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Exposure Draft Proposed Improvements to Financial Reporting Standards

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft of Proposed Improvements to Financial Reporting Standards (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

Proposed amendments

Although we have detailed comments on a number of the issues in the ED, we agree with the substance of most of the proposed amendments. We also consider that the proposed amendments are (with one exception) appropriate matters to be addressed in the annual improvements process and welcome the reduction in the number of proposals compared to the 2007 Exposure Draft.

In order to reduce the length of our response, we have not responded to the individual questions relating to proposals with which we agree and in relation to which we have no other comments or suggestions. In some cases we support the Board's objective but have some concerns or suggestions as to the detailed wording of the proposal. Our comments on those cases are set out in the Appendix to this letter.

We have more significant concerns on one of the proposals. These concerns are summarised below and are explained in more detail in the Appendix.

Issue 12: Bifurcation of an embedded foreign currency derivative

The Board proposes to clarify that embedded derivatives contained in contracts denominated in foreign currencies that have one or more of the characteristics of a functional currency (as set out in IAS 21 *The Effect of Changes in Foreign Exchange Rates*) are likely to be integral to the contractual arrangement and therefore closely related to the host contract and prohibited from being accounted for separately.

We do not agree with this proposal. We believe that this proposal does not fully resolve the problem identified and does not clearly address the issue. Additionally, we believe the proposed amendment would result in a substantive change to current requirements and should therefore be more prominently exposed outside the annual improvement process. A more comprehensive due process would also allow a more detailed consideration of the points that we raise in the Appendix to this letter.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,

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Appendix 1: Responses to Invitation to Comment questions

As noted in the accompanying letter, we have not responded to the Invitation to Comment questions relating to proposed amendments with which we agree and have no further comments.

We agree with the proposed transition provisions and effective date for each issue so make no further comments on these, except regarding issue 3 below.

Our comments on proposals on which we have concerns or suggestions are as follows.

Issue 1: Scope of IFRS 2 and revised IFRS 3

The Board proposes to amend paragraph 5 of IFRS 2 *Share-based Payment* (IFRS 2.5) to confirm that the contribution of a business on formation of a joint venture and common control transactions are not within the scope of IFRS 2 even though they do not meet the definition of a business combination in IFRS 3 *Business Combinations* (revised 2008).

Response

We agree with the proposed amendment. The current wording of IFRS 2.5 does suggest that such transactions are within the scope of IFRS 2. An amendment is therefore appropriate if this is not the Board's intention.

We take this opportunity to note that the lack of guidance on the treatment of the formation of joint ventures and common control transactions causes many difficulties in practice and so we encourage the Board to resolve these issues as soon as practicable.

Issue 3: Disclosure of information about segment assets

The Board proposes to amend the Basis for Conclusions accompanying IFRS 8 *Operating Segments*, to clarify its view on the disclosure of segment assets. IFRS 8.BC35 sets out the reasons for the Board's decision to require a measure of segment profit or loss and segment assets to be disclosed regardless of whether those measures are reviewed by the chief operating decision maker. This has created an unintended difference from US generally accepted accounting practice (US GAAP) under SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*.

Response

We agree that the unintended difference between US GAAP and IFRS 8 should be eliminated. As explained in IFRS 8.BC9-17, the requirements of IFRS 8 are based on a management approach and so are intended to disclose information used by management rather than require information to be created merely for disclosure purposes. We support that approach.

It is a logical consequence of adopting that approach that segment assets should be disclosed only when they are included with the information presented to and used by the Chief Operating Decision Maker (CODM). This is the approach already adopted by IFRS 8.23 for segment liabilities, which are only disclosed if regularly provided to the CODM. However, IFRS 8.23 takes a different approach for segment assets. It states that an entity 'shall report a measure of profit or loss and total assets for each reportable segment'. The natural reading of this paragraph leads to the conclusion that the reporting of this measure is therefore not dependant on it being regularly reported to the CODM, as expressed in the existing IFRS 8.BC35.

Although we can see that the interpretation in the proposed amendment to IFRS 8.BC35 can be used to compensate for the contradiction between IFRS 8.23 and 25, we do not believe that changes to the requirements of Standards should be made only via a change to the Basis for Conclusions to the Standard. The Basis for Conclusions should only explain the reasoning behind what is required by the Standard. It should not, as a result, contain requirements, interpretations or guidance, nor should it contradict the natural reading of the wording used in the Standard.

For these reasons, we believe that a change also needs to be made to the Standard itself to clarify when disclosure of segment asset information is required. This could be achieved by amending the wording of IFRS 8.23 to refer to segment assets in the same way as liabilities; eg

"23. An entity shall report a measure of profit or loss for each reportable segment. An entity shall report a measure of assets and a measure of liabilities for each reportable segment if such an amount is regularly provided to the chief operating decision maker."

We also believe that additional clarity is needed to confirm that the requirement of IFRS 8.23 and 25 is to disclose only measures that are provided to the CODM, irrespective of the monetary value of those measures. IFRS 8.BC34 refers to service industries and other industries with a low utilisation of physical assets as examples where a measure of segment assets may not be regularly provided to the CODM. In the Basis for Conclusions to the proposed amendment, BC2 also refers to some industries with a low base of physical assets. This wording implies that only entities in such industries should be in a position where disclosure of a measure of segment assets is not required by IFRS 8. The principle of disclosing only the information that is regularly provided to the CODM applies to all entities. Consequently, the Basis of Conclusions should be clear that any entity that does not report a measure of segment assets does not need to disclose such information under IFRS 8 and the specific types of industries mentioned are merely examples of where a measure of segment assets is not expected.

The ED does not propose an effective date for this amendment. We assume that this is because the change is intended only to amend the Basis for Conclusions. However, the change is likely to have a real effect in practice and, as noted above, should be made in the Standard itself. Consequently, we believe that an effective date should be added. As this change is likely to reduce unintended disclosure, early adoption should be permitted.

Issue 4: Classification of expenditures on unrecognised assets

In 2008 the International Financial Reporting Interpretations Committee (IFRIC) reported to the Board that practices differ for the classification of cash flows for expenditures incurred with the objective of generating future cash flows when those expenditures are not recognised as assets in accordance with IFRSs. Some entities classify such expenditures as cash flows from operating activities and others classify them as investing activities. The Board proposes to amend IAS 7 *Statement of Cash Flows*, to state explicitly that only an expenditure that results in a recognised asset can be classified as a cash flow from investing activities.

Response

We agree that the possible inconsistency between the definition of investing activities and the wording of IAS 7.16 should be eliminated. However, we do not believe the wording change proposed will be effective nor do we find the explanation in the Basis for Conclusions clear.

IAS 7.6 defines investing activities as: 'the acquisition and disposal of long-term assets and other investments not included in cash equivalents'. In our view, this already implies that expenditures that do not result in the recognition of long-term assets or investments in the statement of financial position cannot be classified as investing.

The wording of the proposed amendment does not provide a sufficiently clear link to the definition of investing activities. It refers to both 'resources' (which has a broad meaning) and 'assets' (which includes both current and non-current items). If the Board wishes to clarify that only expenditures that result in a recognised asset can be classified as an investing cash flow then we believe this should be stated explicitly.

To achieve this we suggest that the wording in IAS 7.6 is amended to:

"7.6 Investing activities are the acquisition and disposal of **recognised** long-term assets and other investments not included in cash and cash equivalents." [emphasis added]

Similarly, we recommend IAS 7.16 be changed as follows:

"7.16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made **to acquire or dispose long-term assets and other investments that are initially recognised as assets in the statement of financial position**. Examples of cash flows arising from investing activities are: . . . ." [emphasis added]

Issue 5: Determining whether an entity is acting as a principal or as an agent

The Board proposes to amend the guidance accompanying IAS 18 *Revenue*, to provide guidance on determining whether an entity is acting as a principal or as an agent. IAS 18.8 specifies the accounting for amounts collected on behalf of a principal. However, IAS 18 does not provide guidance on determining when this applies.

Response

We agree with the proposed amendment and believe such guidance will be valuable in practice. However, although we acknowledge that the list of indicators provided is not intended to be comprehensive, we believe that it should include further indicators. The indicators provided are consistent with some of those provided in US GAAP (in EITF 99-19). We believe that some of the other indicators in EITF 99-19.10-12 merit inclusion. Specifically, we consider that the following are useful indicators that the entity is acting as principal: the entity has discretion to change the product (beyond its packaging) or perform part of the service ordered by a customer and these changes may influence the profitability of that product or service; the entity has discretion in supplier selection; and the entity is involved in the determination of product or service specifications.

Also, example 18(d) in the Appendix to IAS 18 'Agency transactions' presents a situation where a franchisor is acting as agent for the franchisee. As the proposed new example 21 'Determining whether an entity is acting as a principal or as an agent (2008 amendment)', provides indicators for determining whether an entity is acting as a principal or as an agent, we believe that example 18(d) should be modified. This should at least make a reference to the criteria in example 21 to evaluate whether the franchisor is acting as agent or as a principal or, preferably, it should directly demonstrate how the criteria from example 21 apply to the situation

Issue 6: Unit of accounting for goodwill impairment

The Board proposes to amend IAS 36 *Impairment of Assets*, to clarify whether the largest unit permitted by IAS 36 is the operating segment level as defined in IFRS 8.5 before or after the aggregation permitted by IFRS 8.12.

Response

We agree with the proposal as this will help to avoid inconsistency of interpretation and follows the intention of IFRS 8 to focus on the information used by management for decision-making purposes. However, the wording of the Basis for Conclusions BC1 implies that the requirement of IAS 36.80(b) applies only to entities that apply IFRS 8.

The scope of IFRS 8 is restricted to (in simple terms) entities whose debt or equity instruments are (to be) traded in a public market. There is no such scope restriction in IAS 36. Consequently, all entities within the scope of IAS 36 are required to reconsider the allocation of goodwill because of the revised definition of operating segment introduced by IFRS 8, even if they are not within the scope of IFRS 8. This should be made clear in BC1.

Although not directly relevant to the proposal, we also suggest that the Board should reconsider the appropriateness of aggregating cash generating units (CGUs) on the basis of operating segments. IFRS 8's definition of operating segments is based on the segmentation used in internal reporting and is therefore a matter decided upon by management's internal reporting processes. By contrast, CGUs are determined by the definitions in IAS 36. For this reason a CGU or group of CGUs will not necessarily correspond to an operating segment.

Issue 12: Bifurcation of an embedded foreign currency derivative

The Board proposes to clarify, in IAS 39 *Financial Instruments: Recognition and Measurement*, what the 'economic environment' is in determining whether a currency is commonly used in contracts to buy or sell non-financial items and therefore is closely related to the host contract. The proposed amendment clarifies that contracts denominated in foreign currencies that have one or more of the characteristics of a functional currency (as set out in IAS 21 *The Effect of Changes in Foreign Exchange Rates*) are likely to be integral to the contractual arrangement and therefore closely related to the host contract and prohibited from being accounted for separately.

Response

Although we agree that there is a need to clarify what the 'economic environment' is in determining whether a currency is 'commonly used' in certain contracts and so can be considered 'closely-related' to the host contract, we do not agree with the amendment proposed. Our reasons for this disagreement are as follows:

- The proposed amendment would make IAS 39.AG33(d)(iii) overlap with AG33(d)(i) (functional currency of any substantial party to the contract). AG33(d)(i) sets a higher requirement and so will be rendered irrelevant.
- The proposal would probably require the reporting entity to try and obtain knowledge of the counter-party's financial reporting environment in order to identify the characteristics of its functional currency listed in IAS 21.9.

- We are not convinced that the examples provided in BC19 can be clearly linked to the characteristics of functional currency in IAS 21.9. If they can be, then the examples should be incorporated into the Standard (in the Application Guidance or at least in the Implementation Guidance or Illustrative Examples), together with clear links to the relative characteristics that they display. The examples should not be restricted only to the Basis for Conclusions.
- We noted in our 16 September 2008 letter in response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, "we believe IAS 39's requirements on the identification and possible separation of embedded derivatives are difficult to understand and apply for many preparers. Part of the problem is that IAS 39 lacks a clear economic principle on the application of the 'closely related' test. Instead, this is governed by a series of complex and sometimes contradictory rules. We believe that developing a guiding principle on the closely related test (which might still need to be supported by application guidance) would clarify and simplify this aspect of IAS 39". We do not believe that the proposed amendment achieves any greater clarity than the existing guidance and merely adds more complexity to it. Consequently, this proposed change should be considered as part of the wider review of reducing complexity in dealing with embedded derivatives rather than as a partial amendment introducing more rule-based requirements that are not clearly supported by an underlying principle.
- The proposed amendment to IAS 39.AG33(d) introduces the concept that an embedded currency derivative is closely related if it 'integral to the contractual arrangement'. This is a new proposition. In our view, prior to introducing this new concept in the AG33(d) context, the Board should consider whether it should form the basis for application of the 'closely related' test more generally. We therefore believe that the concept should be considered more widely, and also defined clearly, before being introduced.

In summary, the proposal would, in our view, represent a substantive change to the requirements of IAS 39.AG33(d) and so should be exposed more prominently outside the annual improvements process.