EFRAG
European Financial Reporting Advisory Group

# EFRAG's Letter to the European Commission Regarding Endorsement of Annual Improvements to IFRS Standards 2015-2017 Cycle

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European Commission
1049 Brussels

[dd Month] 201X

Dear Mr Guersent

**Endorsement of *Annual Improvements to IFRS Standards 2015-2017 Cycle***

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 *Annual Improvements to IFRS Standards 2015-2017 Cycle* ('the Amendments'), which was issued by the IASB on 12 December 2017. The Amendments comprise amendments to four Standards. The Exposure Drafts, related to those amendments, were issued on 12 January 2017 (ED/2017/1) and on 28 June 2016 (ED/2016/1). EFRAG provided its comment letters on those Exposure Drafts on 19 April 2017, and on 9 November 2016, respectively.

The objective of the Amendments is to address non-urgent but necessary issues discussed by the IASB during the project cycle that began in 2015 on areas of inconsistency in IFRS Standards or where clarification of wording is required.

The Amendments become effective for annual periods beginning on or after 1 January 2019, with earlier application permitted. A detailed description 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 are not 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.

**Do the Amendments meet the IAS Regulation technical endorsement criteria?**

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 raises no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in its interaction with other IFRS Standards 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?**

In EFRAG's assessment of whether the Amendments would be conducive to the European public good, EFRAG has assessed whether the Amendments would improve financial

reporting, would reach an acceptable cost-benefit trade-off, and whether the Amendments could affect economic growth.

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 endorsing 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, raises 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 without further delay.

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 of the Amendments

1 The IASB has adopted an annual process to deal with non-urgent, but necessary, Amendments to IFRS Standards (the annual improvements process). Issues dealt with in this process arise from matters raised by the IFRS Interpretations Committee and suggestions from staff or practitioners and focus on areas of inconsistency in IFRS Standards or where clarification of wording is required.

2 The IASB published *Annual Improvements to IFRS Standards 2015-2017 Cycle* (henceforth referred to as 'the Amendments') together with the related Basis for Conclusions on 12 December 2017.

3 The Amendments, were issued in draft form on 28 June 2016 in Exposure Draft ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests*, and on 12 January 2017 in Exposure Draft ED/2017/1 *Annual Improvements to IFRS Standards 2015-2017 Cycle*.

4 Set out below is a description of each of the amendments made to current Standards.

### The issues and how they have been addressed

*Issue 1 - IFRS 3 Business Combinations and IFRS 11 Joint Arrangements: Previously held interest in a joint operation*

5 The issue is related to the observed diversity in practice regarding acquisitions of interests in businesses that are joint operations.

Obtaining control over joint operation

6 The IASB observed that entities, on obtaining control of a business that is a joint operation, accounted for their previously held interest in the joint operation differently. The IASB concluded that such a transaction results in a significant change in the nature of, and economic circumstances surrounding, any interest in the joint operation.

7 Therefore, the Amendments clarify that such a transaction is a business combination achieved in stages and the acquirer shall apply the relevant requirements of IFRS 3, including remeasuring the entire previously held interest in the joint operation.

Obtaining joint control over joint operation

8 The IASB also observed that entities, on obtaining joint control of a business that is a joint operation, accounted for their previously held interests in the joint operation differently. The IASB concluded that although such a transaction changes the nature of the interest in a joint operation, it does not result in a change in the group boundaries and, in this respect, the transaction is similar to an investment in an associate becoming an investment in a joint venture.

9 Therefore, the Amendments clarify that when a party, that participates in but does not have joint control over a joint operation in which the activity constitutes a business, obtains joint control over that joint operation, the previously held interests are not remeasured.

*Issue 2 – IAS 12 Income Taxes: Income tax consequences of payments on financial instruments classified as equity*

10 This issue is related to the observed diversity in practice for income tax consequences of distributions on financial instruments classified as equity. This diversity resulted from the ambiguity of the application scope of requirements of paragraph 52B of IAS 12.

11 Paragraph 52B of IAS 12 explains when the tax consequences of distributions should be recognised in or outside profit or loss. However, it was not clear if paragraph 52B applied only in the circumstances indicated in paragraph 52A – that is when the distribution results in the application of a higher or lower income tax rate than usual.

12 The IASB noted that the reason for the income tax consequences of dividends, which are defined in IFRS 9 as 'distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital', should not affect where those income tax consequences are recognised. Moreover, those consequences are more directly linked to past transactions or events that generated distributable profits. Furthermore, linking the recognition of the income tax consequences of dividends to how the tax consequences arise would lead to arbitrary results and a lack of comparability across entities in different tax jurisdictions.

13 The Amendments accordingly clarify that the requirements apply to all income tax consequences of dividends and move them to paragraph 57A. The new paragraph 57A requires recognising the income tax consequences of dividends according to where the past transactions or events that generated distributable profits have been recognised.

*Issue 3 – IAS 23 Borrowing Costs: Borrowing costs eligible for capitalisation*

14 The issue is related to accounting for borrowing costs. In accordance with IAS 23, an entity needs to distinguish and treat differently borrowing costs from funds borrowed specifically to obtain a qualifying asset and funds borrowed generally to obtain a qualifying asset. It was however not clear whether the funds borrowed specifically need to be transferred to the pool of generic funds, after the qualifying asset has been completed and is ready for its intended use or sale.

15 The amended paragraph 14 of IAS 23 clarifies that if a specific borrowing remains outstanding after the qualifying asset is ready for its intended use or sale, it becomes part of the funds an entity borrows generally.

**When do the Amendments become effective?**

16 The Amendments become effective for annual reporting periods beginning on or after 1 January 2019, with earlier application permitted. However, individual amendments prospectively apply as follows.

<u>Transition</u>

*Issue 1 - IFRS 3 Business Combinations and IFRS 11 Joint Arrangements: Previously held interest in a joint operation*

17 The amendments to IFRS 3 prospectively apply to business combinations for which the acquisition date is on or after the beginning of the annual reporting period in which the entity first applies those amendments.

18 The amendments to IFRS 11 prospectively apply to transactions in which an entity obtains joint control on or after the beginning of the annual reporting period in which the entity first applies those amendments.

*Issue 2 – IAS 12 Income Taxes: Income tax consequences of payments on financial instruments classified as equity*

19 The amendments to IAS 12 prospectively apply to the income tax consequences of dividends recognised on or after the beginning of the earliest comparative period of the annual reporting period in which the entity first applies those amendments.

*Issue 3 – IAS 23 Borrowing Costs: Borrowing costs eligible for capitalisation*

20 The amendments to IAS 23 prospectively apply to borrowing costs incurred on or after the beginning of the annual reporting period in which the entity first applies those amendments.

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

**Notes to Constituents:**

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606/2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments leads to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

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 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 IFRS 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 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 notes that the three subjects addressed by the Amendments i.e.

(a) IFRS 3 *Business Combinations* and IFRS 11 *Joint Arrangements: Previously held interest in a joint operation*;

(b) IAS 12 *Income Taxes: Income tax consequences of payments on financial instruments classified as equity*; and

(c) IAS 23 *Borrowing Costs: Borrowing costs eligible for capitalisation*

are clarifications of existing IFRS Standards.

7 In EFRAG's view, the above amendments to existing IFRS Standards are straightforward and not controversial. They do not include any measurement requirements that could give rise to significant concerns about relevance or reliability. By clarifying existing IFRS Standards in some – albeit small – way, they make the Standards easier to apply consistently, thus increasing understandability, without raising any new concerns. As they are straightforward clarifications, they do not raise any issues about prudence.

8 In EFRAG's view, the Amendments do not involve changes to the existing accounting requirements or additional guidance on the implementation of those requirements which could affect the relevance and reliability of financial information. Consequently, they have been discussed collectively in this Appendix except for the following assessment of year-by-year comparability of financial statements.

*Comparability*

9 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.

10 In assessing comparability, EFRAG has considered the following issues:

(a) avoiding future diversity in practice;

(b) transition requirements.

11 EFRAG observes that the Amendments clarify the existing requirements of IFRS 3, IFRS 11, IAS 12, and IAS 23 and addresses the existing divergence. Therefore, in EFRAG's opinion, the Amendments will bring consistency in accounting for previously held interest in a joint operation, income tax consequences of payments on financial instruments classified as equity and borrowing costs eligible for capitalisation. Consequently, applying the Amendments will increase comparability between entities.

12 Regarding the transition requirements, EFRAG notes that the Amendments shall prospectively apply to transactions beginning from the first application. Therefore, applying the Amendments may disrupt year-by-year comparability of an entity's financial statements.

13 Generally, EFRAG considers retrospective application of new requirements appropriate. However, in the case of the Amendments, EFRAG agrees that retrospective application may have been burdensome due to the following:

(a) retrospective application of the amendments to IFRS 3 may have required the use hindsight to remeasure the entity's previously held interest;

(b) the costs of retrospective application of the amendments to IFRS 11 are expected to outweigh the benefits to users in the way of decision-useful information;

(c) retrospective application of the amendments to IAS 12 could affect only components of equity as at the beginning of the earliest comparative period, and therefore the costs of application would exceed the benefits for users in the way of decision-useful information; and

(d) the costs of gathering the information required to capitalise borrowing costs retrospectively may be significant and the nature of each development generally varies; therefore, retrospective application might not provide useful trend information to users of financial statements and the costs of applying the amendments retrospectively might exceed the potential benefits of doing so.

14 Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

**True and Fair View Principle**

15 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 Standards, 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.

16 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards. In particular, the Amendments introduce additional guidance for preparers, improve clarity, and make IFRS Standards easier to apply. 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.

17 EFRAG has concluded that the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.

18 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**

19 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 endorse 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 is likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments are designed to clarify existing guidance for preparers and thereby improve clarity and make IFRS Standards easier to apply.

4 EFRAG has therefore concluded that the Amendments may provide some improvements to the quality of financial reporting, although, they may not eliminate all sources of diversity under certain conditions.

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

5 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, 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.

6 EFRAG's initial assessment is that, regarding costs for preparers, the Amendments would:

(a) create a one-off cost for preparers in reading, understanding the Amendments, and eventually updating their accounting policies, but that cost will be insignificant. There will be no additional cost in gathering disclosure information; and

(b) regarding issue 2 i.e. amendments to IAS 12, create a one-off cost to restate the comparative information, however this cost is not expected to be significant.

7 EFRAG's initial assessment is that, regarding costs for users, the Amendments would create a one-off insignificant cost for users in reading and understanding the Amendments.

8 EFRAG's initial assessment is that the benefits from clarity of financial information to be derived from implementing the Amendments are likely to outweigh any costs involved for preparers or users.

**Conclusion**

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

10 EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth.

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

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