EFRAG
European Financial Reporting Advisory Group

XX January 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 9 January 2009

Dear Madam/Sir

Re: Exposure Draft of Proposed Amendments to IFRS 1 *Additional Exemptions for First-time Adopters*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of Proposed Amendments to IFRS 1 *Additional Exemptionsfor First-time Adopters* (the ED). 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 amendments on the issues.

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 (ie when an entity is a 'first-time adopter'). The IASB's objective, when it was developing IFRS 1, was to ensure that an entity's first IFRS financial statements (and its interim financial reports for part of the period covered by those financial statements) contain high quality information that is transparent for users and comparable over all periods presented, provides a suitable starting point for accounting under IFRSs, and can be generated at a cost that does not exceed the benefits for users. IFRS 1 provides some relief from the requirements in IFRS that would otherwise apply in order to ensure that the cost/benefit objective in particular is met.

The objective of this proposed amendment to IFRS 1 is include certain additional exemptions in IFRS 1 so that first-time adopters from the jurisdictions that are expected to adopt IFRS over the next few years are also able to prepare financial statements that meet the above criteria. The areas where additional exemptions are proposed are:

- deemed cost for oil and gas assets, and disclosures relating to those assets,
- changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment
- deemed cost for assets used in operations subject to rate regulation, and
- determination of whether or not an arrangement involves a lease.

EFRAG is generally supportive of the amendments proposed, believing that a good case has been made for granting relief in the circumstances described and that the relief that it is proposed should be granted is appropriate. However, we have some concerns about the industry-specific nature of the exemptions being proposed; in our view if there is to be an end to the changes being made to IFRS 1, it is important to express the exemptions in IFRS 1 in general terms wherever possible. That is how the existing exemptions in IFRS 1 are expressed and it is how we would have preferred these exemptions to have been expressed.

Our detailed comments are set out in the appendix to this letter.

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

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
EFRAG's detailed comments on the ED of proposed amendments to IFRS 1 *Additional Exemptions for First-time Adopters*

RESPONSES TO THE INVITATION TO COMMENT IN THE ED

Question 1—Deemed cost for oil and gas assets

The exposure draft proposes that an entity that used full cost accounting under its previous GAAP may elect, at the date of transition to IFRSs, to measure exploration and evaluation assets at the amount determined under the entity's previous GAAP and to measure oil and gas assets in the development or production phases by allocating the amount determined under the entity's previous GAAP for those assets to the underlying assets pro rata using reserve volumes or reserve values as of that date.

Do you agree with the proposed deemed cost option for entities using full cost accounting under previous GAAP? Why or why not? If not, what alternative do you propose and why?

<u>Proposed new paragraph 19A of IFRS 1, and related consequential amendments</u>

1 EFRAG understands that the main issues for oil and gas assets accounted for under full cost accounting under previous GAAP are that many entities, even if they continue to apply full cost accounting, will need under existing IFRS to determine the carrying amounts for these assets at the date of transition. That is because:

(a) information about oil and gas assets recorded in a 'full cost accounting system' will often be at a larger unit of account than the unit of account that is acceptable under IFRS. This makes it necessary to separate the costs recognised in one cost centre by field so that amortisation and depreciation (and impairment tests) can be done to comply with the requirements in IFRS. It is also necessary to calculate amortisation at the IFRS unit of account level on a unit of production basis for each year, using a reserve base that has changed over time due to changes in factors such as geological understanding and prices for oil and gas.

(b) unsuccessful prior period exploration and evaluation costs that would have been written off under IFRS 6 are instead capitalised as part of the single cost centre that gets allocated to producing assets. These costs cannot be capitalised under IFRS.

2 Our understanding is that the IASB has concluded that in many cases, particularly for older assets, the information necessary to comply with IFRS on transition may not be available; and that, when the necessary information is available, the calculations needed to apply existing IFRS are sufficiently complex and difficult in other ways to result in the costs involved in implementation exceeding the benefits. For example, compared to property, plant and equipment (PP&E) whose estimated useful life does not change much, retrospective application for oil and gas assets is a more complicated process and the useful life of oil and gas assets may be re-estimated annually because reserve volumes are re-estimated (and therefore might change) during the process. Furthermore the depletion, depreciation and amortisation and impairments are recognised at the country level.

3 EFRAG agrees with the proposal in the ED to grant first-time adopters some relief from these requirements. We also agree that that relief should involve permitting such entities to use previous GAAP carrying amounts for oil and gas assets, even though the carrying amount for development and production assets will be based on an allocation of the full cost in the cost centre.

4 EFRAG supports the proposal that a mandatory impairment test shall be required when an entity takes advantage of the proposed relief. Such a test will help ensure that the transition date deemed cost, if based on the previous GAAP carrying amount, is a suitable starting point for the accounting under IFRSs.

<u>Proposed new paragraph 25EA of IFRS 1, and related consequential amendments</u>

5 Many entities have obligations to dismantle, remove and restore items of property, plant and equipment ('decommissioning, restoration and similar liabilities'). IAS 16 requires that the cost of an item of PP&E shall include the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. IFRIC 1 explains that changes in the amount of an existing decommissioning, restoration or similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, should be adjusted against the cost of the related asset and depreciated prospectively over that asset's useful life. However:

(a) if a decrease in the liability exceeds the carrying amount of the asset, the excess shall be recognised immediately in profit or loss.

(b) if the adjustment results in an addition to the cost of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable and, if it is, shall test the asset for impairment.

6 IFRS 1 already includes an exemption for a first-time adopter from the IFRIC 1 requirements summarised above in respect of changes in decommissioning, restoration and similar liabilities that occurred before the date of transition to IFRSs. Under this exemption:

(a) to the extent that the liabilities are within the scope of IFRIC 1, the entity shall estimate the amount that would have been included in the cost of the related asset when the liability first arose by discounting the transition date liability (calculated in accordance with IAS 37) to that date using its best estimate of the historical risk-adjusted discount rate(s) that would have applied for that liability over the intervening period; and

(b) the entity shall calculate the accumulated depreciation on that amount as at the date of transition to IFRSs on the basis of the current estimate of the useful life of the asset using the depreciation policy adopted by the entity under IFRSs.

7 EFRAG's understanding is that the IASB has concluded that using this exemption would require detailed calculations that would often not be practicable for oil and gas assets. That is because:

(a) in order to apply the existing exemption, not only does the entity have to determine when the liability arose, it also has to reconstruct the accumulated depreciation from that point to the present. That might be straightforward for PP&E whose estimated useful life does not change much, but the depletion of oil and gas reserves is based on reserve volumes that are re-estimated annually.

(b) the requirement in IAS 16.16(c) to separate the amount of the change in the IAS 37 liability between the amount that arises from current period production (which is included either in expense or inventory) and the balance of the change (which is included in PP&E) was difficult to do. As a result, it would be much simpler to adjust opening retained earnings for the difference between previous GAAP and IAS 37 than to try to estimate which amount to capitalise.

8 The IASB has therefore concluded that an additional exemption is needed to allow any difference between decommissioning, restoration and similar liabilities arising in respect of oil and gas assets measured at transition date in accordance with IAS 37 and the liability determined at that same date under the entity's previous GAAP to be recognised in retained earnings; rather than requiring the difference to be adjusted on transition against the carrying amount of the related assets.

9 EFRAG agrees with the proposal in the ED to grant first-time adopters some additional relief from the existing requirements in the circumstances described in the ED. We also agree that that relief should involve, as the ED proposes, recognising any difference between decommissioning, restoration and similar liabilities measured at transition date in accordance with IAS 37 and the liability determined at that same date under the entity's previous GAAP directly in retained earnings.

Question to Constituents

The proposed additional exemptions discussed above are available only in relation to oil and gas assets; not to extractive industry exploration and evaluation assets and extractive industry development and production assets in general. EFRAG is not aware of any demand for similar exemptions for other extractive industries, but would particularly welcome comment on the issue. Are you aware of any other extractive industries that may have similar problems at transition to IFRS as the ones described above and, if you are, please could you provide us with some information about the circumstances involved and your view as to whether the proposed exemption should be extended to cover such circumstances?

Question 2—Oil and gas assets—disclosure

The exposure draft proposes that if an entity uses the exemption described in Question 1 above, it must disclose that fact and the basis on which it allocated the carrying amounts to the underlying assets.

Do you agree with the proposed disclosure requirements relating to the deemed cost option for oil and gas assets? Why or why not?

10 EFRAG agrees with the proposed disclosure requirements relating to the deemed cost option for oil and gas assets.

Question 3—Deemed cost for operations subject to rate regulation

The exposure draft proposes an exemption for an entity with operations subject to rate regulation. Such an entity could elect to use the carrying amount of items of property, plant and equipment held, or previously held, for use in such operations as their deemed cost at the date of transition to IFRSs if both retrospective restatement and using fair value as deemed cost are impracticable (as defined in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors).

Do you agree with the proposed deemed cost option for entities with operations subject to rate regulation? Why or why not? If not, what alternative do you propose and why?

11 EFRAG understands that the main issue for property, plant and equipment held or previously held for use in operations subject to rate regulation is that:

(a) under previous GAAP the entities might have capitalised costs as part of the carrying amount that do not qualify for capitalisation under IFRSs and

(b) once the amounts are added to the cost of PP&E, they are no longer tracked separately.

As a result, it can be difficult for a first-time adopter to apply existing IFRS. EFRAG agrees that relief should be available in such circumstances.

12 The proposal in the ED is that relief should take the form of allowing first-time adopters to use the previous GAAP carrying amount for PP&Eused in rate regulated operations, even though this carrying amount would include capitalised costs that do not qualify for capitalisation under IFRSs. However, the ED also proposes that:

(a) this relief should be available only when it is impracticable (as defined in IAS 8) to comply with either the requirement for retrospective application of IAS 16 or using fair value as deemed cost as permitted in paragraph 16 of IFRS 1; and

(b) a mandatory impairment test should be required.

13 This proposal is in line with the existing relief in IAS 8 that applies when it is impracticable to apply a requirement in IFRS retrospectively. However, first-time adopters cannot rely on that relief because it applies only to entities that already apply IFRSs—not to first-time adopters.

14 On the other hand, some would argue that the ED is inconsistent in requiring the application of existing IFRS to be impracticable in this case but not in the case discussed in question 1; either the proposed exemptions should be available only when it is impracticable to apply existing IFRS or they should be widely available. However, EFRAG supports the proposal that this exemption should be available only when it is impracticable to comply with existing IFRS. When deciding whether to include additional exemptions in IFRS 1, the IASB has to balance comparability between entities within a single industry and within a single jurisdiction with more general comparability. In the case of oil and gas entities applying full cost accounting, many will find it impracticable to apply existing IFRS whilst, in the case of operations subject to rate regulation, relatively fewer entities will find themselves in that position.

15 EFRAG supports the proposal that a mandatory impairment test should be required when an entity takes advantage of the proposed relief, for exactly the same reason it supported a mandatory impairment test in the circumstances discussed in question 1 (see paragraph 4).

16 EFRAG agrees with the proposed consequential changes regarding changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment.

Question 4—Leases

The exposure draft proposes that if a first-time adopter made the same determination under previous GAAP as that required by IFRIC 4 Determining whether an Arrangement contains a Lease but at a date other than that required by IFRIC 4, the first-time adopter need not reassess that determination when it adopts IFRSs.

Do you agree with the proposal not to require the reassessment of whether an arrangement contains a lease in the circumstances described in this exposure draft? Why or why not?

17 EFRAG agrees with the proposal that, when a first-time adopter has made the same determination under previous GAAP as that required by IFRIC 4 *Determining whether an Arrangement contains a Lease* at a date prior to that required by IFRIC 4, existing IFRS should be amended so that it is not required to reassess that determination when it adopts IFRSs.

Question 5—Assessments under previous GAAP before the date of transition to IFRSs

The Board considered whether to modify IFRS 1 so that entities need not reassess, at the date of transition to IFRSs, prior accounting if that prior accounting permitted the same prospective application as IFRSs with the only difference from IFRSs being the effective date from which that accounting was applied. In this regard, the Board noted that any such proposal must apply to identical, rather than similar accounting, because it would be too difficult to determine and enforce what constitutes a sufficient degree of similarity. The Board decided not to adopt such a modification because it concluded that the situation referred to in Question 4 is the only one in which relief of this type is needed.

Do you agree that the situation referred to in Question 4 is the only one in which additional relief of this type is needed? If not, in what other situations is relief necessary and why?

18 EFRAG is not aware of any other situations in which the problem described in question 4 arises.

OTHER COMMENTS

19 Although EFRAG supports the proposed exemptions, it notes that those discussed in questions 1 to 3 above are industry specific exemptions. EFRAG is concerned about including industry specific exemptions in IFRS 1, because it could mean an almost never-ending stream of exemptions being added to IFRS 1 as new transition issues are found in different industries around the world. For that reason, EFRAG encourages the IASB to do what it can to continue to apply the principle-based, generic approach in IFRS 1 that it has been adopting previously in the standard.