Draft Comment Letter

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

[Date]

Dear Mr Hoogervorst,

Re: Exposure Draft ED/2017/1 *Annual Improvements to IFRS Standards 2015-2017 Cycle*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2017/1 *Annual Improvements to IFRS Standards 2015-2017 Cycle,* issued by the IASB on 12 January 2017 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG understands that the annual improvements process offers a valuable opportunity to deal efficiently with a collection of minor amendments to IFRS. EFRAG agrees that the issues addressed by the IASB within the ED meet the criteria of the IASB Due Process Handbook and therefore they should be resolved as part of the annual improvement project.

EFRAG broadly agrees with most of the proposals in the ED, but is concerned that amending IAS 12 *Income Taxes* without providing guidance on how to determine whether the payments are distributions of profits or not may not lead to an improvement compared to the current practice.

Moreover, EFRAG believes that the IASB should include an example or other guidance illustrating the application of the proposed amendment to IAS 28 *Investments in Associates and Joint Ventures*.

Lastly, whilst EFRAG understands the benefits from aligning the effective date of the amendment to IAS 28 with the effective date of IFRS 9, we are concerned about the short time period between the expected date of issuing the amendment and the proposed effective date of 1 January 2018. We consider that this will create difficulties for all jurisdictions with a translation or endorsement process, including the European Union.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Ioanna Chatzieffraimidou or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions raised in the ED

Issue 1 - IAS 12 *Income Taxes*: Income tax consequences of payments of financial instruments classified as equity

Notes to constituents

1 The issue relates to where an entity should recognise any income tax consequences of tax-deductible payments on financial instruments classified as equity – in equity or in profit or loss.

2 Paragraph 52A of IAS 12 Income Taxes states: "In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits".

3 Paragraph 52B of IAS 12 states: "In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b)."

4 The issue is whether the requirements in paragraph 52B of IAS 12 apply only in the circumstances described in paragraph 52A of IAS 12 (i.e. when there are different tax rates for distributed and undistributed profits), or whether they apply also beyond those circumstances (for example to all payments on financial instruments classified as equity if those payments are distributions of profit).

5 The IASB is proposing to clarify that the requirements in paragraph 52B (now proposed as paragraph 58A) of IAS 12 apply to all income tax consequences of dividends, however it noted that this proposed amendment should not be interpreted as meaning that an entity recognises in profit or loss the income tax consequences of all payments on financial instruments classified as equity.

6 Rather, an entity would exercise judgement in determining whether payments on such instruments are distributions of profits (i.e. dividends). If they are, then the requirements in paragraph 52B (now proposed as paragraph 58A) would apply. If they are not, then the requirements of paragraph 61A of IAS 12 apply to the income tax consequences of those payments.

7 In assessing whether to present in equity or in profit or loss the income tax consequences of payments on financial instruments classified as equity, the IASB identified that, as a result of this proposed amendment, the main assessment would be to determine whether the payments are distributions of profits and observed that IFRS 9 Financial Instruments defines dividends as distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.

8 The IASB decided, however, not to propose requirements regarding this determination mainly because including indicators or requirements that distinguish distributions of profits from other distributions would go beyond the scope of an amendment to IAS 12. It would affect several other IFRS Standards and Interpretations, with a high risk of unintended consequences if the IASB were to attempt to define or describe distributions of profits. Moreover, the IASB considers *that the amendment does not change the determination of what is, and what is not, a distribution of profits. They simply clarify that the requirements in paragraph 52B (now proposed as paragraph 58A) apply to all income tax consequences of dividends.*

9 *The IASB is proposing that the amendment is applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors for annual periods beginning on or after their effective date that has not been set yet. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.*

Question 1 - Proposed amendment to IAS 12

Do you agree with the IASB's proposal to amend IAS 12 in the manner described in the Exposure Draft?

If not, why, and what alternative do you propose?

EFRAG's response

Whilst EFRAG agrees with the proposed amendment to IAS 12 *Income Taxes*, EFRAG is concerned that amending IAS 12 without providing guidance on how to determine whether the payments are distributions of profits or not may not lead to an improvement compared to the current practice.

10 EFRAG understands that as written, paragraphs 52A and 52B could be read to imply that the requirements in paragraph 52B apply only to the circumstances described in paragraph 52A (i.e. different tax rates applied to distributed and undistributed profits or to circumstances where an entity receives tax refunds from the tax deductible payments).

11 Therefore, EFRAG welcomes the IASB's proposal to clarify that the requirements in paragraph 52B apply to all income tax consequences of dividends.

12 However, in assessing whether to present in equity or in profit or loss the income tax consequences of payments on financial instruments classified as equity, the main assessment is to determine whether the payments are distributions of profits.

13 Therefore, without disagreeing with the proposed amendment, EFRAG considers that amending IAS 12, without providing guidance on this key issue, may not lead to an improvement compared to the current situation, because we think the main diversity in practice arises from determining whether payments on financial instruments that are classified as equity are dividends or not.

14 In other words, the proposed amendment to IAS 12 will only eliminate the potential diversity in cases of payments on financial instruments that are classified as equity where it is straightforward whether the payment constitutes a dividend or not.

Questions to Constituents

15 Do you agree with EFRAG's view that pursuing the narrow-scope amendment to IAS 12, without providing some guidance on the key issue of determining whether payments on financial instruments that are classified as equity are dividends or not, may not lead to an improvement compared to the current situation? If not, why?

16 Have you encountered difficulties in practice determining whether payments on financial instruments that are classified as equity are dividends or not? If yes, can you provide some examples?

Issue 2 - IAS 23 *Borrowing Costs*: Borrowing costs eligible for capitalisation

Notes to constituents

17 The issue relates to whether an entity includes borrowings made specifically to obtain a qualifying asset in general borrowings when the qualifying asset is ready for its intended use or sale in accordance with IAS 23 Borrowing Costs.

18 Paragraph 14 of IAS 23 requires an entity, when determining the funds that it borrows generally, to exclude 'borrowings made specifically for the purpose of obtaining a qualifying asset'.

19 The IASB noted that the reference in paragraph 14 should not be interpreted to apply to borrowings originally made specifically to obtain a qualifying asset that is ready for its intended use or sale.

20 Accordingly, if any specific borrowing remains outstanding after the related asset is ready for its intended use or sale, that specific borrowing becomes part of the funds that an entity borrows generally as described in paragraph 14. The IASB is proposing to amend paragraph 14 of IAS 23 to clarify this requirement.

21 *An entity should apply the amendment to borrowing costs incurred on or after the beginning of the first annual reporting period beginning on or after their effective date that has not been set yet. Earlier application is permitted.*

22 The IASB noted that the development of a qualifying asset may take a long time and the development of some assets currently in use may have been completed many years ago. Therefore, the costs of gathering the information required to capitalise borrowing costs retrospectively may exceed the potential benefits. Accordingly, the IASB decided to propose prospective application of the proposed amendment. Earlier application is permitted.

Question 2 - Proposed amendment to IAS 23

Do you agree with the IASB's proposal to amend IAS 23 in the manner described in the Exposure Draft?

If not, why, and what alternative do you propose?

EFRAG's response

EFRAG agrees with the proposed amendment to IAS 23 *Borrowing Costs*.

23 EFRAG supports the IASB's proposal to clarify the accounting treatment of borrowing costs on completed qualifying assets, as part of the annual improvements process. EFRAG agrees that after the related asset is ready for its intended use or sale, that borrowing does not meet the definition of specific borrowing any more (i.e. borrowing made specifically for the purpose of obtaining a qualifying asset) and becomes part of the funds that an entity borrows generally as described in paragraph 14 of IAS 23.

24 Regarding the transition provision, EFRAG generally supports retrospective application of new, or amendments to existing, Standards and Interpretations.

25 However, in this case, EFRAG agrees that the proposals should be applied prospectively (i.e. only to borrowing costs incurred on or after the effective date of the amendment) as the costs for preparers of retrospective application are expected to outweigh the benefits to users in the way of decision-useful information. EFRAG notes that this decision is consistent with the previous decision of the IASB when it first introduced the requirement to capitalise borrowing costs in accordance with IAS 23.

Issue 3 - IAS 28 *Investments in Associates and Joint Ventures*: Long-term interests in an associate or joint venture

Notes to constituents

26 The issue is whether IFRS 9 Financial Instruments applies to long-term interests in an associate or joint venture that, in substance, form part of the net investment in the associate or joint venture but to which the equity method is not applied ('long-term interests'). The request to the IFRS Interpretations Committee ('IFRS IC') is whether long-term interests are within the scope of IFRS 9 and, if so, whether the impairment requirements in IFRS 9 apply to such long-term interests.

27 The IASB and the IFRS IC did not reconsider the existing requirements in IFRS 9 and IAS 28. Both bodies noted that the request was narrowly and clearly defined. They noted that any reconsideration of the accounting for long-term interests could not be undertaken as a narrow-scope project and would be likely to involve reconsideration of the equity method of accounting, a topic which is included in the IASB's pipeline of future research projects. Consequently, the focus of both bodies' discussions, and of the proposed amendment, was limited to clarifying the IASB's intention when it issued the existing requirements in IFRS 9 and IAS 28.

28 Paragraph 2.1(a) of IFRS 9 states that interests in associates and joint ventures that an entity accounts for in accordance with IAS 28 are excluded from the scope of IFRS 9. Paragraph 38 of IAS 28 requires that, in recognising its share of losses of an associate or joint venture, an entity allocates such losses to both (a) investments that it accounts for using the equity method and (b) long-term interests. The net investment, which includes long-term interests, is then subject to the impairment requirements in paragraphs 40 and 41A-43 of IAS 28. Paragraph 41 of IAS 28 states that "The entity applies the impairment requirements in IFRS 9 to its other interests in the associate or joint venture that are in the scope of IFRS 9 and that do not constitute part of the net investment".

29 The IASB noted that paragraph 41 of IAS 28 should not be read to imply that the impairment requirements in IFRS 9 do not apply to long-term interests. The IASB further noted that the expected credit loss impairment model in IFRS 9 is part of, and interlinked with, amortised cost accounting in IFRS 9. Consequently, an entity could not apply amortised cost accounting in IFRS 9 without also applying the impairment requirements in IFRS 9.

30 In addition, the IASB observed that paragraph 2.1(a) of IFRS 9 excludes only those interests in an associate or joint venture to which the equity method is applied. The IASB further noted that IAS 28 does not specify general recognition and measurement requirements for long-term interests, but only mentions them in the context of recognising losses of an associate or joint venture and impairment. Accordingly, the IASB concluded that paragraph 2.1(a) of IFRS 9 does not exclude long-term interests from the scope of IFRS 9. An entity therefore is required to apply IFRS 9, including its impairment requirement, to such long-term interests. The IASB is proposing to amend IAS 28 to clarify these requirements.

31 The IASB is proposing aligning the effective date of the proposed amendment with the effective date of IFRS 9, which is 1 January 2018, with earlier application permitted. This is because the proposed amendment clarify the applicability of IFRS 9 to long-term interests. The amendment should be applied retrospectively in accordance with IAS 8.

32 The IASB acknowledged the short period between the expected date of issuing the amendment and the proposed effective date, however, it noted the benefit for entities in applying the proposed amendment for the first time in 2018 - if an entity first applies the amendment in 2018, it would be able to use the transition relief in

IFRS 9 and incorporate the accounting for long-term interests into its IFRS 9 implementation. Those reliefs would be unavailable to an entity after it first applies IFRS 9.

33 *The IASB is also proposing to provide relief on transition from presenting comparative information if an entity does not restate comparative information in accordance with IFRS 9. The IASB is proposing similar transition requirements for insurers electing, in accordance with IFRS 4 Insurance Contracts, to apply the temporary exemption from IFRS 9.*

Question 3 - Proposed amendment to IAS 28

Do you agree with the IASB's proposal to amend IAS 28 in the manner described in the Exposure Draft?

If not, why, and what alternative do you propose?

Question 4 - Effective date of the proposed amendment to IAS 28

The IASB is proposing an effective date of 1 January 2018 for the proposed amendment to IAS 28. The reasons for that proposal are explained in paragraphs BC7-BC9 of the Basis for Conclusions on the proposed amendment to IAS 28.

Do you agree with the effective date for the proposed amendment?

If not, why, and what alternative do you propose?

EFRAG's response

EFRAG supports the IASB's decision to address the issue before IFRS 9 *Financial Instruments* becomes effective.

EFRAG generally agrees with the proposed amendment to IAS 28 *Investments in Associates and Joint Ventures*. However, EFRAG considers that the IASB should include an example or similar guidance illustrating the application of the proposed amendment.

Regarding the effective date, EFRAG considers that the IASB should propose an effective date of 1 January 2019, with earlier application permitted.

The proposed amendment

34 EFRAG understands that there is diversity in practice in the application of the requirements of IAS 39/IFRS 9 and IAS 28 to long-term interests. This is not a new issue, but with the new expected credit loss model under IFRS 9, the impact is likely to be larger. Therefore, we support the IASB's decision to address this issue.

35 EFRAG notes that the equity method project is a future research project of the IASB, where no work is expected until the Post-implementation Review ('PIR') of IFRS 11 *Joint Arrangements* is undertaken. Unless the IASB addresses this issue now, constituents would not have an answer to their question before IFRS 9 becomes effective.

36 EFRAG generally agrees with the proposed amendment to account for these long-term interests applying IFRS 9, including its impairment requirements. EFRAG considers this is consistent with the existing requirements of IFRS Standards, is the most practical way to address the issue and does not require reconsidering existing requirements.

37 EFRAG notes that long-term interests meet the definition of financial instruments and as such, they should be wholly within the scope of IFRS 9 from a classification, measurement and impairment perspective. Although we acknowledge that applying two different impairment requirements could create confusion and additional costs

to preparers, we understand that the impairment requirements of IFRS 9 and IAS 28/IAS 36 are applied to different units of account (long-term interest alone and net investment (including long-term interest) respectively).

38 This is already the case in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations,* where non-current assets that are not within the measurement requirements of IFRS 5 are first measured in accordance with applicable Standards, including the impairment requirements. Then, those non-current assets become part of a disposal group, which is measured at the lower of its fair value less costs of disposal and its carrying value.

39 Therefore, given that the IASB does not wish to open the equity method topic at the moment, the most appropriate solution would be to apply the impairment requirements of both IFRS 9 and IAS 28 to these long-term interests.

40 However, EFRAG observes that some form of clarification is needed, because as currently drafted, the proposed amendment is not clear on the sequence of the steps that entities need to take related to impairments under both standards.

41 As there is an overlap between the requirements of IFRS 9 and IAS 28 to long-term interests, EFRAG considers it is necessary to include an example or some related guidance illustrating the application of the proposed amendment. This example/guidance would not stray into the application of the equity method, but would illustrate that an entity:

(a) first applies the impairment requirements of IFRS 9 to long-term interests;

(b) second, recognises any share of losses of an associate or joint venture in accordance with paragraph 38 of IAS 28;

(c) third, assesses the net investment for impairment in accordance with paragraphs 40 and 41A-43 of IAS 28; and

(d) finally, ignores losses or impairment allocated under IAS 28/IAS 36 when applying IFRS 9 in subsequent periods to long-term interests.

42 EFRAG observes that there are no specific requirements in IAS 28 on how to allocate impairment of the net investment as a whole to the different components of the net investment (i.e. the investment accounted for using the equity method and long-term interests).

43 Although EFRAG is of the view that there should be clarity on whether or how to allocate such impairment losses among the components of the net investment, we think that this issue could not be resolved within the Annual Improvements process and would require an amendment to IAS 28. However, we note that the IASB staff has identified that it would be rare (if ever) that an entity would recognise an IAS 28/IAS 36 impairment loss relating to long-term interests, especially if losses have been allocated to those long-term interests applying the loss allocation requirements in IAS 28. If this is the case, then the necessary clarity can be addressed in the IASB's equity method project.

44 Lastly, EFRAG acknowledges the view that where a long-term interest is in substance part of the 'net investment', it is akin to an equity interest and it would therefore make sense to account for it in the same way as the equity investment. However, should these interests be scoped out of IFRS 9, there would be no basis for classifying and measuring them. As these interests cannot be accounted for using the equity method, (they are subject to only one part of the equity method procedures), it would be necessary to develop guidance on their measurement.

Effective date and transition

45 EFRAG understands the benefits from aligning the effective date of the amendment with the effective date of IFRS 9. However, EFRAG is concerned about the short

time period between the expected date of issuing the amendment to IAS 28 and the proposed effective date of 1 January 2018. We consider that this will create difficulties for all jurisdictions with a translation or endorsement process, including the European Union.

46 Therefore, we recommend that the IASB includes an effective date of 1 January 2019, with earlier application permitted. This would allow entities to early apply the amendment, if they want to take advantage of the transition reliefs in IFRS 9.

Questions to Constituents

47 Do you agree with EFRAG's view that the IASB should include an example or guidance illustrating the proposed amendment, as described in paragraph 41 above? If not, why, and what alternative do you propose?

48 Do you think it would be usual in practice that an entity would recognise an impairment loss under IAS 28/IAS 36 relating to long-term interests, if losses have been allocated to those long-term interests applying the loss allocation requirements in IAS 28?

49 Do you agree with EFRAG's suggestion that the IASB should consider an effective date of 1 January 2019, with earlier application permitted?