INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS OF THE REVISED VERSION OF IFRS 1 'FIRST-TIME ADOPTION OF IFRS: ADDITIONAL EXEMPTIONS FOR FIRST-TIME ADOPTERS'

Comments should be sent to commentletter@efrag.org by 7 October 2009

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards: Additional Exemptions for First-time Adopters* (the Amendments). In order to do that, EFRAG has been carrying out a technical assessment of the Amendments to IFRS 1 against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

A summary of the Amendments is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

(b) Are you/Is your organisation or company a:

☐ Preparer ☐ User ☐ Other (please specify)

(c) Please provide a short description of your activity/the general activity of your organisation or company:

(d) Country where you/your organisation or company is located:

(e) Contact details including e-mail address:

2 EFRAG's initial assessment of the Amendments is that they meet the technical criteria for endorsement. In other words, they are not contrary to the true and fair principle and they meet the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendments? If there are, what are those issues and why do you believe they are relevant to the evaluation?

3 EFRAG is also assessing the costs that will arise for preparers and for users on application of the Amendments in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment are set out in Appendix 3. To summarise, EFRAG's initial assessment is that:

(a) the deemed cost and decommissioning, restoration and similar liability amendments are likely to be cost neutral for the preparers affected both in year one and on an ongoing basis; an

(b) the lease determination amendment is likely to result in year one cost savings for the preparers affected and no change in ongoing costs for preparers.

Furthermore, as entities have a choice as to whether they implement the Amendments, EFRAG believes it can be assumed that an entity will implement one or more of the amendments set out only if it believes the benefits to it of implementation are likely to exceed the implementation costs involved.

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

4 As also explained in Appendix 3, EFRAG believes that the Amendments will involve users in additional but insignificant year one costs and ongoing costs. However, the Amendments will make it possible for more entities to adopt IFRS, and EFRAG's assessment is that will result in a significant reduction in costs for users. As a result, EFRAG's overall assessment is that the Amendments will result in reduction in costs for users.

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

5 Based on the conclusions described in paragraphs 3 and 4 above, EFRAG has tentatively concluded that the benefits to be derived from implementing the Amendments in the EU are likely to exceed the costs involved.

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

6 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendments.

Do you agree that there are no other factors?

☐ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

APPENDIX 1
A SUMMARY OF THE AMENDMENTS TO IFRS 1

1 Generally when an entity prepares its first IFRS financial statements the entity shall, in its opening IFRS statement of financial position, apply IFRSs in full when recognising and measuring assets and liabilities. IFRS 1 provides guidance on the initial adoption of IFRS and provides a limited number of exemptions and exceptions as a practical solution for certain implementation issues that arise on first-time adoption.

2 The Amendments comprise three separate amendments, each of which introduces further or amended exemptions to existing IFRS for first-time adopters.

Deemed cost for oil and gas assets

3 IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* apply to the recognition and measurement of most assets under IFRS, including assets used in the development and production phases of oil and gas activities. IFRS 6 *Exploration and Evaluation of Mineral Resources* apply to the recognition and measurement of assets in the exploration and evaluation phases of oil and gas activities.

4 Certain entities with oil and gas activities are allowed under their local GAAP to recognise and measure assets using a different unit of account than required under IFRS. These entities account for both exploration and development costs in large cost centres or geographical areas that may contain many oil and gas properties using a method often referred to as 'full cost accounting'. IAS 16 requires a smaller unit of account such as the individual property for oil and gas activities. As a result, the full cost method of accounting can include in the carrying amount of oil and gas assets unsuccessful exploration costs of prior periods that would have been expensed under IFRS. Re-measuring oil and gas assets on first-time adoption in accordance with existing IFRS is difficult for some of these entities because either the information may not be available or the effort and associated costs to determine the opening IFRS statement of financial position might be very high.

5 The Amendments allow entities with oil and gas activities to transition to IFRS using carrying amounts for oil and gas assets determined under their previous GAAP. They further allow, for oil and gas assets in the development and production phases, the entity to allocate the previous GAAP carrying amount of the cost centre on a pro rata basis to the underlying assets using either reserves quantities or values. The Amendments refer to this as measuring the assets at 'deemed cost'.

6 The Amendments ensure that the resulting asset amounts are not overstated by requiring them to be tested for impairment at the date of transition in accordance with IAS 36.

Decommissioning, restoration and similar liabilities

7 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that an entity recognise a liability for the future costs to dismantle, remove and restore assets when the entity has an obligation to do so. IAS 16 requires that initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located to be

included as part of the cost of an item of property, plant and equipment. IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* sets out requirements on the subsequent re-measurement of the obligation because of changes in the estimated future cash flows needed to settle the obligation, and explains that, if the assets are being measured on a cost basis, the remeasurement of the obligation should be adjusted against the carrying amount of the asset.

8 Although IFRS 1 already includes an exemption for first-time adopters from the IFRIC 1 requirements for changes in existing decommissioning, restoration and similar liabilities that occurred before the date of transition to IFRS, the deemed cost exemption described above creates further issues for first-time adopters that are not addressed by the existing exemption. The Amendments address these issues by requiring an entity that uses the deemed cost exemption to measure decommissioning, restoration and similar liabilities as at the date of transition to IFRS in accordance with IAS 37 and <u>recognise directly in retained earnings</u> any difference between that amount and the amount of the liability under the entity's previous GAAP.

Reassessment of lease determination

9 IFRIC 4 *Determining whether an Arrangement contains a Lease* specifies criteria for determining, at the inception of an arrangement, whether it contains a lease. It also specifies when an arrangement should be subsequently reassessed.

10 Under existing IFRS, a first-time adopter can either apply IFRIC 4 retrospectively (and carry out re-assessments as required by IFRIC 4 for the periods before transition) or can apply it to arrangements existing at the start of the earliest period for which comparative information is presented on the basis of facts and circumstances existing at the start of that period.

11 It has been brought to the IASB's attention that some jurisdictions have national requirements that have the same effect as IFRIC 4, including the same transitional provisions. However, if a first-time adopter in such a jurisdiction has applied those requirements from a different date from the date in the transitional provisions of IFRIC 4, existing IFRS would require the entity to reassess that accounting retrospectively on first-time adoption. The IASB believes this could result in additional costs with no obvious benefits.

12 The Amendments seek to address this issue by providing an optional exemption for a first-time adopter if the entity made the same determination of whether an arrangement contains a lease under its previous GAAP, provided that the application of their previous GAAP would be expected to produce a similar result as IFRIC 4.

Effective date

13 Entities are required to apply the Amendments for annual periods beginning on or after 1 January 2010. Earlier application is permitted but must be disclosed.

APPENDIX 2
EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENTS TO IFRS 1 AGAINST THE ENDORSEMENT CRITERIA

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 adviser 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 carrying out its initial assessment of the Amendments, EFRAG considered:

(a) whether the Amendments are needed; and

(b) whether the accounting that results from the application of the Amendments meets the criteria for EU endorsement.

Are the Amendments needed?

Deemed cost for oil and gas assets

2 The amendment that allows entities transitioning to IFRS that use full cost accounting for their oil and gas assets to use deemed cost for those assets is intended to provide relief in circumstances in which the information needed to determine IFRS cost may not be available or, if the information is available, the costs to determine IFRS amounts are very high.

3 In such circumstances, under existing IFRS the entity is currently permitted to measure the assets at their transition date fair value. However, as the IASB explains in paragraph BC47B of the Amendments' Basis for Conclusions:

> Determining the fair value of oil and gas assets is a complex process that begins with the difficult task of estimating the volume of reserves and resources. When the fair value amounts must be audited, determining significant inputs to the estimates generally requires the use of qualified external experts. For entities with many oil and gas assets, the use of this fair value as deemed cost alternative would not meet the Board's stated intention of avoiding excessive cost (see paragraph BC41).

The IASB therefore concluded that it needed to amend IFRS 1 to introduce a third alternative measurement basis to the options currently available.

4 EFRAG's initial assessment is that this third alternative measurement basis may not always be more cost effective than the existing fair value alternative, but this particular

amendment is optional and is needed to enable certain entities with oil and gas activities to transition to IFRS.

Decommissioning, restoration and similar liabilities

5 The amendment described above has consequences for the accounting treatment of changes in decommissioning, restoration and similar liabilities relating to oil and gas assets. Under existing IFRS, if those assets are accounted for on a cost basis, changes in related decommissioning, restoration and similar liabilities are accounted for by adjusting the asset's cost. However, if a first-time adopter is required to recognise a different amount of decommissioning, restoration and similar liabilities on transitioning to IFRS to the amount recognised immediately prior to transition, it cannot adjust that change in liabilities against the asset's carrying amount if it also wishes to apply the deemed cost exemption (because the adjusted amount would not be deemed cost as defined).

6 EFRAG's initial assessment is that the IASB is correct in concluding that the result is that a consequential amendment needs to be made to the accounting treatment of changes in decommissioning, restoration and similar liabilities relating to oil and gas assets.

Reassessment of lease determination

7 The third amendment relates to the application of IFRIC 4. The IASB has identified a circumstance in which existing IFRS would require entities transitioning to IFRS to in effect re-apply the requirements they have been applying prior to IFRS, albeit with different 'as at' date. The IASB believes this could result in additional costs with no obvious benefits. EFRAG's initial assessment is that it agrees with the IASB.

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

8 EFRAG has considered whether the Amendments meet the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that the Amendments:

(a) 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

(b) 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.

EFRAG has also considered whether it is in the European interest to adopt the Amendments.

Comparability

9 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

10 Existing IFRS permit entities to use one of two measurement bases for their oil and gas assets when transitioning to IFRS. The deemed cost amendment introduces a third measurement basis (deemed cost) for certain types of assets. Having a third alternative might initially reduce comparability (between first-time adopters and between first-time adopters and entities that already apply IFRS). On the other hand, EFRAG believes the amendment will make it possible for more entities to adopt IFRS and, as more entities apply the same set of standards, the more comparable financial statements will become generally. Indeed, IFRS 1 in its entirety involves a compromise of comparability in the short-term, but by doing so it enables more entities to adopt IFRS resulting over time in greater comparability. Similarly, the other two amendments might initially reduce comparability to a degree, but they also make it possible for more entities to adopt IFRS and, as such, to achieve greater comparability in the long-term

11 As a result, EFRAG's overall assessment is that the Amendments meet the comparability criterion.

Relevance

12 According to the Framework, information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

13 EFRAG considered whether the Amendments would result in the provision of relevant information; in other words, information that has predictive value, confirmatory value or both. EFRAG's assessment about the Amendments' relevance is very similar to its assessment of comparability; there might be a slight, short-term deterioration in relevance, but it will make it possible for more entities to adopt IFRS, which will result in an overall improvement in the relevance of the information provided. For that reason, EFRAG's overall assessment is that the Amendments meet the relevance criterion.

Reliability

14 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. The Framework explains that information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

15 The Amendments do not require any amounts to be estimated that are not being estimated currently under existing national requirements, which in the EU's case means national requirements that are in accordance with the EU Accounting Directives. In EFRAG's view, amounts calculated in accordance with those Directives will not give rise to reliability concerns.

Understandability

16 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence. Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendments is understandable is whether that information will be unduly complex.

17 In EFRAG's view the Amendments do not introduce any new complexities into the financial statements.

True and fair view

18 EFRAG has 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.

European interest

19 EFRAG is not aware of any reason to believe that it is in the European interest not to adopt the Amendments.

Conclusion

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

APPENDIX 3
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENTS TO IFRS 1

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

2 IFRS 1 sets out exemptions to the normal requirements of IFRS that can be applied when an entity prepares its first set of financial statements in compliance with IFRS. The exemptions in IFRS 1 provide some relief from the normal requirements that would otherwise apply in order to ensure that the costs of adopting IFRS do not exceed the benefits.

3 The Amendments include additional exemptions in IFRS 1. The IASB's intention is that the additional exemptions in the Amendments should provide relief from the full retrospective application of IFRS for the measurement of oil and gas assets and for the determination of whether an arrangement involves a lease.

Costs for preparers

Deemed cost for oil and gas assets and implications for decommissioning, restoration and similar liabilities

4 EFRAG believes that an entity electing to take advantage of the deemed cost exemption available under the Amendments would be required for each oil and gas property to:

(a) determine an amount to allocate to the property based on its pro rata share of reserve quantities or reserve values, and

(b) determine a 'value in use' under IAS 36 for the property as part of a transition date impairment test.

5 EFRAG thinks the cost to preparers of using fair value as the deemed value of oil and gas assets would be approximately the same as the cost to determine a 'value in use' under IAS 36. Thus, because the deemed cost approach involves calculating value in use and doing some other things (determining an amount to allocate to oil and gas assets and carrying out an impairment test), EFRAG's initial assessment is that, compared to the existing fair value exemption, there will be an incremental one-time cost incurred by a preparer electing to measure its oil and gas properties at deemed cost.

6 Entities that elect to use the deemed cost exemption would be required to recognise any difference as at the IFRS transition date between decommissioning, restoration and similar liabilities measured in accordance with IAS 37 and those liabilities measured under their predecessor GAAP directly in retained earnings. EFRAG believes this additional requirement will provide one-time cost savings to those

preparers as they will not need to estimate the amount that would have been included in the cost of the asset when the liability first arose and the subsequent accumulated depreciation.

7 EFRAG believes the additional costs referred to in paragraph 5 above and the cost savings referred to in paragraph 6 will probably broadly balance each other out.

8 EFRAG's initial assessment is that the deemed cost and decommissioning, restoration and similar liability amendments will involve preparers in no additional ongoing costs.

9 Perhaps more importantly, entities are not forced to use these amendments—they are optional—and will therefore use them only when they perceive the benefits to them to exceed the costs they will incur in implementing them.

Reassessment of lease determination

10 The third amendment imposes no additional burdens on preparers; rather, it relieves a burden than currently exists for some entities. EFRAG's assessment is that this will result in year one cost savings for those preparers affected by the amendment. It is unlikely that there will be any ongoing cost implications.

Costs for users

11 Prior to the deemed cost amendment, users would have had to deal with some entities using fair value and some using IFRS-based cost. Now some entities might use a deemed cost which could be calculated in a multitude of different ways. So, there will be a comparability issue; and in many cases also a quality of information (ie relevance) issue because deemed cost will not be as good a number as the number IFRS would have required an entity to present prior to the amendment. Thus, users are likely to incur additional analysis costs, both in year one and on an ongoing basis, to manage the comparability issue and to overcome the relevance issue. The other two amendments will have similar implications. EFRAG's initial assessment is that these additional costs will not be significant.

12 On the other hand, the Amendments make it possible for such companies to transition to IFRS, and the more entities that are on the same set of accounting requirements, the lower the costs for users. EFRAG's initial assessment is that the result is likely to be significantly reduced costs for users.

13 EFRAG's overall assessment is that the benefits for users described in the preceding paragraph are likely to outweigh the additional costs for users described in paragraph 11.

Benefits for preparers and users

14 EFRAG's assessment is that the Amendments will not result in any benefits to preparers or users not already taken into account in the above assessments.

Conclusion

15 EFRAG's overall assessment is that:

(a) implementing the deemed cost and decommissioning, restoration and similar liability amendments is likely to be cost neutral, both in year one and on an ongoing basis, and implementing the lease determination amendment will result in year one cost savings and no change in ongoing costs. In any event, implementing the Amendments is optional, so preparers will implement them only if they believe the benefits to them that are likely to arise from implementation will exceed their implementation costs;

(b) the Amendments are likely to involve users in additional but insignificant costs. On the other hand, the Amendments will make it possible for more entities to adopt IFRS, and EFRAG's assessment is that overall users will benefit from the Amendments.

16 EFRAG's initial assessment is therefore that the benefits arising from implementation of the Amendments in the EU are likely to exceed the costs of implementation.