30 August 2012

Our ref: ICAEW Rep 124/12

Mme Françoise Flores
Chair
European Financial Reporting Advisory Group
13-14 Avenue des Arts
B-1210 Brussels

By email: commentletter@efrag.org

Dear Mme Flores

Annual Improvements to IFRSs 2010—2012 Cycle

ICAEW welcomes the opportunity to comment on EFRAG's draft comment letter in respect of the Exposure Draft *Annual Improvements to IFRSs 2010—2012 Cycle* published by the IASB on 3 May 2012.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

Attached as an appendix to this letter is a copy of ICAEW's draft response to the IASB. This indicative draft is provided to EFRAG in advance of the IASB's comment deadline to assist in the finalisation of EFRAG's own comment letter. The draft is not yet final and has still to receive approval from ICAEW's Financial Reporting Committee. The principal themes and specific detail of our response is set out in that document; in this letter we respond specifically to the points raised by EFRAG in their draft comment letter to the IASB.

We support EFRAG's suggestion, which is particularly relevant for European constituents, for the proposed Improvement to IFRS 9 to be extended to IAS 39. The 'own credit' issue persists for users of IAS 39 and any action to address it would be most welcome. We also second EFRAG's call for the

scope of the IAS 12 Improvement to be considered very carefully. Indeed in our own draft response we go somewhat further. In our opinion a number of the issues addressed by the Improvements do not merit immediate attention through the annual improvement process. We feel that in the case of IAS 12 and IFRS 2 the issues in question raise wider questions about those standards that can only effectively be tackled by a more comprehensive project. EFRAG's valuable research paper on IAS 12 *Improving the financial reporting of income tax* is a useful step in this direction and we support the continuation of this work, although it must be noted that any IASB project cannot be expected to commence until after the conclusion of the next three year agenda period. We also question the value of amending IFRS 13 at this stage as the Improvement is rather trivial in nature.

Our draft comments on each of the individual improvements are set out in the appendix to this letter.

EFRAG'S QUESTIONS TO CONSTITUENTS

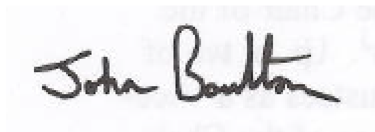
Issue 7: IAS 12 – Income Taxes: Recognition of deferred tax assets for unrealised losses

Do you believe that the application of the proposed amendments to IAS 12 would have unintended consequences? If so, could you please explain?

We agree that the Improvement to IAS 12 could have unintended consequences and indeed our concerns go somewhat further than those expressed in EFRAG's draft comment letter. Our views on this topic are set out above and in the appendix to this letter.

Please do get in touch should you have any questions on our response.

Yours sincerely



John Boulton ACA
Manager, Corporate Reporting
ICAEW Financial Reporting Faculty

T +44 (0) 20 7920 8642
E john.boulton@icaew.com

APPENDIX – DRAFT ICAEW RESPONSE TO THE IASB

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft *Annual Improvements to IFRSs 2010—2012 Cycle* published by the IASB on 3 May 2012.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

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4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

ICAEW welcomes the IASB's transparent due process in its maintenance of IFRS

5. We appreciate this opportunity to comment on the Board's latest package of annual improvements. By grouping together more minor changes into a regular, timetabled document we feel that constituents are able to better plan and coordinate their response efforts. In our view this demonstrates the Board's commitment to transparent due process. Some of the improvements in ED/2012/1 will enhance the application of IFRS and are well worth making a change for at the current time. However, we do question the urgency of others of the Improvements proposed, and more importantly we are concerned that for some of the standards targeted, piecemeal minor amendment is neither appropriate nor effective in achieving the improvements in application sought. These concerns are explored further below.

Improvements can only be justified where there is a compelling case for change

6. Annual improvements offer a valuable opportunity to amend IFRS where a particular issue of widespread concern and urgency can realistically be addressed through minor amendment. Unfortunately, a number of the improvements proposed in the current paper would not pass a test of this kind. Therefore, while we disagree with a number of individual improvements for the reasons explored below, cumulatively we have a greater concern about the purposes for which the annual improvement exercise is currently being used.

7. All change carries a cost and therefore in our opinion IFRSs should only be amended where there is a compelling case to do so and the benefits to be gained outweigh the costs. Some of the amendments in the 2010-12 cycle, for example that to IFRS 13, are rather trivial in nature. It is not apparent to us why it has been felt necessary to amend those standards this year. In other cases, such as IFRS 2 and IAS 12, the amendment is attempting to cure the symptoms of a more

fundamental deficiency in the standard. This is not an effective way of securing improvement, will only perpetuate the underlying problems and risks introducing other inconsistencies and unintended consequences. Better in these cases to postpone change until a proper revision or replacement for the standard can be made. The Board should seek in future years to limit improvements to those areas that can appropriately and effectively be addressed in this way. Pressures to address specific application difficulties through minor amendments will only intensify in coming years as new IFRSs bed down and the global spread of IFRS widens. It is essential that a strict protocol is in place to ensure that maintenance is targeted and efficient. We will be responding in due course to the Board's Due Process Handbook consultation and will at that point further elucidate our concerns regarding the protocol for maintaining IFRS.

OBSERVATIONS ON INDIVIDUAL IMPROVEMENTS

IFRS 2 *Share-based Payment*

8. We agree that the application of IFRS 2 is complicated by the variety of forms that the conditions attached to the grant of share based payments could take. We appreciate that the amendment is attempting to clarify this position by differentiating purely time based conditions from those referring to a particular element of performance. But we are not convinced that it is successful in resolving the issue. Indeed there is a danger that it merely replaces one type of problem with another. Given that change is costly and in itself creates the opportunity for confusion, this is unfortunate. On balance we agree that there is an issue with IFRS 2 and that action to address it through a broader project could usefully be considered once the much needed 'period of calm' has run its course. We do not agree that it is appropriate to tackle the issue via a minor amendment.

9. If the Board nevertheless continues with the amendment, we are concerned that there is a lack of clarity in BC5. The paragraph starts with an assumption: 'a share market index target may be predominantly affected by many external variables …' and then goes on to a rule: 'it is therefore remote from the influence of the employee' and 'it is not related to the performance of the entity'. This leads to the following considerations:

   - The company's share price may make up a substantial part of the index, as is certainly possible with some narrowly-drawn indices. In this case the index would not be 'predominantly affected by external variables' and would not be 'remote from the influence of the employee' or 'unrelated to the performance of the entity'. This paragraph should therefore be redrafted to clarify the Board's intention.
   - The text should confirm that performance <u>comparative</u> to an index is fine; eg, company's share price must increase by greater percentage than index, since the employee's service can be seen as influencing one leg of the test.
   - If a 'share market index' is not to be used as an example, this raises a question about other types of index. Again, the Board's intention is unclear because of lack of clarity in drafting.

10. We are also concerned about group arrangements: The performance condition definition refers to 'the performance of the entity as a whole or to some part of the entity' but the treatment is unclear if the condition refers to, for example, the performance of the wider group of which the entity is a part (eg, the parent's share price). This should be captured by the definition but appears currently not to be.

11. In addition, while the definition of a performance condition and a service condition appear to be mutually exclusive, the definition of a performance condition includes a requirement to satisfy the performance condition whilst rendering services; ie, the individual must be employed. Therefore a condition that says that the EPS must increase by 3% over the next three years and that an award holder must be employed at that time for the award to vest is a performance condition. This therefore raises the question whether the explicit service requirement should be considered a separate service condition as well as being part of the performance condition. This might matter if a

market performance target is hit but the employee fails to be employed throughout the entire explicit service period. If the explicit service requirement is considered part of the market performance condition an entity would not true up. However, if it is considered to be a separate service condition as well then the expense would be trued up. Greater clarity would be welcomed.

IFRS 3 *Business Combinations*

12. Again, the proposed amendments to IFRS 3 and IFRS 9 relating to contingent consideration appear to arise from a wider deficiency in this area. We are unconvinced that a minor amendment represents the best way forward.

13. Paragraph 40 of IFRS 3 illustrates these wider issues. This paragraph contains the ambiguous sentence 'the acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met'. It appears that the phrase 'if specified conditions are met' is intended to define what a contingent consideration asset is, however it could be read to imply that there are conditions which need to be met before such contingent consideration could be recognised as an asset. In due course it would desirable to address these issues through a thorough examination of IFRS 3. Attempting to fix some, but not all, of these issues would not appear to be an optimal approach.

14. Moreover, the proposed amendment might not itself reach an appropriate solution. Before further action is taken, further investigation would be beneficial to ascertain whether all types of contingent consideration that are not equity really do take the form of a financial liability and whether it would always be appropriate for contingent consideration which is a financial liability to be accounted for as if the fair value option is applied. We are not convinced that this is necessarily the case, particularly with non-cash contingent consideration. The amendment also raises some issues with IFRS 9, which we explore further below:

IFRS 9 Financial Instruments

15. The amendment places a liability to pay contingent consideration into the scope of IFRS 9 only. The previous text referred to both IFRS 9 and IAS 39. IFRS 9 has been delayed to at least 2015 and as a result the transition provisions for the amendment would not apply until 2015 (unless an entity chooses to early adopt both). This only accentuates the issues arising from the continued delays to the finalisation and EU endorsement of IFRS 9. Rather than linking the amendment to IFRS 9, a better approach may be to consider making a limited amendment to IAS 39 to facilitate the early adoption of the own credit risk element of IFRS 9. This would not only allow the 'own credit' issue to be addressed on a more timely basis than waiting for IFRS 9 to become effective but allow the amendment to IFRS 3 to be decoupled from IFRS 9 and therefore able to be applied more quickly.

16. In working through the amendment to IFRS 3, we identified some improvements and editorial corrections which may be needed to IFRS 9 itself.

17. IFRS 9 paragraph 4.2.1 establishes a general requirement for all financial liabilities to be classified as subsequently measured at amortised cost, but it does then make a number of exceptions to this. Indeed, including the proposed IFRS 3 amendment and IFRS 9 paragraph 4.2.2, the standard effectively introduces seven categories of financial liabilities. The intention appears to be to have a 'fair value through profit or loss category' where all fair value movements are recognised in profit or loss (paragraph 4.2.1a) and a 'designated as at fair value category' where fair value movements are recognised in profit or loss except for those relating to own credit which are recognised in OCI (unless this results in an accounting mismatch in which case all fair value movements are recognised in profit or loss) - being paragraph 4.2.2.

18. In the interests of reducing complexity it would be beneficial if the Board could simplify the text in IFRS 9 to reduce the number of measurement categories. At the very least, it would be helpful to

clarify the use of the 'financial .liability at fair value through profit or loss' category as this includes both items where fair value is mandatory (those held for trading) and items designated as such. The fair value option category should for example be consistently described in the heading above paragraph 4.2.2, in the heading above paragraph 5.7.7 and elsewhere in the text. Text and headings need to make it very clear whether they refer to both types of fair valued liability or apply only to one.

19. The amendment also raises the question of the correct accounting treatment where the contingent consideration is a derivative. As currently drafted, it would be prevented from being classified under paragraph 4.2.1 (a) and therefore would have a different accounting treatment from other derivatives. It is unclear whether the Board intended this difference (or whether it merely short-cuts considering paragraph 4.3.5 for hybrid contracts), but it risks re-opening the debate about what are and are not non-financial underlyings specific to a party to a transaction.

IFRS 8 *Operating Segments*

20. As we have explored in paragraph 8 and 9, attempting to extend disclosure requirements through minor amendments can be particularly problematic. It is better for disclosure to be approached on a more holistic basis, through, for example, the development of an overarching disclosure framework. Where incremental disclosures accrete over time, the financial statements risk becoming progressively more cluttered and less coherent. The first of the two proposed amendments to IFRS 8 is an unfortunate example of this process. We appreciate that where there is a disparity between the segments reported and those used to manage the business, greater transparency around the selection process might be desirable. But we are not convinced that the insertion of an additional, prescriptive disclosure requirement will provide an adequate solution to this issue. Disclosures of this type are invariably responded to with boiler plate text that clutters the financial statements while adding little information of value for users. In any case, the standard already contains a requirement to disclose the factors used to identify reportable segments and it is reasonable to expect that this would allow users to understand any difference between reportable and management segments. Consequently, it does not appear that the problem the Board has identified results from a deficiency with the standard – rather it seems to stem from an implementation issue. Given that the Board has recently commenced its post implementation review of IFRS 8 now would not seem to be the right time to be proposing changes.

IFRS 13 *Fair Value Measurement*

21. Any change to existing financial reporting literature carries with it a cost to constituents both in terms of evaluating and processing the change that has been made in a particular version of a standard and in updating documentation and systems. Changes therefore should only be made when there is a compelling case for doing so. We do not believe that the proposed amendment to the basis for conclusions to IFRS 13 would pass such a test and suggest that this change would be better deferred until such a time that it can be bundled together with more compelling revisions to the standard.

IAS 1 *Presentation of Financial Statements*

22. The classification of borrowings between short and long-term is an important metric that can have significant implications for user decision making. The phrase 'existing loan facility'as currently used in paragraph 73 of IAS 1, could be interpreted ambiguously and therefore we agree that it would be useful to draw a more explicit boundary in defining what would qualify as an existing facility. However, we would suggest some modification to the proposed wording. Specifically, the phrase 'same lender' will be problematic in practice as loans are commonly raised from a consortium of lenders. We believe that the principle here is whether a cash outflow would be necessary within the next 12 months. On that basis it would appear sensible to allow a change in the composition of lenders in a consortium that did not trigger any repayment (ie, where the consortium as a whole is

committed from the outset to permit continued borrowing) to benefit from the exemption. In our opinion, the amendment should be redrafted to reflect these situations.

IAS 7 *Statement of Cash Flows*

23. We are not convinced that this amendment is successful in clarifying the basis for classification of capitalised interest. At the March IFRIC Board meeting the staff agreed that ‘cash flows should be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with the definitions of operating, investing and financing activities in paragraph 6 of IAS 7.’ However, in making this amendment the Board appear to be adopting the alternative principle also considered at that meeting ‘...cash flows in IAS 7 should be classified consistently with the classification of the related or underlying item in the statement of financial position’. To avoid future uncertainty it would be better if the underlying principle could be resolved before IAS 7 is revised.

IAS 12 *Income Taxes*

24. There are a number of criticisms that could be made of the income tax accounting model set out in IAS 12. Some commentators have been calling for the standard’s replacement and there has been much recent activity in the constituent community in recent months investigating possible alternatives. EFRAG’s recent discussion paper *Improving the Financial Reporting of Income Tax* examined IAS 12 in some detail (our response ICAEW REP 81/12 sets out our views on the standard in more detail).

25. However, given the desirability of maintaining a period of calm, we would not envisage any fundamental revision of IAS 12 in the immediate future. In the absence of a comprehensive project to consider accounting for deferred tax, we are not convinced that minor amendments are an effective way of achieving the improvements sought. The amendment adds a considerable amount of additional text to the section of IAS 12 dealing with deferred tax assets, but given the criticisms of the current accounting model it may not be particularly effective in assisting application. Indeed, by failing to consider the origination of temporary differences the amendment appears to only address half of the problem.

26. We do however agree that a limited amendment is worthwhile to clarify that an action that results only in the reversal of existing deductible temporary differences is not a tax planning opportunity.

IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*

27. We agree with the amendment.

IAS 24 *Related Party Transactions*

28. In general we agree that this is a useful clarification of the disclosure requirement in situations where management services are provided by a separate entity. It is helpful to explicitly bring management entities within the scope of IAS 24 and to require separate disclosure of these amounts. Some commentators are concerned that the exemption from paragraph 17 could provide an opportunity to structure management services to avoid transparency. This is not a significant issue in the UK where the Companies Act Directors’ Remuneration Report disclosures for private, and especially listed, companies go somewhat further than IAS 24 anyway. But it could mean in some cases that the IAS 24 disaggregation by class of benefits could be viewed as misleading in situations where, for example, the management entity pays material pension contributions, or conceivably, compensation for loss of office. To guard against this the exemption could perhaps be made more conditional by adding, ‘where the information is not available’, or ‘not readily available’ or some similar wording.

IAS 36 *Impairment of Assets*

29. We agree with the amendment.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose?

30. We do agree with a number of the amendments. However, there are some where we disagree with the Board's conclusion and others where we question the need for an improvement at all. In paragraphs 8 to 29 above we set out our comments on each individual improvement. Paragraphs 5 to 7 make some general comments about the annual improvements exercise.

Question 2: Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft? If not, why and what alternative do you propose?

31. To the extent that the Board proceeds with the amendments as drafted, we agree with the effective dates proposed. We also agree that permitting early adoption is appropriate. However, we also refer you to our comments on linking the amendment to IFRS 3 only to IFRS 9 as set out in paragraph 15 above.