EFRAG
European Financial Reporting Advisory Group

DRAFT ENDORSEMENT ADVICE AND EFFECTS STUDY REPORT ON AMENDMENTS TO IFRS 11: ACCOUNTING FOR ACQUISITIONS OF INTERESTS IN JOINT OPERATIONS

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS

Comments should be sent to commentletters@efrag.org by 16 July 2014

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the Amendments to IFRS 11 *Accounting for Acquisitions of Interests in Joint Operations* ('the Amendments'). In order to do that, EFRAG has been carrying out an assessment of the Amendments against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

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

Note to constituents

Amendments to IFRS 11 *Accounting for Acquisitions of Interests in Joint Operations* refers to IFRS 9 *Financial Instruments*, which has not yet been endorsed in the EU. These references to IFRS 9 are not addressed in this Draft Endorsement Advice and will be considered together with the related requirements in IFRS 9.

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

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

1 Please provide the following details about yourself:

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

Financial Reporting Council

(b) Are you a:

☐ Preparer ☐ User ☒ Other (please specify)

Regulator

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

Financial regulator and standard setter

(d) Country where you are located:

United Kingdom

(e) Contact details including e-mail address:

Annette Davis
Project Director
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS
UNITED KINGDOM

a.davis@frc.org.uk

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

(a) Do you agree with this assessment?

☒ Yes ☐ No

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

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

No.

3 EFRAG is also assessing the costs that are likely to arise for preparers and for users on implementation of the Amendments in the EU, both in year one and in subsequent

years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

The results of the initial assessment of costs are set out in paragraphs 7 and 11 of Appendix 3. To summarise, EFRAG's initial assessment is that the Amendments will not significantly affect the costs for users. One-off and ongoing costs will be affected for some preparers in industries where transactions on interests in joint operations are frequently entered into.

Do you agree with this assessment?

☒ Yes ☐ No

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

____

____

____

4 In addition, EFRAG is assessing the benefits that are likely to be derived from the Amendments. The results of the initial assessment of benefits are set out in paragraph 17 of Appendix 3. To summarise, EFRAG's initial assessments is that users and preparers are likely to benefit from the Amendments as the new requirements should enhance consistency of application and increase comparability, in areas where IFRSs were previously silent or contained limited guidance.

Do you agree with this assessment?

☒ Yes ☐ No

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

____

____

____

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

Do you agree with this assessment?

☒ Yes ☐ No

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

____

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

Do you agree that there are no other factors?

☒ Yes ☐ No

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

Appendix 1

A summary of the Amendments

Background

1 IAS 31 *Interests in Joint Ventures* did not provide guidance on how joint operators should account for the acquisition of an interest in a jointly controlled operation when the activity of the jointly controlled operation constituted a business, as defined in IFRS 3 *Business Combinations*.

2 The lack of guidance in IFRSs caused diversity in practice which was likely to continue with IFRS 11 *Joint Arrangements* (which superseded IAS 31), in relation to the accounting for acquisitions of joint arrangements that are classified as joint operations in which the activity of the joint operation constitutes a business as defined in IFRS 3, as the Standard does not provide any specific guidance on the accounting for such acquisitions.

3 The objective of the Amendments is to introduce guidance into IFRS 11 on the accounting for such transactions.

What has changed?

4 The guidance amends IFRS 11 so that the acquirer of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3:

(a) applies all of the principles of business combinations accounting in IFRS 3 and other IFRSs except for those principles that conflict with the guidance in IFRS 11; and

(b) discloses the information required by IFRS 3 and other IFRSs for business combinations.

5 The Amendments apply to both the consolidated financial statements, and separate financial statements of the investors. They apply to the acquisition of the initial interest and to any additional interests in a joint operation in which the activity of the joint operation constitutes a business. They do not apply, however, if the formation of the joint operation coincides with the formation of the business.

6 The principles of business combinations accounting that do not conflict with the guidance in the Amendments include, but are not limited to:

(a) measuring the joint operator's share of identifiable assets and liabilities at fair value, other than items for which exceptions are given in IFRS 3 and other IFRSs;

(b) recognising acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with the exception that the costs to issue debt or equity securities are recognised in accordance with IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*;

(c) recognising deferred tax assets and deferred tax liabilities that arise from the initial recognition of assets or liabilities, except for deferred tax liabilities that arise from the initial recognition of goodwill;

(d) recognising the excess of the consideration transferred over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, if any, as goodwill; and

(e) testing for impairment a cash-generating unit to which goodwill has been allocated at least annually, and whenever there is an indication that the unit may be impaired, as required by IAS 36 *Impairment of Assets* for goodwill acquired in a business combination.

7 Two illustrative examples have been introduced to provide guidance on how to apply the Amendments in the following situations:

(a) acquisition of interests in joint operations in which the activity constitutes a business (Illustrative Example 7); and

(b) contributing the right to use know-how to a joint operation in which the activity constitutes a business (Illustrative Example 8).

When do the Amendments become effective?

8 The Amendments shall be applied prospectively in annual periods beginning on or after 1 January 2016. Earlier application is permitted disclosing the fact.

Appendix 2

EFRAG's Technical assessment of the Amendments against the endorsement criteria

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments.

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

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

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

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

(a) are not contrary to the principle of 'true and fair view' set out in Article4(3) of Council Directive 2013/34/EU; and

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

2 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 the Amendments.

Relevance

3 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

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

5 EFRAG acknowledges that the acquisition of an interest in a joint operation in which the activity of that joint operation constitutes a business does not imply the

acquisition of control and therefore does not meet the definition of a business combination under IFRS 3. However, applying the guidance in IFRS 3 and other IFRSs gives a consistent set of accounting principles for the different components of all transactions involving the acquisition of a business.

6 EFRAG notes that the application of business combination principles to situations where control is not obtained is already required under IAS 28 which states that '*the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of interests in associates and joint ventures*' (paragraph 26 of IAS 28).

7 EFRAG believes that information provided by IFRS 3 and other relevant IFRSs on business combinations accounting, including the disclosures required by those Standards, is relevant for the acquisitions of interests in a joint operation in which the activity constitutes a business.

8 Measuring the joint operator's share of identifiable assets and liabilities at fair value and separately recognising goodwill, when present, generally provides relevant information about the amount at which the interests in the assets and liabilities would have been recognised if they had been acquired separately. The Amendments will enable the joint operator to reflect the expected synergies that stem from the acquisition of a joint operation where the activities constitute a business. However, EFRAG acknowledges that, in the case of acquisitions of interests in joint operations achieved in stages while maintaining joint control, the Amendments may not always result in enhanced relevance of information as each tranche of an interest in the joint operation is recognised separately on acquisition and the previously held interest is not remeasured.

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

Reliability

10 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. 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.

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

12 The Amendments require that the definition of a business in IFRS 3 be applied in determining which acquisitions are within the scope of the Amendments. This may require significant judgement by preparers, and the Amendments include examples to illustrate certain of the requirements to assist in this respect.

13 As mentioned in the assessment of the 'relevance' criterion above, the Amendments will require greater use of fair value than hitherto. Use of estimates is an essential part of the financial statements and does not undermine their reliability as long as the estimates used can be reasonably determined. Therefore, EFRAG believes that the Amendments are likely to result in financial information that is reliable as they will be based on the application of the well understood principles of

business combinations, contained in IFRS 3 and other applicable IFRSs, to new transactions entered into by all entities.

14 Finally, the Amendments shall be applied prospectively. In EFRAG's view, prospective application of the Amendments results in information that is unbiased because it prevents the undue use of hindsight. Therefore, the Amendments ensure a minimum level of reliability.

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

Comparability

16 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.

17 EFRAG has considered whether the Amendments 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.

18 EFRAG acknowledges that diversity in practice existed on how joint operators accounted for the acquisition of an interest in a jointly controlled operation under IAS 31 *Interests in Joint Ventures*, when the activity of the jointly controlled operation constituted a business. In providing guidance in an area where little or none existed, the amendments will help reduce diversity in practice that was otherwise likely to continue with IFRS 11 (which superseded IAS 31) in relation to the accounting for joint arrangements that are classified as joint operations, and therefore contribute to increased comparability. This is the case even though, due to their scope, the Amendments cover a limited set of circumstances and do not provide guidance on all aspects of acquisitions of interest in joint operations by joint operators.

19 Furthermore, EFRAG believes that the Amendments will require an entity to account for transactions involving the acquisition of an interest in a 'business' similarly, irrespective of the form that the investor's interest takes (subsidiary, joint venture, associate or joint operation). We note, in this respect, that applying the principles of business combinations to acquisitions of interests in joint operations is consistent with the current requirements applicable to the equity method under IAS 28.

20 However, EFRAG also notes that each tranche of an interest in a joint operation in which the activities constitute a business is recognised separately on acquisition if joint control is maintained. Therefore, comparability between an interest acquired in a single transaction and a similar interest acquired through more than one transaction could, in certain circumstances, be hindered.

21 Finally, the Amendments apply prospectively for transactions occurring in annual periods beginning on or after 1 January 2016. In EFRAG's view, prospective application of the Amendments could also hinder comparability between acquisitions of interests in joint operations entered into before or after the date of

application. However, EFRAG acknowledges that it may not always be practicable for an entity to retrospectively determine the fair value of the identifiable assets and liabilities without use of hindsight and, as mentioned in the assessment of the 'reliability' criterion, the need for reliable information commands prospective application.

22 Overall and on balance, EFRAG's initial assessment is that the Amendments satisfy the comparability criterion.

Understandability

23 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.

24 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.

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

26 In EFRAG's view, applying the principles of business combination accounting in IFRS 3 and other IFRSs to acquisitions of interests in a joint operation in which the activity constitutes a business results in financial information that is understandable. This is because the Amendments do not introduce new principles but apply existing accounting principles to the transactions within the scope of the Amendments.

27 EFRAG's overall initial assessment is that the Amendments satisfy the understandability criterion in all material respects.

True and Fair

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

European public good

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

Conclusion

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

Appendix 3

EFRAG's evaluation of the costs and benefits of the Amendments

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

Cost for preparers

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

3 The Amendments require that principles of business combinations in IFRS 3 *Business Combinations* and other relevant Standards are applied to account for the acquisitions of Interests in joint operations that constitute a business, to the extent that they do not conflict with the guidance in IFRS 11 *Joint Arrangements*.

4 This implies that, under the affected transactions, all the joint operation assets and liabilities are initially measured at fair value (with certain exceptions), deferred taxation is recognised, goodwill is separately recognised and tested for impairment and all the required disclosures are provided. As a consequence more information may need to be collected and processed by preparers.

5 Therefore, in EFRAG's view, it is likely that the Amendments would result in higher costs for some preparers in any industry where acquisitions and exchanges of interests in joint operations that constitute businesses are frequent.

6 We believe that the cost of implementing the new requirements will be mitigated by the following factors:

(a) The Amendments do not introduce new accounting principles but extend, to the accounting of acquisition of interests in joint operationsin which the activity constitute a business, current requirements that are already applicable to associates and joint ventures using the equity method; and

(b) The prospective application of the Amendments will reduce one-off costs of implementing the new requirements by not requiring restatement of previous acquisitions.

7 Overall, EFRAG's initial assessment is that the Amendments might result in increased one-off ongoing costs for some preparers.

Costs for users

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

9 EFRAG believes that there will be some insignificant one-off costs for users to familiarise with the new requirements in the Amendments.

10 EFRAG believes that the Amendments are not likely to result in increased ongoing costs for users as they will result in information that is more readily usable and

comparable than cost allocation, and consistently applied to new transactions entered into by entities.

11 Overall, EFRAG's initial assessment is that the Amendments are likely to result in insignificant one-off or ongoing costs for users.

Benefits for preparers and users

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

13 The Amendments address diversity in practice on the accounting for acquisitions of interests in joint operations due to the lack of specific guidance in current standards.

14 EFRAG believes that both users and preparers are likely to benefit from the outcomes of these Amendments as they are likely to result in information that is comparable and understandable without adding undue complexity.

15 Users are likely to benefit, as the information resulting from the implementation of the Amendments has greater predictive value and is more comparable between entities and therefore will enhance users' analysis.

16 The Amendments will provide clarification to preparers in selecting the appropriate accounting treatment and introduce a comprehensive and consistent set of accounting principles for the acquisition of an interest in a 'business' irrespective of the form the investor's interest takes.

17 Overall, EFRAG's initial assessment is that preparers and users are likely to benefit from the Amendments. In areas where current IFRSs were silent or contained limited guidance, the new requirements should enhance consistency of application by preparers and increase comparability for users.

Conclusion

18 EFRAG's overall initial assessment is that, on balance, the benefits that are expected to arise from the implementation of the *Amendments to IFRS 11: Accounting for Acquisitions of Interests in Joint Operations* in the EU will exceed the costs expected to be incurred.