EFRAG
European Financial Reporting Advisory Group

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Comments should be submitted by 5 August 2019.

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX Month 2019]

Dear Mr Hoogervorst,

Re: Exposure Draft ED/2019/2 *Annual Improvements to IFRS Standards 2018-2020*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2019/2 *Annual Improvements to IFRS Standards 2018-2020* issued by the IASB on 21 May 2019 (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 Standards in the European Union and European Economic Area.

EFRAG generally agrees with the proposals in the ED and considers that these minor changes will improve the consistency and understandability of the IFRS standards concerned. However, EFRAG proposes that:

(a) *Issue 2*: IAS 39 *Financial Instruments: Recognition and Measurement* be amended in the same way as the amendment proposed to IFRS 9 *Financial Instruments*; and

(b) *Issue 3:* additional guidance to be added to IFRS 16 *Leases* on where the reimbursement of leasehold improvements may be considered as a lease incentive.

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 EFRAG Technical Managers Galina Borisova, Ricardo Torres 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 - IFRS 1 *First-time Adoption of International Financial Reporting Standards:* Subsidiary as a first-time adopter

Notes to constituents – Summary of proposals in the ED

2 The issue relates to the accounting for the cumulative translation differences by a subsidiary that becomes a first-time adopter of IFRS Standards later than its parent. More precisely, whether the subsidiary is permitted to recognise cumulative translation differences at the amount that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs by applying paragraph D16(a) of IFRS 1.

3 This issue was discussed by IFRS IC in March and September 2017 which concluded that the exemption in paragraph D16(a) of IFRS 1 does not apply to the cumulative translation differences.

4 Paragraph D16(a) applies only to assets and liabilities and not to components of equity. In addition, the relief in D16(a) is an exemption and exemptions in IFRS 1 cannot be applied by analogy to other items. Accordingly, a subsidiary that becomes a first-time adopter later than its parent would apply paragraphs D12–D13 of IFRS 1 to the cumulative translation differences at its date of transition to IFRSs. Applying these paragraphs, the subsidiary would be required to keep two parallel sets of accounting records for the cumulative translation differences.

5 Consequently, based on the rationale in paragraph BC60 of IFRS 1, the IASB proposes that the exemption provided by paragraph D16(a) be an option for the measurement of the subsidiary's cumulative translation differences. The IASB concluded that extending the exemption to cumulative translation differences would reduce costs for first-time adopters without being detrimental to users of financial statements. This is because IFRS 1 already provides an exemption relating to cumulative translation differences and, thus, extending the exemption in paragraph D16(a) would not diminish the relevance of information reported by a subsidiary that become a first-time adopter later than its parent.

6 The IASB also considered, but decided against, extending the scope of the proposed amendment to other components of equity, such as:

(a) *remeasurement of pensions plans;*

(b) *cash flow hedge reserve;*

(c) *unrealised gain/loss on financial instruments; and*

(d) *revaluation surplus for property plant and equipment.*

7 The IASB concluded that extending the exemption in paragraph D16(a) to those other components of equity is unnecessary because, for example, no difference between the amounts reported by a subsidiary and its parent would arise for those components, or a subsidiary would be able to avoid any potential difference by applying (or not applying) some exemptions in IFRS 1.

8 In addition, the IASB considered, but decided against, permitting or requiring entities that previously applied IFRS 1 to apply the proposed amendment. This is because doing so would:

(a) *provide no additional cost relief for entities; and*

(b) *potentially confuse users of financial statements.*

9 *This proposed amendment would also apply to an associate or joint venture that elects to apply paragraph D16(a) of IFRS 1.*

10 The IASB proposes to permit earlier application. If an entity applies the amendment early, it shall disclose that fact.

Question 1: Proposed amendments to IFRS 1

11 Do you agree with the IASB's proposal to amend IFRS 1 and accompanying documents in the manner described in the Exposure Draft?

12 If not, why not, and what do you recommend instead?

EFRAG's response

EFRAG agrees with the IASB's proposal to amend IFRS 1 by extending the optional exemption in paragraph D16(a) to cumulative translation differences of a subsidiary that becomes a first-time adopter later than its parent.

13 EFRAG supports the IASB's proposal to extend the optional exemption in paragraph D16(a) of IFRS 1 to cumulative translation differences of a subsidiary that becomes a first-time adopter later than its parent. This amendment will increase the internal consistency of IFRS 1, reduce the costs of the first-time adopters of IFRSs and not be detrimental to users of financial statements. EFRAG also supports this optional exemption being available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

14 In addition, EFRAG supports the IASB's proposal to permit earlier application as this makes the relief available before the effective date.

Issue 2 - IFRS 9 *Financial Instruments:* Fees included in the '10 per cent' test for derecognition of financial liabilities

Notes to constituents – Summary of proposals in the ED

15 The IFRS IC received a request to clarify which fees an entity includes in the '10 per cent' test in deciding whether to derecognise a financial liability that has been modified or exchanged. That is whether the entity should include only fees paid to, or received from, the lender or also directly attributable third-party fees.

16 The IASB agreed with this proposal as in its view this clarification aligns with the objective of the 10 per cent test to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows between the borrower and lender. The IASB also considered that including cash flows paid to or received from parties other than the borrower and lender would go beyond assessing the difference between the old and new contractual terms.

17 Based on the IFRS IC conclusions, the IASB proposes to amend IFRS 9 paragraph B3.3.6 and add paragraph B3.3.6A to clarify that the reference to fees in the 10 per cent test includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf. In the view of the IASB, the significance of any difference between the old and new contractual terms depends on the changes in the contractual cash flows between the borrower and lender. The IASB also considered that including cash flows paid to or received from parties other than the borrower and lender would go beyond assessing the difference between the old and new contractual terms.

18 The IASB proposes to apply the amendment prospectively with an earlier application permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

19 The IASB decided not to propose an amendment to paragraph AG62 of IAS 39 Financial Instruments: Recognition and Measurement which includes the same requirements as those in paragraphs B3.3.6 of IFRS 9. This is because any such amendment would apply only to a limited number of insurance entities for a limited period of time (until the effective date of IFRS 17 Insurance Contracts).

Question 2: Proposed amendments to IFRS 9

20 Do you agree with the IASB's proposal to amend IFRS 9 and accompanying documents in the manner described in the Exposure Draft?

21 If not, why not, and what do you recommend instead?

EFRAG's response

EFRAG agrees with the IASB's proposal to amend IFRS 9 by clarifying what fees an entity should include in a '10 per cent' test for derecognition.

EFRAG considers that a similar amendment should be made to IAS 39.

22 EFRAG supports the IASB's proposal.

23 EFRAG considers that the proposal will clarify the application of the '10 per cent' test for derecognition consistently with the IASB's original purpose in including the '10 per cent' test in IFRS 9. The proposed clarification will also avoid diversity in practice.

24 EFRAG notes the IASB's decision not to propose an amendment to IAS 39, on the basis of the limited applicability of IAS 39. However, EFRAG recommends that IAS 39 and IFRS 9 remain consistent where they have equivalent provisions. Consequently, EFRAG proposes that a similar amendment is made to IAS 39.

25 Although EFRAG generally supports retrospective application, EFRAG notes that the IASB's research indicates that the benefits of the retrospective application will not outweigh the costs and will not, in majority of cases, change the outcome of the '10 per cent' test. Therefore, in this case, EFRAG supports prospective application of the amendments.

Issue 3 - Illustrative Examples accompanying IFRS 16 *Leases:* Lease incentives

Notes to constituents – Summary of proposals in the ED

26 The issue relates to the potential confusion regarding the treatment of lease incentives resulting from Illustrative Example (IE) 13 accompanying IFRS 16. In particular, it is unclear why, in IE13 based on the limited facts provided, the lessee does not consider the reimbursement relating to leasehold improvements to be a lease incentive as defined in IFRS 16.

27 The IASB developed IE13 to illustrate requirements in IFRS 16 for initial and subsequent measurement of a right-of-use asset and lease liability. IE13 concludes that the lessee does not account for the payments relating to leasehold improvements as a lease incentive but applies other relevant Standards. The explanation provided - 'because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset' - implies that these payments are not associated with the lease. However, IE13 should have stated more clearly that these payments did not meet the definition of lease incentives in

IFRS 16 (that is, the payments were not associated with the lease and were not the reimbursement or assumption by the lessor of costs of the lessee because, for example, the payments reimbursed for improvements made to the lessor's asset).

28 The IASB also explains that because Illustrative Examples do not provide mandatory requirements, the requirements in IFRS 16 would prevail in the case of any confusion or apparent conflict.

29 However, to avoid the potential for confusion from this example, the IASB proposes to remove the illustration of payments from the lessor relating to leasehold improvements from IE13.

30 The IASB does not propose any transition requirements or effective date as the proposed amendment affects material that accompanies, but is not part of, IFRS 16.

Question 3: Proposed amendments to Illustrative Examples accompanying IFRS 16

31 Do you agree with the IASB's proposal to amend Illustrative Examples accompanying IFRS 16 in the manner described in the Exposure Draft?

32 If not, why not, and what do you recommend instead?

EFRAG's response

EFRAG notes that this amendment relates to the Illustrative Examples and Illustrative Examples are not subject to endorsement in Europe. However, the confusion that this example has generated indicates that the IASB should clarify the facts and circumstances where the reimbursement of leasehold improvements by the lessor to lessee may be considered as a lease incentive.

33 EFRAG notes that interpretation of the reimbursement of the leasehold improvements by the lessor to the lessee in IE13 has generated confusion which should be addressed by the proposed amendment.

34 However, given the need to address this confusion, EFRAG considers that just removing the reference to the reimbursement of leasehold improvements from IE13 is insufficient and that the explanation provided by the IASB in paragraph BC2 does not resolve the confusion. In EFRAG's view, further clarification of when the reimbursement of leasehold improvements by the lessor constitute a lease incentive under IFRS 16 is required to remove any future potential for confusion.

35 In addition, EFRAG notes that this question leads to a broader issue of whether any leasehold improvements and restoration costs should be included in a right-of-use asset under paragraph 24 of IFRS 16.

36 EFRAG proposes that IFRS 16 should include the facts and circumstances where the reimbursement of the leasehold improvements by the lessor to lessee may be considered to be a lease incentive either in the Basis for Conclusions or directly in IE13.

Issue 4 - IAS 41 *Agriculture*: Taxation in fair value measurements

Notes to constituents – Summary of proposals in the ED

37 In May 2008, the IASB amended IAS 41 to remove the requirement for entities to use a pre-tax rate to discount cash flows when measuring fair value. However*, at that time the IASB did not amend paragraph 22 of IAS 41 to delete the reference to cash flows for taxation. Consequently, when measuring fair value IAS 41 requires an entity to use pre-tax cash flows but does not require the use of a pre-tax rate to discount those cash flows.*

38 The IFRS IC supported the proposal on the following grounds:

(a) *Such an amendment would align the requirements in IAS 41 on fair value measurement with those in IFRS 13 Fair Value Measurement. IFRS 13 neither prescribes the use of a single present value technique nor limits the use of present value techniques to measure fair value to only those discussed in that Standard. However, when using a present value technique paragraph B14 of IFRS 13 requires assumptions about cash flows and discount rates to be internally consistent. Depending on the particular facts and circumstances, applying IFRS 13 an entity applying a present value technique might measure fair value by discounting after-tax cash flows (using an after-tax discount rate) or pre-tax cash flows (at a rate consistent with those cash flows).*

(b) *The IASB's intention in amending IAS 41 in 2008 was to permit entities to include tax cash flows in measuring fair value. Removing 'taxation' from paragraph 22 is consistent with that intent.*

39 The IASB proposes to apply the amendment prospectively with an earlier application permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

Question 4: Proposed amendments to IAS 41

40 Do you agree with the IASB's proposal to amend IAS 41 and accompanying documents in the manner described in the Exposure Draft?

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

EFRAG's response

EFRAG agrees with the IASB's proposal to amend IAS 41 by excluding the reference to "taxation" from paragraph 22.

42 EFRAG supports the IASB's proposal to remove the requirement in paragraph 22 of IAS 41 to exclude cash flows for taxation when measuring fair value applying IAS 41.

43 EFRAG considers that it will bring clarity to the fair value requirements of IAS 41 and will also make IAS 41 consistent with the requirements of IFRS 13.

44 EFRAG supports the IASB's proposal for prospective application of the amendment with earlier application permitted, EFRAG agrees with the IASB's reasoning that retrospective application will bring little or no added value to the users of financial statements and will be costly for preparers.