EFRAG's Draft Letter to the European Commission Regarding Endorsement of Foreign Currency Transactions and Advance Consideration

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European Commission
1049 Brussels

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Dear Mr Guersent

Adoption of IFRIC Interpretation 22 *Foreign Currency Transactions and Advance Consideration*

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 IFRIC Interpretation 22 *Foreign Currency Transactions and Advance Consideration* ('IFRIC 22'), which was issued by the IASB on 8 December 2016. A Draft Interpretation of IFRIC 22 was issued on 21 October 2015. EFRAG provided its comment letter on that Draft Interpretation on 5 February 2016.

The objective of IFRIC 22 is to clarify how the date of the transaction should be assessed for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or non-monetary liability arising from advance consideration in a foreign currency.

IFRIC 22 becomes effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. A description of IFRIC 22 is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether IFRIC 22 would meet the technical criteria for endorsement, in other words whether IFRIC 22 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 IFRIC 22 would be conducive to the European public good. We provide our conclusions below.

Does IFRIC 22 meet the IAS Regulation technical endorsement criteria?

Based on the above reasoning, EFRAG has concluded that IFRIC 22 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and leads to prudent accounting. EFRAG has also assessed that IFRIC 22 does not create any distortion in its interaction with other IFRS and that all necessary disclosures are required. Therefore, EFRAG has concluded that IFRIC 22 is not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Is IFRIC 22 conducive to the European public good?

EFRAG has assessed that IFRIC 22 would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that IFRIC 22 could have any adverse effect on the European economy, including financial stability and economic growth.

Accordingly, EFRAG assesses that adopting IFRIC 22 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 IFRIC 22 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, leads to prudent accounting, and that it is not contrary to the true and fair view principle. We have also concluded that IFRIC 22 is conducive to the European public good. Therefore, we recommend IFRIC 22 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 IFRIC 22

Background of IFRIC 22

1 The IFRS Interpretations Committee ('the Interpretations Committee') was asked how to determine the date of the transaction when applying paragraphs 21-22 of IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The question specifically addressed circumstances in which an entity recognises a non-monetary asset or non-monetary liability relating to the payment or receipt of advance consideration before it recognises the related asset, expense or income.

2 The Interpretations Committee was informed that there was diversity in practice as some entities were using the exchange rate at the date of the receipt of the advance consideration, whilst others were using the exchange rate at the date of recognition of the related asset, expense or income.

The issue and how it has been addressed

3 IFRIC Interpretation 22 *Foreign Currency Transactions and Advance Consideration* ('IFRIC 22') applies to the accounting for transactions in which the consideration is denominated or priced in a foreign currency; the entity recognises a prepayment asset or a deferred income liability in respect of that consideration in advance of the recognition of the related asset, expense, or income (or part of it); and the prepayment asset or deferred income liability is non-monetary. IFRIC 22 does not apply to transactions measured at fair value at the date of initial recognition or at the fair value of the consideration paid or received at a date other than the date of initial recognition of the non-monetary asset or non-monetary liability arising from advance consideration. IFRIC 22 is not required to be applied to insurance contracts that it issues and income taxes.

4 The Interpretations Committee observed that there could be two ways of identifying 'the transaction' for the purpose of determining the exchange rate to use on initial recognition:

(a) the 'one-transaction' approach: the receipt or payment of consideration and the transfer of the goods or services are all considered to be part of the same transaction. Thus, the date of the transaction is determined by the date on which the first element of the transaction qualifies for recognition applying IFRS.

(b) the 'multi-transaction' approach: the receipt or payment of consideration and the transfer of the goods or services are considered to be separate transactions, each of which has its own 'date of the transaction' when it first qualifies for recognition applying IFRS.

5 IFRIC 22 clarifies that, for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it), the date of the transaction is the earlier of:

(a) the date of initial recognition of the non-monetary asset or non-monetary liability; and

(b) the date that the asset, expense or income (or part of it) is recognised in the financial statements.

6 If there are multiple payments or receipts in advance, IFRIC 22 clarifies that the entity shall determine a date of the transaction for each payment or receipt of advance consideration.

When does IFRIC 22 become effective?

7 IFRIC 22 becomes effective for annual reporting periods beginning on or after 1 January 2018. Earlier application is permitted.

8 On initial application, IFRIC 22 may be applied either:

(a) retrospectively, applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or

(b) prospectively to all assets, expenses and income in the scope of IFRIC 22 initially recognised on or after:

(i) the beginning of the reporting period in which the entity first applies IFRIC 22; or

(ii) the beginning of a prior reporting period presented as comparative information in the financial statements of the reporting period in which the entity first applies IFRIC 22.

9 IFRIC 22 clarifies that in case of prospective application, the entity is required, on initial application, to apply IFRIC 22 to assets, expenses and income initially recognised on or after the beginning of the reporting period or the beginning of the prior reporting period (as appropriate) for which the entity has recognised non-monetary assets or non-monetary liabilities relating to advance consideration before that date.

Appendix 2: EFRAG's technical assessment on IFRIC 22 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 IFRIC 22. In it, EFRAG assesses how IFRIC 22 satisfies the technical criteria set out in the Regulation (EC) No 16062002 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 IFRIC 22 leads to prudent accounting and finally considers whether IFRIC 22 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.

Introduction

1 In evaluating IFRIC 22, EFRAG asked itself four questions:

(a) Is there an issue that needs to be addressed?

(b) If there is an issue that needs to be addressed, is an Interpretation an appropriate way of addressing it?

(c) Is IFRIC 22 a correct interpretation of existing IFRS?

(d) Does the accounting that results from the application of IFRIC 22 meet the technical criteria for EU endorsement?

Is there an issue that needs to be addressed?

2 EFRAG understands that at present there is diversity in practice as to how entities determine the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) when advance consideration was received or paid in a foreign currency. EFRAG agrees that this diversity is undesirable and is an issue that needs to be addressed.

Is an Interpretation an appropriate way of addressing it?

3 An Interpretation is not considered to be an appropriate way to address diversity in accounting practice if that diversity arises from inconsistencies between IFRS or relates to major issues that should be considered in standards-level projects.

4 EFRAG's assessment is that the diversity in practice that is the subject of IFRIC 22 falls into neither of these categories. As such, EFRAG has concluded that an Interpretation is an appropriate way of addressing the uncertainties relating to determining the date of the transaction for the purpose of determining the exchange

rate to use on initial recognition of the related asset, expense or income (or part of it) when advance consideration was received or paid in a foreign currency.

Is IFRIC 22 a correct interpretation of existing IFRS?

5 EFRAG has considered whether IFRIC 22 is a correct interpretation of existing IFRS literature.

6 Paragraphs 21-22 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* require that a foreign currency transaction should be recorded, on initial recognition in the functional currency, by applying the exchange rate at the date of the transaction.

7 Paragraph 22 of IAS 21 defines the date of the transaction as 'the date on which the transaction first qualifies for recognition' in accordance with IFRS.

8 Therefore, EFRAG agrees that the guidance proposed by IFRIC 22 is consistent with the principles in IAS 21.

Conclusions

9 IFRIC 22 clarifies that, in determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) applying paragraphs 21-22 of IAS 21, the date of the transaction is the date on which an entity initially recognises the non-monetary asset or non-monetary liability relating to advance consideration. EFRAG agrees with this conclusion.

10 EFRAG agrees that this is an appropriate interpretation of existing IFRS.

Does the accounting that results from the application of IFRIC 22 meet the technical criteria for endorsement in the European Union?

11 EFRAG has considered whether IFRIC 22 meets 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 IFRIC 22:

(a) is not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (the Accounting Directive); and

(b) meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

12 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.

13 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).

14 EFRAG's assessment as to whether IFRIC 22 would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

15 In its assessment, EFRAG has considered IFRIC 22 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 IFRIC 22 is appropriate both for making decisions and assessing the stewardship of management.

16 EFRAG's assessment on whether IFRIC 22 is 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 it meets all other technical criteria and whether it leads to prudent accounting. EFRAG's assessment also includes assessing whether IFRIC 22 does 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 17 to 21;

(b) reliability: paragraphs 22 to 26;

(c) comparability: paragraphs 27 to 31;

(d) understandability: paragraphs 32 to 37;

(e) whether overall it leads to prudent accounting: paragraphs 38 to 41; and

(f) whether it would not be contrary to the true and fair view principle: paragraphs 42 to 45.

Relevance

17 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.

18 EFRAG considered whether IFRIC 22 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

19 EFRAG observes that the reason for issuing IFRIC 22 is to address diversity in practice on how to determine the exchange rate to use in applying IAS 21 when recognising revenue. Furthermore, EFRAG understands that similar diversity was observed in the accounting for other transactions when consideration is denominated in a foreign currency and is paid or received in advance.

20 EFRAG therefore considers that, by ensuring a consistent determination of the exchange rate, IFRIC 22 will improve the relevance of the information provided to users about an entity's foreign currency transactions.

21 EFRAG's overall assessment is that IFRIC 22 would result in the provision of relevant information and therefore satisfies the relevance criterion.

Reliability

22 EFRAG also considered the reliability of the information that will be provided by applying IFRIC 22. 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.

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

24 EFRAG observes that the requirements and guidance in IFRIC 22 are closely aligned with the requirements in IAS 21. Therefore, in EFRAG's view, IFRIC 22 does not raise

any significant concerns about reliability, especially given that the necessary information is already available.

25 In addition, as IFRIC 22 provides guidance on how to determine the appropriate exchange rate in accounting for transactions involving advance consideration denominated in foreign currency, EFRAG considers that the guidance will improve the faithful representation of foreign currency transactions in the financial statements.

26 EFRAG's overall assessment is that IFRIC 22 results in reliable information.

Comparability

27 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.

28 EFRAG has considered whether IFRIC 22 results 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.

29 EFRAG observes that IFRIC 22 clarifies existing requirements in IAS 21 and addresses existing divergence in respect of determining the date of the transaction for the purpose of determining the exchange rate. Therefore, in EFRAG's opinion, IFRIC 22 will bring consistency in accounting for a foreign currency transaction (or part of it) when an entity recognises a non-monetary asset or non-monetary liability relating to the payment or receipt of advance consideration before the entity recognises the related asset, expense or income (or part of it) and therefore will increase comparability between entities.

30 Regarding the transition requirements, EFRAG acknowledges that the presence of several transition methods negatively affects the comparability of the information provided in the financial statements. However, EFRAG considers that requiring full retrospective application on transition would have been burdensome, in particular for foreign currency transactions involving purchases of assets. In addition, EFRAG observes that the requirement to apply IFRIC 22 to any assets, expenses and income initially recognised on or after the beginning of the reporting period or the beginning of the prior reporting period (as appropriate) is expected to significantly reduce the negative effect on comparability.

31 Therefore, EFRAG's overall assessment is that IFRIC 22 satisfies the comparability criterion.

Understandability

32 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.

33 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.

34 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRIC 22 is understandable, is whether that information will be unduly complex.

35 EFRAG observes that, as noted above in the assessment of the reliability criterion, IFRIC 22 is closely aligned with the requirements in IAS 21. In addition, EFRAG notes that the objective of IFRIC 22 is to clarify the application of current requirements in

IAS 21. Therefore, in EFRAG's view, IFRIC 22 does not introduce any new complexity that may impair understandability.

36 In addition, EFRAG considers that the improved consistency in the application of the requirements in IAS 21 are likely to improve users' understanding of the effect of the entity's foreign currency transactions involving advance consideration on its financial statements.

37 EFRAG's overall assessment is that IFRIC 22 satisfies the understandability criterion in all material respects.

Prudence

38 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.

39 EFRAG observes that IFRIC 22 does not affect the recognition of foreign currency-denominated assets, expenses or income, but only their measurement. In addition, EFRAG notes that the requirements and guidance in IFRIC 22 are closely aligned with the requirements in IAS 21.

40 By clarifying how the transaction date should be determined when applying IAS 21, EFRAG considers that IFRIC 22 ensures that the accounting for the assets, expenses and income reflects the entity's exposure to foreign currency risk. IFRIC 22 therefore reduces the risk of misstating assets, expenses or income.

41 Based on all of the above, EFRAG has concluded that the application of IFRIC 22 will lead to prudent accounting.

True and Fair View Principle

42 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.

43 EFRAG has assessed that IFRIC 22 does not create any negative interactions with other IFRS. In particular, EFRAG observes that IFRIC 22 aims to improve the application of requirements in IAS 21 that, as evidenced during the discussions of the Interpretations Committee, could be interpreted in different ways. Accordingly, EFRAG has assessed that IFRIC 22 does not lead to unavoidable distortions or significant omissions and therefore does not impede financial statements from providing a true and fair view.

44 EFRAG notes that IFRIC 22 does 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.

45 As a result, EFRAG concludes that the application of IFRIC 22 would not lead to information that would be contrary to the true and fair view principle.

Conclusion

46 Accordingly, for the reasons set out above, EFRAG's assessment is that IFRIC 22 meets the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether IFRIC 22 is conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to adopt IFRIC 22. 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 IFRIC 22. In doing this, EFRAG considered:

(a) Whether IFRIC 22 improves financial reporting. This requires a comparison of IFRIC 22 with the existing requirements and how it fits into IFRS as a whole;

(b) The costs and benefits associated with IFRIC 22; and

(c) Whether IFRIC 22 could have an adverse effect on 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, IFRIC 22 will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether IFRIC 22 is likely to improve the quality of financial reporting

3 EFRAG notes that IFRIC 22 is intended to clarify how to apply existing principles of IAS 21 *The Effects of Changes in Foreign Exchange Rates* in respect of foreign currency transactions involving advance consideration. It brings guidance that reduces diversity in practice in determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) when advance consideration was received or paid in a foreign currency.

4 In addition, EFRAG notes that, in their feedback to EFRAG on the Draft Interpretation that preceded IFRIC 22, most respondents supported the proposals. Only a few respondents indicated they were not aware of any diversity in practice and questioned the need for the proposed guidance.

5 EFRAG has therefore concluded that IFRIC 22 is likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of IFRIC 22

6 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 IFRIC 22, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

Cost for preparers

7 EFRAG has carried out an assessment of the cost implications for preparers resulting from IFRIC 22.

8 EFRAG observes that two practices are commonly applied to account for foreign currency transactions involving advance consideration. As IFRIC 22 permits only one approach, preparers that previously applied another approach will incur a one-time cost to modify their systems. The significance of the cost will depend on the frequency

and complexity of foreign currency transactions involving advance consideration and the preparer's existing accounting system.

9 As IFRIC 22 does not require any financial statement disclosures, EFRAG does not expect any significant ongoing costs in applying IFRIC 22.

10 Overall, whilst some preparers may incur a one-time cost to modify their system, EFRAG's assessment is that, for many preparers, IFRIC 22 will not result in increased costs, i.e., it is likely to be cost neutral.

Costs for users

11 EFRAG has carried out an assessment of the cost implications for users resulting from IFRIC 22.

12 EFRAG considers that users may incur one-off costs related to understanding the new requirements. However, as these requirements are a clarification of existing principles for accounting for foreign currency transactions involving advance consideration, EFRAG expects these costs to be insignificant.

13 EFRAG does not expect users to incur ongoing costs.

14 Overall, EFRAG's assessment is that IFRIC 22 is likely to result in insignificant costs for users which are limited to understanding the new requirements.

Benefits for preparers and users

15 EFRAG has carried out an assessment of the benefits for users and preparers resulting from IFRIC 22.

16 EFRAG's assessment is that IFRIC 22 will benefit users in assessing an entity's overall exposure to foreign currency risk. This is because IFRIC 22 will provide consistency in the reported amount of exchange gains or losses in the income statement and of assets in the statement of financial position.

17 Even when the advantages for preparers may not be direct, they would benefit from their financial statements being prepared on a more consistent basis.

18 Overall, EFRAG's assessment is that users are likely to benefit from IFRIC 22, as the information resulting from its application will increase comparability between entities and will improve financial reporting in respect of foreign currency transactions.

19 EFRAG's assessment is that preparers are likely to benefit from the additional guidance provided by the Amendments that clarifies the accounting for foreign currency transactions involving advance consideration.

Conclusion on the costs and benefits of IFRIC 22

20 EFRAG's overall assessment is that the overall benefits resulting from improved financial information being available on a more relevant, understandable and comparable basis are likely to outweigh the one-off implementation costs incurred by some preparers.

Conclusion

21 EFRAG believes that IFRIC 22 will generally bring improved financial reporting when compared to current guidance. As such, its adoption is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

22 EFRAG has not identified that IFRIC 22 could have any adverse effect to the European economy, including financial stability and economic growth.

23 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.

24 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing IFRIC 22, EFRAG assesses that adopting IFRIC 22 is conducive to the European public good.