EFRAG

European Financial Reporting Advisory Group

15 December 2008

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Dear Sir or Madam

**Exposure Draft of proposed Improvements to IFRSs**

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Improvements to IFRSs*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

Our detailed comments on the ED are set out in the appendices to this letter. To summarise, we agree with most of the proposals in the ED, although we sometimes see a need for some rewording or for an additional amendment to make the issue clearer. Our main areas of disagreement are:

- Issue 3: IFRS 8 *Operating Segments – Disclosures of information about Segment Assets.* The IASB proposes to amend the basis for conclusion so that only those assets and liabilities that are included in the measure of the segment's assets and segment's liabilities that are used by the chief operating decision maker shall be reported for that segment. EFRAG is particularly concerned at the suggestion that this objective should be achieved by changing only the Basis for Conclusions. We refer to paragraphs 16 and 17 for further comments.

- Issue 8: IAS 38 *Intangible Assets – Measuring the fair value of an intangible asset acquired in a business combination.* The IASB proposes to amend the description of valuation techniques commonly used by entities when measuring the fair value of intangible assets acquired in a business combination that are not traded in active markets. EFRAG believes these proposed amendments attempt to clarify something that is already clear. We believe that, if IFRS are to remain high-level, principle-based standards, it is important that 'clarifications' of this kind are not made. We refer to paragraph 37.

- Issue 12: IAS 39 *Financial Instruments – Recognition and Measurement – Bifurcation of an embedded foreign currency derivative.* The IASB is proposing to replace the notion of a commonly used currency in IAS 39.AG33(d) by a reference to the characteristics of a functional currency as set out in paragraph 9 of IAS 21 *The effects of Changes in Foreign Exchange Rates*. The intention in doing this is to clarify which currencies could be considered "commonly used" in a particular economic environment (and therefore would be treated as embedded derivatives that are closely related to the host contract). We do not support the proposed amendments because we do not think they result in greater clarity. Our detailed concerns are set out from paragraphs 59-62.

We would also like to make a couple of general comments.

- We note that several of the proposals involve making changes to the requirements to IFRS through changes only to the Bases for Conclusions or to non-mandatory parts of standards. We strongly disagree with this approach.

    - In our view, a Basis for Conclusions should be used only to explain the reasoning behind what is required by the standard; it should not contain requirements or guidance, and it should not contradict things said in the standard.

    - We would also like to point out that amending a Basis for Conclusions and/or a non-mandatory part of a standard would have no effect in the European Union because such material is not endorsed for use in the EU.

- As we understand it, the IASB sees the Annual Improvements process as the appropriate process for non-urgent, but necessary, amendments to IFRSs. However, we think the range of amendments made through the Annual Improvements process should be more limited than that. In particular, we think some issues are too significant to be dealt with via the process, because they involve one or more material cross-cutting issues. We also think some issues are too minor to be dealt with through the process (and indeed too minor to be worth addressing at all). Finally, we also think that, if the IASB is working separately on a project that could address the issue and is expected to be finished before or soon after the relevant Annual Improvements project, that issue is best dealt with in that separate project rather than in the Annual Improvements process. We think that the IASB should set some explicit limitations along these lines on the issues it addresses in the Annual Improvements project.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Frederiek Vermeulen or me.

Yours sincerely

Stig Enevoldsen
**EFRAG, Chairman**

## Appendix 1 — Responses to the invitation to comment

### Issue 1: IFRS 2 *Share-based payment*: Scope of IFRS 2 and the revised IFRS 3

1 The existing IFRS 3 defines a business combination as the "bringing together of separate entities or business into one reporting entity", without mentioning control explicitly. It follows that the formation of a joint venture and (some) common control transactions meet the definition of a business combination. IFRS 3R changed the definition and defines a business combination as "a transaction or event in which an acquirer obtains control of or one more business". Thus, the new definition focuses on obtaining control of "businesses". It also no longer refers to "entities". This change means that the formation of a joint venture no longer meets the definition of a business combination.

2 Paragraph 5 of IFRS 2 and a subsequent clarification in IASB Update make it clear that IFRS 2 does not apply "to transactions in which the entity acquired goods as part of the net assets acquired in a business combination" as defined in IFRS 3. Thus the formation of a joint venture was, prior to IFRS 3R, clearly excluded from the scope of IFRS 2. That was also true of certain common control transactions.

3 As the IASB did not intend to change the existing accounting under IFRS 2 for the formation of joint ventures or common control transactions, it is proposing to amend paragraph 5 of IFRS 2 to reflect that intention.

<u>EFRAG's comment</u>

4 EFRAG agrees with the proposed amendment.

5 In addition, EFRAG notes that paragraph 5 of IFRS 2 has been interpreted in practice as meaning that the following transactions are also not included in the scope of IFRS 2:

(a) Transactions involving acquisitions of minority interest (NCI) after control is achieved.

(b) Acquisition of significant influence.

The basis for the above interpretation appears to be that such transactions also met existing IFRS 3's definition of a business combination.

6 Given the change in the definition of a business combination, we think it would be helpful if the IASB clarified whether the above transactions are now within the scope of IFRS 2.

### Issue 2: IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* – Disclosures required for non-current assets (or disposal groups) classified as held for sale or discontinued operations

7 It would seem that there is some uncertainty as to whether the disclosure requirements of standards other than IFRS 5 apply, in the absence of specific exclusions, to non-current assets (or disposal groups) classified as held for sale or discontinued operations in accordance with IFRS 5.

8 The IASB is therefore proposing to amend IFRS 5 to clarify that IFRS 5, and other IFRSs that specifically refer to non-current assets (or disposal groups) classified as held for sale or discontinued operations, set out all the disclosures required in respect of those assets or operations. Additional disclosures about such assets (or disposal groups may be necessary to comply with the general requirements of IAS 1).

EFRAG's comment

9 EFRAG agrees with the IASB's conclusion that this is an issue that needs to be addressed. However, we do not see why reference to IFRS 1 is needed in proposed paragraph 5A. We think that cross-reference introduces a rather ambiguous statement about compliance with IAS 1—that satisfaction of fair presentation of discontinued operations may warrant separate disclosures—but it offers no guidance on how to arrive at such a judgement. It is also unclear how this statement sits alongside the general presentation principles outlined in IAS 1.

10 Paragraph 5A intends to make it clear that disclosure requirements in IFRSs other than IFRS 5 do not apply to non-current assets held for sale or discontinued operations unless the standard includes a specific statement that disclosures apply. However, we think that the explanation given in the Basis for Conclusions to the proposed amendment (BC4) is very unclear and might contradict what proposed new paragraph 5A is trying to make clear. It is also unhelpful that, whilst paragraph BC4 refers to both assets and liabilities, proposed new paragraph 5A refers only to assets.

**Issue 3: IFRS 8 *Operating Segments* – Disclosures of information about Segment Assets**

11 According to paragraph 23 of IFRS 8 *Operating Segments* an entity shall report a measure of total assets for each reportable segment. However, paragraph 25 seems to contradict paragraph 23 by stating "...only those assets... that are included in the measures of the segment assets...that are used by the chief operating decision maker shall be reported for that segment".

12 Paragraph BC35 re-iterates the message in paragraph 26 by stating that the standard requires a measure of segment assets to be disclosed regardless of whether those measures are reviewed by the chief operating decision maker. BC35 goes on to say that this is what US GAAP requires.

13 However, it is not what US GAAP requires and the IASB wishes its standard to be in line with US GAAP on this issue. It is proposing to do this by amending BC35 to make it clear that only those assets that are included in the measure of the segment's assets and segment's liabilities that are used by the chief operating decision maker shall be reported for that segment.

EFRAG's comments

14 EFRAG agrees with the IASB's decision to ensure that IFRS and US GAAP are the same on this issue. The key principle underlying IFRS 8 is that a 'through the eyes of management' approach is to be applied in reporting segment information. EFRAG supports that approach. It is a logical consequence of adopting that approach that segment assets should be disclosed only when they are amongst the information

presented to the Chief Operating Decision Maker (CODM). That is the objective of the amendment being proposed.

15 We understand that some users are concerned that this amendment will result in a loss of valuable information. We do not believe it will because, if segment assets are material or are important to the management of the business in some other way, they will be part of the information presented to the CODM—and as a result will be required to be disclosed under this amendment. On the other hand, if segment assets are both immaterial and perceived by the CODM to be unimportant for the management of the business, we would have thought that they contain no informational value for users either.

16 EFRAG strongly disagrees with the Board's proposal that the change described above should be achieved by amending only the Basis for Conclusions. In our view, the Basis for Conclusions should only explain the reasoning behind what is required by the standard; it should as a result contain neither requirements nor guidance, and should also not contradict things said in the standard. For those reasons, we believe a change also needs to be made to the standard itself (ie to paragraph 23 of the standard). We suggest that paragraph 23 should be amended along the following lines:

> "An entity shall report a measure of profit or loss for each reportable segment. An entity shall report measures of assets and of liabilities for each reportable segment if such an amount is regularly provided to chief operating decision maker."

17 We would also like to point out that amending only the Basis for Conclusions would in any case have no effect in the European Union because the Basis for Conclusions are not endorsed.

18 We note that there are some other differences between FAS 131 and IFRS 8. One of these differences concerns the requirement in IFRS 8.23 sentence 2 to disclose the measure of liabilities for each reportable segment. However, this requirement is explicitly limited in IFRS 8.23 sentence 2 to the situation that the measure of liabilities is reported to the chief operating decision maker. Because this requirement furthermore follows directly the disclosure requirement regarding segment assets, the difference between sentence 1 and 2 in IFRS 8.23 could imply an intended difference in respect of being a minimum disclosure in a segment report. We would, therefore, prefer removing this potential for misinterpretation by amending sentence 1 accordingly or by connecting sentence 1 and 2 in a meaningful manner.

### Issue 4: IAS 7 *Statement of Cash Flows* – Classification in the cash flow statement of expenditures on unrecognised assets

19 Practices apparently differ as to the classification of cash flows for expenditures incurred with the objective of generating future cash flows when those expenditures are not recognised as assets. Examples of such expenditure include R&D expenditure that has not been capitalised and uncapitalised oil and gas exploration and evaluation expenditure. Some entities classify such expenditures as cash flows from operating activities while others classify them as cash flows from investing activities. The IASB decided that IAS 7 *Statement of Cash Flows* should be amended to make it clear that only expenditures that result in a recognised asset can be classified as a cash flow from investing activity.

EFRAG's comment

20 We agree with the IASB that there is an issue to be clarified. However, we think a number of important considerations arise from the issue that are best considered and addressed within the context of a comprehensive project on presentation. One of these issues is whether it is appropriate for the classification in the statement of cash flows to be driven by the accounting rather than by the 'economics'; we think ignoring the economics might result in some odd results that will be sub-optimal from a users' perspective.

21 As a result, we do not think that amending existing IFRS in the way proposed is ideal. However, we can accept it as a quick fix pending a more comprehensive solution as part of the Financial Statement Presentation project.

**Issue 5: IAS 18 *Revenue* – Determining whether an entity is acting as a principal or as an agent**

22 The IASB has been informed that there is some uncertainty as to how to determine whether an entity is acting as a principal or as an agent in accordance with IAS 18 *Revenue* for situations in which an entity employs a second entity to meet the requirements of a customer under a sales contract.

23 The IASB is proposing to provide guidance on the subject by adding some examples to the Appendix of IAS 18. Those examples are based on the principle that an entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services.

EFRAG's comments

24 EFRAG agrees that there is uncertainty on this issue and that guidance is needed. We also agree with the essence of the clarification proposed. We understand why this change is being made through an amendment to the examples in IAS 18, and can accept that approach. However, we thought we should remind the IASB that, as those examples are not part of the standard, they are not part of IFRS as endorsed in the EU; which means the amendment will also not be part of IFRS as endorsed in the EU.

25 In addition to the proposed examples we think it would be useful to discuss also the situation when the entity has the primary responsibility for providing the goods and services desired by the customer to fulfil the order by, for example, being responsible for acceptability of the products or services ordered or purchased by the customer or by being responsible for the design, content or other specifications of the products or services involved.

26 It would also be helpful if it could be made clear that the list of indicators in proposed new paragraph 21 is not comprehensive. We recognise the word 'include' has been used but, although the implications of this word are clear to some, it appears that the implications are not clear to some non-English speakers.

**Issue 6: IAS 36 *Impairment of Assets* – unit of accounting for goodwill impairment**

27 According to paragraph 80 of IAS 36, goodwill arising from a business combination shall be allocated to a cash generating unit, or a group of cash generating units, which

is/are expected to benefit from the synergies of the business combination. Paragraph 80 goes on to say that such unit or group of units shall, inter alia, "not be larger than an operating segment determined in accordance with IFRS 8." However, paragraph 12 of IFRS 8 permits two or more operating segments to be aggregated into a single segment in certain circumstances, and there is apparently some uncertainty as to whether IAS 36.80 refers to an operating segment before or after aggregation.

28 The IASB proposes that the Amendment should be applied prospectively for annual periods beginning on or after 1 January 2010.

<u>EFRAG's comment</u>

29 EFRAG agrees that this is an issue that needs to be addressed and we also agree with the proposed amendment.

30 However, we have concerns relating to the proposed transitional arrangements and date. We note that this Amendment may result in some entities having to recognise an additional impairment loss because it requires them to test for impairment at a lower level than before. Our concern relates to the way any additional goodwill will be recognised and whether prospective application would always be appropriate. On the other hand, applying the Amendment retrospectively would require the use of hindsight, and would therefore not be a solution either.

31 If the IASB proceeds with prospective application, we think it should be clarified how an entity should prospectively account for the effect of applying this change and whether any potential impairment would be recognised in profit or loss or in equity. If, in the context of this Amendment, 'prospective application' means that at the effective date existing goodwill needs to be re-allocated it would helpful if the IASB clarified how this should be done.

32 Furthermore, we wonder whether additional disclosures would be helpful to ensure that users understand why an impairment loss has arisen even though there is no change in the entity's economic position.

**Issue 7: IAS 38 *Intangible Assets* – Additional consequential amendments arising from the revised IFRS 3**

33 When the IASB revised IFRS 3 *Business Combinations* (ie when it issued IFRS 3R) it changed the standard to state that, if an intangible asset acquired in a business combination can be identified – in other words if it meets the separability criterion – or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of that asset. At the same time, the IASB amended IAS 38 to reflect this decision.

34 The IASB has since concluded that the amendments it made to IAS 38 do not fully reflect in a clear enough fashion the change to IFRS 3R. It is therefore proposing further amendments to IAS 38 (to paragraphs 36 and 37) to make clear that, if an intangible asset is separable only with another asset, it must still be recognised separately from goodwill.

35 The IASB is proposing that the Amendment be applied prospectively for annual periods beginning on or after 1 July 2009.

EFRAG's comment

36 Although EFRAG agrees with the clarification in this Amendment that the guidance on this issue should be consistent in both standards, we are concerned about having the same guidance in two places in IFRS, especially as one set of guidance contains examples and the other that does not. We think this could lead to some confusion. Our preference therefore would be to consolidate the guidance on initial recognition and measurement of an intangible asset acquired in a business combination in one single IFRS.

37 EFRAG also thinks that it would be helpful if the IASB clarifies that the separability criterion of assets from goodwill also applies to situations when an intangible asset is linked to an item of PPE (Property, Plant and Equipment), instead of intangible asset.

38 If it is not possible to address this issue in the 2008 Annual Improvements, we suggest it is considered in the 2009 project.

39 EFRAG does not agree with the proposal that this amendment should apply for annual periods beginning on or after 1 July 2009; such an effective date makes no allowance for endorsement processes such as the one in the EU. We think the same effective date should be applied for all the amendments in the Annual improvements 2008 project to keep things simple for preparers (with earlier adoption possible). We think that date should be 1 January 2010.

**Issue 8: IAS 38 *Intangible Assets* – Measuring the fair value of an intangible asset acquired in a business combination**

40 IFRS 3R requires an intangible asset acquired in a business combination to be measured at fair value at the date of the acquisition. Paragraphs 39-41 of IAS 38 provide some guidance on how to do that. However, there are apparently some concerns about that guidance.

41 The first concern relates to whether the guidance in paragraph 40 of the standard permits the entities to use valuation multiples to measure the fair value of an intangible asset acquired in a business combination. The IASB is proposing to amend paragraph 40 to clarify that an entity can use multiples.

42 Secondly, some apparently believe that the wording of paragraph 41 of the standard does not permit the use of a number of the valuation techniques commonly used by entities when measuring the fair value of intangible assets acquired in a business combination that are not traded in active markets. Again, the IASB is proposing to amend paragraph 41 to make it clear that it is not intended to be restrictive.

EFRAG's comments

43 Although EFRAG has no difficulty with the content of the amendments proposed, we find the proposals to be very rule-based and, for the reasons explained below, we do not believe that either of the amendments is necessary.

44 The proposed amendment to paragraph 40 of IAS 38 is in EFRAG's opinion unnecessary because there is nothing in the paragraph to suggest that the use of multiples *is* prohibited. Similarly, in our view the proposed amendment to paragraph 41

is attempting to make clear something that we believe is already clear; that the wording of paragraph 41 is not restrictive. We want IFRS to be principle-based and written at a high-level. Adding text to existing standards to make clear things that are already clear is not in our view consistent with that. Even though the Annual Improvements process is a very stream-lined way of making amendments, the IASB has to draw the line somewhere.

45 Having said that, EFRAG agrees with the view expressed during the IASB's consultations with valuation professionals that there is a need for clear guidance in IFRSs on how to measure intangible assets in a business combination. However, we accept that that is beyond the IASB's Improvement Project and believe that issues relating to valuation are best addressed in the IASB's fair value measurement project.

46 If the IASB proceeds with the Amendments as proposed, we have some concerns with the way the changes to paragraph 41 are being proposed. In particular, we are concerned that the word 'hypothetical' could be interpreted as implying that the estimates need to be determined reliably and with due regard to verifiable evidence. We therefore suggest that the word 'hypothetical' be removed from paragraph 41.

**Issue 9: IAS 39 *Financial Instruments: Recognition and Measurement* – Scope Exemption for business combination contracts**

47 Paragraph 2(g) of IAS 39 states that "contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date" are outside the scope of IAS 39. The IASB has observed diversity in practice in the way this paragraph is being interpreted and, as a result, is proposing to clarify the paragraph to eliminate that diversity. The main questions being raised about the paragraph are:

(a) What type of contracts does this scope exemption apply to? Only binding contracts such as forwards or also options?

(b) Can the scope exemption be applied to transactions that are similar to business combinations, such as those to acquire an interest in an associate?

48 The IASB is proposing to clarify that the scope exemption in paragraph 2(g) applies only to binding contracts (ie forward contracts) between an acquirer and a vendor in a business combination to buy an acquiree at a future date. In support of this conclusion the IASB points out that currently exercisable option contracts that will result in control over an entity are excluded from the scope of IAS 39 by paragraph 2(a) on the grounds that IAS 27 would require consideration of such contracts in determining whether one entity controls another. On the other hand, the IASB points out that, since non-currently exercisable potential voting rights are not under IAS 27A considered in determining control, they would not meet the definition of a business combination in IFRS 3; thus such instruments are not excluded from the derivative accounting in accordance with IAS 39.

49 The IASB concluded that paragraph 2(g) should not be applied by analogy to investments in associates and similar transactions. The basis for conclusion (paragraph BC 6) explains this decision as follows "The concern that the structure of a business combination transaction may result in different accounting treatments without the exemption in paragraph 2(g) does not arise in the case of investments in

associates because an investment in an associate does not represent an acquisition of the constituent assets of the investee."

EFRAG's comments

50 From our consultations with constituents, EFRAG noted that the proposed amendment does not provide sufficient clarity: questions still remain as to what type of contracts the exemption applies to as well as to the rationale behind the proposed clarification. For example, it is not clear whether the scope exemption would apply to a contract in a business combination that is contingent upon regulatory approval or to a contract that is structured as a combination of option contracts with the same strike price that in substance result in a forward contract.

51 In addition, EFRAG notes that an implication of not extending the scope exemption to contracts to acquire an interest in an associate would be that a contract to acquire an associate will be accounted for as a derivative (i.e. at fair value through profit or loss); yet when the investment in the associate is made, the investment will be accounted for in the consolidated financial statements using the equity method (i.e. by recognising in profit or loss the investor's share of the associate's profit or loss, rather than changes in fair value). Some commentators argue that this change in measurement basis on completing the acquisition of the interest in the associate results in information that is not helpful; or easily understandable.

52 In view of the above, it appears to us that the issues on which there is a diversity of views as to why and in which circumstances the scope exemption from derivative accounting for contracts to acquire interests in other entities at a future date is appropriate are much broader than those the proposed amendment is attempting to clarify. Therefore, our recommendation is that the IASB should not proceed with this amendment as part of the 2008 annual improvement project. Instead, it should deal with it comprehensively at a later date.

**Issue 10: IAS 39 *Financial Instruments: Recognition and Measurement* – Application of the fair value option**

53 According to paragraph 11A of IAS 39, (subject to certain restrictions that are not relevant here) if an entity has a contract that contains one or more embedded derivatives, it may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss. The IASB has been informed that there is a diversity in practice as to whether this fair value option can be applied to all contractual arrangements with embedded derivatives, including those where the host contracts are outside the scope of IAS 39.

54 The IASB is proposing to clarify that the fair value option applies only to financial instruments within the scope of IAS 39 that contain embedded derivatives. The IASB's reasoning is that the fair value option was developed for application only to financial instruments within the scope of IAS 39 in order to avoid complexities that would otherwise arise (in identifying embedded derivatives, deciding whether they require separation, and separating and measuring them separately) and the IASB did not consider an exemption to this rule in developing the requirements of paragraph 11A.

EFRAG's comments

55 EFRAG agrees that the existing wording is ambiguous. In EFRAG's view, the proposed amendment clarifies what EFRAG believes was the IASB's intention.

56 However, we understand that there is a diversity in practice on whether the fair value option could be applied to hybrid contracts that have embedded commodity contracts that need to be accounted for as derivatives under IAS 39 because they do not qualify for the so called 'own use exemption'. We encourage the IASB to address applicability of the fair value option to such contracts when finalising the amendment.

**Issue 11: IAS 39 *Financial Instruments: Recognition and Measurement* – Cash flow hedge accounting**

57 If a hedged forecast transaction results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 requires the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment (ie recycling) in the same period or periods during which the asset acquired or liability assumed affects profit or loss.

58 It has been noted that this wording might be problematical in situations when, for example, an entity applies hedge accounting to hedges of cash flows associated with a time period that is shorter than the time to maturity of the instrument. In such circumstances, paragraph 97 can be interpreted to suggest that the gains and losses on the hedging instrument should be reclassified to profit or loss over the time until maturity of the instrument rather than a shorter time period when hedged cash flows affect profit or loss. This is not the intention of IAS 39.

59 The IASB therefore proposes to amend paragraphs 97 and 100 of IAS 39 to clarify that the gains or losses on the hedging instrument should be reclassified from equity to profit or loss in the period that the hedged forecast cash flows affect profit or loss.

EFRAG's comment

60 EFRAG agrees with the proposed amendment.

**Issue 12: IAS 39 *Financial Instruments: Recognition and Measurement* – Bifurcation of an embedded foreign currency derivative**

61 IAS 39 requires the separation of embedded derivatives from host contracts that are not accounted for at fair value through profit or loss—unless the embedded derivative is considered closely related to the host contract, in which case separation is prohibited.

62 Paragraph AG33(d) of IAS 39 specifies the circumstances in which foreign currency derivatives embedded in other contracts are considered closely related. Paragraph AG33(d)(iii) states that an embedded derivative will be closely related to the host contract if it is denominated in a currency that is commonly used in contracts to buy or sell non-financial items in the economic environment where the transaction takes place.

63 There would appear to be some uncertainty as to the evidence an entity requires to present to support the notion that the use of a currency is common. The IASB is

therefore proposing to amend paragraph AG33(d) to clarify the position. The proposed amendment involves replacing the notion of a commonly used currency with a reference to the characteristics of a functional currency as set out in paragraph 9 of IAS 21 *The Effects of Changes in Foreign Exchange Rates.*

<u>EFRAG's comments</u>

64 Although EFRAG also understands that it is not always clear what currencies could be considered "commonly used" in a particular economic environment, we do not support the proposed amendment, primarily because we do not believe the proposed amendment achieves a greater clarity. Our concerns are as follows:

(a) The basis for conclusions for the proposed amendment explains (in paragraph BC18) that paragraph AG 33(d) is intended to exempt preparers from separating embedded foreign currency derivatives if the embedded derivatives are integral to the arrangement and hence bear a close economic relationship to the terms of the contract; that is, embedded foreign currency derivatives that have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes. If this is indeed the intention the proposed amendment does not achieve it because it covers only some but not all types of currencies that could potentially be in line with this reasoning.

(b) In paragraph BC19, the IASB mentions that contracts denominated in the following foreign currencies are likely to be integral to the contractual arrangement:

(i) the functional currency of any substantial party to that contract,

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions),

(iii) a local currency of any substantial party to that contract,

(iv) a liquid international currency used by parties domiciled in small countries as a convenient means of exchange,

(v) a hard currency used by an entity operating in a hyperinflationary economy to protect against inflation, or

(vi) a foreign currency commonly used in local business transactions - for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of another related currency.

We question whether the proposed amendment's reference to the characteristics of the functional currency in IAS 21 would cover all these examples, and in particular the last three.

(c) Furthermore, we are not convinced that the six examples mentioned above sufficiently clarify proposed new paragraph BC18's notion of "integral to the arrangement and hence bear a close economic relationship to the terms of the contract; that is, embedded foreign currency derivatives that have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes". We think that many other types of currencies would meet this description.

(d) The proposed amendment is structured so that clarifications are partially included in the text of the Standard and partially in the Basis for Conclusions. We believe that the objective of clarifying the existing requirement should be achieved by amending the Standard and only the rationale for the amendment should be explained in the Basis for Conclusions.

65 In our view, in order to achieve a better clarity in this area, one needs to identify a general reason why in certain circumstances it is appropriate not to separate foreign currency embedded derivatives and not to account for them at fair value through profit or loss. Paragraph BC18 in the basis for conclusions makes such an attempt by stating that the requirement of being 'closely related' would be satisfied if the embedded derivatives are 'integral to the contractual arrangement, ie they have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes.' However, as we mentioned above, that reasoning is neither reflected in the examples that follow nor in the proposed amendment to the Standard. Therefore, we think that a further consideration is required before one can establish that the test of 'integral to the contractual arrangement' is sufficiently robust and operational in distinguishing when foreign currency embedded derivatives should be accounted for separately and when they should not. The question also arises whether this test would be applicable to other (ie not only foreign currency) embedded derivatives.

66 We noted in our response to the DP *Reducing Complexity in Reporting Financial Instruments* that the existing requirements regarding embedded derivatives generally lack an underlying principle and the issue addressed here is an example of that. We believe that it is important for the IASB to reconsider the accounting for embedded derivatives generally, including this issue in particular, to make this area of reporting more principle-based.

67 For all of the above reasons, we would prefer the current wording in AG33(d)(iii) to be retained or a more principle-based approach to be developed.

68 In addition, we have the following comment on the transitional provisions. At the moment the transitional provisions require entities to apply the amendment prospectively for annual periods beginning on or after 1 January 2010. The question is whether for hybrid contracts outstanding at the effective date of the amendment the entity will be required to reassess whether embedded derivatives have to be accounted for separately or must no longer be separated and, if that is the case, how recognition and measurement should work. We note that similar questions were raised at the time when IFRIC 9 *Reassessment of Embedded Derivatives* was developed. However, IFRIC 9 addresses such situations as changes in economic condition after the initial recognition of the hybrid contract and first-time adoption of IFRS and concludes that "subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required." Since IFRIC 9 does not address reassessment of embedded derivatives when there is an amendment in the requirements in the Standard, transitional arrangements would require a further clarification if the Board decides to amend paragraph AG33(d) in one or the other way.

## Appendix 2 – Changes to the Annual Improvements Process

1 From next year, the IASB will publish most of the individual amendments on its website well in advance of their publication in the form of an Exposure Draft. Constituents will be able to provide feedback on the individual proposed amendments at this stage. In addition, the IASB will publish once a year an omnibus ED containing all individual amendments. EFRAG welcomes this change as we think it will enhance the process.