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Ms Dora Cheung
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Our ref MT/288
Contact Mary Tokar

7 November 2008

Dear Ms Cheung

Exposure Draft of *Proposed Improvements to IFRSs*

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB or the Board) Exposure Draft of *Proposed Improvements to IFRSs* (the ED) published in August 2008. This letter expresses the views of the international network of KPMG member firms.

Appendix 1 to this letter contains our detailed responses to the proposals about which we have fundamental concerns, which are:

- IAS 7 *Statement of Cash Flows* – Classification of expenditures on unrecognised assets

- IAS 39 *Financial Instruments: Recognition and Measurement* – Bifurcation of an embedded foreign currency derivative

Appendix 2 to this letter contains our detailed responses to the proposals that broadly we support but about which we have comments or suggestions, which are:

- IFRS 2 *Share-based Payment* – Scope of IFRS 2 and revised IFRS 3

- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* – Disclosure of non-current assets (or disposal groups) classified as held for sale or discontinued operations

- IFRS 8 *Operating Segments* – Disclosure of information about segment assets

- IAS 18 *Revenue* – Determining whether an entity is acting as a principal or as an agent

- IAS 36 *Impairment of Assets* – Unit of accounting for goodwill impairment test

- IAS 38 *Intangible Assets* – Additional consequential amendments arising from revised IFRS 3

- IAS 38 *Intangible Assets* – Measuring the fair value of an intangible asset acquired in a business combination

- IAS 39 *Financial Instruments: Recognition and Measurement* – Scope exemption of business combination contracts

- IAS 39 Financial Instruments: Recognition and Measurement – Application of the fair value option

We support the Board's proposal to amend IAS 39 to clarify the timing of reclassification of gains or losses arising from cash flow hedge accounting without comment or suggestion, and note that the Board's proposal is consistent with our interpretation of the existing guidance in this area.

Please contact Mary Tokar or Bruce Darton at +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited

Appendix 1

This appendix contains our detailed responses to the proposals about which we have fundamental concerns.

IAS 7 *Statement of Cash Flows* – Classification of expenditures on unrecognised assets

We do not support the proposal to amend IAS 7 by rewording paragraph 16 to state explicitly that only expenditure that results in a recognised asset can be classified as a cash flow from investing activities.

We believe that the current proposal is a rules-driven amendment that deals with a specific concern in respect of extractive activities, but raises further questions about its application in other areas:

- We believe that this proposal is inconsistent with certain of the specific classification examples given in IAS 7. For example, it appears inconsistent with the May 2008 amendment to IAS 7 requiring cash flows relating to the acquisition of certain rental assets, which are initially recognised as property, plant and equipment, to be classified as operating cash flows.

- The emphasis on the initial recognition of an asset raises questions about the classification of cash flows related to *subsequent* expenditure that is capitalised relating to an existing asset.

Accordingly, we recommend that the Board does not address this issue on an individual basis, but rather deals with this issue as part of its financial statement presentation project; we note that the recent discussion paper proposes new guidance in this regard.

IAS 39 *Financial Instruments: Recognition and Measurement* – Bifurcation of an embedded foreign currency derivative

We do not support the proposal to amend IAS 39 by rewording paragraph AG33(d)(iii) to state that a currency with one or more of the characteristics of a functional currency set out in paragraph 9 of IAS 21 *Effects of Changes in Foreign Exchange Rates* is integral to the contract arrangement. While we support the Board's intention to prohibit the separation of embedded foreign currency derivatives that are *integral to the arrangement*, we believe that the proposed amendment to paragraph AG33(d)(iii), as currently drafted, is technically flawed and too narrow in scope. The factors specified in paragraph 9 of IAS 21, which "mainly" influence sales prices, competitive forces, costs, etc., are intended to be applied in the context of analysing the functional currency of an entity as a whole, rather than in evaluating individual contracts. In our view, those factors are not sufficiently comprehensive to cover the examples of currencies, as listed in BC19, that are likely to be integral to a contractual arrangement. Accordingly, we believe that an approach based on paragraph 9 of IAS 21 would not be an effective solution and recommend that the Board does not proceed with this proposal as drafted.

As an alternative approach, we recommend that the Board clarify the meaning of *integral to the arrangement* by bringing the examples in BC19 into AG33(d), thus replacing the proposed language referring to paragraph 9 of IAS 21. Given the importance of this guidance, we also recommend that the Board move the definition of the term *integral to the arrangement* from the Basis of Conclusions to paragraph AG33(d) so that it is an integral part of the amended Standard.

Additionally, we recommend the following drafting changes:

- With respect to the definition of *integral to the arrangement*, BC18 states that it applies to foreign currency derivatives "if they have been entered into for reasons that are clearly not based on achieving a desired accounting result or for speculative purposes." We believe that it may be difficult in practice to demonstrate that a foreign currency settlement term was "clearly" not entered into for particular reasons, since generally it will be the absence of evidence indicating the presence of those particular reasons that will be determinative. We therefore recommend that the word "clearly" be deleted from this definition.

- We recommend that the Board delete the word "small" in BC19(d) as we believe the smallness or largeness of the country concerned is not relevant and additionally it is unclear to us what criteria would be used to determine whether a country is "small".

Appendix 2

This appendix contains our detailed responses to the proposals that broadly we support but about which we have comments or suggestions.

Based on our consideration of the likely costs of retrospective application of the proposals and benefits of comparability, unless otherwise stated in our detailed responses we support the Board's proposed effective date and transition requirements for each of the proposed amendments that we support.

IFRS 2 *Share-based Payment* – Scope of IFRS 2 and revised IFRS 3

Generally we support the proposal to amend IFRS 2 to clarify which transactions in the context of business combinations are excluded from the scope of the standard. In particular, we support the proposed change from "to which IFRS 3 applies" to "as defined by IFRS 3", since it reflects the informal clarification included in the September 2004 IASB Update, which in our experience has been applied in practice.

However, we recommend a drafting change to deal with the implication in paragraph 5 that neither common control transactions nor contributions of a business in a joint venture formation can be business combinations.

We believe that there will be combinations of entities under common control and contributions of businesses on the formation of a joint venture that meet the definition of a business combination under IFRS 3 (2008), which BC3 acknowledges is the case for common control transactions, and others that do not meet that definition. To reflect these concerns we recommend amending the proposed paragraph 5 as follows, together with a corresponding amendment to the Basis for Conclusions:

> As noted in paragraph 2, this IFRS... However, an entity shall not apply this IFRS to transactions in which the entity acquires goods as part of the net assets acquired in a business combination as defined by IFRS 3 *Business Combinations* (as revised in 2008). Hence, equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of this IFRS. The scope exemption also applies to combinations ~~in a combination~~ of entities or businesses under common control as described in paragraphs B1-B4 of IFRS 3, ~~or the contribution~~ and contributions of a business on the formation of a joint venture as defined by IAS 31 *Interests in Joint Ventures*, that do not meet the definition of a business combination under IFRS 3 (as revised in 2008). ~~Hence, equity instruments issued~~… (and therefore within the scope of this IFRS).

We further recommend expanding this scope exception to transactions in which an investment in an associate is acquired. Paragraph 23 of the Basis for Conclusions to IFRS 2 explains that the scope exception for business combinations was made because IFRS 3 provides more specific guidance on how to account for these transactions. Since paragraph 20 of IAS 28 *Investments in Associates* requires the same concepts underlying the procedures used in accounting for the acquisition of a subsidiary to be adopted when accounting for an acquisition of an investment in an associate, we believe that these transactions should be excluded from the scope of IFRS 2 as well. This would be consistent with current practice under currently effective requirements.

IFRS 5 _Non-current Assets Held for Sale and Discontinued Operations_ – Disclosure of non-current assets (or disposal groups) classified as held for sale or discontinued operations

Generally we support the proposal to amend IFRS 5 to clarify that the disclosure requirements of standards other than IFRS 5 do not apply to non-current assets held for sale, to assets and liabilities that are part of a disposal group classified as held for sale and to discontinued operations, unless specified explicitly in those standards.

However, we believe that a contradiction exists between the proposal in paragraph 5A and the explanation given in BC4. Paragraph 5A states that disclosures required in respect of non-current assets or disposal groups classified as held for sale and discontinued operations are specified by IFRS 5 and that the disclosure requirements of other standards do not apply unless specified explicitly in these standards. However, BC4 states that when disposal groups contain assets and liabilities to which the measurement rules of IFRS 5 do not apply, disclosures about those measurements “normally” are provided in the notes to the financial statements. This seems to contradict the intention that only the IFRS 5 disclosures are to be given for these assets and liabilities. Therefore we recommend adjusting the wording in paragraph BC4 accordingly.

For clarity, we recommend that the following issues also are addressed:

- Paragraph 5A would be clearer if it referred explicitly to non-current assets held for sale and other assets and liabilities that form part of a disposal group.

- The reference to IAS 1 *Presentation of Financial Statements* would be clearer if it referred to specific paragraphs, for example to paragraph 112(c) in respect of general information in the notes to the financial statements, and/or to paragraphs 122 and 125 in respect of significant judgements and sources of estimation uncertainty.

IFRS 8 _Operating Segments_ – Disclosure of information about segment assets

Generally we support the proposal to amend the Basis for Conclusions accompanying IFRS 8 to clarify that not disclosing a measure of segment assets would be in accordance with IFRS 8 when no such measure is reported to the Chief Operating Decision Maker (CODM). However, we believe that paragraph 23 of IFRS 8, as currently drafted, may be read as implying that a measure of total assets for each reportable segment is required to be disclosed regardless of whether this measure is reported to and reviewed by the CODM. Therefore, to eliminate a potential inconsistency, we recommend that the Board consider amending paragraph 23 to clarify that not disclosing a measure of segment assets would be in accordance with IFRS 8 if such a measure is not reported to the CODM.

Whether the Board amends only the Basis for Conclusions of IFRS 8 or the standard itself, we believe that an effective date for the proposed amendment is required. We recommend an effective date of 1 January 2010, and that, consistent with the initial application of IFRS 8, retrospective application be required.

IAS 18 *Revenue* – Determining whether an entity is acting as a principal or as an agent

Generally we support the proposal to amend the guidance accompanying IAS 18 to address the issue of whether an entity is acting as a principal or as an agent, and the inclusion of indicators for considerations. However, we believe that the Board should consider the following:

- We recommend that the sentence “Features that, individually or in combination, indicate that an entity… ” be redrafted to require an overall evaluation of the features. The current drafting implies that if the arrangement has just one of these features, then the entity is presumed to be acting as a principal. In our experience, the individual features of such arrangements often include some indicators of acting as an agent and some indicators of acting as a principal; judgement is required in making an overall assessment. Any suggestion that one indicator can be presumptive may lead to inappropriate conclusions.

- We recommend that the Board clarify that the guidance should be applied to each separately identified component of a single transaction, which would be consistent with paragraph 13 of IAS 18. In practice, an entity might act as principal for one component of a transaction and as agent for another.

- We recommend that the sentence “An entity is acting… *has exposure to* significant risks and rewards associated with… ” be redrafted as “An entity is acting… *retains* significant risks and rewards… ” We believe that the current drafting does not capture adequately what we believe is the Board’s intention and could result in an entity being identified as the principal when it has only insignificant exposure to (a significant) risk.

In practice, often some features of an arrangement indicate acting as agent and others indicate acting as principal. As outlined above, we noted that the features of an arrangement should be evaluated as a whole in determining whether an entity is acting as an agent or as a principal. Consistent with this view, we recommend adding the following additional indicators of acting as a principal, which we have found useful in practice:

- the entity takes title to the goods;

- the entity has discretion in supplier selection;

- the entity modifies or performs part of the services; and

- the entity is involved in determining product or service specifications.

Notwithstanding that the proposals relate to the appendix of IAS 18 rather than to the standard itself, we believe that an effective date is required: the absence of an effective date for the amendment may imply that any changes should be accounted for as the correction of an error. We recommend an effective date of 1 January 2010 with no specific transitional requirements; earlier application should be permitted.

IAS 36 *Impairment of Assets* – Unit of accounting for goodwill impairment test

Generally we support the proposal to amend IAS 36 to clarify that the largest unit to which goodwill is allocated is an operating segment as defined in paragraph 5 of IFRS 8 before aggregation.

While we agree with the proposed effective date of 1 January 2010, we are not convinced that prospective application (i.e., in profit or loss) is appropriate. We note that IFRS 8 has no special transitional requirements, meaning that any change in the level of impairment testing caused by the adoption of that standard is accounted for retrospectively in accordance with the general requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. We question this inconsistency between retrospective and prospective application since both cases relate to the same fundamental issue of the unit of accounting for goodwill impairment testing; accordingly, we believe that the Board should amend or provide support for its decision.

If the Board proceeds with prospective application, then we recommend a clarification in terms of what this means. There appear to be two possible interpretations:

- impairment is calculated immediately before and after the effective date, and any difference is recognised in profit or loss on the effective date; or

- there is no change in respect of historical impairments, but any new impairment is calculated on the basis of the new allocation.

We prefer the second approach, which has the advantage of not disrupting an entity’s usual timing of goodwill impairment testing in the annual cycle.

IAS 38 *Intangible Assets* – Additional consequential amendments arising from revised IFRS 3

Generally we support the proposal to amend paragraphs 36 and 37 of IAS 38 with regard to the recognition of intangible assets acquired in a business combination.

However, as currently drafted, the proposal implies that if an intangible asset is separable only together with a related asset other than another intangible asset, or together with a liability, then that group may *not* be recognised together as a single asset. This is because the last sentence of paragraph 36 focuses solely on the recognition of two or more intangible assets that are separable only together. We believe that the proposed wording is too restrictive; for example, paragraph 32(b) of Appendix B of IFRS 3 (2008) permits recognition as a single asset when the related item is a tangible asset and the useful lives are similar. We recommend that the Board expand paragraph 36 of IAS 38 to reflect this.

IAS 38 *Intangible Assets* – Measuring the fair value of an intangible asset acquired in a business combination

Generally we support the proposal to clarify the description of valuation techniques used to measure the fair value of intangible assets. However, we believe that the Board should consider the following suggestions:

- Adding a description of the *multi-period excess earnings method* as an example of a discounted cash flow valuation technique in paragraph 41(b) of IAS 38. In our experience, this method commonly is used in practice to determine the fair value of intangible assets.

- Providing guidance on when the *cost approach* is considered an appropriate valuation technique. In our experience, this method rarely is appropriate in practice for determining the fair value of intangible assets other than internal-use software. Therefore we recommend adding cautionary language indicating that this approach will be appropriate only in limited circumstances.

IAS 39 *Financial Instruments: Recognition and Measurement* – Scope exemption of business combination contracts

Generally we support the proposal to amend IAS 39 to clarify the scope exemption of business combination contracts in paragraph 2(g) of IAS 39. However, we believe that the scope exemption should be limited to forward contracts that transfer control within the normal time frame for a business combination, for example, in a time frame sufficient only to allow necessary regulatory and legal processes, such as required third party approvals, to be completed. We recommend that the Board consider clarifying the term *at a future date* to limit the scope exemption to these circumstances. If the Board decides not to limit the scope exemption, then we believe that additional guidance is required as to whether or which conditional forward contracts are covered, such as those subject to, for example, regulatory approval.

Additionally, we disagree with the statement in BC6 that paragraph 2(g) should not be applied by analogy to investments in associates and similar transactions. IAS 28 states that "…the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate." A similar logic would apply to acquisitions of interests in joint ventures accounted for under IAS 31. Since equity method accounting and proportionate consolidation under IAS 28 or IAS 31 for investments in associates and joint ventures are based on analogy to the concepts applying to accounting for subsidiaries and, when applicable, business combinations, we believe that the same exemption under paragraph 2(g) should apply to transactions to acquire or dispose of an investment in an associate or joint venture that is a business as applies to transactions to acquire or dispose of an investment in a subsidiary that is a business.

For clarity, we also recommend drafting changes to address the following matters:

- The purpose of the additional words inserted "at a specified price (or on a specified price basis)" is unclear. We recommend that the Board clarify the purpose of this phrase or delete it.

- We believe that BC4 and BC5 are unclear as to the distinction between option contracts not currently exercisable and forward contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date, as neither give rise to currently exercisable voting rights. We recommend that the Basis of Conclusions be redrafted to address why the Board concluded that option contracts not currently exercisable are excluded from the scope exemption but forward contracts are included.

IAS 39 *Financial Instruments: Recognition and Measurement* – Application of the fair value option

Generally we support the proposal to amend IAS 39 to clarify that the fair value option in paragraph 11A applies only to financial instruments within the scope of IAS 39 that contain embedded derivatives.

However, we note that the application of the fair value option to those contracts to buy or sell a non-financial item that falls within the scope of IAS 39 as defined in IAS 39.5, which are <u>not</u> financial instruments, is not addressed. We recommend that the Board expand the amendments to clarify the interaction between paragraphs 11A and 5 of IAS 39, for example, by amending the words of paragraph 11A to "financial instrument <u>*or other contract*</u> within the scope of this Standard".