Mr Jonathan Faull
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

30 March 2012

Dear Mr Faull

Adoption of IFRS 10 *Consolidated Financial Statements* (IFRS 10), IFRS 11 *Joint Arrangements* (IFRS 11), IFRS 12 *Disclosure of Interests in Other Entities* (IFRS 12), IAS 27 *Separate Financial Statements* (IAS 27 (2011)) and IAS 28 *Investments in Associates and Joint Ventures* (IAS 28 (2011)).

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 IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities*, IAS 27 *Separate Financial Statements* (2011) and IAS 28 *Investments in Associates and Joint Ventures* (2011), referred to as ('the Standards'). IFRS 11 and IFRS 10 were separately issued as Exposure Drafts in September 2007 and December 2008, respectively, both of which proposed to make amendments to IAS 27 and IAS 28. EFRAG commented on those Exposure Drafts. The IASB issued the Standards on 12 May 2011.

The objective of IFRS 10 is to provide a single consolidation model that identifies control as the basis for consolidation for all types of entities. IFRS 10 replaces IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*. IFRS 11 establishes principles for the financial reporting by parties to a joint arrangement, and replaces IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities–Non-monetary Contributions by Venturers*. IFRS 12 combines, enhances and replaces the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities. As a consequence of these new IFRSs, the IASB also issued the amended IAS 27 (2011) and IAS 28 (2011).

The Standards are effective for annual periods beginning on or after 1 January 2013, with earlier application permitted. Except for IFRS 12, if an entity applies one of the Standards earlier, it shall disclose that fact and apply the other Standards at the same time. An entity is encouraged to provide information required by IFRS 12 earlier than the annual periods beginning on or after 1 January 2013, and is permitted to provide some of the disclosures required by IFRS 12 without complying with all of its requirements and without applying IFRS 10, IFRS 11, IAS 27 (2011) and IAS 28 (2011) at the same time.

EFRAG decided that it would assess each of the Standards separately. Therefore, EFRAG published a separate invitation to comment on its draft endorsement advice and effect study report on each of these five standards. To support its assessment, EFRAG carried out field-tests with European constituents before issuing an invitation to comment on its initial assessments. In finalising its endorsement advice and the content of this letter, EFRAG took the comments received in response to the invitations to comment into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG's assessment is that it supports the adoption of the Standards 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 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

- 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 Standards. Notwithstanding the positive recommendation that the Standards meet the endorsement criteria, EFRAG does not support the effective date of 1 January 2013 for the following reasons:

(a) Constituents raised concerns about the effective dates of the Standards shortly after the Standards were published. From the final wording of the Standards, it had become clear to them that developing a common understanding of how the principles should be applied, would require more effort and time than they had originally expected. These constituents observed that the Standards were only published in May 2011, rather than in the beginning of 2011 as had been originally expected. The concerns expressed relate specifically to the implementation of IFRS 10, IFRS 11 and in some cases the related disclosures in IFRS 12.

(b) A further concern of EFRAG is that the IASB is currently consulting on two exposure drafts that will amend the requirements of IFRS 10 and are expected to be incorporated into the Standard prior to its effective date. In particular, the Exposure Draft *Investment Entities*, issued by the IASB in August 2011, has the potential to change consolidation decisions and might lead to unnecessary cost and uncertainty for constituents. The Exposure Draft proposes an exception from consolidation for companies that fulfil the definition of an investment entity in accordance with specific criteria. It also requires a parent of an investment entity that is not itself an investment entity to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities. However, the corresponding FASB exposure draft proposes that such parent entities retain the fair value accounting applied by their subsidiaries that are investment entities. In its exposure draft, the IASB has asked its constituents whether or not they agree with the proposed requirements. Some constituents (mainly banks and insurance companies) have raised the concern with EFRAG that they might be required to start consolidation of certain investments under the current requirements of IFRS 10, but might need to adopt investment entity accounting (i.e. fair value through profit and loss accounting) once the Exposure Draft on investment entity accounting is issued as an amendment to IFRS 10.

(c) With regard to IFRS 11, some constituents have raised concerns with EFRAG that they will need to collect additional information about assets, liabilities, revenue and expenses of the joint arrangements classified as joint operations. They believe that gathering this information will be challenging, particularly if those joint operations were previously classified as jointly controlled entities under IAS 31 and were accounted for under the equity method, when the existing contractual arrangements currently do not foresee the provision of such detailed information to the joint operator.

(d) EFRAG has conducted field-tests of the requirements of IFRS 10, IFRS 11 and IFRS 12 in recent months. These field-tests confirm the concerns listed under (a), (b) and (c) above. In these field-tests some participants noted that they have concerns that the mandatory effective date of 1 January 2013 would not allow them sufficient time to implement the new requirements set out in IFRS 10 and IFRS 11, which includes developing a common understanding of the Standards and making the required assessments, which in some cases require significant judgement. The issues regarding IFRS 10 are concentrated in the banking industry and insurance industry, where some companies are required to present more than one comparative period in their financial statements.

In December 2011, EFRAG requested the IASB to defer the mandatory effective dates of the Standards, which was considered by the IASB in a public meeting held in January 2012. Although the IASB acknowledged the concerns raised by EFRAG and by some European constituents, it decided to retain the mandatory effective date of 1 January 2013 of the Standards. In reaching this conclusion, the IASB gave particular weight to the fact that the Standards, particularly IFRS 12, are part of the response to the financial crisis and address matters raised by the G20 and the Financial Stability Board.

Nevertheless, EFRAG recommends the mandatory effective date of the Standards to be 1 January 2014 with early adoption permitted. Finally, given the interaction between the Standards, EFRAG believes that the mandatory effective date should be the same for all the Standards.

On behalf 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,

Françoise Flores
EFRAG Chairman

APPENDICES – BASIS FOR CONCLUSIONS

The following appendices set out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRS 10, IFRS 11, IFRS 12, IAS 27 and IAS 28. Appendix 1B notes two dissenting opinions on the endorsement of IFRS 10 and Appendix 2B notes four dissenting opinions on the endorsement of IFRS 11.

APPENDIX 1A – BASIS FOR CONCLUSIONS: IFRS 10

EFRAG'S TECHNICAL ASSESSMENT OF IFRS 10 AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRS 10 Consolidated Financial Statements *(IFRS 10).*

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 IFRS 10 meet the technical criteria for EU endorsement?

1 EFRAG has considered whether IFRS 10 meets 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 IFRS 10:

(a) is 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) meets 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, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt IFRS 10.

Approach adopted for the technical evaluation of IFRS 10

2 EFRAG observed that some requirements in the existing consolidation model are carried forward from existing IFRSs without a significant change and therefore do not need to be assessed in relation to the endorsement criteria. In performing its overall assessment, EFRAG focused on the impact of the new requirements introduced by IFRS 10 that involves a significant change to the current consolidation requirements.

3 IFRS 10 introduces new elements that affect the following areas when assessing control:

(a) Ability to direct the investee's relevant activities.

(b) De facto control.

(c) Potential voting rights.

(d) Agent/principal relationships.

(e) Consolidation of structured entities.

4 EFRAG overall assessments of IFRS 10 are discussed below.

5 In order to get evidence to support its overall assessment of IFRS 10, EFRAG considered the effect analysis published by the IASB, held meetings with the various groups of constituents and conducted field-testing activities. The results of the various consultations have been reflected in this overall assessment of IFRS 10.

Relevance

6 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.

7 EFRAG considered whether IFRS 10 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.

8 In EFRAG's view, the relevance of information is affected by each of the five areas mentioned in paragraph 3, each of which is assessed separately below.

<u>Ability to direct the investee's relevant activities</u>

9 IFRS 10 introduces the concept of 'relevant activities' and requires an entity to identify the relevant activities of an investee when assessing control of the investee. Relevant activities are defined by the standard as those activities of an investee that *significantly affect its returns* and can exist, even if those activities occur only when particular circumstances arise.

10 IFRS 10 takes a broad view about what activities of the investee should be considered, and indicates that 'operating and financing' activities can sometimes be considered to be relevant activities that significantly affect returns, but that is not the only factor.

11 EFRAG agrees that in order for an entity to be able to apply a uniform control model to a wider range of investees, it is necessary and appropriate to broaden the focus on the activities of the investee that significantly affect its returns and which an investor can direct (or has the ability to do so).

12 EFRAG notes that the reference to 'relevant activities' that significantly affect the returns of the investee, aims to provide guidance on which activities of an investee

should be considered when assessing control. The term 'relevant activities' requires a more comprehensive analysis of an entity's relationship with an investee and understanding of the way it engages with other investors in the activities of the investee, and assists entities to identify which investees they control.

13 In EFRAG's view, identifying the relevant activities of an investee will be straightforward in some cases; however in other cases it will not, particularly when an entity is involved with structured entities or in cases in which several investors separately have the ability to direct different relevant activities. EFRAG considered the following situations in which determining 'relevant activities' might be challenging:

(a) The involvement of 'multiple' investors which split the responsibility for specific operations or activities of the investee among themselves. In such cases, determining which relevant activities significantly affect the returns of the investee might be challenging.

(b) When an entity is set up with predetermined activities (e.g. an 'autopilot' entity), the design of the entity is an important factor to evaluate power. In the banking and insurance industry it is common practice for an entity to be set up with predetermined activities, for example to securitise receivables, with all activities and responsibilities laid out in the set up agreement. Using an example of a simple securitisation vehicle, the only activity that can affect returns is the management of the receivables on default.

(c) If the terms and conditions of the contractual agreements between investors determine the possible range of business activities of an investee at inception, it might be difficult to identify what should be considered as relevant activities and how to evaluate whether the features of the involvement provide the investor with rights that are sufficient to give it power.

14 In the above cases, it is not always obvious which activities could significantly affect the returns of the investee and will require judgement which might, if applied incorrectly, have a negative impact on the relevance of information provided. Some constituents believe that the level of judgement might be high in some cases, and that the requirement to focus on relevant activities when assessing control represents one of key challenges introduced by IFRS 10.

15 Particularly, in the case of investees that involve entity structures set up for tax, regulatory and similar purposes, or involve investees that are created with a predetermined purpose, relevant activities might occur only when particular circumstances arise or an event has taken place. These constituents argue that although the term 'relevant activities' is broader than 'financial and operating policies'. In their view, IFRS 10 does not provide a clear dividing line between those two concepts. Due to the broader focus, and a lack of a clear definition of the terms used, judgement is required to apply the concept of relevant activities appropriately in light of the specific business operations of an investee, which may affect relevance of the information produced.

16 EFRAG agrees that in the cases described above, identifying which activities should be considered relevant activities that affect the returns significantly in the assessment of control can be challenging. The challenges will particularly arise when entities are still trying to understand which activities should be considered as part of their assessment in the first year of application.

17 EFRAG also notes that, in cases where the evaluation is subjective, the disclosure required by IFRS 12 about assumptions and judgement used to determine 'relevant activities' should be helpful to explain decisions reached in those more challenging scenarios and thereby will either enhance relevance of information or limit the loss of relevance that might result from applying inappropriate judgement.

<u>De facto control</u>

18 IFRS 10 introduces a uniform control principle, and reduces the reliance on 'bright lines' that, strictly applied, would, require control to be based on an absolute majority of the voting rights. Rather the standard focuses on an 'ability to control' model and provides application guidance on factors to be considered to determine de facto control.

19 EFRAG notes that the issue of de facto control is not a new one and has been implicitly embedded in existing IFRSs. The IASB has in previous debates recognised the existence of de facto control in the existing consolidation model. Companies that already consolidated subsidiaries under existing IAS 27 based on de facto control will not be affected by IFRS 10. However, those companies that did not do so, will be required to do so under IFRS 10.

20 Explicitly extending the 'ability to control' approach to situations where an entity controls an investee with less than the majority of voting rights, requires a degree of judgement because it requires an entity to consider all relevant facts and circumstances that can lead to control. In some cases, particularly situations involving more 'conventional' investees without complex transactions and simple shareholder structures, the assessment is likely to be a straightforward one.

21 In other cases, EFRAG acknowledges that it might be challenging to make the assessment, in particular:

(a) Determining whether other shareholders are widely dispersed and understanding whether they would be able to form a blocking interest.

(b) Determining whether there is a possibility of agreements between other shareholders.

(c) Access to information and gathering evidence on whether rights held by other investors (through agreements between them) are substantive and obtaining information on ownership structures of other investors.

(d) Assessing what are substantive rights – for example would financial covenants contain substantive rights and therefore lead to de facto control.

(e) Assessing whether rights held by others are only protective in nature and whether or not they impact the control assessment.

22 EFRAG notes that similar situations as those described above may arise when an investor assesses control in agent/principal relationships, which is discussed later in this appendix.

23 EFRAG believes that in some cases, where other shareholders are dispersed, it would seem reasonable to conclude that they would not be able to form a blocking interest, without having to conduct a very detailed analysis to assess whether the entity has de facto control.

24 Other constituents disagree that the application guidance will be helpful in all cases, particularly when it is difficult to obtain the necessary information about ownership by other investors and existing agreements between them. This information is necessary to assess the impact these will have on another entity's control rights. EFRAG has learned that some banks and insurers will have difficulties in monitoring and collecting such information, because these entities are not always the 'record keeper' of certain investment products and do not have the legal rights to access the records for monitoring the ownership structure. In situations where agreements between other shareholders are concluded without the involvement of the entity, it could be challenging to obtain the information about those agreements and the rights they convey to others. For non-publicly traded companies, the necessary shareholder information is not publicly available. Furthermore, in some jurisdictions disclosure of such information might not be legally permitted (e.g. limited partnerships).

25 EFRAG acknowledges that IFRS 10 requires an entity to consider additional facts and circumstances, making the decision about whether control exists difficult and complex in some cases. Even though IFRS 10 provides guidance it might still be difficult to assess the situation described in the paragraphs above, and IFRS 10 does not go 'far enough' to address these more complex situations and provide 'real-life' illustrative examples of complex cases.

26 EFRAG notes that if inappropriate judgements are made when conducting the assessment and considering facts and circumstances, the information obtained might be incomplete or misrepresent the rights of other investors, and lose its predictive value. This will have a negative effect on relevance. However, the guidance in IFRS 10 (which includes a range of factors to access control – such as voting rights and potential voting rights held by the investor, along with other facts and circumstances), should provide a helpful starting point to allow an entity to assess and consequently draw a conclusion about whether it controls an investee. Preparers that were applying the de facto control notion under the current IFRS guidelines have not reported fundamental issues in applying the de facto guidance in IFRS 10.

27 EFRAG further notes that consideration of facts of circumstances is already required in existing IFRSs and that the use of judgement is inherent in a principles-based environment. In EFRAG's view, an alternative to a principles-based control model would be a 'bright-line' control approach that is based on a threshold of at least half the voting rights of an investee. EFRAG notes that the existing control model in IAS 27 is already based on an 'ability' model and this model has proved to work appropriately in practice.

<u>Potential voting rights</u>

28 The existence of potential voting rights must be considered in assessing control under IFRS 10, which requires an entity to consider all the rights that it and other investors hold, including the purpose and design of the rights, when assessing control. IFRS 10 shifts the focus from the 'exercise date' in existing IAS 28 to the economic characteristics of potential voting rights, which inherently requires the use of judgement.

29 In general, EFRAG acknowledges that operational difficulties may arise to assess whether the rights are substantive or not, which may affect the relevance of information. In some cases, this assessment might be complex, particularly when differentiating between substantive and protective rights of the investors. EFRAG

notes that the assessment should be supported by an analysis of the purpose and design of the instrument giving rise to potential voting rights. The assessment also considers regarding investor's relationship with the investee. This includes an assessment of the terms and conditions of such rights as well as the apparent expectations, motives and reasons for agreeing them, which should assist in appropriate assessment of the rights conveyed by the underlying instruments.

30 Some constituents argue that IFRS 10 and IAS 28 are interrelated and cannot be considered on a stand-alone basis. Given this interrelationship, there is a need for a consistent use of definitions in prescribing the principles underlying the consolidation or non-consolidation of entities in which a reporting entity has an interest.

31 Some constituents also argue that by only changing the definition of potential voting rights in IFRS 10 and not in IAS 28, the IASB has created an inconsistency between these standards. Absent a consistent definition of terms, they believe there is a risk that the resulting financial statements may not meet the relevance criterion, because relevant information might be omitted or irrelevant information might distort otherwise relevant information.

32 While EFRAG generally supports consistency of definitions, it notes that IFRS 10 and IAS 28 apply to different types of investments and these differences in definitions do not cause inconsistencies in the accounting for the same class of holdings. Furthermore, EFRAG notes that the IASB did not reconsider the equity method of accounting, including the impact of potential voting rights when assessing significant influence, when it developed IFRS 10.

33 Overall, EFRAG believes that the requirement to focus on economic characteristics will enhance relevance of information.

<u>Agent/principal relationships</u>

34 Existing IFRS literature does not contain requirements or guidance to assess whether a decision maker is an agent or a principal. IFRS 10 provides criteria and guidance for an entity to evaluate whether a decision maker is using its power as a principal or as an agent. These criteria would affect the assessment of whether an entity is a principal and, if so, whether the entity should consolidate the investee being evaluated.

35 EFRAG believes that some of the aspects about the requirements to assess control of an investee in an agent/principal relationship are covered in the discussion above about de facto control. However, EFRAG considered other arguments which are relevant specifically to situations involving agent/relationships, which are discussed below.

36 As a general principle, when assessing control under IFRS 10, only *substantive rights* held by the entity and other shareholders are considered. Similar to the control assessment regarding de facto control, if an entity holds less than the majority of the voting rights, it is required to consider both substantive rights that it holds and substantive rights held by others. IFRS 10 requires an entity to consider a range of factors (that include substantive rights, and other facts and circumstances) when assessing whether a decision maker is acting as an agent or a principal, including whether any single party holds *substantive rights* to remove the decision maker without cause. The existence of a single party with substantive rights to remove the decision maker alone would be sufficient to conclude that the

decision maker is an agent. In the absence of unilateral removal rights involving various parties, an entity must consider a range of other factors including:

(a) the scope of authority entrusted to the decision maker;

(b) the rights held by other parties;

(c) remuneration; and

(d) its rights and its exposure to variability of returns from the investee.

37 EFRAG understands that the need to apply judgement in assessing control in a situation involving agent/principal relationships poses a significant challenge in practice.

(a) EFRAG has learned that determining which rights are substantive, and specifically understanding the combined effect of variability of returns from an investment fund and ownership interest in the fund, can be very subjective and difficult to determine. In many cases, the assessment of whether ‘removal rights’ are substantive or not involves significant judgement because if there are removal rights, they are normally not held by one party alone or a relatively small group of investors.

(b) Furthermore, EFRAG has learned that some constituents believe that assessing ‘exposure to variability of returns’ is highly judgemental and believe that it is often difficult to determine whether an entity acts as an agent or as a principal. They believe that IFRS 10 does not contain clear guidance on which factors a fund manager has to consider in the determination of the ‘exposure to variability of returns’. These constituents also argue that IFRS 10 lacks clear guidance on how to proceed in more complex cases when rights to remove the fund manager held by more than one party should influence the control decision, in particular when information on the dispersion of rights held by other parties is missing.

38 EFRAG notes that a counterargument to the concerns expressed above in paragraph 37, is that the requirement to consider a broad range of factors and circumstances that focus on control and economic interest, rather than on majority of rewards and benefits, offers a principles-based approach to consolidation. As noted in the discussion about ‘relevance’ of de facto control approach, the consideration of facts of circumstances is already required in existing IFRSs and that it is inherent in a principles-based environment the use of judgement.

39 EFRAG acknowledges that similar to the concern described in assessing de facto control, gathering information from a widely dispersed group of investors is not always an easy task as the entity does not always have access to the ownership records of other investors and does not have access to agreements between them. EFRAG agrees that lack of important information might lead to incorrect consolidation decisions and thus diminish the relevance of information produced. Overall, EFRAG believes that, despite the need to apply judgement, over time entities will be able to gather the required information which might not be currently readily available.

40 Consolidation of investment funds (including mutual and other types of investment funds) will require some preparers to include some funds on a line by line basis in the income statement and statement of financial position instead of accounting for

the fund in some other way – at either fair value or the equity method. It could be argued that line by line consolidation, fair value accounting and equity accounting offer different perspectives of how investees affect an investor's financial performance and position, and that all three perspectives provide useful information for some investment funds. As a general principle, EFRAG believes that it is conceptually the correct principle to apply the control principle to all investees that an investor controls and will therefore lead to appropriate financial reporting.

41 EFRAG notes that some constituents argue that applying the guidance in IFRS 10 on agent/principal relationships to investment funds (or to some funds) does not lead to meaningful financial information. These constituents argue that the characteristics of some funds are such that it is doubtful that the control model in IFRS 10 is always appropriate and produces relevant information. EFRAG understands that the following concerns have been raised:

(a) The application of the new control model results in the consolidation of financial assets that 'belong' to third parties (the policyholders) and that do not result in risks and rewards for the entity (generally an asset or a fund manager). In many cases, an entity might control an investment fund under IFRS 10, yet hold substantially less than the majority of the interest in the fund (e.g. 30 per cent), in which case it will need to present a 70 per cent non-controlling interest, either in equity or as a liability (in the case of an open-ended fund with puttable units). This is consequence of replacing the "risks and rewards" model in existing IFRSs with a uniform control approach for all investees. These constituents argue that the issue becomes more challenging in funds with puttable units where the investor has no control over its percentage holding in the fund, which might question whether the decision maker has power over risks and rewards associated with the fund. Therefore, some constituents are of the view that such funds should not be consolidated.

(b) Some constituents have raised concerns about consolidation of mutual funds in which fund managers operate under strict regulatory provision. The strict regulatory requirements limit the decision-making authority of fund managers regardless of their holding in the fund. In such cases, these constituents question the power of the fund manager over the fund. Therefore, they argue that such funds should not be consolidated as the fund manager does not 'actually' have control over the fund. Furthermore, they argue that the IASB has not appropriately defined agency relationships in IFRS 10. In particular, the need to consider the level of interest that a fund manager holds in an investment fund should not be a deciding factor in assessing whether such fund should be consolidated. This is especially the case when a fund manager is subject to strict regulation and must operate according to narrowly defined operating and financing policies, to ensure that the entity is operated in the best interests of all investors.

(c) When an entity acquires its own shares in a fund that it needs to consolidate under IFRS 10, current IFRSs require own shares to be eliminated against equity on consolidation, and some constituents (particularly banks and insurers) have expressed concern with the impact this might have on the reporting entity's equity. A related concern was expressed regarding the consolidation of mutual funds that hold bonds issued by the group.

(d) A further concern is that existing hedge accounting relationships might be broken, because the item that was hedged may no longer exist as a result of changes in the scope of consolidation (e.g. issued bonds might now be eliminated upon consolidation and no longer qualify as hedged items). This could distort information on funding and liquidity reported by the reporting entity.

42 The concerns in paragraph 41 are mainly expressed by banks and insurers with involvement in particular funds. In their view, those funds should not be assessed for control under IFRS 10.

43 Despite the challenges of implementing IFRS 10 for agency relationships, EFRAG supports in principle a single model to assess control with reduced reliance on ‘bright lines’ and believes that IFRS 10 offers a robust solution to address at least some of the concerns users expressed about lack of transparency and omission of relevant information.

44 The application of a uniform consolidation principle based on ability to control (which incorporates risks and rewards but requires power over those risks and rewards to have control) and applies to all investees could help prevent non-consolidation when control exists, because there are situations in which an entity can control an investee even though it does not have the majority of the voting rights and does not have other contractual rights relating to the activities of the investee. In principle, this should lead to appropriate financial reporting. EFRAG notes that jurisdictions have different legal and regulatory environments relating to the protection of shareholders and investors, which often determine or influence the rights held by shareholders and therefore affect whether or not an entity controls an investee. Therefore, drawing a line at 50 per cent in terms of voting power and the key to determining control, might lead to inappropriate consolidation decisions and diminish the relevance of the information.

45 Overall, EFRAG believes that a control model based on a uniform set of principles together with comprehensive application guidance and examples to illustrate the principles will result in relevant financial reporting.

<u>Consolidation of structured entities</u>

46 As noted earlier, IFRS 10 applies to all investees, including structured entities as defined in IFRSs. IFRS 10 builds on the requirements and concepts in IAS 27 with regard to the concept of control and sets out a consolidation model that applies to all investees including entities that are accounted for under SIC-12. In doing so, IFRS 10 provides additional context, explanations and application guidance on how to assess control, without changing the fundamental concept of control on which IAS 27 is based.

47 Under IFRS 10, assessment of control may not be the same compared to IAS 27 and SIC-12; in some cases ‘more’ entities might be consolidated and in other cases ‘fewer’ entities might be consolidated. This is primarily because, when assessing the existence of control, there is a reduced focus on a ‘majority of risks and rewards’, as required in SIC-12; rather IFRS 10 sets out a single control model that applies to all investees based on an ‘ability to control’.

48 EFRAG acknowledges that challenges may arise to determine which investees are structured entities, and it can be difficult to determine whether an investor has power over investees that do not require substantive continuous decision-making.

49 In some cases, it could be argued that the application of a single control model (based on the ability of an entity to use its power over an investee to affect the

amount of the investor's returns), may result in some true 'autopilots' remaining unconsolidated, because there are no decisions to be taken by its investors.

50 Similar to the arguments discussed above on de facto control and agent/principal relationships, EFRAG believes that a uniform principles-based approach to consolidation will over time help entities assess which investees they control, and reduce inappropriate deconsolidation decisions or off-balance sheet treatment. In particular, these situations would include when an entity has the power to direct an investee's relevant activities, even though it is not exposed to the majority of risks and rewards of the investee. In other cases, the uniform approach would reduce inappropriate consolidation decisions when an entity is exposed to the majority of risks and rewards but has no control over an investee.

51 EFRAG notes that IFRS 12 requires comprehensive disclosure about unconsolidated structured entities. EFRAG understands that users welcome information on structured entities that are not consolidated, to ensure that they have sufficient information to understand an entity's involvement with those unconsolidated entities, including exposure to risk and understanding the nature of risk and the impacts on the reporting entity's performance.

52 Overall, EFRAG believes that the requirement in IFRS 10 to consider the ability to control on the basis of a range of facts and circumstances regarding an investee, would include assessing the risks and rewards of the investee. In EFRAG's view, this would provide relevant information.

<u>Conclusion</u>

53 EFRAG acknowledges that in some cases identifying relevant activities of an investee and performing the control assessment where an entity holds less than the majority of voting rights, can be challenging and involve considerable judgement. EFRAG notes that IFRS 12 requires disclosures about the significant judgements and assessments made by entities, which should help users understand the underlying decisions taken by management and therefore enhance relevance.

54 The guidance in IFRS 10, serves as an appropriate starting point that helps entities in determining which investees they control. For more challenging cases, the guidance provides direction for entities to make an assessment based on facts and circumstances.

55 On balance, EFRAG's overall assessment is that the requirements in IFRS 10 on relevant activities, de facto control, potential voting rights, agent/principal relationships and consolidation of structured entities would result in the provision of relevant information, and therefore satisfy the relevance criterion.

Reliability

56 EFRAG also considered the reliability of the information that will be provided by applying the new elements. 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.

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

58 In EFRAG's view, the reliability of information is affected by each of the five areas mentioned in paragraph 3, which are assessed separately below.

Ability to direct the investee's relevant activities

59 For most investees it will be clear that one party or body has decision-making authority to direct the activities of an investee that significantly affect the investee's returns. In these cases, identifying relevant activities will be a straight forward exercise.

60 However, EFRAG notes that in some other cases it is possible that more than one party has decision making authority over different activities of an investee and that each activity may significantly affect the investee's returns. Examples include structured arrangements such as multiple seller conduits, multi seller securitisations, and investors for which the assets are managed by one party and the funding is managed by another. In these cases, identifying the relevant activities requires judgement and might affect the reliability of information.

61 Overall, EFRAG understands that the introduction of the concept of relevant activities will not have a significant impact on the way control is assessed and as a result does not believe reliability of information will be affected in a significant way.

62 EFRAG notes that IFRS 12 requires investors, as part of their control assessment, to disclose the assumptions made in determining relevant activities that significantly affect an investee. This would faithfully represent management's reasoning in making its assessment of control especially in cases where an investor is involved in investees with complex ownership structures.

De facto control

63 EFRAG notes that the assessment of 'de facto control' requires consideration of all facts and circumstances, for example, determining the exact point and about when other investors are sufficiently dispersed. In some cases, it will be challenging for some investors to determine the date when they obtain de facto control. Nevertheless, EFRAG believes that in order to faithfully represent the activities of a group of companies, the consolidated information would need to be based on the substance of the arrangements and the careful exercise of judgement is inherent in such a principles-based approach.

64 In addition, IFRS 12 requires disclosure in respect to the judgement exercised and assumptions used to determine control, when an entity owns less than half of the voting rights. In EFRAG's view, these disclosures provide information that reduces the degree of uncertainty introduced by the use of judgement in the assessment of de facto control.

Potential voting rights

65 EFRAG acknowledges that, in some cases, determining whether potential voting rights are substantive or not may be challenging. In particular, the assessment of control requires an analysis of various factors including the purpose and design of the instruments that provide potential voting rights and any other involvement that an entity has with the investee. This includes an assessment of the terms and conditions of such rights as well as an entity´s motives and reasons for agreeing to them.

66 EFRAG notes that some difficulty in performing this analysis might arise in cases of ‘deadlock’ clauses between the investors inherent in some of these instruments. In such cases, there may be a negative impact on reliability of information if the primary (dominant) investor has limited access to information to appropriately perform its evaluation of control. This might occur because, even though an entity might have the ‘ability’ to control an investee, it might not have legal rights to control under local laws, and might need to undertake additional procedures to gather information to meet its reporting obligations.

67 On balance, EFRAG does not expect such cases to have a significant impact on reliability of information, because if an entity simply cannot obtain information about the rights of other shareholders and the agreements entered into by other parties, it might be that the entity does not in fact have the ‘ability’ to control the underlying investee.

<u>Agent/principal relationships</u>

68 IFRS 10 provides criteria and guidance for an entity to evaluate whether a decision maker is using its power as a principal or an agent. As noted earlier in the discussion about ‘relevance’, entities need to consider a range of factors, when making this evaluation. In some cases, obtaining the information needed for the assessment of control might be challenging and involve significant judgement to analyse the information, and raise concerns about reliability.

69 In particular, EFRAG believes that the following situations are likely be the most challenging when assessing control in an agent/principal scenario:

(a) Determining whether (and which) rights are substantive (particularly in the absence of unilateral removal rights).

(b) Obtaining information on ownership structures and monitoring how the interests of other investors will change over time. In particular, it would include situations when a preparer is involved in complex ownership structures or (and) many structured entities.

(c) Determining at what point the exposure and variability of an investor’s returns change from insignificant to significant.

(d) Determining whether the investor’s remuneration is commensurate with that of other service providers.

70 EFRAG notes that making judgements is inherent in a principles-based environment and that the level of judgment required by IFRS 10 should not so exceptional in nature that it would be impracticable to apply IFRS 10. In fact, in this particular case the guidance in IFRS 10 explains what type of evidence to look for when assessing the existence of control, and sets of a range of factors an entity should consider, without specifying whether a single factor in isolation will lead to conclusive evidence of control. The weighting of factors will depend of the relevant facts and circumstances that are appropriate to the entity conducting the assessment.

71 Furthermore, the disclosures required by IFRS 12 will assist users in understanding the assumptions made by management and the degree of judgement exercised to apply the requirements and reach a conclusion on control in situations involving agency/principal relationships.

Consolidation of structured entities

72 IFRS 10 includes application guidance followed by examples to assist preparers to apply the requirements in IFRS 10 for consolidation of structured entities. The examples illustrate that some investees may not be consolidated under IFRS 10, whereas they were consolidated under current IAS 27. This may be the case when an investor receives the majority of risks and rewards but does not have the ability (power) to affect the returns of the investee.

73 EFRAG notes that the revised control definition may be difficult to apply in some cases and might require a significant amount of judgement in order to assess whether an investor has control over a structured entity. For example, assessing control over structured entities when there is a change in the business purpose (from ongoing activity to termination).

74 However, as previously mentioned, like other IFRSs, IFRS 10 involves judgement and requires careful analysis of facts and circumstances. This is likely to ensure a more rigorous analysis of an entity´s involvement with another entity and consideration of facts and circumstances associated with the purpose and design of a structured entity.

Conclusion

75 For the above reasons explained above, EFRAG's overall assessment is that the requirements in IFRS 10 on relevant activities, de facto control, potential voting rights, agent/principal relationships and consolidation of structured entities satisfy the reliability criterion.

Comparability

76 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.

77 EFRAG has considered whether the changes introduced by IFRS 10 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.

78 EFRAG has noted that comparability of information about the areas mentioned in paragraph 3 is determined more by the provision of a general objective and overall application of the control model in IFRS 10. For this reason, EFRAG decided to assess comparability of IFRS 10 in its entirety.

Uniform control model for all investees including situations of de facto control, agent/principal relationships and structured entities

79 When determining control of an investee under IFRS 10, entities will apply a uniform 'ability' to control model to all investees. IFRS 10 considers the rights held by an entity, as well as the rights held by other investors, when assessing control,

which, in principle, will be applied in a similar way when other investors hold potential voting rights, kick-out rights or similar rights, and therefor enhance comparability of information.

Application of judgement and assumptions

80 In EFRAG's view, the main concern regarding comparability arises from the degree of judgement required by IFRS 10 in some areas, particularly when the evaluation requires various factors to be considered and those factors might contain uncertainty or the information to support them might be difficult to obtain.

81 In general, EFRAG acknowledges that in some cases the guidance and examples provided in IFRS 10 might be interpreted in different ways which may lead to inconsistency and diverse application within group entities. In particular, to assess de facto control and assess control in agent/principal relationships (which involves determining substantive rights, rights of other parties and other challenging assessments), IFRS 10 might not provide detailed answers in the form of specific guidance and examples.

82 EFRAG notes that in a principles-based control model, the use of judgement is an inherent factor, and the disadvantage of applying principles instead of rules, is that there might be divergence in practice. As noted earlier in the discussion about 'relevance' and 'reliability', EFRAG believes that the level of judgment required by IFRS 10 is not so exceptional in nature that it would be impracticable to apply the standard in a consistent manner.

83 Furthermore, EFRAG understands that the issue of consistent application is most prominent upon initial application, as entities will become more familiar with the guidance and the assessments that they are required to make.

84 IFRS 10 requires entities to consider a broad range of facts and circumstances in determining control. It provides application guidance and examples on how to apply the new requirements that articulate the principles in a simple way without making the fact patterns overly complex. This is helpful to ensure that entities apply the control model and the requirements in a similar way and, therefore, lead to comparable information between investees.

85 In some cases, IFRS 10 does not provide a definition of the terms used (e.g. sponsored entity). EFRAG believes that relevant terms in an IFRS should be defined to avoid divergent interpretations in practice. However, on balance EFRAG notes that it is not possible to define every term that is necessary in applying IFRS 10. Therefore, the existence of undefined terms should not raise significant concerns about comparability, because management would have enough knowledge to interpret the terminology in a consistent manner or use other IFRS literature for interpretation where necessary.

86 Taken together, the requirements in IFRS 10 and the enhanced disclosures in the new IFRS 12 is likely to result in consistent application of the requirements in IFRS 10 and improve comparability of information amongst entities over time.

Conclusion

87 For the above reasons, EFRAG's overall assessment is that the requirements in IFRS 10 on relevant activities, de facto control, potential voting rights,

agency/principal relationships and structured entities satisfy the comparability criterion.

Understandability

88 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.

89 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.

90 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 10 and in particular whether the information about the areas mentioned in paragraph 3 is understandable, is whether that information will be unduly complex.

91 EFRAG acknowledges the argument that the increase in application guidance and clarifications provided by IFRS 10 will be useful to allow entities to assess better the cases in which 'de facto' control exists, and IFRS 12 will also assist with relevance of information by requiring an entity to disclose the assumptions and judgement used in determining 'de facto control'. Therefore, the guidance and disclosure would make the financial information understandable by users.

92 IFRS 10 does not alter the fundamental nature of the consolidated financial information. Therefore EFRAG does not expect any new issues about understandability to arise.

<u>Conclusion</u>

93 For the above reasons explained above, EFRAG's overall assessment is that the requirements in IFRS 10 on relevant activities, de facto control, potential voting rights, agency/principal relationships and structured entities satisfy the understandability criterion.

True and Fair

94 EFRAG has concluded that the information resulting from the application of IFRS 10 would not be contrary to the true and fair view principle.

European public good

95 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 10.

Conclusion

96 For the reasons set out above, EFRAG's overall assessment is that IFRS 10 meets the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

97 With regards to the mandatory effective date of IFRS 10, please refer to Appendix 6.

APPENDIX 1B – DISSENTING OPINIONS: IFRS 10

1 Nicklas Grip and Gabi Ebbers (EFRAG TEG members) dissent from the endorsement of IFRS 10, for the reasons explained below.

Dissenting opinion of Nicklas Grip

2 Nicklas Grip dissents from the endorsement of IFRS 10 for two reasons, each of which separately would warrant a dissenting opinion in his view:

(a) The IASB changed the definition of potential voting rights in IFRS 10 such that it is no longer aligned with the definition of potential voting rights in IAS 28.

(b) The definition of agency relationships as interpreted in the application guidance to IFRS 10.

Definition of potential voting rights in IFRS 10 versus IAS 28

3 Nicklas Grip considers that IFRS 10 and IAS 28 are part of a package of interrelated standards and cannot be considered on a stand-alone basis. Given this interrelationship, he believes that there is a need for a consistent use of definitions in prescribing the principles underlying the consolidation or non-consolidation of entities in which a reporting entity has an interest.

4 The definitions determine the boundaries between cases in which a reporting entity concludes it should (1) not consolidate (i.e. when it has a pure ownership interest without control or significant influence), (2) apply one-line consolidation (i.e. when it applies the equity method on the grounds that it has significant influence) and (3) consolidate (i.e. when it has control).

5 Nicklas Grip believes that, by only changing the definition of potential voting right in IFRS 10 and not in IAS 28, the IASB has created an inconsistency in the chain of definitions. Absent a consistent definition of terms between IFRS 10 and IAS 28, he believes there is a risk that the consolidated financial statements may not meet the relevance criterion, because relevant information might be omitted or irrelevant information may distort otherwise relevant information. Therefore he believes that IFRS 10 may also fail the reliability criteria since the degree of control that an entity have over different entities may not be faithfully represented in the consolidated financial statements. In particular, he is concerned about the potential risk that the difference in the definition of potential voting rights may in theory create a situation in which IFRS 10 requires consolidation, even when a reporting entity would not be considered to have significant influence as defined in IAS 28.

6 Nicklas Grip does not recommend the endorsement of IFRS 10, because the above case clearly illustrates that the relevance criterion will possibly not be met.

The definition of agency relationships as interpreted in the application guidance to IFRS 10

7 Nicklas Grip considers that the IASB has not appropriately defined agency relationships in IFRS 10. In particular, the definition is too broad and results in the consolidation of not just those SPEs that are worthwhile, but also in the consolidation of holdings in traditional mutual funds and similar transactions in which there exist neither economic or legal rights nor market risks. According to

Nicklas Grip, the definitions combined with the application guidance will in those circumstances result in financial reporting that does not faithfully represent the economic substance of the holdings in the investees in the statement of financial position and in the income statement.

8 Nicklas Grip understands that this issue is of concern to the financial services industry and more specifically life insurance companies and a significant proportion of universal banks and investment banks. He believes that this issue on its own would warrant a reconsideration of the requirements of IFRS 10 before its effective date.

9 This issue appears most starkly in the case of a reporting entity that manages a mutual fund that is strictly governed by law or regulation to ensure that the fund is operated in the best interests of all investors; the law requires the reporting entity to have holdings in the mutual fund that exactly correspond to the amount of the liability of the customers (e.g. policyholders in a life insurance agreement); and the holdings of those mutual funds are protected if the reporting entity were to be liquidated. Although the reporting entity, in its capacity as fund manager, has some discretion both in choosing the type of fund, and in making investment decisions, it does so within narrow parameters that have been determined and are governed by regulation.

10 Nicklas Grip considers that the fund manager is subject to strict regulation that restricts its decision-making authority to narrowly defined operating and financing policies, and make decisions on behalf of the investors/customers. Irrespective of its direct investment, the fund manager cannot use its decision-making powers 'so as to benefit itself' due to regulatory oversight. Hence, the fact that the fund manager holds direct interests in such a mutual fund on its own account, it does not provide it with the power to manage the fund for its own benefit.

11 Nicklas Grip, therefore, believes that regardless of the ownership interest (e.g. whether it holds 0%, 40% or 80% or not), such a mutual fund should not be consolidated. Given that IFRS 10 would require consolidation of the funds in such cases, he does not believe the standard meets the relevance criterion. In addition, he considers that the standard would not meet the reliability criterion as there is a lack of faithful representation in the statement of financial position and the income statement.

12 Finally, Nicklas Grip believes that the conclusion that IFRS 10 should not be recommended for endorsement is also supported by the following:

(a) In the case of open-ended investments funds that are required to redeem shares/units that are offered by its investors, the fund manager would not have any form of control over its ownership percentage. Consequently, those shares/units not owned by the fund manager would be classified as a liability that would change constantly as investors enter and leave the fund. That means the fund manager would be required to capture the percentage of its ownership interest continuously to be able to prepare its financial statements in accordance with the requirements of IFRS 10.

(b) In the case of a mutual fund that hold shares in the reporting entity (e.g. index funds that include the reporting entity in the index), the reporting entity would be required to eliminate those 'treasury shares' on consolidation, even if the reporting entity has no market risk regarding its interests in the mutual fund (e.g. the share/units are used in unit-linked investment products). This results in an imbalance between mutual funds' assets and liabilities as those treasury shares would need to be eliminated on consolidation.

Dissenting opinion of Gabi Ebbers

13 Gabi Ebbers dissents from the endorsement of IFRS 10 for the following reasons:

14 Gabi Ebbers believes that contrary to the IASB's objective to clarify and provide guidance on existing consolidation requirements, IFRS 10 is highly complex and unclear to implement in practice and requires significantly more judgement compared to IAS 27 and SIC 12. The principles based approach in IFRS 10 removes "bright lines" and requires the application on a case by case basis considering numerous factors and broad terms. The practical examples provided in IFRS 10 lack a definite understanding of the control concept, which implies the risk of different interpretation in financial reporting practice. Contrary to its aim, IFRS 10 is not suited to improve relevance and comparability in financial reporting. In the asset management industry, instead, it would lead to inappropriate consolidation of a potentially large number of investment funds and thereby inappropriately grossing up balance sheets of companies.

In particular:

Clear rationale for distinguishing between an agent and a principal is missing in IFRS 10

15 The distinction of agent and principal under IFRS 10, whilst useful in considering other types of investments, is not appropriate to deciding whether consolidation is required for investment funds. Such a distinction presumes that the level of holdings of the fund manager in investment funds is decisive for consolidation. Consolidation requires the inclusion of all of the funds' assets, even if third party investors can always redeem their interests in the investment funds at any time. Thus, the inclusion of funds' assets not effectively controlled by the fund manager would not represent the economic reality and would reduce the relevance of consolidated financial statements because of a significantly grossed up balance sheet and the consolidation of non-controlling interest. This would lead to non-decision useful information for capital markets.

16 The criterion "exposure to variability of returns" (paragraphs B71 and B72 of the application guidance in IFRS 10) is highly judgemental and not practicable to distinguish between a fund manager and a principal. IFRS 10 does not contain clear guidance which factors a fund manager has to consider in the determination of the "exposure to variability of returns". Different fee structures, a large variety of transactions and fee splits across different jurisdictions, performance guarantees and fluctuations in the markets complicate the assessment of "exposure to variability of returns" and require a continuous assessment as returns for a fund manager usually vary disproportionally higher than investors' return.

17 IFRS 10 lacks clear guidance on how to proceed when rights to remove the fund manager held by more than one party should influence the control decision, in particular when information on the dispersion of rights held by other parties is missing and when it cannot be assessed whether those rights are "substantive" (paragraph B65 of the application guidance in IFRS 10).

IFRS 10 implementation is highly complex

18 Companies need to review all investments directly or indirectly held to assess if the ultimate parent has the ability to exercise control on a case by case basis. In particular for financial institutions holding a large amount of investment funds, the implementation of IFRS 10 is expected to be very complex and costly.

19 In the asset management business there is typically involvement with a large number of products with different agents to monitor information. Data collection will be challenging, as the fund manager is not the record keeper of certain investment products and there are no legal rights to access the records for monitoring the ownership structure. There are no mandatory notifications to the fund manager in place once the ownership structure in an investee changes. Information about ownerships held by other investors and possible agreements between other shareholders might be impossible to obtain.

Parts of IFRS 10 are still under consideration and might reverse a consolidation decision

20 The IASB's Exposure Draft Investment Entities, which is currently under consultation, proposes an exemption from consolidation for investment entities in accordance with specific criteria. Any resulting amendments are expected to be included in IFRS 10 prior to its effective date of application. These amendments to IFRS 10 cause considerable uncertainty and raise the concern that companies might be required to start consolidation of certain investment funds under the current version of IFRS 10, but may have to change to fair value through profit or loss accounting once the amendments as a result of the Exposure Draft Investment Entities are incorporated in IFRS 10.

In summary

21 Gabi Ebbers supports the IASB's objective to develop a principle based control model as a basis for consolidation, however believes that the above described conceptual flaws in IFRS 10 must be corrected to ensure that the IASB achieves its original intentions.

APPENDIX 2A – BASIS FOR CONCLUSIONS: IFRS 11

EFRAG'S TECHNICAL ASSESSMENT OF IFRS 11 AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRS 11 Joint Arrangements *(IFRS 11).*

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 IFRS 11 meet the technical criteria for EU endorsement?

1 EFRAG has considered whether IFRS 11 meets 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 IFRS 11:

(a) is 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) meets 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, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt IFRS 11.

Approach adopted for the technical evaluation of IFRS 11

2 In performing its overall assessment, EFRAG focused on the impact of the new following elements introduced by IFRS 11:

(a) Core principle for classification and accounting for interests in joint arrangements;

(b) Parties without joint control having an interest in a joint operation; and

(c) Accounting for interests in joint operations in separate financial statements.

Each of these elements has been assessed separately in this Appendix.

3 The scope exception in existing IAS 31 for venture capital organisation, mutual funds, unit trusts or similar entities, including investment-linked insurance funds, has been moved to IAS 28 (2011) and characterised as a measurement exception. The main effect of this change is that it triggers a requirement for additional disclosure under IFRS 12. EFRAG's overall assessment of IFRS 12 is discussed in Appendix 3.

4 The accounting guidance in SIC-13 on non-monetary contributions has been incorporated into IAS 28 (2011) and now also applies to associates. This amendment to IAS 28 is further discussed in Appendix 5. In that document EFRAG assessed that this amendment is straightforward and does not raise any new concerns.

5 The new disclosure requirements of IFRS 12 on interests in joint arrangement are discussed and assessed in Appendix 3.

6 To obtain evidence to support its overall assessment of IFRS 11, EFRAG considered the effect analysis published by the IASB, held meetings with the various groups of constituents and conducted field-testing activities. The results of the various consultations have been reflected in this overall assessment of IFRS 11.

Core principle for classification and accounting for interests in joint arrangements

Relevance

7 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.

8 EFRAG considered whether IFRS 11 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.

9 EFRAG notes that accounting for interest in joint operations not structured through separate vehicle is consistent with existing IFRSs and does not raise any concerns about relevance.

10 EFRAG notes that based on the 'core principle', IFRS 11 requires parties to joint arrangements which have rights to the assets and obligations for the liabilities to the joint arrangement, to recognise those assets and liabilities in their financial statements.

11 In practice, the accounting outcome for joint arrangements classified as joint operations, will be similar to proportionate consolidation under existing IFRSs for consolidated financial statements (unless a party's ownership interest in the joint operation differs from its share of assets, liabilities, revenue and expenses). However, the rationale under IFRS 11 is that an entity has rights to assets and obligations for liabilities, which is not something that is required to exist to qualify for proportionate consolidation under IAS 31. For this reason, some argue that proportionate consolidation does not produce relevant information because in their view there is no basis for combining jointly controlled assets and liabilities with those 'fully' consolidated (and controlled) by an entity. Supporters of this view

contend that a party to a joint arrangement that does not control its share of the assets and liabilities of the joint arrangement, should not report those items in its statements of financial position because they do not meet the definition of an asset or liability, respectively.

12 The concern described above would be addressed if the focus in classifying a joint arrangement was on the 'rights to assets and obligations for the liabilities' a party has relating to its involvement in the arrangement. IFRS 11 does that, and states that rights and obligations conferred on the parties can arise in various ways: from a legal perspective, from contractual agreements between the parties to the arrangements or from other facts and circumstances.

13 EFRAG notes that under IFRS 11, an entity would recognise assets and liabilities relating to its interests in the joint operation, if they meet the IFRSs recognition criteria for assets and liabilities. In particular, when the legal form of a joint arrangement does not grant a separation between the parties and the separate vehicle, the parties have rights to the assets of the joint arrangement and are liable for its obligations. In EFRAG's view the accounting required under IFRS 11 will reflect this lack of 'separation' in an appropriate manner and therefore provides relevant information. Also in cases when the contractual arrangement between the parties reverse the separation between the parties and a joint arrangement and give the parties *direct* rights to the assets and the parties agree to take over the liabilities of this joint arrangement, recognition of these assets and liabilities in the financial statements of the parties would be appropriate and should bring relevant information to users.

14 Under IFRS 11, an entity would be considered to have rights to assets also if the *purpose* of the joint arrangement is to provide the parties with all output being produced by the assets. In such cases, the economic benefits generated by those assets flow entirely (or substantially) to the parties that jointly control the arrangement and therefore the parties are required to recognise those assets in their financial statements. A similar argument could be used for the liabilities of a joint arrangement, if the liabilities it incurs, are in substance, satisfied by the parties either through a contractual agreement or by the cash flows received from the parties through their purchases of the output. In both cases, the indication is that the parties have an obligation for the liabilities of the arrangement, which they should recognise. In EFRAG's view, in such cases the substance of the joint arrangement overrides its legal form. In such cases parties have in essence set up a joint arrangement with the intention to have access to the assets and not in order to receive a profit from the investment.

15 However, some constituents argue that applying the 'core principle' might result in an entity recognising liabilities for which it does not have an obligation. According to these constituents when a joint arrangement has been structured through a separate vehicle, and the legal form grants a separation between the parties *and* this feature has not been reversed by a contractual agreement, it should not be concluded that the parties have rights to assets and obligations for liabilities based solely on the other facts and circumstances (e.g. whether the parties purchase the output of the arrangement or not). In the fact pattern described in the above paragraph, the parties are not severally liable for the obligations of the joint arrangement from a legal perspective and in case of liquidation of a separate entity their potential loss is limited to their share in the net assets.

16 Furthermore, these constituents argue that the parties do not have direct rights to the assets of the arrangement as they do not control the assets. Accordingly, the

differentiating feature between a joint operation and a joint venture should not be whether the parties purchase the output from the joint arrangement. The outcome should be the same irrespective of whether the parties purchase all the output from a joint arrangement or from an independent supplier.

17 EFRAG notes that IFRS 11 requires recognition of the share of assets, liabilities, revenue and expenses based on the contractual rights of the parties and which could in some cases be different from the share of assets, liabilities, revenue and expenses recognised based on the ownership interest in a joint arrangement. In EFRAG's opinion the information based on those contractual rights and obligations would have more predictive value.

18 EFRAG notes that based on the 'core principle' in IFRS 11, if parties to a joint arrangement have neither rights to assets nor obligations for the liabilities, they recognise their interest in the joint venture in accordance with the equity method under IAS 28 (2011), as this reflects the fact that the parties have only rights to the net assets of the joint arrangement. The parties are not liable for the obligations of the joint venture and should therefore not recognise these as liabilities. They also do not have direct rights to the specific assets of the joint arrangement.

19 EFRAG notes that IFRS 11 eliminates proportionate consolidation, which means that the parties to joint arrangements will not be able to recognise a share of assets and liabilities, revenue and expenses of the joint arrangement in their financial statements unless they have rights to the assets and obligations for the liabilities. Under IFRS 11 those rights and obligations can be conferred to the parties by legal form of an arrangement, through contractual agreements or as a result of other fact and circumstances indicating that in substance the parties have rights to the assets and obligations for the liabilities.

20 Some constituents argue that the 'core principle' should not focus solely on 'rights and obligations', rather on the fact to which extend the activity of the joint arrangement is linked to the business of the parties.

21 EFRAG considered whether there are cases when relevant information will be omitted because the loss of proportionate consolidation would no longer allow entities (parties to a joint arrangement) to report performance and underlying revenue and expenses of the activities in the joint arrangement in a way that provides relevant information to users.

22 EFRAG notes that in many cases activities undertaken through the joint arrangement are closely related to the business and operating activities of the parties and the parties are highly involved in the activities of the arrangement which is consequently considered as an 'extension' of the activities of these parties. For example, when parties agree that part of their production activity should be outsourced to a joint arrangement. In such cases, the joint arrangement is often structured such that it would meet the definition of a joint operation, in which case the parties to the arrangement would need to recognise their share of assets, liabilities, revenue and expenses based on the contractual rights. This accounting would provide – unless a party's ownership interest in the joint operation differs from its share of assets, liabilities, revenue and expenses – in practice similar information as proportionate consolidation would have under IAS 31, as it provides information about the scale of the operations managed by, and the risks borne by, the parties undertaking the joint activity.

23 EFRAG notes that in some cases a joint arrangement may not meet the criteria to be classified as a joint operation, for example, because the arrangement has been structured so that the output it produces is sold to a third party rather than to the parties to the arrangement. In these cases the legal form of a joint arrangement that confers separation between the parties and the separate vehicle might have been chosen because of legal constraints in the jurisdiction in which it operates, or for tax purposes. In those cases joint venturers will be precluded from recognising their share of the joint arrangements' assets, liabilities, revenue and expenses in their financial statements. This would cause a loss of useful information in the statement of financial position and the income statement of the parties to the joint arrangement.

24 Furthermore, EFRAG understands that applying the equity method to joint ventures will in some cases be inconsistent with management reporting under IFRS 8 *Segment Reporting* and the way in which management views its business operations and makes strategic and operating decisions.

25 EFRAG notes a potential concern expressed by users about the equity method being applied to interests in joint ventures is the lack of information it provides about the performance of a joint venture and its debt. Therefore, users have stressed the importance and relevance of the additional disclosure about interest in joint ventures and the risks associated with those interests. In EFRAG's view, a key element to consider are the enhanced disclosure requirements in IFRS 12 for all joint arrangements, particularly those accounted for using the equity method.

26 Under IFRS 12 much of the information about the assets, liabilities and performance of the joint venture will be presented separately for each joint venture considered material to the reporting entity. Furthermore, in relation to individually immaterial joint ventures, limited aggregate information will be provided about an entity's share in the joint ventures' profit and loss and other comprehensive income. Moreover, EFRAG notes that the summarised financial information for each joint venture will be disaggregated from the assets, liabilities, revenues and expenses of the parties as presented on the face of the financial statements. EFRAG understands that disaggregation of information on joint ventures is considered useful for users in their analysis.

27 EFRAG notes that the accounting in IFRS 11 is complemented by the disclosure of interests in joint arrangements under IFRS 12; the potential loss of information on the face of the financial statements will be, at least partially, compensated for by the information provided in the notes to the financial statements.

<u>Conclusion</u>

28 Overall, EFRAG agrees with the 'core principle' in IFRS 11, which requires an entity to recognise its interests in a joint arrangement based on its *rights and obligations*. In EFRAG's view, it is appropriate to recognise assets and liabilities in the financial statements of the parties if they have direct rights to the assets and are liable for the obligations, as this results in relevant information to users.

29 EFRAG also agrees that in some cases other facts and circumstances might indicate that the recognition of assets and liabilities in the financial statements of the parties would be more relevant than equity accounting. That could be the case when parties set up a joint arrangement with a sole purpose of receiving the whole output of this joint arrangement, that is being produced according to their specifications. In this case the joint arrangement's only source of cash flow to settle

its liabilities comes from the parties of the joint arrangement. In EFRAG's view, recognition of assets, liabilities, revenue and expenses relating to this joint arrangement in the financial statements of the parties reflects the economic substance of the joint arrangement.

30 However, as explained above, EFRAG acknowledges that there will be situations in which IFRS 11 requires application of the equity method to joint arrangements despite the fact that they might be a key element of an entity's core business. In such situations, relevant information might be omitted from the face of the primary financial statements. In EFRAG's view, this loss of relevance will be partially compensated by the detailed disclosure about interest in joint arrangements required by IFRS 12.

31 Taken together, EFRAG's overall assessment is that IFRS 11, in relation to the 'core principle' for classification and accounting for interests in joint operation, meets the relevance criterion.

Reliability

32 EFRAG also considered the reliability of the information that will be provided by applying IFRS 11. 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.

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

<u>Classification</u>

34 IFRS 11 requires an entity to consider a number of factors when assessing classification of joint arrangements: their legal form, contractual agreements, and when relevant, other facts and circumstances.

35 EFRAG believes that a classification principle based on indicative factors such as legal form of the vehicle, contractual agreements, and where necessary the purpose and design of the arrangement, will help an entity to make a comprehensive assessment about why it is involved with the joint arrangement. This approach is, therefore, likely to help entities make the right assessment and thus provide reliable information.

36 EFRAG notes that determining the type of joint arrangement structured through a separate vehicle requires a degree of judgement. (IFRS 11 does not provide 'bright lines' for the classification of a joint arrangement).

37 In particular, this is the case when the legal form of the separate vehicle ensures the separation between the parties and the joint arrangement, and the contractual agreement does not explicitly provide the parties with the rights and the obligations, the entities should consider other facts and circumstances to conclude on the classification.

38 Although, the standard assumes that the contractual arrangements will include terms that make reference to the assets, liabilities, revenue and expenses to which each joint operator is entitled, it stresses that in some cases it is necessary to refer

back to the purpose of the joint arrangement (for example, whether the purpose is to provide the parties with an output).

39 IFRS 11 provides guidance on the facts and circumstances that should lead to classifying the separate entity as a joint operation. However, EFRAG acknowledges in some cases the guidance may require a considerable degree of judgement particularly in complex fact patterns. EFRAG notes that IFRS 12 requires an entity to disclose the significant judgements and assumptions made in determining the type of joint arrangement. In EFRAG's view, the disclosures required by IFRS 12 will provide useful information to users that help them understand the assessments made by the entity, which should mitigate concerns about the impact of significant judgement on the reliability of information.

Accounting for joint operations and joint ventures

40 IFRS 11 requires the parties to *a joint operation* to recognise their assets and liabilities, revenues and expenses based on the contractual agreements, and to account for them in accordance with all applicable IFRSs. In EFRAG's view, this should lead to the provision of reliable information as it only broadens the application of existing standards.

41 EFRAG notes that in some cases the contract may not state clearly the percentage of assets to which a party to a joint operation has rights (the same for liabilities, revenue and expenses). This may happen when the classification to the joint operation is based solely on the fact that the parties purchase the output of the joint arrangements and the percentage purchased may either vary from the ownership percentage and vary from year to year. In these cases, management would need to apply judgement to determine the appropriate share of assets, liabilities, revenue and expenses that should be recognised in the financial statement, which may raise a concern about reliability of information.

42 IFRS 11 requires a party to *a joint venture* to recognise their interests as an investment and account for their interests applying the equity method under IAS 28 (2011). In EFRAG's view, applying the equity method should not raise concerns about reliability.

Conclusion

43 EFRAG's overall assessment is that IFRS 11, in relation to the 'core principle' for classification and accounting for interests in joint operation, satisfies the reliability criterion.

Comparability

44 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.

45 EFRAG has considered whether IFRS 11 results 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.

Classification

46 As noted earlier, IFRS 11 requires the parties to classify their interests in joint arrangements as joint operations or joint ventures based on the assessment of their rights and obligations in relation to the joint arrangements. In performing the classification, the parties should consider the legal form of an arrangement, contractual terms and other facts and circumstances. Therefore, in EFRAG's view, IFRS 11 would lead to the provision of comparable information, by ensuring that like arrangements are being accounted for similarly, while dissimilar transactions would not be accounted for as if they were similar.

47 EFRAG notes that in some cases, contractual agreements establish that parties to a joint arrangement have *different* rights to assets and obligations for liabilities. Under IFRS 11, this fact pattern would need to be considered when determining the classification of the joint arrangement for each of the parties concerned. On this basis, EFRAG believes that comparability of information will be preserved because the joint arrangements will be classified based on the parties' rights and obligations. In reaching this conclusion, EFRAG also notes that paragraph BC35 of IFRS 11 states 'that the unit of account of a joint arrangement is the activity that two or more parties have agreed to control jointly, and that a party should assess its rights to the assets, and obligations for the liabilities, relating to that activity'. Furthermore, paragraph 18 of IFRS 11 provides guidance when entities are bound by a framework agreement that sets up different joint arrangements to undertake different activities and which can result in the parties having different rights and obligations. In such cases, each joint arrangement set up under the framework agreement would be assessed separately and classified either as a joint operation or a joint venture.

48 Some constituents argue that IFRS 11 does not provide clear guidance to address situations in which a joint arrangement that is structured through separate vehicle undertakes more than one activity. In such cases, the rights and obligations of the parties might differ with regard to the different activities undertaken by the joint arrangement. For the reasons noted in paragraph 47 above, EFRAG believes that the guidance in IFRS 11 is sufficient to enable consistent application in situations when two separate activities coexist in one separate vehicle.

49 EFRAG observes that the classification of joint arrangements structured through a separate vehicle requires judgement which in some cases may lead to a different classification of similar joint arrangements, and have a negative impact on comparability. In EFRAG's view, it is likely that entities require time to apply the requirements in a consistent manner, and that full comparability will only be achieved over time between entities.

50 EFRAG notes that IFRS 12 requires the entities to disclose the significant judgements and assumptions applied when determining the type of joint arrangements, which should be helpful to address at least some of the concerns expressed above about comparability.

Accounting for joint operations and joint ventures

51 IFRS 11 requires all interests in joint ventures to be accounted for using the equity method, and does not allow a choice of accounting policy for those interests.

52 Furthermore, IFRS 11 develops a single accounting method for all interests in joint operations; that is, recognition of assets, liabilities, revenue and expenses in the financial statement of the joint operator in accordance with applicable IFRSs.

53 In EFRAG's view, the elimination of accounting options together with the requirement applicable for all joint arrangements, that the interests in the joint arrangements should be recognised based on the parties rights and obligations will enhance comparability of information.

54 EFRAG observes that IFRS 11 does not provide specific guidance about how a party to a joint operation should recognise its share of assets and liabilities when the parties to a joint arrangement have ownership interests that are different to the percentage of output acquired (or the right to reserve capacity) – on the basis of ownership interest or on the basis of percentage of output acquired. IFRS 11 assumes that the contractual arrangements will include terms that make reference to the share of assets, liabilities, revenue and expenses to which each joint operator is entitled to and requires the joint operators to refer to the contracts. EFRAG understands that some constituents perceive this as a lack of specific guidance in IFRS 11 that could lead to diversity in practice, and reduce comparability. However, in most cases, parties to a joint arrangement are likely to agree on their rights and obligations in the contractual terms of their joint arrangement and entities will be able to consistently reflect these in the accounting.

<u>Conclusion</u>

55 EFRAG's overall assessment is that IFRS 11, in relation to the 'core principle' for classification and accounting for interests in joint operation, satisfies the comparability criterion.

Understandability

56 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.

57 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.

58 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 11 is understandable, is whether that information will be unduly complex.

59 EFRAG notes that IFRS 11 requires joint operators to recognise and account for their assets, liabilities, revenue and expenses in accordance with all applicable IFRSs. Furthermore, the joint venturers should apply the equity method to their interests in joint ventures. In EFRAG's view, the requirements in IFRS 11 do not raise significant concerns about complexity of information.

60 Moreover, the requirement of IFRS 12 to disclose significant judgements and assumptions made in determining the type of joint arrangement ensure that the information produced under IFRS 11 is understandable to users, as it will enable them to better understand the financial information provided in case of more

complex arrangements, particularly when the classification assessment is based on other facts and circumstances and structure of the joint arrangement is complex.

<u>Conclusion</u>

61 EFRAG's overall assessment is that IFRS 11 in relation to the 'core principle' for classification and accounting for interests in joint operation satisfies the understandability criterion.

Parties without joint control having an interest in a joint operation

62 Under IFRS 11, parties to a joint operation that do not have joint control in the arrangement, are required to recognise their interest in the arrangement in the same way as joint operators, provided that they have rights over the assets and obligations for the liabilities of the arrangement (recognition of assets, liabilities, revenue and expenses). Parties to a joint operation that do not have joint control and neither rights to assets nor obligations for the liabilities, account for their interests in the joint operation in accordance with IFRSs applicable to their interests.

Relevance

63 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.

64 EFRAG considered whether IFRS 11 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.

65 EFRAG considered whether the fact that some parties to joint operation do not have *joint control* of the arrangement should prevent them from recognising assets to which they have rights or obligations for which they are not liable. EFRAG notes that parties to a joint operation might have an agreement that gives them access to their share of the assets and obligations for their share of liabilities. Also, such parties may receive their returns in the form of product produced by the arrangement.

66 EFRAG understands that the examples of such agreements are common in particular in the oil and gas industry. In EFRAG's view, when parties without joint control have rights to assets and obligations for the liabilities of the joint operations, recognising those rights and obligations in their financial statements would provide relevant information.

<u>Conclusion</u>

67 EFRAG's overall assessment is that IFRS 11, in relation to the recognition of interest in joint arrangements by parties without joint control, satisfies the relevance criterion.

Reliability

68 EFRAG also considered the reliability of the information that will be provided by applying IFRS 11. 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.

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

70 IFRS 11 requires the parties to the joint arrangement that do not have joint control to recognise their interests in the joint operation according to their contractual rights and obligations. In EFRAG's view, this should not create concerns about reliability.

<u>Conclusion</u>

71 EFRAG's overall assessment is that IFRS 11, in relation to the recognition of interest in joint arrangements by parties without joint control, satisfies the reliability criterion.

Comparability

72 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.

73 EFRAG has considered whether IFRS 11 results 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.

74 In EFRAG's view, IFRS 11 would lead to provision of comparable information in similar situations, by requiring the parties to a joint arrangement that do not have joint control to recognise always – regardless of the legal form – the assets to which they have rights and the liabilities for which they have an obligation.

<u>Conclusion</u>

75 EFRAG's overall assessment is that IFRS 11, in relation to the recognition of interest in joint arrangements by parties without joint control, satisfies the comparability criterion.

Understandability

76 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.

77 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.

78 In EFRAG's view, by requiring the parties to the joint operation without joint control but with rights to assets and obligations for liabilities to recognise those assets and liabilities instead of a single line investment IFRS 11 enhances the understandability of the financial statements.

<u>Conclusion</u>

79 EFRAG's overall assessment is that IFRS 11, in relation to the recognition of interest in joint arrangements by parties without joint control, satisfies the understandability criterion.

Accounting for interests in joint operations in the separate financial statements

80 Under existing IFRSs, interests in jointly controlled entities are accounted for at cost or at fair value under IFRS 9 or IAS 39.

81 Under IFRS 11, a joint operator will recognise its assets, liabilities, revenues and expenses relating to its interests in a joint operation. Therefore, interests in joint operations are accounted for in the separate financial statements in the same manner as they are accounted for in the consolidated financial statements. This requirement has been extended to parties to a joint operation which do not have joint control in the arrangement.

Relevance

82 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.

83 EFRAG considered whether IFRS 11 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.

84 As discussed above in respect to accounting for interests in joint arrangements in the consolidated financial statements, EFRAG's overall assessment is that the accounting for joint operations under IFRS 11 reflects the underlying rights and obligations of the parties to a joint operation and therefore provides users with relevant information of an entity's assets and liabilities, revenue and expenses that arise from its interest in the joint operation.

85 EFRAG notes that under IFRS 11, an investor (a joint operator or a party to joint operation which does not have joint control) only recognises assets and liabilities of a joint operation to the extent that it has rights to the assets and obligation for the liabilities, in which case the assets and liabilities must meet the recognition criteria from the investors' perspective.

86 EFRAG notes that in some cases the legal form of a separate vehicle does not grant a separation between that vehicle and the parties to the arrangement. In those cases parties have *direct* rights to assets and are liable for the obligations of the joint arrangement. Therefore, in EFRAG's view, it is appropriate to recognise those assets and liabilities in the separate financial statements of the entity.

87 EFRAG notes that if an entity concludes that it has rights to the assets of the joint arrangement and is liable for its obligations, that fact should be taken into account in preparing the consolidated as well as the separate financial statements. EFRAG also notes that, if an entity has contracts in place that give it rights to the assets of a subsidiary and is liable for its obligations, that fact should be taken into account in preparing the consolidated as well as the separate financial statements. In EFRAG's view, such rights and obligations should be accounted for in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses that they give rise to.

88 EFRAG notes that the accounting required by IFRS 11 is based on the economic substance of the contract, which overrides its legal form. EFRAG observes that application of the substance-over-form principle in IFRSs is not restricted to just the consolidated financial statements, but is also applicable to the separate financial statements.

89 For the reasons explained above, EFRAG's overall assessment is that IFRS 11 will enable users to have access to the relevant information about the rights and obligations of the parties to the joint operation directly in their separate financial statements. EFRAG believes that this information is relevant if a joint operation is structured through a legal entity. Moreover, this information could be particularly valuable for users in relation to those entities that do not have subsidiaries and are therefore not otherwise required to produce this information.

90 However, some constituents believe that in the case of entities that do prepare consolidated financial statements, such information might be redundant. These constituents also believe that the recognition of assets and liabilities of the joint operation structured through separate vehicle in the separate financial statements of the parties would be misleading and would not provide the relevant information. Moreover, they argue that investments in joint operations structured through an entity should be accounted for in accordance with existing IAS 27 which they believe requires that the assets and liabilities of joint operations to which the entity has rights should not be recognised in the separate financial statements.

<u>Conclusion</u>

91 Taken together, EFRAG's overall assessment is that IFRS 11, in relation to the information provided for the joint operations in separate financial statements, satisfies the relevance criterion because joint operators will recognise in their separate financial statements those assets and liabilities that meet the IFRS recognition criteria.

Reliability

92 EFRAG also considered the reliability of the information that will be provided by applying IFRS 11. 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.

93 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness. In EFRAG's view, IFRS 11 does not raise any significant issues concerning freedom from material error and bias.

94 IFRS 11 does not provide new requirements in terms of measurement; it simply prescribes the same recognition and measurement requirements for joint operations in the consolidated accounts and the separate accounts of the joint operator. It therefore does not raise significant concerns about reliability.

<u>Conclusion</u>

95 EFRAG's overall assessment is that IFRS 11, in relation to the information provided for the joint arrangements in separate financial statements, satisfies the reliability criterion.

Comparability

96 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.

97 EFRAG has considered whether IFRS 11 results 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.

98 IFRS 11 ensures that, in the separate financial statements of the joint operator, joint operations structured through an entity are accounted for in the same way as those that are not structured through an entity. Furthermore, IFRS 11 requires other parties to a joint operation which do not have joint control but have rights to assets and obligations for the liabilities of the joint operation to recognise those assets and liabilities also in their separate financial statements.

99 In EFRAG's view, IFRS 11 will result in economically similar transactions being accounted for in a similar way in the separate financial statements of the joint operators.

100 Some constituents believe that the recognition criteria for joint operations structured through a separate vehicle are inconsistent with the requirements that apply to the treatment of subsidiaries in the separate financial statements. As explained in paragraph 87 above, EFRAG believes that to the extent that an entity has rights to the assets of a subsidiary and is liable for its obligations, that fact should be taken into account in preparing the consolidated as well as the separate financial statements. In EFRAG's view, such rights and obligations should be accounted for in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses that they give rise to.

101 Moreover, some constituents believe that IFRS 11 is not clear on how a joint operator should account in its separate financial statements for subsidiaries held by a joint operation. EFRAG observes that IFRS 11 requires joint operators to recognise and account for its assets, liabilities, revenue and expenses relating to its interests in a *joint operation* in accordance with applicable IFRSs. Therefore, provided that the interest held by a joint operation meets the definition of a subsidiary it should be accounted for in accordance with IAS 27 (2011) in the separate financial statements of the joint operators.

Conclusion

102 On balance, EFRAG's overall assessment is that IFRS 11, in relation to the information provided for the joint arrangements in separate financial statements, satisfies the comparability criterion.

Understandability

103 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.

104 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.

105 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 11 is understandable, is whether that information will be unduly complex.

106 In EFRAG's view, the requirements of IFRS 11 do not introduce any new complexities in the separate financial statements that may impair understandability.

107 Some constituents argue that the inconsistency between the requirements for subsidiaries and joint operations structured through separate vehicle, could also affects the understandability of financial statements. However, for the reasons explained in paragraph 100, EFRAG believes that IFRS 11 would in fact improve understandability in most cases as comparability is improved.

Conclusion

108 EFRAG's overall assessment is that IFRS 11, in relation to the information provided for the joint arrangements in separate financial statements, satisfies the understandability criterion.

True and Fair

109 Overall, EFRAG has concluded that the information resulting from the application of IFRS 11 would not be contrary to the true and fair view principle.

European public good

110 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 11.

Conclusion

111 For the reasons set out above, EFRAG's overall assessment is that IFRS 11 satisfies the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

112 With regards to the mandatory effective date of IFRS 11, please refer to Appendix 6.

APPENDIX 2B – DISSENTING OPINIONS: IFRS 11

1 Araceli Mora, Nicolas De Paillerets, Carsten Zielke and Andrea Toselli (EFRAG TEG members) dissent from recommending the endorsement of IFRS 11 *Joint Arrangements*.

Elimination of proportionate consolidation

2 IFRS 11 eliminates proportionate consolidation as a method of accounting for interests in joint arrangements classified as joint ventures. Under IFRS 11, interests in joint ventures are accounted for using the equity method in accordance with IAS 28 (2011).

3 Araceli Mora, Nicolas De Paillerets and Carsten Zielke disagree with the elimination of proportionate consolidation for the reasons explained below.

4 The view of Araceli Mora and Nicolas De Paillerets is based on previous empirical research studies that investigate the relative information content of the equity method compared to proportionate consolidation as a means to explain market risk and bond ratings. They observe that the findings from these studies are consistent with the view that financial statements prepared using proportional consolidation (1) provide a better basis to predict shareholder returns on equity and (2) are more risk relevant for explaining price volatility of market prices than financial statements prepared using the equity method.

5 Although there is some evidence that indicates that the application of the equity method could be more relevant to explain bond ratings, most of the findings analysed by Araceli Mora and Nicolas De Paillerets conclude that proportionate consolidation is, in all cases, more relevant for creditors.

6 For the above reasons, Araceli Mora and Nicolas De Paillerets believe that the elimination of proportionate consolidation for interests in joint arrangements classified as joint ventures will result in a loss of relevant information to users.

7 Carsten Zielke believes that proportionate consolidation reflects more appropriately the performance and the debt position of a joint arrangement that is classified as a joint venture under IFRS 11. The equity method provides limited information and does not provide users with sufficient insight for the purposes of performing a debt analysis of the operations that are jointly controlled, because the total statement of financial position is artificially reduced.

8 For the above reasons, Carsten Zielke believes that the elimination of proportionate consolidation for interests in joint arrangements classified as joint ventures will result in a loss of relevant information to users.

9 In addition, Nicolas De Paillerets believes that EFRAG's basis for conclusions supporting its overall decision to recommend endorsement of IFRS 11 should, with respect to the European public good, have reflected the fact that often the development of European companies is substantially made through joint ventures in certain geographic areas. He is concerned that these companies may be inadequately assessed and valued by investors as their consolidated financial statements will not fully reflect their operations and underlying performance, and will lack key financial data required by investors.

Insufficient guidance in IFRS 11 for classification and accounting for interests in joint arrangement structured through separate legal entity

10 IFRS 11 lacks clear application guidance on the application of the criteria to determine whether a joint arrangement is a joint operation or a joint venture. Carsten Zielke is concerned that the lack of guidance in this area will result in different interpretations of IFRS 11 and create a lack of comparability of information.

11 IFRS 11 requires an investor in a joint arrangement structured through a separate vehicle to recognise either direct individual rights and obligations or the equity interest in the separate vehicle, depending on the joint arrangement being classified as a joint operation rather than a joint venture. This is true for both consolidated and separate financial statements.

12 The classification of an arrangement as joint operation rather than a joint venture may lead to dramatic differences in the purported information therefore such decision must, in Andrea Toselli's view, be guided to limit the scope for similar arrangements being classified differently. ThHe is convinced that IFRS 11 does not contain sufficiently clear guidance to ensure that such decision is made consistently.

13 In addition, the wording in the standard does not provide sufficiently clear guidance in respect to the extent to which, in a joint operation, the rights and obligations are to be measured and presented: either based on the extent of interest held in the separate vehicle (resembling proportionate consolidation) or based on the actual exposure to individual assets and liabilities conveyed by the arrangement (as the main principle seems to suggest). Certain joint arrangements could also present a mix of exposure in the vehicle's equity as well as direct exposure to specific assets/liabilities. The treatment to be followed in these cases is even more unclear.

14 The lack of guidance in IFRS 11 would force preparers to apply an extraordinary level of judgement to the extent of impairing the reliability criterion. Andrea Toselli believes that this would inevitably generate diversity in practice and hence the comparability criterion would also be undermined.

Accounting for interests in joint operations structured through a separate vehicle in separate financial statements

15 Nicolas De Paillerets and Andrea Toselli disagree with new accounting requirements in IFRS 11 with regard to the accounting for interests in joint operations structured through separate vehicle in separate financial statements. Their reasons are explained below.

16 Andrea Toselli observes that the specific reference to the application of IFRS 11 to separate financial statements, the views presented in paragraphs 11-14 above hold true. In addition, in those cases where a preparer would conclude that the assets and liabilities of a joint operation are to be presented on the basis of the interest held in the separate vehicle (a sort of proportionate consolidation), the information would not be relevant as it would not report the actual exposure and rights of the entity. It would in fact be a simulation of an overall position not necessarily in place.

17 On the other hand a preparer who believes that a joint operation is to be presented based on the actual involvement of the entity in the individual assets and liabilities of the arrangement reaches the same accounting already in place based on current

standards (as per certain types of consortiums). IFRS 11 is, in Andrea Toselli's view, a step back from what currently in IAS 27.

18 As a consequence of this lack of clarity and considering the current use of separate financial statements in the EU, Andrea Toselli believes that also the understandability criterion is not satisfied.

19 IFRS 11 requires a joint operator, in its separate financial statements, to account for its interest in a joint operation structured through a separate legal entity, in the same manner as in the consolidated financial statements, regardless of the existence of the separate legal entity. Nicolas De Paillerets disagrees with this requirement, as he believes that IFRS 11 will:

(a) result in inconsistency with the accounting for interests in subsidiaries under IAS 27 (2011) at cost or fair value. IAS 27 (2011) does not consider whether the parent controls the assets or has an obligation for the liabilities of the subsidiary. Even if the parent had such control (or obligation), it would recognise the equity investment under IAS 27 (2011) at cost or fair value. Nicolas De Paillerets struggles to understand why such a distinction is relevant only in circumstances when parties share joint control. For that reason, he believes that extending the recognition principle in IFRS 11 to separate financial statements could give rise to comparability issues since economic similar situations could be accounted for differently; and

(b) lead to situations when assets and liabilities would be directly (even if only pro-rata) recognised in the annual accounts of an entity, irrespective of the existence of direct ownership rights or control by the entity over the individual assets or liabilities of the joint operation. In the view of Nicolas De Paillerets, this could conflict with the legal frameworks that define the purposes of annual accounts in the EU member states requiring or permitting the use of IFRSs in annual accounts, as further explained hereunder.

20 Under IFRSs, separate financial statements are those presented by a parent (i.e. an investor with control of subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9/IAS 39. Separate financial statements are presented in addition to consolidated financial statements or in addition to financial statements in which associates or joint ventures are accounted for using the equity method, unless an entity is exempted from consolidation or from applying equity accounting for associates or joint ventures. Hence, unless an entity has neither an investee nor a subsidiary, separate financial statements are never presented without consolidated financial statements. This reflects the definition of an entity under IFRSs.

21 European regulations do not refer to separate financial statements, but to 'annual accounts' and differentiates them from consolidated accounts. The *Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards* leaves to Member States the option to permit or require companies to prepare their annual accounts in conformity with IFRSs as endorsed by the European Union. Annual accounts are also commonly described as company-only accounts, stand-alone accounts or statutory accounts.

22 In their Basis for Conclusions to IFRS 11, 'the IASB [had] acknowledged that the requirement for joint operations to be accounted for in the same way in the entity's

consolidated financial statements as in the entity's separate financial statements might lead to additional costs to entities in jurisdictions in which separate financial statements are required to be reported in accordance to IFRSs. This is because those requirements might cause entities to perform additional manual procedures such as reconciliations between the statutory accounts and the tax returns, and might require an entity to provide additional explanations of the impact of the changes to, for example, its creditors. Except for these costs […], the costs of accounting for joint arrangements once the entities have determined their classification will remain unchanged as a result of the IFRS.'

23 Nicolas De Paillerets believes that the IASB's assessment, as described above, does not recognise the diversity of the legal frameworks that define the purposes of statutory accounts in the European Union, and that this matter is not within the remit of the IASB. Therefore, this EFRAG TEG member is of the view that an additional assessment by the European Union and the Member States would be necessary to determine whether the European public good criterion is met when applying the requirements of IFRS 11 to annual accounts.

APPENDIX 3 – BASIS FOR CONCLUSIONS: IFRS 12

EFRAG'S TECHNICAL ASSESSMENT OF IFRS 12 AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRS 12 Disclosure of Interests in Other Entities *(IFRS 12).*

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 IFRS 12 meet the technical criteria for EU endorsement?

1 EFRAG has considered whether IFRS 12 meets 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 IFRS 12:

(a) is 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) meets 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, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt IFRS 12.

Approach adopted for the technical evaluation of IFRS 12

2 EFRAG observes that some disclosures have been carried forward from existing IFRSs without a significant change and therefore do not need to be assessed in relation to the endorsement criteria.

3 IFRS 12 extends the disclosure requirements about significant restrictions on a parent's ability to access or use the assets and settle the liabilities of its subsidiaries. EFRAG notes that these requirements are not new, because existing IAS 27 already requires similar disclosures. In EFRAG's view, this change should

not significantly impact the quality of information provided and has therefore not been assessed in this appendix.

4 In performing its overall analysis, EFRAG focused on the impact of the requirements introduced by IFRS 12 that involve new elements to existing disclosure requirements. IFRS 12 impacts the following areas:

(a) unconsolidated structured entities;

(b) significant judgements and assumptions;

(c) interest in subsidiaries with material non-controlling interests;

(d) consolidated structured entities;

(e) interests in joint arrangements and associates; and

(f) venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds that have an interest in a joint venture or associate.

5 EFRAG's overall assessments of the disclosure requirements listed above are discussed in the paragraphs that follow.

6 EFRAG notes that although IFRS 12 requires more extensive and voluminous disclosure about interest in other entities, it requires entities to aggregate or disaggregate the disclosure such that useful information is not obscured. Furthermore, IFRS 12 puts an emphasis on the disclosure of material and significant items. EFRAG has conducted its overall assessment on the basis that entities will be able to aggregate information reasonably. However, EFRAG acknowledges that in some cases entities might face difficulties to aggregate data in a consistent and understandable manner, in particular when they hold numerous interests in other entities that are not homogeneous. EFRAG's overall assessment is that if the disclosures are not aggregated in a reasonable manner and presented in a meaningful way, this would impact the relevance and understandability of financial reporting.

7 To get evidence to support its overall assessment of IFRS 12, EFRAG considered the effect analysis published by the IASB, held meetings with the various groups of constituents and conducted field-testing activities. The results of the various consultations have been reflected in this overall assessment of IFRS 12.

Relevance

8 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.

9 EFRAG considered whether IFRS 12 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.

10 In EFRAG's view, the difference in the nature and risks that arise from interests in different types of investees is reflected in the disclosure requirements. Therefore, EFRAG has assessed relevance of information provided under IFRS 12, by conducting a separate assessment of the new requirements.

Unconsolidated structured entities

11 The relationships between a parent entity and its investees that are considered structured entities cover a wide spectrum. IFRS 10 provides new guidance on consolidation of structured entities. If an entity has the majority of voting rights or exposure to risks and rewards but does not have the ability to control (the power to direct the relevant activities of the investee) it should not consolidate an investee under IFRS 10.

12 IFRS 12 provides a definition of a structured entity and requires an entity to disclose qualitative and quantitative information about the nature of its interest in unconsolidated structured entities which exposes an entity to risks. EFRAG notes that these new disclosure requirements were developed by the IASB to address users' needs, particularly in light of the global financial crisis in 2008/09.

13 EFRAG notes that an entity's involvement in transactions with a structured entity can, due to the special nature and designed purpose of the entity, expose that entity to different types of risks. EFRAG understands that users welcome a framework for disclosing information on structured entities that are not consolidated, to ensure that they have sufficient information to understand an entity's involvement with those unconsolidated entities, including exposure to guarantees and commitments, potential losses and the impact on the entity's performance.

14 EFRAG has considered whether the disclosures for unconsolidated structured entities are too far reaching and will obscure the actual risks. Some constituents have expressed concern that the broad definition of unconsolidated structured entities will encompass many interests that are insignificant to the reporting entity and the disclosures in IFRS 12 will result in a mix of relevant and irrelevant information. EFRAG also observes that IFRS 12 provides guidance on how an entity should aggregate the data and that it clarifies that materiality is a key point of focus. The focus on 'materiality' is expected to help preparers to develop a consistent and understandable pattern of aggregation policies for items that have similar characteristics.

15 EFRAG also considered the disclosures an entity is required to provide when it has no interests in a structured entity at the end of reporting period, but may still be required to support the structured entity. In EFRAG's view, the information is useful to users because, as a sponsor of that structured entity, the entity can remain exposed to risk including reputational or litigation risk and commitments for ongoing support.

16 Finally, EFRAG considered to what extent the disclosures required by IFRS 12 on interests in unconsolidated structured entities overlap with the disclosures already required by IFRS 7 *Financial Instruments: Disclosures* and whether the disclosure requirements should be limited to those unconsolidated structured entities where the entity is the sponsor. Some constituents have informed EFRAG that the disclosure requirements should be limited to structured entities where the reporting entity is sponsor, and guidance on materiality should be added to explain that such individually immaterial interests in unconsolidated structured entities should not be disclosed, not even in aggregated form.

17 EFRAG notes that IFRS 12 focuses on the nature of and risks associated with an entity's interest in another entity, rather than on the specific risks arising from financial instruments, which is the focus of IFRS 7. Therefore, it could be argued that the IFRS 12 disclosures complement the disclosures required by IFRS 7, rather than duplicate them.

18 EFRAG notes that this requirement was developed in IFRS 12 specifically to address user concerns about information on off-balance sheet entities, and should result in a significant increase in transparency and useful information to users.

Significant judgements and assumptions

19 The assessment of whether an entity controls, jointly controls or significantly influences another entity requires a degree of judgement that would generally depend on factors such as complexity of the transaction and ownership structure of the underlying investee.

20 EFRAG notes that the main objective of this disclosure requirement is to develop a principle that requires an entity to disclose information about all significant judgements and assumptions made in determining the nature of its interest in another entity and the type (classification) of joint arrangement in which it has an interest.

21 EFRAG observes that IFRS 10 introduces a uniform consolidation principle and removes some of the existing 'bright lines'. Therefore, more judgement will be required to assess control when an entity holds less than the majority of voting rights – for example when determining de facto control or whether an investment fund manager is acting as an agent or as a principal, to evaluate whether a fund manager controls the underlying fund. The level of judgement will be significant, particularly when the ownership structure of the investee is complex and involves investors that are widely dispersed. In these cases, the information about the facts and circumstances and the level of judgement and assumptions made to determine control over an investee, will be relevant for users to understand the consolidation decisions taken by entities.

22 IFRS 12 also requires disclosures about significant judgements and assumptions in determining whether a joint arrangement under IFRS 11 is a joint operation or a joint venture. This assessment requires management to exercise a degree of judgement and consider all facts and circumstances to determine the classification of a joint arrangement, particularly when it is structured through a separate entity. In EFRAG's view, it will be relevant for users to understand in which situations significant judgement has been exercised and the factors that support the classification decision.

23 EFRAG notes that IAS 1 *Presentation of Financial Statements* already requires disclosure about significant judgements and assumptions made in applying the entity's accounting policies that have a significant effect on the amounts recognised in the financial statements. However, EFRAG's assessment is that the disclosure requirements in IFRS 12 are more focused on a principle about how an entity determines the nature of its interest in another entity or joint arrangement. Therefore, EFRAG considers that providing information about assumptions and judgement exercised that supports an entity's assessment will be relevant to users.

Subsidiaries with material non-controlling interests

24 IFRS 12 requires new disclosures in relation to subsidiaries with non-controlling interests (NCI) that are material to the entity. This requirement aims to address user concerns about the lack of information about NCI in relation to cash flows attributable to the shareholders of the parent entity and those attributable to the NCI.

25 In EFRAG's view, the information will enable users to understand the composition of a group and how profits will be distributed among shareholders. Furthermore, the information will help users to identify the subsidiaries that hold debt, to assess the financial situation of a particular entity structure within the group and the ability to generate cash and to fund its commitments.

26 For the reasons explained above, EFRAG' overall assessment is that the expanded disclosures will be relevant to users and help address concerns about the lack of useful information in this area.

Consolidated structured entities

27 IFRS 12 requires additional disclosures about consolidated structured entities that are not required for other non-structured subsidiaries. In particular, IFRS 12 requires an entity to disclose whether it is required, either through a contractual agreement or a special relationship (e.g. the entity being a sponsor), to provide support to a structured consolidated entity. EFRAG's overall assessment is that this disclosure should be relevant for users in order to assess the risks associated with the interest in that entity, and the level of support provided by an entity to structured entities.

28 Furthermore, EFRAG notes that this requirement refers to the provision of support by a parent or a subsidiary of the group to the consolidated structured entity. Those transactions are eliminated in the consolidated financial statements.

Interests in joint arrangements and associates

29 IFRS 12 requires additional disclosure about an entity's interests in joint arrangements (particularly joint ventures) and associates. The requirements focus mainly on joint ventures and associates that are material to the reporting entity, and require less detailed information for individually immaterial investments. The requirement aims to address concerns expressed by users about a lack of information regarding the nature and extent of risks associated with associates and joint ventures as well as the potential loss of information due to the elimination of proportionate consolidation for joint arrangements classified as joint ventures under IFRS 11.

30 EFRAG understands that users want a more comprehensive breakdown of current assets and current and non-current liabilities (in particular, cash and certain financial liabilities) to help them understand the asset and debt position of joint ventures. Furthermore, users highlighted the need for more comprehensive information about amounts reported in statement of comprehensive income that would help them when valuing an entity's investment in a joint venture that is accounted for under the equity method. The summarised financial information should be based on IFRSs and reconciled to the carrying amount of the investment in the reporting entity's financial statements. In EFRAG's view, the summarised financial information required for each joint venture and associate that is material to

the reporting entity will address some of these needs, and enhance the relevance of information provided to users. In EFRAG's view, the aggregation of information provided for individually immaterial associates and joint ventures that are accounted for under the equity method will alleviate concerns about excessive and too granular information.

31 EFRAG notes that the summarised financial information required by IFRS 12 for each material associate is less detailed than for each material joint venture. In EFRAG's view, significant influence is different from joint control. EFRAG's overall assessment is that the additional information required for interests in joint ventures is appropriate because a joint venturer is generally more involved in the operations of a joint venture, and thus the level of information required by users is likely to be different.

32 IFRS 12 requires only limited disclosure in relation to interests in joint arrangements classified as joint operations, because in those cases the joint operator recognises assets, liabilities, revenue and expense that arise from its interest in the joint operation in accordance with all applicable IFRSs and provides all the disclosures required by IFRSs. It is therefore not necessary to require further information in IFRS 12 in relation to joint operations.

<u>Venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds that have an interest in a joint venture or associate</u>

33 IFRS 12 requires the same information to be provided for interests in joint ventures and associates held by venture capital and similar organisations even, if these investees are accounted for at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

34 EFRAG considers that the summarised financial information for each material joint venture and associate will help users to obtain information that supports the fair value of the underlying investment.

<u>Conclusion</u>

35 For the reasons explained above, EFRAG's overall assessment is that IFRS 12 would result in the provision of relevant information, and therefore satisfies the relevance criterion.

Reliability

36 EFRAG also considered the reliability of the information that will be provided by applying IFRS 12. 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.

37 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness. In EFRAG's view, IFRS 12 does not raise any significant issues concerning freedom from material error and bias.

38 For the purpose of assessing reliability of information provided under IFRS 12, EFRAG has analysed separately the new disclosure requirements for all types of entities. Similar to its assessment on 'relevance', EFRAG's overall assessment is that the difference in the nature and risks for interests in different types of entities is reflected in the disclosure requirements and, therefore warrants separate assessment.

<u>Unconsolidated structured entities</u>

39 The disclosure requirements about interests in unconsolidated structured entities required by IFRS 12 are new. An entity with an interest in a structured entity will often have the information (or some of the information) required in IFRS 12, if it is used for its internal risk management purposes or for compliance with regulatory reporting.

40 However, EFRAG understands that some entities will not have all the information readily available to comply with all the requirements in IFRS 12 regarding unconsolidated structured entities, particularly when they are managed by other parties unrelated to the entity. In these cases, new processes or contractual agreements might need to be established to ensure the entity has access to the required information on a timely basis. Once entities have the processes in place, the initial concerns about reliability should diminish.

41 EFRAG notes that the disclosures required when the reporting entity has no interest in a structured entity at the reporting date are limited, and refer mainly to the events that have taken place in the reporting period (for example, income received from the structured entity and carrying amount (at the time of transfer) of all assets transferred to the structured entity). Therefore, in EFRAG's view, providing these disclosures should not cause significant issues with regard to the availability and reliability of information.

42 EFRAG is concerned that the disclosure requirement about the 'current intention' to provide financial support to an unconsolidated structured entity is forward-looking information that might raise a reliability concern. However, this type of information is already required by IFRSs. For example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* already requires disclosure of information about uncertain future events (e.g. contingent liabilities) and the requirements in IFRS 12 should not be so exceptional that they would raise additional concerns about reliability.

<u>Significant judgements and assumptions</u>

43 EFRAG notes that information about significant judgements and assumptions made in assessing control and significant influence, are already required under existing IFRSs, including IAS 1 *Presentation of Financial Statements*. Therefore, this requirement does not impose significant additional concerns with reliability.

<u>Subsidiaries with material NCI</u>

44 In EFRAG's view, entities should have all or most of the information available in respect of subsidiaries with material NCI in preparing its consolidated financial statements. Therefore, the new requirement does not raise significant reliability concerns.

Consolidated structured entities

45 IFRS 12 requires disclosures that did not exist previously. Entities that are obliged to provide financial support to consolidated structured entities, with or without having an obligation to do so, will be required to provide information in this respect. EFRAG notes that a similar type of forward-looking disclosure is already required in other IFRSs, for example IAS 37 requires an entity to provide information on contingent liabilities and provide estimates of its financial effects.

46 Therefore, EFRAG's overall assessment is that the disclosure requirements regarding the nature of risks associated with an entity's interests in consolidated structured entities should not cause significant issues with reliability of information.

Interests in joint arrangements and associates

47 IFRS 12 requires an entity to provide qualitative information and summarised financial information for each joint venture and associate that is *material* to the reporting entity.

48 In EFRAG's view, the qualitative information (name, place of business, activities) should be readily available, and would not lead to significant reliability concerns.

49 For joint ventures and associates accounted for under the equity method, the summarised financial information required by IFRS 12 should be based on the joint venture's or associate's IFRS financial statements and adjusted for group entries made at consolidation level. In addition, the standard requires the summarised financial information to be reconciled to the carrying amount of the investment in the reporting entity's financial statements.

50 For individually immaterial associates and joint ventures that are accounted for under the equity method, the information requirements are less detailed and an entity is required to provide aggregate information about the carrying amounts of those investments and limited aggregate information about profit and loss and comprehensive income.

51 EFRAG understands that in some cases, entities will need to perform additional procedures and perhaps change the reporting structures to gather the required IFRS data for investments in joint ventures and associates. However, in EFRAG's view, entities should have most of the required information and the requirements should not pose a significant reliability concern.

Venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds that have an interest in a joint venture or associate

52 IFRS 12 requires venture capital and similar entities that have interests in associates and joint ventures – that they measure at fair value and that are material to them – to provide the same type of information as required for other interests in associates and joint ventures.

53 However, for associates and joint ventures measured at fair value, the reporting entity is not required to present summarised financial information based on IFRS numbers if those numbers are not available (or difficult to obtain) and is permitted to use another basis that it needs to disclose. Therefore, this requirement should not raise significant reliability concerns.

Conclusion

54 Overall, EFRAG's overall assessment is that the disclosures required by IFRS 12 satisfy the reliability criterion.

Comparability

55 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.

56 EFRAG has considered whether IFRS 12 results 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.

57 EFRAG notes that the comparability of information provided by the disclosure requirement under IFRS12 is determined more by the provision of a general objective and aggregation guidance rather than specific disclosure requirements. For this reason, EFRAG decided to assess whether or not IFRS 12 meets the comparability criterion for the standard in its entirety.

58 The application guidance in IFRS 12 should help with consistent interpretation and application of the disclosure requirements. The standard prescribes a list of mandatory disclosures in some areas, and provides examples of additional disclosures.

59 EFRAG notes that some terms remain undefined in IFRS 12 (for example, 'sponsor', 'financial support', 'size of a structured entity') which could result in inconsistent interpretations of the underlying terms and affect comparability of information. However, in EFRAG's view, the objectives of IFRS 12 was clearly laid out in the standard, and through discussions with group entities and peers, entities will be able to develop definitions that are consistent with IFRS 12's objectives and mitigate potential loss of comparability within and between entities in the initial year(s) of implementation, while getting familiar with the requirements.

60 As discussed earlier, some of the existing disclosure requirements are new, for example existing IFRSs do not require disclosure about an entity's involvement in unconsolidated structured entities. The lack of guidance has led to divergence in practice and inconsistencies in the information provided in the notes to the financial statements in relation to risks associated with those entities. In EFRAG's view, the new set of disclosure about interests in unconsolidated structured entities should improve the comparability of information between entities.

61 IFRS 12 requires similar disclosures for interests in all joint ventures and associates that are material to the reporting entity, regardless of whether they are held by venture capital and similar organisations or by other investors. This is a change from existing IFRSs, which require only limited disclosures when an entity is a venture capital organisation or a similar entity. The objective of IFRS 12 is to set out a single source of guidance for all disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured

entities. In EFRAG's view, the disclosures in IFRS 12 have been developed as a package, which should promote consistency and coherence of the requirements thereby comparability of financial reporting.

Conclusion

62 EFRAG's overall assessment is that IFRS 12 satisfies the comparability criterion.

Understandability

63 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.

64 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.

65 EFRAG has noted that the understandability of information provided under IFRS 12 is determined more by the provision of a general objective and aggregation guidance rather than by specific disclosure requirements. For that reason, EFRAG decided to assess the understandability criterion of IFRS 12 in its entirety.

66 As mentioned under 'comparability', one of the objectives of IFRS 12 is to integrate in one standard all disclosure requirements for interests a reporting entity has in other entities, including unconsolidated structured entities.

67 EFRAG notes that IFRS 12 sets out a clear objective for all disclosures required, which is to enable users to evaluate the nature of and risks associated with its interests in other entities, and to assess the effects of those interests the financial position, financial performance and cash flows.

68 IFRS 12 requires an entity to consider the level of detail necessary to satisfy the disclosure objective and to aggregate or disaggregate disclosures, so that useful information is not obscured by either inclusion of voluminous insignificant detail or the aggregation of items that have different characteristics. IFRS 12 provides examples of aggregation criteria and requires the entity to disclose how it has aggregated the information.

69 EFRAG observes that IFRS 12 requires more comprehensive disclosures in some areas (e.g. interests in unconsolidated structured entities, summarised financial information about interests in subsidiaries with material NCI, material joint ventures and material associates). In EFRAG's view, as already explained in paragraph 7 above, if the new voluminous disclosures are not aggregated in a reasonable manner, and provided in a meaningful way, this could impact understandability of financial reporting. It could be the case, when an entity has numerous investments that are not homogeneous, in which case it cannot aggregate the information.

Conclusion

70 For the above reasons, EFRAG's overall assessment is that IFRS 12 satisfies the understandability criterion.

True and Fair

71 EFRAG has concluded that the information resulting from the application of IFRS 12 would not be contrary to the true and fair view principle.

European public good

72 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 12.

Conclusion

73 For the reasons set out above, EFRAG's overall assessment is that IFRS 12 meets the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

APPENDIX 4 – BASIS FOR CONCLUSIONS: IAS 27

EFRAG'S TECHNICAL ASSESSMENT OF IAS 27 AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IAS 27 Separate Financial Statements (IAS 27 (2011))*.*

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 IAS 27 (2011) meet the technical criteria for EU endorsement?

1 EFRAG has considered whether IAS 27 (2011) meets 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 IAS 27 (2011):

(a) is 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) meets 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, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt IAS 27 (2011).

Approach adopted for the technical evaluation of IAS 27 (2011)

2 EFRAG notes that the following changes to existing IAS 27 are mainly minor consequential amendments or clarifications of existing IFRSs:

(a) Terms and definitions;

(b) Relocation of requirements;

(c) IFRSs applicable for separate financial statements; and

(d) Disclosure.

3 In EFRAG's view, these four amendments are straightforward – they clarify or correct existing IFRSs in minor ways – and do not raise significant concerns. For this reason, they are not discussed specifically in this Appendix.

4 The more fundamental amendment to existing IAS 27 relates to the accounting for joint arrangements structured through a separate vehicle and classified as joint operations under IFRS 11. EFRAG overall assessments of IFRS 11, including this amendment, are discussed in a separate document.

5 For the above reasons, EFRAG's overall assessment is that IAS 27 (2011) satisfies the criteria of relevance, reliability, comparability and understandability.

True and Fair

6 EFRAG has concluded that the information resulting from the application of IAS 27 (2011) would not be contrary to the true and fair view principle.

European public good

7 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IAS 27 (2011).

Conclusion

8 For the reasons set out above, EFRAG's overall assessment is that IAS 27 (2011) satisfies the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

APPENDIX 5 – BASIS FOR CONCLUSIONS: IAS 28

EFRAG'S TECHNICAL ASSESSMENT OF IAS 28 AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IAS 28 Investments in Associates and Joint Ventures *(IAS 28 (2011)).*

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 IAS 28 (2011) meet the technical criteria for EU endorsement?

1 EFRAG has considered whether IAS 28 (2011) meets 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 IAS 28 (2011):

(a) is 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) meets 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, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt IAS 28 (2011).

Approach adopted for the technical assessment of IAS 28 (2011)

2 EFRAG notes that the following small changes resulting from IAS 28 (2011) are primarily clarifications of existing IFRSs or confirm existing practices in the absence of specific guidance in IFRSs:

(a) Potential voting rights;

(b) Classification as held for sale;

(c) Partial use of fair value option extended to a portion of an associate;

(d) Application of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*; and

(e) Incorporation of SIC-13 into IAS 28.

3 In EFRAG's view, amendments (a) to (d) above are straightforward – they clarify or correct existing IFRS in minor ways – and do not raise any significant new concerns. For this reason, they are not discussed specifically in this Appendix.

4 Regarding the incorporation of SIC-13 *Jointly Controlled Entities–Non-Monetary Contributions by Venturers* into IAS 28, EFRAG notes that it was not the IASB's intention to reconsider the fundamental approach to the equity method established by IAS 28 and related Interpretations, and this approach has been carried forward from existing IAS 28. As a consequence, EFRAG has not reconsidered "unchanged" accounting to IAS 28 and related Interpretations and therefore this amendment is not discussed specifically in this Appendix.

5 IAS 28 (2011) also requires that entities provide the disclosures in IFRS 12 for all investments in joint ventures and associates, including those that are held by venture capital organisations or similar entities and measured at fair value. The main effect of this change is that it triggers a requirement for additional disclosure under IFRS 12, but does not change the way these interests are measured or the entities that fall within its scope. EFRAG's overall assessments on IFRS 12, including this amendment, are discussed in a separate document.

6 Finally, IAS 28 (2011) introduces a change in accounting with respect to scenarios where an investment in an associate becomes an investment in a joint venture, or vice versa, and eliminates the requirement to remeasure the retained interest. This amendment is discussed in the paragraphs that follow.

Changes in interests held when an associate becomes a joint venture or vice versa

<u>Relevance</u>

7 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.

8 EFRAG considered whether this amendment 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.

9 The amendment eliminates the requirement to remeasure a retained interest when an entity changes its interest in an investment from an associate to a joint venture, or vice versa. In such cases, both interests will be measured using the equity method 'before' and 'after' the change. It follows that there is neither a change in the "group boundaries" nor a change in the measurement requirements, and therefore information will be relevant to users without remeasurement.

10 For the reasons stated above, EFRAG's overall assessment is that this amendment meets the relevance criterion.

Reliability

11 EFRAG also considered the reliability of the information that will be provided by applying this amendment. 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.

12 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness. EFRAG notes that this amendment does not involve significant judgement and would therefore not raise any significant issues with regard to reliability of information.

13 EFRAG's overall assessment is that this amendment satisfies 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 amendment results 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 This amendment applies to situations that involve an entity losing joint control of a joint venture and retaining significant influence in the underlying investment (an associate) and vice versa, and requires no remeasurement in such cases.

17 The purpose of this amendment is to address the accounting when an entity changes its interest in an associate to a joint venture or vice versa. EFRAG acknowledges that, in such cases, the investor-investee relationship and the nature of the interest changes. However, EFRAG notes that in both cases the underlying interests will continue to be accounted for using the equity method. In such cases the information would be more comparable from year to year as nothing has changed as it would not be necessary to remeasure the investment.

18 For this reason, EFRAG's overall assessment is that this amendment satisfies 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 notes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

21 As a result, EFRAG is of the view that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the amendment is understandable, is whether that information will be unduly complex.

22 In EFRAG's view, the amendment does not introduce any new complexities that may impair understandability. Therefore, EFRAG's overall assessment is that this amendment satisfies the understandability criterion.

True and Fair

23 EFRAG has concluded that the information resulting from the application of IAS 28 (2011) 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 IAS 28 (2011).

Conclusion

25 For the reasons set out above, EFRAG's overall assessment is that IAS 28 (2011) satisfies the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

26 EFRAG notes that the amendment relating to disclosure is assessed as part of EFRAG's overall.

APPENDIX 6 – BASIS FOR CONCLUSIONS: DEFERRAL OF THE MANDATORY EFFECTIVE DATE

1 IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities*, IAS 27 *Separate Financial Statements* (2011) and IAS 28 *Investments in Associates and Joint Ventures* (2011), referred to as ('the Standards') are effective for annual periods beginning on or after 1 January 2013, with earlier application permitted. Except for IFRS 12, if an entity applies one of the Standards earlier, it shall disclose that fact and apply the other Standards at the same time. An entity is encouraged to provide the information required by IFRS 12 earlier than annual periods beginning on or after 1 January 2013, and is permitted to provide some of the disclosures without complying with all of the requirements of IFRS 12 and without applying the other four Standards.

Approach adopted for the technical evaluation of the effective dates of the Standards

2 The European Commission Regulation (EC) No 1606/2002, requires that a Standard or an Interpretation:

(c) is 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

(d) meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

3 EFRAG believes that to produce financial reporting that meets the EU regulation endorsement criteria, financial reporting standards must not only provide for sensible accounting requirements, but also ensure that those requirements can be implemented as intended. Therefore, EFRAG considered as part of its assessment against the endorsement criteria whether the effective date of the Standards was set accordingly. Specifically, when assessing whether the Standards met the technical criteria for endorsement, EFRAG considered the evidence received from constituents that indicated that a mandatory effective date of 1 January 2013 for the Standards would result in a quality of implementation such that one or more endorsement criteria would not be met.

4 Some constituents raised a number of significant practical concerns in respect to the mandatory effective date of 1 January 2013. In particular, these constituents noted that the mandatory effective date of 1 January 2013 would not allow them sufficient time to implement the new requirements set out in IFRS 10 and IFRS 11 in a manner that would produce reliable information. These constituents indicated that they needed more time to develop a common understanding of IFRS 10 and IFRS 11 and prepare for their implementation, particularly when the requirements and necessary assessments involve significant judgement.

5 EFRAG notes that deferring the adoption of the Standards, raises concerns about loss of comparability of information, particularly when permanent differences arise as a result of differences in in the start date of application of IFRS 10 and IFRS 11. However, EFRAG believes that permanent differences would only arise in limited circumstances, as explained below. EFRAG also acknowledges that deferring the mandatory effective date would affect comparability as some entities would adopt early and others would not. EFRAG believes, however, that first and foremost, the

conditions for preparation of reliable financial reporting must be met, as a lack of reliability may result in the true and fair view principle not being met.

6 For the reasons mentioned in paragraph 4 above, which are further explained in the letter to the European Commission, EFRAG concluded that the mandatory effective date of 1 January 2013 in IFRS 10 and IFRS 11, would not allow meeting the reliability criterion, for all entities. In EFRAG's view, a deferral of the mandatory effective date to 1 January 2014, while permitting early adoption, would allow those constituents that experience the concerns noted above to ensure that their financial statements are prepared reliably, and EFRAG concluded that IFRS 10 and IFRS 11 meet the endorsement criteria. However, those constituents that do not experience the concerns noted above should not be prevented from complying with the original mandatory effective date of 1 January 2013.

7 Therefore, notwithstanding EFRAG's positive recommendation that the Standards meet the endorsement criteria, EFRAG does not support the mandatory effective date of 1 January 2013, and recommends the mandatory effective date of the Commission Regulation amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards to the Standards to be 1 January 2014 with early adoption permitted. The letter to the European Commission sets out EFRAG's findings on the concerns raised with an effective date of 1 January 2013 for the Standards.

Temporary and permanent differences resulting from a deferred effective date

8 EFRAG acknowledges that a difference in adoption dates can create both temporary and permanent differences in financial reporting between IFRS as issued by the IASB and IFRS as endorsed by the EU. The temporary difference in 2013, as a result of the application of different standards, would disappear in 2014. However, to the extent that companies are permitted to apply the Standards prospectively – as a result of transitional reliefs in those Standards – any differences in the start date of application might give rise to permanent differences that would not disappear in 2014.

9 EFRAG believes that such permanent differences would only arise in limited circumstances and they could be minimised by avoiding reliance on the transitional reliefs. Companies that need to comply with IFRS as issued by the IASB, such as those with a listing in the US, would avoid permanent differences altogether as they would adopt the Standards in 2013.

Investment entities ED

10 The Exposure Draft *Investment Entities*, issued by the IASB in August 2011, proposes an exception from consolidation for companies that meet the definition of an investment entity. In EFRAG's view, the Exposure Draft may result in a change in the scope of consolidation compared to the requirements in IFRS 10, which may lead to unnecessary cost and uncertainty for constituents. EFRAG notes that the IASB, when consulting on the proposals in the Exposure Draft, specifically asked constituents whether or not they believed that a parent entity should retain the fair value accounting applied by their subsidiaries that are investment entities. In EFRAG's view, some companies (mainly banks and insurers) might be required to start consolidation of certain investments under the current requirements of IFRS 10, but might need to adopt investment entity accounting (i.e. fair value through profit and loss accounting) once a standard on investment entities is

completed. EFRAG believes that the IASB should have finalised its decisions on the Exposure Draft, before requiring the mandatory adoption of IFRS 10.

One effective date for the Standards

11 Given the interaction between the Standards, EFRAG believes that the mandatory effective date should be the same for all the Standards.