

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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Dear Mr Holmquist

Adoption of the Improvements to International Financial Reporting Standards

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Improvements to International Financial Reporting Standards ('the Amendments'), which were published in May 2008. The Amendments were issued in an exposure draft which EFRAG commented on.

The IASB has adopted an annual process to deal with non-urgent, but necessary, minor 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 IASB staff or practitioners, and focus on areas of inconsistency in IFRSs or where clarification of wording is required.

The amendments considered in this letter are the amendments to International Financial Reporting Standards (IFRSs) made in the International Accounting Standards Board's 2007 annual improvements project. Part I of the document includes those amendments that result in accounting changes for presentation, recognition or measurement purposes. Part II includes those amendments that are terminology or editorial changes only, which the IASB expects to have no or minimal effect on accounting.

An entity shall apply the amendments in Part I for annual periods beginning on or after 1 January 2009. Earlier application is permitted. The amendments in Part II have no effective date.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued a draft evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and EFRAG's discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- they are not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendments and, accordingly, EFRAG recommends their adoption. (EFRAG's reasoning is explained in the attached 'Appendix—Basis for Conclusions'.)

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix Basis for Conclusions

Set out below is the basis for the conclusions reached and for the recommendation made by EFRAG on the Improvements to International Financial Reporting Standards ('the Amendments').

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

- 1 When evaluating the merits of the Amendments, EFRAG considered the following key questions:
 - (a) Are the requirements of the Amendments consistent with the IASB's Framework for the Preparation and Presentation of Financial Statements ('the Framework')?
 - (b) Would the Amendments' implementation result in an improvement in accounting?
 - (c) Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?
- 2 Having formed tentative views on the issues and prepared a draft assessment report, EFRAG issued that draft for comment on 22 May 2008 and asked for comments on it by 23 June 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

Are the requirements of the Amendments consistent with the IASB's Framework?

- 3 EFRAG considered whether the requirements in the Amendments are consistent with the IASB's Framework. The Amendments focus primarily on providing clarification and additional guidance on some aspects of IFRSs, and do not introduce fundamental changes to existing IFRS literature.
- 4 When EFRAG considered whether existing IFRSs should be endorsed, it took into account whether their accounting treatments were consistent with the Framework. As the Amendments focus on providing clarification of and guidance on existing IFRSs, EFRAG concluded that no new issues arise relative to the Framework.

Would the Amendments' implementation result in an improvement in accounting?

- 5 EFRAG next asked itself whether the Amendments were likely to result in an improvement in the financial information provided, a deterioration, or make little difference.
- 6 The Amendments comprise 34 individual amendments. The IASB has divided those 34 amendments into two parts.
 - (a) Part I includes those amendments that result in accounting changes for presentation, recognition or measurement purposes.
 - (b) Part II includes those amendments that are only terminology or editorial changes, which the IASB expects to have no or minimal effect on accounting.
- 7 EFRAG found this to be a useful classification for the purpose of its technical assessment because amendments that are expected "to have no or minimal effect on accounting" ought not to be a significant factor in the technical analysis. EFRAG therefore considered whether the amendments included in Part II were correctly classified. Having concluded that they were, EFRAG considered them no further in its technical analysis.
- 8 EFRAG then turned its attention to the 23 amendments included in Part I (in other words, the amendments that are expected to result in presentation, recognition or measurement changes). In EFRAG's view, 19 of those amendments are both relatively straight forward, would result in improvements in accounting and would clearly meet the endorsement criteria. Those 19 amendments are:
 - IFRS 5 – Plan to sell the controlling interest in a subsidiary
 - IAS 1 – Current/non-current classification of derivatives
 - IAS 16 – Recoverable amount
 - IAS 19 – Curtailments and negative past service cost
 - IAS 19 – Plan administration costs
 - IAS 19 – Replacement of term 'fall due'
 - IAS 19 – Guidance on contingent liabilities
 - IAS 23 – Components of borrowing costs
 - IAS 27 – Measurement of subsidiary held for sale in separate financial statements
 - IAS 28 – Required disclosures when investments in associates are accounted for at fair value through profit or loss
 - IAS 28 – Impairment of investment in associate
 - IAS 31 – Required disclosures when investments in jointly controlled entities are accounted for at fair value through profit or loss

- IAS 36 – Disclosure of estimates used to measure recoverable amount
 - IAS 38 – Units of production method of amortization
 - IAS 39 – Reclassification of derivatives into or out of the classification of at fair value through profit or loss
 - IAS 39 – Designating and documenting hedges at the segment level
 - IAS 39 – Applicable effective interest rate on cessation of fair value hedge accounting
 - IAS 41 – Discount rate for fair value calculations
 - IAS 41 – Additional biological transformation
- 9 EFRAG decided however that the other four amendments are less straight forward and merit closer analysis. That analysis is set out in the paragraphs below.

Amendment A: IAS 16 – Sale of assets held for rental

- 10 The IASB identified some industries where entities are in the business of renting out and subsequently selling the same assets (so-called “dual intention assets”). Existing IAS 16 *Property, Plant and Equipment* prohibits the classification as revenue of gains arising from derecognition of items of property, plant and equipment, so income from renting out these assets is shown as revenue while income from selling them is not. The effect of the amendment is that entities whose ordinary activities include renting and subsequently selling the same assets will henceforth be required to recognise revenue from both renting and selling the assets. In the IASB’s view, the presentation of gross selling revenue, rather than a net gain or loss on the sale of the assets, better reflects the ordinary activities of such entities.
- 11 At the same time, the amendment clarifies that IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* should not be applied to such transactions.
- 12 EFRAG agrees that this amendment results in the financial statements better reflecting the substance of the ordinary activities of entities that are in the business of renting out and subsequently selling items of property, plant and equipment. Thus, the amendment improves the representational faithfulness, and therefore the reliability, of the information provided.
- 13 Some constituents are concerned that the amendment is fairly narrowly scoped and somewhat rules-based and that, as a result, it would not apply to activities that are similar in nature to those activities within the scope of the amendment (ie the renting out and subsequent sale of items of plant, property and equipment). Some were also concerned that there might not be a difference in substance between some of the assets within the scope of this amendment (and therefore scoped out of IFRS 5) and some assets within the scope of IFRS 5. However, EFRAG does not share these concerns. Furthermore, EFRAG is not persuaded by the argument concerning IFRS 5. In its view, IFRS 5 was not intended to address this type of circumstance; although the assets might have similar characteristics, the business purpose of dual intention assets is different and therefore it is appropriate to have a different accounting principle applied to such transactions.

Amendment B: IAS 20 – Government loans with a below-market rate of interest

- 14 IAS 20 and IAS 39 were not consistent in the treatment they required to be applied to below-market government loans and it was not clear which treatment should be applied in which circumstances. As a result, economically similar arrangements were being accounted for differently. In addition, the provisions in IAS 20 prior to the amendments implied that accounting for a loan depended on who the lender was: a commercial institution or the government. Loans received from commercial institutions are recorded on initial recognition at their fair value in accordance with IAS 39 while loans received from the government may be not. The Amendments make it clear that IAS 39 should be applied and that the identity of the lender is an irrelevance.
- 15 Some EFRAG members note that entities that receive below-market interest rate government loans are often entities that experience financial difficulties and for which it might not be possible to receive a loan from any other lenders except for the government. In such cases there might be a degree of approximation involved in estimating the market interest rate that entities would have to use to calculate the present value of the cash flows under the loan agreement in order to record the loan in the financial statements at its fair value in accordance with IAS 39. As a result there is a concern that applying IAS 39 to such loans might result in less reliable information reported in primary financial statements. However, EFRAG notes that IFRS 7 *Financial Instruments: Disclosures* requires disclosure of the assumptions applied in determining fair values for a class of financial assets or financial liabilities if the fair value was determined based on a valuation model. Thus, entities will be required to provide information on the assumptions they used in applying the discounted cash flow model to determine the fair value of below-market interest rate loans on initial recognition. These disclosures would enable users to understand the degree of uncertainty in the reported amounts.
- 16 EFRAG further notes that the imputation of market interest rate would reveal the degree of support that the entity is receiving as a result of the government subsidised interest rate, and thus result in a faithful representation to be given of below-market interest rate government loans. This would enhance the reliability of the information provided. For that reason EFRAG has concluded that this amendment will not result in reliability concerns.
- 17 The amendments eliminate the uncertainty as to how to apply existing IFRS to below-market interest rate government loans, thus improving consistency and enhancing comparability. In addition, recognising that who provides a loan is not a relevant attribute to justify a difference in accounting for the loan—and therefore that below-market interest government loans should be within the scope of IAS 39 and accounted for in accordance with the provisions of that standard as any other loan—will improve understandability and comparability of the financial information provided to users.
- 18 Based on the above analysis, EFRAG has concluded that the amendment will result in an improvement in accounting.

Amendment C: IAS 38 – Advertising and promotional activities

- 19 IAS 38 requires expenditure on advertising or promotional activities, training activities and start-up activities, and on relocating or reorganising part or all of an entity to be recognised as an expense “as incurred”. Divergent interpretations

have developed about when such expenses are “incurred”. This amendment seeks to clarify the meaning of ‘as incurred’ in this context.

- 20 It does that by stating that, in the case of the supply of goods, an expense should be recognised when the recipient of the goods “has a right to access those goods.” It goes on to state that examples of expenditure that should be recognised as an expense when it is incurred include “expenditure on advertising and promotional activities (including mail order catalogues).”
- 21 Some EFRAG members have concerns about this amendment. In their view the amendment touches on a very fundamental issue—the distinction between expenditure that results in the creation of an asset and expenditure that represents an immediate expense—that is difficult to deal with adequately by simply including a few words in a standard. In their view, there is a risk that the amendment will give rise to anomalies that will affect the understandability and comparability, and perhaps even the representational faithfulness, of the information provided. For example, it could be argued that producing a mail order catalogue involves developing a product range and printing and distributing information about that product range and that the costs involved in the former might need to be accounted for in a different way from the latter costs. Others might argue that producing a mail order catalogue also involves the development of a distribution network, and that costs involved in developing that network should be accounted for in the same way as analogous arrangements, including retail websites and shop units. This concern was echoed in a number of the comments that EFRAG received in response to its invitation for comments on its draft technical assessment. Those respondents argued, inter alia, that the catalogues of mail order companies are comparable to ‘department stores at home’; in other words, they form part of the sales infrastructure, are analogous to website costs, and therefore involve internally-generated intangible assets that should be capitalised.
- 22 However, the majority of EFRAG members noted that the extent to which such catalogue costs are analogous to website costs and the extent to which such costs should be capitalised are issues that are specifically addressed by the IASB in new paragraph BC46H, which is inserted in the Basis for Conclusions of IAS 38. In that paragraph, the IASB points out that SIC-32 Intangible Assets—Web Site Costs “requires the cost of the content (to the extent that it is developed to advertise and promote products and services) to be recognised as an expense as it is incurred.” The IASB goes on to say that the majority of the content of a mail order catalogue is intended to advertise and promote products and services, and it concludes from that that mail order catalogue costs need to be expensed if the accounting is not to be based on the nature of the media used to deliver the content. The majority of EFRAG members accept these arguments, and therefore do not share the concerns raised. In their view the amendment will reduce uncertainty and therefore improve consistency and enhance comparability.

Amendment D: IAS 40 – Property under construction or development for future use as investment property

- 23 Through this amendment, the IASB has removed property under construction or development for future use as an investment property from the scope of IAS 16 *Property, Plant and Equipment* and included it within the scope of IAS 40 *Investment Property*. The intention behind this amendment is to permit entities to revalue such assets at fair value.

- 24 In addition, the IASB has amended IAS 40 to allow investment property under construction to be measured at cost if its fair value cannot be measured reliably, until such time as its fair value becomes reliably measurable or construction is completed (whichever comes earlier).
- 25 EFRAG believes that this amendment will remove an inconsistency in the accounting of investment property (namely the different accounting for assets under construction and assets under redevelopment) and therefore will improve accounting, as it allows companies to consistently apply one accounting model (i.e. cost or fair value) for the whole life time of an investment property. Comparability will thus be enhanced,
- 26 Some constituents are concerned about the reliability of fair value measures of investment property under construction. They note the amendment permits cost to be used when a reliable fair value is not available, but remain concerned that the overall effect of the amendment might be to introduce greater uncertainty into the accounting numbers. However, EFRAG believes that the ability to use cost when reliable fair values are not available is sufficient to address the reliability concerns that might otherwise arise.
- 27 EFRAG therefore believes that the amendment will result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided.

Does the accounting that results from the application of the amendment meet the criteria for EU endorsement?

- 28 As already mentioned, EFRAG has previously concluded that IFRSs affected by the amendments meet the endorsement criteria. Furthermore, as explained above, EFRAG believes that the amendments are consistent with the Framework, and its assessment is that the amendments are likely either to improve the financial information provided or have no effect on that information. In particular, EFRAG has concluded that the amendments meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.
- 29 EFRAG also concluded that there was no reason to believe that the information resulting from the application of the Amendments would be contrary to the true and fair view principle.

Conclusion

- 30 Having considered the various arguments described in this Appendix, EFRAG has concluded that the Amendments satisfy the criteria for endorsement in the EU.