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D18 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER

EFRAG extends comment period
Comments should be sent to Commentletter@efrag.org by **27 March 2006**

Although D18 is quite short and the issue it addresses seems quite easy to understand, discussions among EFRAG members suggest the subject is more complex than it seems. Therefore, we include behind the letter questions and some notes explaining background of D18 and EFRAG's reasoning in this draft comment letter. We hope you find them useful. The notes do not form part of the actual comment letter that we are proposing to submit.

Dear Sir/Madam,

Re: IFRIC Draft Interpretation D18 *Interim Financial Reporting and Impairment*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IFRIC Draft Interpretation D18 *Interim Financial Reporting and Impairment*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues. Our comments are as follows:

We agree with IFRIC's analysis, as summarised in the Basis for Conclusions section of D18, that there is a conflict between IAS 34 *Interim Financial Reporting* on the one hand and IAS 36 *Impairment of Assets* and 39 *Financial Instruments: Recognition and Measurement* on the other.

IAS 36 and IAS 39 prohibit reversals on impairment of equity instruments and goodwill which has an effect that entities that are identical except that they have different annual accounting dates would report different profits and losses. We understand that these prohibitions were made on feasibility grounds even though they are somewhat arbitrary in nature. It seems to us that if it is not feasible to identify that an impairment loss has reversed it is the case regardless of whether the loss is recognised in the annual financial statements or in the interim reporting. For that reason, we support what the consensus paragraph in D18 is trying to do: which is to require entities to follow the requirements of standards on impairment and not reverse an impairment loss recognised in a previous interim period, even though the frequency of an entity's reporting may affect the measurement of annual results.

However, it is our understanding that conflicts between standards can be eliminated only by amending one or more of the standards involved; IFRIC interpretations do not amend standards and therefore should not be used to resolve conflicts between standards. IFRIC stated this in its work on interpretations concerning emission rights and service concessions. Therefore, we recommend that the IASB should amend IAS 34 by including the consensus conclusion in the text of IAS 34 rather than IFRIC issuing an interpretation on this subject. The amendment to IAS 34 would say that the frequency of an entity's reporting shall not affect the measurement of its annual results, except where the entity recognises impairment losses in an interim period on goodwill, or an investment in an equity instrument measured at fair value or an unquoted equity instrument carried at cost because fair value cannot be measured reliably that cannot be reversed in accordance with IAS 36 or IAS 39.

D18 proposes that the consensus conclusion should be applied retrospectively. The transitional provisions of the current version of IAS 36 require that the version's requirements on recognition of impairment losses should be applied prospectively from the beginning of the first annual period beginning on or after **31 March 2004** and grandfather application of the standard to goodwill and intangible assets in business combinations that took place before **31 March 2004**. As the conflict with IAS 34 arose when the current version of IAS 36 was implemented, it should be sufficient to include in this interpretation/amendment transitional provisions for goodwill impairment that are in line with the transitional provisions in the current IAS 36. If the intention was that the transitional provisions of this interpretation/amendment should be in line with IAS 36's transitional arrangements, we support the proposal. However, that intention should be clarified. If the intention was different, we think this will be problematical and burdensome.

We also recommend clarifying that the interpretation/amendment applies to investments in equity instruments measured at fair value or unquoted equity instruments carried at cost because fair value cannot be measured reliably. The current reference in the consensus paragraph to "an investment in an equity instrument and a financial asset carried at cost" creates confusion as it suggests that "a financial asset" may be a debt instrument.

If you would like further clarification of the points raised in this letter, Paul Ebling or myself would be happy to discuss these further with you.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman

Notes and questions for respondents

EFRAG welcomes comments on all aspects of D18 and EFRAG's draft comment letter on D18. It would particularly welcome comments on the questions it asks below.

Consensus reached in D18

Question 1—EFRAG asks those respondents who disagree with the consensus reached in D18 to consider whether it is D18 they disagree with or the prohibitions on reversals of impairment losses in IASs 36 and 38. If you believe it is D18 that you are disagreeing with, could you please explain your reasoning for disagreeing with the argument that, if it is not feasible to identify that an impairment loss has reversed, that is the case regardless of whether the loss was first recognized in interim financial statements or annual financial statements?

Basis of conclusion for EFRAG's comments

The prohibition on reversing impairment losses on acquired goodwill

Currently IAS 36 requires impairment losses to be recognised in the income statement when assets falling within its scope are deemed to be impaired. The standard allows those impairment losses to be reversed if (and to the extent that) the reporting entity subsequently decides that the asset is no longer impaired, except that paragraph 124 states that an impairment loss recognized for acquired goodwill shall not be reversed in a subsequent period.

Paragraphs BC187 – BC191 of the Basis for Conclusions section of IAS 36 explain the reasoning behind the prohibition on the reversal of impairment losses on goodwill. The paragraphs explain that, if reversals of impairment losses for goodwill are to be permitted, it will be necessary for the reporting entity to establish the extent to which an increase in the recoverable amount of goodwill subsequent to the impairment loss being recognized is attributable to the recovery of the acquired goodwill within a cash-generating unit rather than an increase in the internally generated goodwill within the unit because IAS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. The IASB decided that this would seldom if ever be possible, so reversals should simply be prohibited.

The IASB noted that prohibiting the recognition of reversals of impairment losses for goodwill so as to avoid recognizing internally generated goodwill might be viewed by some as inconsistent with the goodwill impairment test itself (because, as it is not possible to differentiate between internally-generated goodwill in a cash-generating unit and acquired goodwill in the same cash-generating unit, the existence of the internally-generated goodwill will make it less likely that it is concluded that the acquired goodwill has been impaired). However, the IASB decided that it is more concerned about the recognition of internally generated goodwill (which might happen on reversing an impairment loss) than it is about acquired goodwill being 'shielded' from the recognition of an impairment loss because of the existence of internally generated goodwill.

The prohibition on reversing impairment losses on investments in equity instruments

IAS 39 stipulates impairment requirement for financial assets. It requires impairment losses to be recognized in the income statement when there is indication of impairment. The standard allows those impairment losses to be reversed for all financial assets except for investments in equity instruments measured at fair value (paragraph 69) and unquoted equity instruments that are not carried at fair value because their fair value cannot be reliably measured (paragraph 66).

Paragraph BC130 of the Basis for Conclusions section of IAS 39 explains the reasoning behind the prohibition on the reversal of impairment losses on investments in equity instruments. It states that the Board could not find an acceptable way to distinguish reversals of impairment losses (which would normally be accounted for by crediting the income statement) from other increases in fair value (which would normally be accounted for by crediting equity). It therefore decided that precluding reversals of such impairment losses was the only appropriate solution.

Conflict with IAS 34

Paragraph 28 of IAS 34 states that the frequency of an entity's reporting (annual, half-yearly or quarterly) shall not affect the measurement of its annual results and, to achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis. Assume that two identical companies—Company A and Company B—hold an identical equity that is deemed to have become impaired in the first quarter of 2006. In the second quarter, the asset appears no longer to be impaired. Company A reports half-yearly, and therefore, under IAS 39, it does not report an impairment loss. Company B, on the other hand, reports quarterly. It therefore reports an impairment loss in Quarter 1. Unless it is able to reverse that impairment loss in Quarter 2's Interim Financial Statements it will not be able to comply with the requirement of paragraph 28 of IAS 34 that the frequency of an entity's reporting (annual, half-yearly or quarterly) shall not affect the measurement of its annual results. On the other hand, if it does reverse the impairment loss it would appear not to be complying with the paragraph 28 requirement that an entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. Depending on one's interpretation of IASs 36 and 39, it also might not be complying with the prohibitions in those standards on the reversal of impairment losses.

Consensus reached in D18

D18 seeks to resolve these apparent conflicts. It proposes to do so by prohibiting the reversal of the impairment losses recognized in a previous interim period in the identified cases, even if that means that the frequency of an entity's reporting *will* affect the measurement of its annual results.

The prohibitions in IASs 36 and 39 on the reversal of impairment losses have been included in the standards because the IASB does not believe it is feasible to measure the amount of the reversal reliably. EFRAG takes the view that, if it is not feasible to identify that an impairment loss has reversed, it is the case regardless of whether the loss was first recognized in interim financial statements or annual financial statements. For that reason, EFRAG supports the consensus conclusion in D18.

Transitional provisions

Question 2—Do you agree that it would be possible to apply the interpretation retrospectively to impairment of goodwill in line with the transitional provisions in IAS 36, i.e. that any reversals of impairment losses on goodwill recognised prior to 31 March 2004 would be grandfathered?

Question 3—Do you agree that retrospective application for financial assets in scope of IAS 39 that are subject of this interpretation would not pose practicality problems? If you do not, could you please explain the exact circumstances in which D18's proposal will be burdensome?

Please see below reasoning for EFARG's comments on these issues.

Basis of conclusion for EFRAG's comments*Impairments of acquired goodwill*

IAS 36's prohibition on the reversal of impairment losses on goodwill was introduced when IAS 36 was revised in 2004. The previous version of IAS 36 issued in 1998 permitted reversals of impairment losses on goodwill in certain limited circumstances. At the time the prohibitions were introduced, IAS 36 required them to be applied prospectively from the beginning of the first annual period beginning on or after 31 March 2004. The implication of this was that reversals of impairment losses on goodwill that were recognized prior to 31 March 2004 could be grandfathered; adjustments would have to be made only for those reversals of impairment losses on goodwill made from that date.

D18 proposes that its requirements shall be applied retrospectively. EFRAG's tentative view is that that is a little ambiguous.

- One possibility is that the proposal is that the transitional arrangements in IAS 36 should be overruled—in other words, that the reversals of impairment losses on goodwill that were recognized prior to 31 March 2004 can no longer be grandfathered. EFRAG's tentative view is that this would be problematical, because it would impose burdens on entities that have been applying IFRS for some time—burdens that IAS 36 chose to avoid.
- The other possibility is that the proposal is that the requirements of D18 should be applied retrospectively to 31 March 2004, and that any reversals of impairment losses on goodwill recognized prior to 31 March 2004 would be grandfathered. EFRAG's tentative view is that this would be an acceptable transitional arrangement.

EFRAG is therefore proposing to ask IFRIC to clarify its intentions so that it is clear that D18 does not overrule the transitional arrangements of IAS 36.

Impairments of investments in equity instruments

IAS 39 originally permitted the reversal of impairments of investments in equity instruments and unquoted equity instruments measured at cost; reversals were prohibited only when the standard was amended in 2003 (to be effective as of 1 January 2005). At that time the standard required the prohibition to be applied retrospectively. D18, which clarifies (or amends, depending on one's point of view) that prohibition on reversing impairment losses applies to impairment losses recognized in interim financial statements, is proposing that this clarified/amended prohibition should also be applied retrospectively.

EFRAG's tentative view is that, if implementing the revised IAS 39's prohibition retrospectively was not burdensome, it would probably not be burdensome to implement the clarified/amended prohibition in D18.