EFRAG
European Financial Reporting Advisory Group

EFRAG'S EVALUATION OF THE COST AND BENEFITS OF IMPLEMENTING THE IMPROVEMENTS TO IFRS *(ISSUED MAY 2010)*

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the *Improvements to IFRS* issued in May 2010 (the Amendments).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed assessments of the likely costs and benefits of implementing the Amendments in the EU. The next steps have been to consult on the results of those initial assessments and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

APPENDIX 1
A SUMMARY OF THE AMENDMENTS

1 The IASB has adopted an annual process to deal with non-urgent, but necessary, amendments to IFRSs (the annual improvements process). Issues dealt with in this process arise from matters raised by the International Financial Reporting Interpretations Committee (IFRIC) and suggestions from staff or practitioners, and focus on areas of inconsistency in IFRSs or where clarification of wording is required.

2 The amendments considered in this Invitation to Comment are the amendments to International Financial Reporting Standards (IFRSs) and the related Bases for Conclusions and guidance made in the International Accounting Standards Board's annual improvements standard published on 6 May 2010 *Improvements to IFRSs* (henceforth referred to as the Amendments). The Amendments were issued in draft form in one exposure draft on Improvements to IFRSs that were issued in 2009.

3 Set out below is a description of each of the Amendments made by the standard.

IFRS 1 *First-Time Adoption of International Financial Reporting Standard – Accounting policy changes in the year of adoption*

4 Paragraph 27 of IFRS 1 *First-time Adoption of IFRSs* states that "IAS 8 does not deal with changes in accounting policies that occur when an entity first adopts IFRSs. Therefore, IAS 8's requirements for disclosures about changes in accounting policies do not apply in an entity's first IFRS financial statements."

5 The IASB has been asked to clarify:

(a) whether a first-time adopter is exempt from all the requirements of IAS 8 for the interim and annual periods presented in its first IFRS financial statements;

(b) if and to the extent that IAS 8 does not apply, what, if any, requirements apply when an entity changes its accounting policies between the first interim financial statements and its first annual financial statements; and

(c) whether an entity is able under IFRS to change the way it is applying the exemptions and other reliefs available under IFRS 1 in its first annual IFRS financial statements, compared to how it applied them in preparing interim financial statements and, if it is able to change them, what if any requirements apply to those changes in accounting policies.

6 The IASB observed that IFRS 1 deals with the transition from local GAAP to IFRS and IAS 8 deals with changes in accounting policies thereafter. It also observed that an entity completes the transition from local GAAP to IFRS when it has finalised its first IFRS annual financial statements. Thus, a first-time adopter is exempt from all the requirements of IAS 8 for the interim and annual periods presented in its first IFRS financial statements. If that entity wishes to change the way it is applying the exemptions and other reliefs available under IFRS 1 in its first annual IFRS financial statements compared to how it applied them in preparing

interim financial statements, it is free to do so; and such a change will be governed by the requirements of IFRS 1.

7 The IASB further noted that IFRS 1 requires reconciliations of profit or loss and of equity reported under previous GAAP to those under IFRSs at both the date of transition to IFRSs and the end of the latest period presented in the entity's most recent annual financial statements under previous GAAP. If an entity presents interim financial reports in accordance with IAS 34, its first interim financial report for part of the period covered by its first IFRS financial statements shall include those reconciliations.

8 The IASB concluded that, to comply with IFRS 1's requirement to explain its transition to IFRS, an entity should be required to explain any changes in its accounting policies or IFRS 1 exemptions it applied between its first IFRS interim financial report and its first IFRS annual financial statements. The IASB decided that the most useful information it could require was updated reconciliations between previous GAAP and IFRSs.

9 In March, the IASB clarified that changes made by an entity in its accounting policies or in its use of the exemptions contained in IFRS1 shall be explained in each such interim report in accordance with the requirements of paragraph 23 of IFRS 1.

10 The IASB is therefore proposing to amend IFRS 1 to clarify the position.

IFRS 1 *First-Time Adoption of International Financial Reporting Standard – Revaluation basis as deemed cost and use of deemed cost for operations subject to rate regulation*

11 Some entities might have established a deemed cost in accordance with the accounting requirements they were following at the time for some or all of their assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering (IPO). Existing paragraph D8 of IFRS 1 permits a first-time adopter to use such an event-triggered revaluation basis as 'deemed cost' under IFRSs. The existing wording in IFRS 1 suggests that the exemption applies to events that occur before the date of transition to IFRS.

12 The IASB considered and concluded that the exemption should equally apply for similar events that occur after the date of transition to IFRSs but during the periods covered by the first-time adopter's first IFRS financial statements. That conclusion was based on the reasons that it would be unduly onerous because the first-time adopter would have to prepare two sets of measurements for its assets and liabilities – one to comply with IFRS and another to comply with local law. Accordingly, the exemption should equally apply when the event occurs during the period covered by the first IFRS financial statements.

13 At the date of transition to IFRS, the entity shall either establish a deemed cost by applying the criteria in paragraphs D5 to D7 or measure assets and liabilities in accordance with other IFRS. In other words prior to the event driven revaluation, comparative figures will either be measured in accordance with D5 to D7 or be measured in accordance with other IFRSs.

14 The board also concluded that the same relief should apply to an entity that adopted IFRSs in periods before the effective date of IFRS 1 or applied IFRS 1 in a prior period, provided that the event driven measurement date is within the period covered by its first IFRS financial statements.

15 The board also decided to extend the use of deemed cost exemption to entities with operations subject to rate regulation. The exemption allows an entity with operations subject to rate regulation to use the carrying amount of property, plant and equipment held (or previously held) for use in such operations determined under previous GAAP as their deemed cost at the date to transition to IFRSs. The entity shall apply the exemption on an 'item by item' basis.

16 If an entity elects to use the deemed cost exemption, then it shall disclose that fact and the basis for determining the carrying amounts under the previous GAAP.

17 If the exemption is applied at the date of transition then an impairment test is carried out on this date in accordance with IAS 36 *Impairment of assets.*

IFRS 3 *Business Combinations – Transition requirements for contingent consideration from a business combination that occurred before the effective date of the revised IFRS*

18 When the IASB issued IFRS 3 (revised 2008) it deleted the scope exemption in respect to contingent consideration in IFRS 7 *Financial Instruments: Disclosures*, IAS 32 *Financial Instrument: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. The IASB did this to allow the acquirer to account for contingent consideration in accordance with the revised IFRS 3.

19 The deletion of the scope exemption was being by interpreted by some constituents as meaning that IAS 39 would apply to all contingent consideration, including the treatment of contingent consideration arising from a business combination whose acquisition date *preceded* the application of the revised IFRS 3 (pre-adoption contingent consideration). This treatment is inconsistent with the principle of prospective application of the revised IFRS 3.

20 The IASB has amended IFRS 3 to eliminate this inconsistency. The effect of the amendment is to require an entity to account for pre-adoption contingent consideration as an adjustment to the original cost of the business combination (i.e. goodwill would be adjusted), instead of as required by paragraph 58 the revised IFRS 3.

IFRS 3 *Business Combinations – Measurement of non-controlling interests*

21 IFRS 3 (as revised in 2008) introduced a measurement choice for NCI and permits an entity to measure NCI at its acquisition date fair value *or* at NCI's proportionate share of the acquiree's identifiable net assets.

22 The revised IFRS 3 also replaced the term minority interests (MI) with the term NCI and changed the definition of NCI as follows:

(a) MI was defined as: that portion of the profit or loss and net assets of a subsidiary attributable to the equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.

(b) NCI is defined as: the equity in a subsidiary not attributable, directly or indirectly, to a parent.

23 The issue is about measuring components of NCI in accordance with IFRS 3 (as revised in 2008) in a business combination at the acquisition date, when an entity chooses to measure NCI at the proportionate interest of the acquiree's net identifiable assets.

24 The IASB was informed that some constituents thought that the amended definition of NCI had widened the scope of instruments that it covers, to include for example, the equity components of convertible bonds, warrants, options over own shares and options under share-based payment plans under IFRS 2 *Share-based Payment* (not held by the parent). As a result, some were measuring those other components of NCI at nil.

25 In response to the concerns raised, the IASB proposed an amendment to IFRS 3 to limit the measurement choice to cover *non-controlling interests that are present ownership instruments and entitle their holders to a pro rata share of the entity's net assets in the event of liquidation*. The acquirer should measure other components of non-controlling interest at fair value or other measurement bases as required by IFRSs.

IFRS 3 *Business Combinations – Un-replaced and voluntarily replaced share-based payments awards*

26 The current IFRS 3 addresses the replacement in a business combination of share-payment awards of the acquiree with share-based payment awards of the acquirer in two scenarios:

(a) When the acquirer is obliged to replace the acquiree awards;

(b) When the acquirer voluntarily replaces the acquiree awards and these awards would have expired as a consequence of the business combination.

In the first case, entities must allocate some or all the market-based value of the replacement awards to the consideration transferred for the business combination; the residual is recognised as a post-combination cost. Paragraphs B57-B62 provide guidance on how to allocate. In the second case, all the market-based value of the replacement awards should be recognised as a post-combination cost.

27 IFRS 3 does not address the following cases:

(a) When the acquirer voluntarily replaces acquiree awards that would not have expired as a consequence of the business combination;

(b) When the acquirer does not replace the acquiree awards.

The amendments to the Application Guidance extend the same accounting treatment to all replacement awards, except those that the acquirer issues voluntarily to replace acquiree awards that would have expired. Paragraphs B57-B62 are unchanged.

28 The acquirer measures un-replaced acquiree awards at their market-based measure at acquisition date and includes them in non-controlling interest based on the ratio of the portion of vesting period elapsed to the original vesting period (or the new total vesting period, if longer).

29 The amendment shall be applied for annual periods beginning on or after 1 July 2010 with the option of early adoption.

IFRS 7 *Financial Instruments: Disclosures – Clarification of disclosures*

30 The Board amends IFRS 7 as follows:

(a) the qualitative disclosures in paragraph 33 should support and enhance the quantitative disclosures in paragraphs 34–42;

(b) to clarify that the requirement in paragraph 36(a) to disclose information about the maximum exposure to credit risk applies to financial assets whose carrying amounts do not reflect the reporting entity's maximum exposure to credit risk and off balance sheet exposures;

(c) to enhance paragraph 36(b) so that for each class of financial instruments, the financial effect of the extent to which collateral and other credit enhancements mitigate credit risk;

(d) to remove the requirement in paragraph 37(c) to disclose for instruments past due but not impaired and that are determined individually impaired the description of collateral held as security and their fair value;

(e) to remove the requirement in paragraph 36(d) to disclose carrying amount of financial instruments renegotiated to avoid becoming past due or impaired;

(f) to clarify that the requirement in paragraph 38 applies only to foreclosed collateral held at the reporting date to be consistent with the objective to enable users to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

IAS 1 Presentation of Financial Statements – clarification of statement of changes in equity

31 The revised wording clarifies (paragraphs 106 and 107 were amended and paragraph 106A was added) that presentation of reconciliation requirements for classes of accumulated other comprehensive income (which are components of equity) is permitted in the notes. This amendment thus removes inconsistencies between the current wording of paragraph 106(d) and the example of the statement of changes in equity within the implementation guidance, *Part I: Illustrative presentation of financial statements*, accompanying IAS 1.

IAS 27 *Consolidated and Separate Financial Statements – Transition requirements for amendments made as a result of IAS 27 (as amended in 2008) to IAS 21, IAS 28 and IAS 31*

32 The IAS 27 (as amended in 2008) resulted in various consequential amendments to other IFRSs.

33 Some of the consequential amendments include transitional guidance and specify whether the amendments should be applied prospectively or retrospectively (for example the amendment to IFRS 5 specifies that the amendment shall be applied retrospectively). However, other consequential amendments are silent on the transition issue.

34 The amendment clarifies that the 'consequential amendments' should be applied prospectively. This is consistent with the transition requirements in IAS 27 (as amended in 2008).

IAS 34 *Interim Financial Reporting – Significant events and transactions*

35 The IASB has been considering whether some or all of the disclosures required by IFRS 7 *Financial Instruments: Disclosures* for annual financial statements should also be required in interim financial statements.

36 The IASB noted that, although IAS 34 does not require specific disclosures, it sets out disclosure principles to determine what information should be disclosed in an interim financial report. However, the IASB concluded that those principles needed to be further emphasised to ensure that appropriate disclosures were made in interim financial reports. This amendment is thus amending IAS 34 (paragraphs 15-19) to place greater emphasis on the principles (significant events and transactions, updated information) and to include additional examples relating to more recent disclosure requirements, such as fair value measurement disclosures.

IFRIC 13 *Customer Loyalty Programmes – Fair value of award credit*

37 Paragraph AG2 of IFRIC 13 provides guidance on how this fair value can be estimated. However, it has been brought to the IASB's attention that, because paragraph AG2 uses the term "fair value" to refer to both the value of the award credits and the value of the awards for which the credits could be redeemed, the resulting guidance could be misinterpreted. The IASB therefore amends paragraph AG2 (and Example 1 in the illustrative examples) to clarify that, when the fair value of award credits is estimated by reference to the value of the awards for which they could be redeemed, the value of those awards shall be adjusted to reflect expected forfeitures as well as discounts or incentives.

APPENDIX 2
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENTS

General comments

1 EFRAG has also considered whether, and if so to what extent, implementing the Amendments in the EU might involve preparers or users incurring incremental costs, and whether those costs are likely to be exceeded by the benefits to be derived from implementing the Amendments in the EU.

2 EFRAG started its assessment of the costs and benefits of implementing the Amendments by considering whether they were likely to be any measureable costs involved for preparers or users in implementing any of the Amendments the standard. EFRAG's assessment is that there will be a year one cost for preparers in reading and understanding the Amendments made, but that cost will be insignificant. EFRAG's assessment is also that the Amendments will not involve any measurable change in costs for preparers or users except in the areas discussed below.

3 Based on EFRAG's assessment, the application of the following three amendments will have a cost and/or benefit impact on preparers and/or users.

IFRS1 *First-time Adoption of IFRSs - Revaluation basis as deemed cost*

Costs for preparers

4 EFRAG's assessment is that the proposed amendment will result in a significant one-time cost saving because the entity can elect to apply the event driven fair values as deemed cost at any date in the first IFRS financial statements.

Costs for users

5 EFRAG's assessment is that there will be no cost or benefit impact on users.

Benefits for preparers and users

6 The relief brings benefits to preparers by reducing costs of transition to IFRS.

7 The amendment does not benefit users directly. However the relief is a means of enabling entities to adopt IFRS without incurring significant incremental costs which leads to greater benefits over-time

IFRS1 *First-time Adoption of IFRSs - Use of deemed cost for operations subject to rate regulation*

Costs for preparers

8 EFRAG believes that an entity applying the exemption to use the carrying amount of property, plant and equipment held (or previously held) determined under previous GAAP as their deemed cost at the date to transition to IFRSs will result in a significant one-time cost saving because no restatement from previous GAAP to

IFRS would be required. This means an analysis would not have to be carried out to ensure all costs capitalised complies with existing IFRS.

9 However as at the date of transition to IFRS the entity will have to carry out the necessary calculations for impairment testing. This will subject preparers to one-time incremental costs but no on-going costs.

10 EFRAG's assessment is that the proposed amendment will result in a significant one-time reduction in costs however preparers will incur one-time additional costs because of the additional impairment requirements at the date of transition to IFRS. It is believed that the reduction in costs will outweigh the incremental costs.

Costs for users

11 EFRAG's assessment is that there will be insignificant incremental costs to users in year one and on-going insignificant costs because of the lack of comparable information in financial statements of those entities that elect to make use of the relief.

Benefits for preparers and users

12 The relief brings benefits to preparers by reducing costs of transition to IFRS.

13 The amendment does not benefit users directly. However the relief is a means of enabling entities to adopt IFRS without incurring significant incremental costs which leads to greater benefits over-time.

IAS 34 *Interim Financial Reporting – Significant events and transactions*

Costs for preparers

14 EFRAG's assessment is that the amendments to IAS 34 will involve incremental year one costs for preparers. Most of that cost will arise as preparers will probably have to adjust their systems to collect more information for interim financial reporting purposes. There will probably also be some ongoing costs, but EFRAG's assessment is that those ongoing costs will usually be insignificant.

Costs for users

15 EFRAG does not believe that the amendments will increase the costs incurred by users in analysing the financial statements as a result of its adoption. However one of the costs that would probably need to be taken into account is that requiring enhanced disclosures in the field of fair value measurements could delay the publication of interim reports.

Benefits for preparers and users

16 EFRAG's assessment is that the amendments will overall improve the quality of the information provided in the interim financial reports.

IFRS 7 *Financial Instruments: Disclosures – disclosure of the financial effect of the extent to which collateral and other credit enhancements mitigate credit risk*

17 EFRAG has considered the cost and benefit impact of the amendment on banks because it thinks that these entities will be the most affected. EFRAG understands that banks should already have in place the risk management practices and procedures to capture the data that would form the basis of disclosure of the financial effect of under- or over-collaterisation. Hence, EFRAG does not consider that there is not a need to introduce new systems or develop new models.

18 Banks currently are in compliance with the requirements of Basel II, which require banks to track the data on collateral for their loans in order to benefit from lower solvency capital absorption in the presence of collateral. The value of the collateral is taken into account in the quantification of risk-weighted assets for credit risk for the purposes of quantifying the capital requirements. There are two techniques adopted for considering the value of the collateral in the quantification of risk-weighted assets: the standardised and the internal ratings-based approach. The standardised approach usually prevails amongst smaller banks and is based on standardised inputs, whereas the internal rating based approach that usually prevails amongst larger banks, bases the calculation on more sophisticated statistical modelling. This, in our view, is evidence that banks have one possible way to quantifying the financial effect of collateralisation without incurring significant costs.

Costs for preparers

19 EFRAG's assessment is that the amendment to IFRS 7 will not subject costs to preparers.

Costs for users

20 EFRAG does not believe that the amendment will increase the costs incurred by users.

Benefits for preparers and users

21 The Amendment brings benefits to users because it allows users to understand the effects that collateralisation has on the reporting entity's exposure to maximum credit risk for all financial instruments. Overall, the Amendment allows for a better understanding of the reporting entity's net credit risk exposure.

Conclusion

22 EFRAG's assessment is that the benefits from these three amendments are likely to outweigh the costs involved.