EFRAG's Letter to the European Commission Regarding Endorsement of Transfers of Investment Property

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European Commission
1049 Brussels

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Dear Mr Guersent

Adoption of *Transfers of Investment Property*

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, EFRAG is pleased to provide its opinion on the *Transfers of Investment Property (Amendments to IAS 40)* ('the Amendments'), which was issued by the IASB on 8 December 2016. An Exposure Draft of the Amendments was issued on 19 November 2015. EFRAG provided its comment letter on that Exposure Draft on 25 March 2016.

The objective of the Amendments is to reinforce the principle in IAS 40 *Investment Property* that a property should be transferred to, or from, investment property when there is evidence that a change in use has occurred.

The Amendments become effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. A description of the Amendments is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and not be contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, took the comments received in response 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.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

Based on the above reasoning, EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raise no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in its interaction with other IFRS and that all necessary disclosures are required. Therefore EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that adopting the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background to the Amendments

1 The IFRS Interpretations Committee (the 'Interpretations Committee') was asked to provide guidance that would address the lack of clarity and diversity in practice on whether an entity transfers property under construction or development previously classified as inventory to investment property when there is evidence of a change in use but the evidence is not one of the types specifically listed in paragraph 57 of IAS 40 *Investment Property.*

2 The Interpretations Committee reported to the IASB that it had observed diversity in practice on the interpretation of paragraph 57 of IAS 40. Consequently, the IASB addressed the issue by publishing *Transfers of Investment Property (Amendments to IAS 40)* ('the Amendments').

The issue and how it has been addressed

3 The Amendments clarify that an entity should transfer property under construction or development to, or from, investment property when there is a change in the use of such property.

4 The Amendments reinforce the principle in IAS 40 that a property should be transferred to, or from, investment property when there is evidence that a change in use occurred by clarifying that a change in use would involve:

(a) an assessment of whether a property meets, or has ceased to meet, the definition of investment property; and

(b) supporting evidence that a change in use has occurred.

5 The Amendments also re-characterise the list of circumstances in paragraph 57 of IAS 40 as non-exhaustive examples to maintain consistency with the principle for transfers of investment property in paragraph 57.

6 Finally, the Amendments amend two examples in paragraph 57 so that the examples also address a change in use of properties under construction or development.

When do the Amendments become effective?

7 The Amendments apply for annual periods beginning on or after 1 January 2018 with earlier application permitted.

8 The Amendments require that entities reassess the classification of property held at the date of initial application and, if applicable, reclassify property to reflect its use at that date in accordance with the requirements in IAS 40.

9 The Amendments permit retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* if the information necessary is available without the use of hindsight.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

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 (the IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (the Accounting Directive); 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 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive'* (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether they meet all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 7 to 13;

(b) reliability: paragraphs 14 to 19;

(c) comparability: paragraphs 20 to 25;

(d) understandability: paragraphs 26 to 30;

(e) whether overall they lead to prudent accounting: paragraphs 31 to **Error! Reference source not found.**; and

(f) whether they would not be contrary to the true and fair view principle: paragraphs 34 to 36.

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. Information is also relevant when it assists in evaluating the stewardship of management.

8 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 they would result in the omission of relevant information.

9 EFRAG considers that appropriately reflecting a change in the use of property in the financial statements is essential to the provision of relevant information, as this may have a significant effect on the accounting for the property (i.e. as property, plant and equipment, inventory or investment property).

10 EFRAG notes that the IASB had identified circumstances where clarity was needed in the interpretation of paragraph 57 and, in particular, whether an entity should transfer property under construction or development to, or from, investment property when there is a change in the use of such property, supported by evidence other than the circumstances listed in paragraph 57(a)–(d).

11 EFRAG considers that, by addressing this diversity in the interpretation of the guidance in IAS 40, the Amendments will support consistent accounting for a change in use of property and will therefore result in the provision of relevant information.

12 EFRAG observes that the Amendments require prospective application whereby an entity would reassess the classification of property at the date of initial application and, if applicable, reclassify property to reflect its use at that date. EFRAG considers that any negative effect of this transition method on the relevance of the information provided will be limited as this only relates to any gain or loss on a change in use that would have arisen during the comparative period. Furthermore, EFRAG observes that entities have the possibility to apply the Amendments retrospectively if the information necessary is available without the use of hindsight.

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

Reliability

14 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.

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

16 EFRAG observes that appropriately reflecting a change in use is essential to faithfully represent a property in the financial statements. This follows because the classification of property may affect subsequent measurement (that is, measurement at cost, amortised cost or at fair value through profit or loss) and presentation (such as accounting for changes in the carrying amount of the asset in the income statement or the inclusion of the property in the appropriate line item of the statement of financial position).

17 EFRAG notes that, prior to the Amendments, the guidance in IAS 40 could have been read to limit a change in use of property to, or from, investment property only in the circumstances specifically listed in paragraph 57 of the Standard.

18 EFRAG assesses that the Amendments will support the faithful representation of property by clarifying that a property should be transferred to, or from, investment property when there is evidence that a change in use has occurred, irrespective of whether the circumstances are specifically listed in paragraph 57 of IAS 40.

19 EFRAG's overall assessment is that the Amendments result in reliable information.

Comparability

20 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.

21 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.

22 EFRAG observes that paragraph 57 of IAS 40 could be interpreted differently, which could result in a change in use that is economically similar being accounted for differently.

23 EFRAG therefore assesses that the Amendments will result in more comparable information by reinforcing the principle that a property should be transferred to, or from, investment property when there is evidence that a change in use occurred.

24 In respect of the transitional provisions included in the Amendments, EFRAG acknowledges that allowing both prospective and retrospective application negatively affects the comparability of the information provided in the financial statements. However, EFRAG notes that a reclassification of a property does not always require a restatement of the amounts recognised (that is, when the property was sold in a prior annual period or when it continues to be measured at amortised cost) and that the negative effect is limited to the comparative periods. EFRAG therefore expects that the impact on comparability will not be significant.

25 EFRAG considers that the Amendments address existing divergence in respect of accounting for changes in use of property. This will bring consistency in accounting, and therefore will increase comparability between entities. Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

26 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.

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

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

29 EFRAG observes that the Amendments do not introduce new requirements, but only reinforce a principle that already existed in IAS 40. EFRAG therefore expects that, by addressing divergence in the interpretation of the existing guidance and providing additional examples, the Amendments are expected to reduce existing complexity.

30 In EFRAG's view, the Amendments do not introduce any complexity that may impair understandability. Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

31 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

32 As previously noted, EFRAG observes that the Amendments reinforce the principle that a property should be transferred to, or from, investment property when there is evidence that a change in use occurred. Accordingly, the Amendments ensure that a change in use of a property is reflected in the financial statements. However, EFRAG notes that the Amendments do not amend the accounting requirements that an entity would need to apply to the property that is transferred to, or from, investment property.

33 Therefore, EFRAG assesses that the Amendments are neutral to prudence.

True and Fair View Principle

34 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

35 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS. In particular, EFRAG observes that the Amendments aim to clarify the application of guidance on the change in use of a property in IAS 40 that, as evidenced during the discussions of the Interpretations Committee, could be interpreted in different ways. Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

36 EFRAG notes that the Amendments do not include any new disclosure requirements. EFRAG has concluded that no additional disclosures are necessary as sufficient disclosures on the matters concerned are already required in existing IFRS.

37 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

38 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to adopt the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments are designed to reinforce the principle in IAS 40 *Investment Property* that a property should be transferred to, or from, investment property when there is evidence that a change in use has occurred. The Amendments provide additional guidance in accounting for a change in use by clarifying that circumstances other than those listed in paragraph 57 of IAS 40 can result in reclassifying a property to, or from, investment property.

4 The Amendments also clarify that a change in use would involve:

(a) an assessment of whether a property meets, or has ceased to meet, the definition of investment property; and

(b) supporting evidence that a change in use has occurred.

5 In addition, EFRAG observes that, in their feedback to EFRAG on the proposals in the Exposure Draft, all respondents supported the IASB's proposed amendments.

6 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of the Amendments

7 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

8 EFRAG published its initial assessment on 21 February 2017. It invited comments on the material by 20 March 2017. In response, EFRAG received six comment letters. All respondents agreed with EFRAG's assessment of the benefits of implementing the Amendments and the associated costs involved for users and preparers. All respondents therefore supported EFRAG's recommendation that the Amendments be adopted for use in Europe. Based on its initial analysis and stakeholders' views

on that analysis, EFRAG's detailed final analysis of the costs and benefits of the Amendments is presented in the paragraphs below.

Cost for preparers

~~8~~9 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

~~9~~10 EFRAG observes that, as the Amendments are reinforcing an existing principle in IAS 40, the main cost for preparers will be the one-off cost to familiarise themselves with the guidance and for updating internal documents and/or staff if these would be affected by the Amendments.

~~10~~11 EFRAG acknowledges that the Amendments require that entities reassess the classification of property held at the beginning of the annual reporting period in which the entity first applies the Amendments. However, EFRAG notes that, in many cases, the Amendments are, at most, expected to confirm the current application of the requirements in IAS 40. The Amendments are therefore not expected to result in a significant increase in costs for preparers. It may even lead to a reduction in costs for preparers in that they will reduce the time spent by clarifying the meaning of the guidance, thereby reducing complexity.

~~11~~12 As the Amendments are not introducing new requirements in IAS 40, EFRAG does not expect preparers to incur additional ongoing costs due to the application of the Amendments.

~~12~~13 Overall, EFRAG's assessment is that the Amendments will not result in increased costs to preparers, i.e., they are likely to be cost neutral.

Costs for users

~~13~~14 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

~~14~~15 As mentioned above, the Amendments are not intended to change the accounting under IAS 40, but only reinforce the existing principle that a property should be transferred to, or from, investment property when there is evidence that a change in use occurred.

~~15~~16 Therefore, EFRAG's assessment is that no additional one-off costs are expected to be incurred by users as a result of the initial application of the Amendments.

~~16~~17 For that same reason, EFRAG also considers that the Amendments will not result in increased ongoing costs for users.

~~17~~18 Overall, EFRAG's assessment is that implementation of the Amendments will not result in increased costs to users; that is, they are likely to be cost neutral.

Benefits for preparers and users

~~18~~19 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

~~19~~20 EFRAG observes that the Amendments improve guidance in IAS 40 that could be interpreted in different ways. Therefore, in EFRAG's opinion, users will benefit from a more consistent application of the requirements in IAS 40 as this will improve the resulting financial information on properties.

~~20~~21 EFRAG considers that preparers are expected to benefit from:

(a) the improved wording in the guidance that will reduce the effort required to determine how the guidance should be interpreted; and

(b) the additional examples that consider a change in use of properties under construction or development.

~~21~~22 Overall, EFRAG's assessment is that both users and preparers are likely to benefit from the Amendments.

Conclusion on the costs and benefits of the Amendments

~~22~~23 EFRAG's overall assessment is that the overall benefits of a more consistent application of the guidance in IAS 40 are likely to outweigh the minor costs associated with implementing the Amendments. EFRAG does not anticipate any ongoing costs of complying with the Amendments.

Conclusion

~~23~~24 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to current guidance. As such, their adoption is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

~~24~~25 EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

~~25~~26 Furthermore, EFRAG has considered whether there are any other factors that would mean adoption is not conducive to the public good and has not identified any such factors.

~~26~~27 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that adopting the Amendments is conducive to the European public good.