 - Example

29. In our view, the use of hindsight under 'Assumption 2' in the example provided following paragraph IG2 is inappropriate. We suggest that the Board reconsiders the conclusion that 'J' should recognise a provision at 31 December 2004.

Glossary

30. We suggest that the definitions set out in the Glossary are included instead in Appendix A ('Defined Terms') to the proposed standard.

NSJ/November 2002