EFRAG

European Financial Reporting Advisory Group

DRAFT ENDORSEMENT ADVICE AND EFFECTS STUDY REPORT ON SEVERE HYPERINFLATION AND REMOVAL OF FIXED DATES FOR FIRST-TIME ADOPTERS (AMENDMENTS TO IFRS 1)

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS

Comments should be sent to commentletters@efrag.org or uploaded via our website by 8 January 2011

EFRAG has been asked by the European Commission to provide it with advice and supporting material on *Severe Hyperinflation and Removal of fixed dates for first-time adopters (Amendments to IFRS 1)* ('the Amendments'). In order to do that, EFRAG has been carrying out an assessment of the Amendments against the technical 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 European Union (the EU) and European Economic Area.

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

Note to constituents

Severe Hyperinflation and Removal of fixed dates for first-time adopters (Amendments to IFRS 1) includes consequential amendments to IFRS 9 *Financial Instruments*, which has not yet been endorsed in the EU. Those consequential amendments are not addressed in this Draft Endorsement Advice and will be considered together with the related requirements in IFRS 9.

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.

EFRAG initial assessments summarised in this questionnaire will be amended to reflect EFRAG's decisions on Appendix 2 and 3.

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:

CNC - Comissão de Normalização Contabilística

(b) Are you a:

☐ Preparer ☐ User ☒ Other (please specify)

Public Authority

(c) Please provide a short description of your activity:

Accounting Standard Setter

(d) Country where you are located:

Portugal

(e) Contact details including e-mail address:

cecnc@igf.min-financas.pt

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 principle of true and fair view 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 are likely to arise for preparers and for users on implementation 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 of costs are set out in paragraphs 2 to 9 of Appendix 3. To summarise, EFRAG's initial assessment is that the Amendments are likely to reduce the one-off costs at the date of transition to IFRSs and do not impact the ongoing costs of applying IFRS for preparers and will not significantly affect the 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?

4 In addition, EFRAG is assessing the benefits that are likely to be derived from the Amendments. The results of the initial assessment of benefits are set out in paragraphs 10 to 12 of Appendix 3. To summarise, EFRAG's initial assessment is that the Amendments will result in benefits for preparers and users.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

5 EFRAG's initial assessment is that the benefits to be derived from implementing the Amendments in the EU as described in paragraph 4 above are likely to outweigh the costs involved as described in paragraph 3 above.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect 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 agree, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

APPENDIX 1
A SUMMARY OF SEVERE HYPERINFLATION AND REMOVAL OF FIXED DATES FOR FIRST-TIME ADOPTERS (AMENDMENTS TO IFRS 1)

Background

1 IFRS 1 *First-time Adoption of International Financial Reporting Standards* provides guidance on the initial adoption of IFRS and, in doing so, provides a limited number of exemptions and exceptions as practical expedients to deal with certain implementation issues that arise on first-time adoption.

Severe hyperinflation

2 When the functional currency of an entity is the currency of a hyperinflationary economy, circumstances of 'severe hyperinflation' may make IAS 29 *Financial Reporting in Hyperinflationary Economies* difficult or impossible to apply. The measurement of the assets and liabilities of a reporting entity under such circumstances in accordance with IFRSs may not be reliable. As a result, such an entity may be unable to prepare financial statements under IFRSs for a period of time.

3 Once the conditions of severe hyperinflation pass, a reporting entity can resume reporting under IFRSs but would be considered a first-time adopter of IFRSs. However, there was no specific guidance in IFRSs to help a reporting entity resume preparation of financial statements under IFRSs, once the conditions of severe hyperinflation pass.

What has changed?

4 The IASB amended IFRS 1 to add an exemption that allows an entity that had been subject to severe hyperinflation to use fair value as the deemed cost of its assets and liabilities in its opening IFRS statement of financial position. The Amendment is available to reporting entities emerging from a period of severe hyperinflation that had not applied IFRSs in the past.

5 A currency is subject to severe hyperinflation when:

(a) a reliable general price index is not available to all entities with transactions and balances in the currency; and

(b) exchangeability between the currency and a relatively stable foreign currency does not exist.

6 An entity that applies the exemption should disclose the facts and circumstances regarding their functional currency that lead the entity to apply the exemption.

7 The functional currency of an entity ceases to be subject to severe hyperinflation on the functional currency normalisation date, which is the date on which:

(a) the functional currency no longer has either, or both, of the two characteristics which determine a situation of severe hyperinflation explained above; or

(b) there is a change in the entity's functional currency to a currency that is not subject to severe hyperinflation.

8 The exemption can be applied to assets and liabilities that were held before the functional currency normalisation date, but not to other assets and liabilities held by

the reporting entity at the date of transition to IFRSs. In cases when the parent company is subject to a situation of severe hyperinflation but not its subsidiary, the subsidiary would not be permitted to apply the exemption.

9 The Amendments permit a comparative period shorter than 12 months if the functional currency normalisation date would fall within a 12-month comparative period provided that a complete set of financial statements is provided for that shorter comparative period.

10 Adjustments should be recognised directly at the transition date in retained earnings in accordance with paragraph 11 of IFRS 1.

Removal of fixed dates

11 Paragraph B2 in Appendix B of IFRS 1 provides an exception from full retrospective application of the derecognition requirements of financial assets and liabilities in IAS 39. The exception states that a first-time adopter of IFRS shall apply the derecognition requirements of IAS 39 prospectively for transactions that occur on or after 1 January 2004. Similarly, paragraph D20 in Appendix D of IFRS 1 allows a first-time adopter of IFRSs to apply the requirements of paragraphs AG76 and AG76A of IAS 39 prospectively to transactions entered into after 25 October 2002 or 1 January 2004.

12 The fixed dates in IFRS 1 result in exceptions and exemptions that are largely irrelevant because they only apply to transactions that occurred before 2004.

What has changed?

13 The IASB decided to replace the references to those fixed dates in IFRS 1 with references to the date of transition.

When do the Amendments become effective?

14 The Amendments will apply for annual periods beginning on or after 1 July 2011.

APPENDIX 2

EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENTS AGAINST THE ENDORSEMENT CRITERIA

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

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 technical criteria for the European endorsement, 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.

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

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the Amendments:

(a) are not contrary to the principle of 'true and fair view' 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 also considered whether it had any evidence that it would not be conducive to the European public good to adopt the Amendments.

Approach adopted for the technical evaluation of the Amendments

2 The Amendments result from proposals initially included in two different exposure drafts. The Amendments, as described in Appendix 1, have been assessed in the following two groups, based on their nature:

(a) **Group A** – Amendments related to severe hyperinflation

(b) **Group B** – Amendments related to removal of fixed dates

Relevance

3 Information is relevant 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.

4 EFRAG considered whether the Amendments in Group A would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

5 The Amendments in Group A extent the use of fair value as deemed cost – which is already permitted under IFRS 1 in other circumstances – to entities that are first-time adopters after a period of severe hyperinflation. As such, the Amendments do not introduce fundamentally new concepts in the IFRS literature, but merely broaden the scope of application of certain existing concepts.

6 The Amendments in Group B are merely the replacement of fixed dates by the expression 'the date of transition to IFRSs', and do not introduce a new requirement or option into IFRSs, rather they renew the ability of first-time adopters to use an existing exception and an existing exemption.

7 In addition, the Amendments will make it possible for more entities to adopt IFRS, which will result in an overall improvement in the relevance of the information provided.

8 EFRAG's overall initial assessment is that the Amendments would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

9 EFRAG also considered the reliability of the information that will be provided by applying the Amendments in Group A. 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 what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

10 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

11 The Amendments in Group A broaden the scope of application of an existing concept in IFRS 1 and provide entities with an option that allows them to produce more reliable information when applying IFRS 1 after a period of severe hyperinflation.

12 EFRAG's assessment is that the Amendments in Group B do not raise any issues concerning faithful representation or completeness. As noted above, the Amendments in Group B do not introduce a new requirement or option into IFRSs.

13 Therefore, EFRAG's overall initial assessment is that the Amendments would raise no concerns about risk of error or bias; and therefore they satisfy the reliability criterion.

Comparability

14 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.

15 EFRAG has considered whether the Amendments in Group A result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

16 As EFRAG already commented in the case of amendment to IFRS 1 – *Revaluation basis as deemed cost,* Amendments in Group A increase the scope of exemptions of IFRS 1. Hence, it is unlikely that it will have a significant impact on comparability of financial statements.

17 Also, the Amendments in Group A and the Amendments in Group B will facilitate the adoption of IFRSs by more companies, which will enhance comparability.

18 For the reasons stated above, EFRAG's initial assessment is that the Amendments satisfy the comparability criterion.

Understandability

19 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.

20 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

21 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.

22 In EFRAG's view, the Amendments do not introduce any new complexities into the financial statements. Therefore, EFRAG's overall initial assessment is that the Amendments satisfy the understandability criterion in all material respect.

True and Fair

23 EFRAG's initial assessment is that the information resulting from the application of the Amendments would not be contrary to the true and fair view principle.

European public good

24 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments.

Conclusion

25 For the reasons set out above, EFRAG's initial assessment is that the Amendments satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

APPENDIX 3

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

1 EFRAG has also considered whether, and if so to what extent, implementing *Severe Hyperinflation and Removal of fixed dates for first-time adopters (Amendments to IFRS 1)* ('the Amendments') in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from their adoption.

Cost for preparers

2 EFRAG has carried out an initial assessment of the cost implications for preparers resulting from the Amendments.

3 EFRAG notes that the Amendments allow an entity emerging from severe hyperinflation to use the fair value on the date of transition to IFRSs as the deemed cost for certain assets and liabilities in the opening IFRS statement of financial position. To the extent that it is impossible or prohibitively costly to apply retrospectively IAS 29 *Financial Reporting in Hyperinflationary Economies*, preparers are expected to apply the exemption and to benefit from the relief offered by it.

4 The removal of the fixed dates in IFRS 1 provides relief to first-time adopters of IFRSs as they are not required to reconstruct transactions that occurred before their date of transition to IFRSs, because the Amendments allow for a prospective rather than a fully retrospective application of some requirements of IAS 39 at the date of transition.

5 Overall, EFRAG's initial assessment is that the Amendments are likely to reduce the one-off costs at the date of transition to IFRSs and do not impact the ongoing costs of applying IFRSs for preparers.

Costs for users

6 EFRAG has carried out an initial assessment of the cost implications for users resulting from the Amendments.

7 EFRAG is not aware of any aspect of the Amendments that will increase the costs users will incur in analysing the financial statements.

8 For entities emerging from severe hyperinflation there will be an adjustment in retained earnings at the transition date and the comparative period could be less than 12 months if the functional currency normalisation date falls within a 12-month comparative period. EFRAG notes that both facts have to be disclosed or explained in the notes to the financial statements in accordance with paragraphs 31C and D30 of the Amendments and should not result in any additional costs for users.

9 Overall, EFRAG's initial assessment is that the Amendments will not significantly affect the costs for users.

Benefits for preparers and users

10 EFRAG has carried out an initial assessment of the benefits for users and preparers resulting from the Amendments.

11 As EFRAG has noted for other amendments to IFRS 1, the Amendments provide benefits to preparers and users because they facilitate the adoption of IFRSs. As a result, the Amendments enhance comparability.

12 For entities emerging from severe hyperinflation, the measurement at fair value at the transition date and the use of that fair value as the deemed cost results in information that is more relevant and reliable when compared with information based on the application of IAS 29 over a period during which a reliable price index was not available and the local currency was not exchangeable. This fact also enhances relevance, reliability, comparability and it is a benefit for users in order to understand better the financial statements of the reporting entity.

Conclusion

13 Overall, EFRAG's initial assessment is that the benefits to be derived from implementing the Amendments are likely to outweigh the costs involved.