EFRAG

European Financial Reporting Advisory Group

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Dear Mr Stoll

ADOPTION OF IFRIC 10 *INTERIM FINANCIAL REPORTING AND IMPAIRMENT*

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 we are pleased to provide our opinion on the adoption of IFRIC 10 *Interim Financial Reporting and Impairment* (IFRIC 10), which was published by IFRIC on 20July 2006. It was issued in draft as IFRIC D18 and EFRAG commented on that draft.

IFRIC 10 deals with the interaction between on the one hand the requirements in IASs 36 and 39 concerning the reversal of impairment provisions and on the other hand the requirements of IAS 34.

- IAS 36 requires, inter alia, that impairment losses on acquired goodwill should be recognised if the acquired goodwill is deemed to have been impaired and that the provision for those losses shall not be reversed in a subsequent period, regardless of circumstances. IAS 39 contains similar provisions relating to investments in available-for-sale equity instruments and unquoted equity instruments that are not carried at fair value because their fair value cannot be reliably measured.

- IAS 34 requires that an entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements and that the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis. That in turn means that, if an impairment is recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in that subsequent period either by accrual of an additional amount of loss or by reversal of the previously recognised amount.

IFRIC 10 states that, when dealing with impairments and the possible reversal thereof, the requirements of IASs 36 and 39 shall prevail over the requirements of IAS 34. The Interpretation becomes effective for annual periods beginning on or after 1 November 2006, with early application encouraged.

EFRAG has carried out an evaluation of IFRIC 10. As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and EFRAG's discussions of technical matters are open to the public.

EFRAG notes that IFRIC 10 is not consistent in all respects with IAS 34. Had the IASB and IFRIC clarified the interaction between IASs 36 and 39 and IAS 34 by amending the standards themselves, this inconsistency could have been avoided. On the other hand, amending the standard would have taken longer so clarity on this important matter would not have been available so soon. On balance, EFRAG supports the use of an Interpretation to provide that clarity in this instance.

One EFRAG member has concerns about IFRIC 10 that cause that member to believe that EFRAG should not recommend the Interpretation for endorsement. (That member's reasoning is explained in the attached 'Appendix 1—Dissenting View'.)

However, the majority of EFRAG members have concluded that IFRIC 10 meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

i. it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

ii. it 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.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRIC 10 and, accordingly, EFRAG recommends its adoption. (EFRAG's reasoning is explained in the attached 'Appendix 2—Basis for Conclusions'.)

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
Dissenting view

Mr Carsten Zielke believes that IFRIC 10 should not be endorsed for use in the European Union and therefore dissents from EFRAG's decision to recommend its endorsement. The reasons for that dissent are set out below:

1 Mr Zielke believes that, if financial statements are to be relevant, comparable and understandable, they need to conform to certain principles. One of those principles is that the financial statements should not report or imply material volatility in the operating performance of the entity or in the environment in which it operates that does not reflect economic reality.

2 For that reason, Mr Zielke believes it is important inter alia that, if the conditions that gave rise in a previous reporting period to the recognition in the income statement of a provision for an impairment loss on an asset other than goodwill no longer exist, the recognition of that provision should be reversed also through the income statement. He notes that IAS 39 does not apply that principle to impairment of certain investments in equity instruments.

3 Another principle that Mr Zielke believes needs to be met is that financial statements should not report or imply differences in the operating performance of two entities when there are no economic differences. In particular, two reporting entities that start the financial year in exactly the same financial position and end it in exactly the same financial position and apply exactly the same accounting policies, estimates and judgements should not report different amounts of operating profit simply because one reports on a quarterly basis and another reports on a half yearly basis.

4 In Mr Zielke's view, in developing IFRIC 10 the IFRIC had a choice and it chose to interpret IASs 34 and 39 in a way that has amplified the unfortunate effects of the IAS 39 impairment requirements described in paragraph 2 above and has resulted in the principle described in paragraph 3 not being met.

5 As a result, Mr Zielke has concluded that IFRIC 10 does not meet the criteria that need to be met for an IFRIC Interpretation to be endorsed for use in the European Union.

Appendix 2
Basis for Conclusions

Set out below is the basis for the conclusion reached and the recommendation made by the majority of EFRAG's members, It includes the reasons why those EFRAG members do not find the views of Mr Zielke as set out in appendix 1 to be persuasive.

1 When evaluating IFRIC 10, 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 10 a correct interpretation of existing IFRS?

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

Is there an issue that needs to be addressed?

2 It is clear from the discussions that EFRAG has had during its meetings and from the comment letters that it has received that there are different views amongst stakeholders as to how the impairment provisions of IASs 36 and 39 interact with the requirements of IAS 34; and in particular on whether an impairment of acquired goodwill or of certain financial assets that has been recognised in a set of interim financial statements can be reversed later in that annual accounting period.

(a) One view is that the standards (in particular IAS 34) state that IAS 34 prevails over IASs 36 and 39, and as a result such impairments can be reversed. This view is referred to in this appendix as ‘View 1’. This view is held by a few EFRAG members.

(b) The other view (View 2) is that the requirements of IAS 34 are in conflict with the requirements of IASs 36 and 39 and neither standard states which should prevail. This view is held by IFRIC and by a clear majority of EFRAG members.

There is evidence to suggest that these differences of view are leading to differences in practice and that those differences in practice can be significant.

For those reasons, EFRAG concluded that the issue addressed in IFRIC 10 *is* an issue that needs to be addressed.

Is an Interpretation an appropriate way of addressing this issue?

3 One way of resolving the uncertainty as to how IAS 34 and IASs 36 and 39 interact is to make it clear that IAS 34 prevails.

(a) Those holding View 1—which is that the existing literature already says that IAS 34 prevails—would see this as a reaffirmation of the existing literature. Issuing an Interpretation is an appropriate way of reaffirming the meaning of existing standards.

(b) Those holding View 2—which is that IAS 34 and IASs 36 and 39 require different treatments and are therefore in conflict—would see this as an amendment of IASs 36 and 39. Whether an Interpretation is an appropriate way of amending a standard is discussed in paragraphs 5-7.

4 The other way of resolving the uncertainty as to how IAS 34 and IASs 36 and 39 interact is to make it clear that IASs 36 and 39 prevail. Regardless of whether one favours View 1 or View 2, this would involve an amendment of IAS 34. As already mentioned, whether an Interpretation is an appropriate way of amending a standard is discussed in paragraphs 5-7.

5 Interpretations cannot amend standards; only interpret them. (This is important not least because standards are subject to a much more comprehensive due process than Interpretations.) Therefore, issuing an Interpretation to resolve the uncertainty as to how IAS 34 and IASs 36 and 39 interact by amending one or other standard should not be a satisfactory long-term solution.

6 EFRAG also considered whether issuing an Interpretation to amend a standard in these circumstances might nevertheless be an appropriate short-term solution.

(a) EFRAG noted that issuing an Interpretation on this issue at this point in time has the important virtue of making clear relatively quickly to all stakeholders exactly how the IASB and IFRIC believe the matter should be resolved. In EFRAG's view, such a clarification is urgently needed, and issuing an amendment to an IFRS would probably have taken longer to do than issuing an Interpretation.

(b) On the other hand, it could be argued of course that if an Interpretation cannot amend a standard, that is the case regardless of whether it is being used as a long-term solution or a short-term solution. This is a particular problem in a financial reporting system like the EU's where standards and Interpretations are given a legal status by the regulations that adopt them, because conflicting legal requirements cause confusion.

(c) There is also the concern that accepting in this case that an Interpretation can amend a standard will set a precedent that is subsequently used in circumstances that might be considered by some to be less deserving.

7 EFRAG decided that, bearing in mind the circumstances in this particular case, it should support the issuance of an Interpretation at this time.

(a) It is worth noting that, when exposed this conclusion for public comment as part of its draft comment letter on D18 (the draft Interpretation that preceded IFRIC 10) a significant majority—but not all—of those responding supported EFRAG's conclusion.

(b) EFRAG intends to write to the IASB to ask for the standards involved to be amended to eliminate the inconsistency at the earliest possible moment.

(c) EFRAG also decided this matter should be brought to the attention of the European Commission, so it included the following text in its final letter:

> EFRAG notes that IFRIC 10 is not consistent in all respects with IAS 34. Had the IASB and IFRIC clarified the interaction between IASs 36 and 39 and IAS 34 by amending the standards themselves, this

inconsistency could have been avoided. On the other hand, amending the standard would have taken longer so clarity on this important matter would not have been available so soon. On balance, EFRAG supports the use of an Interpretation to provide that clarity in this instance.

Is IFRIC 10 a correct interpretation of existing IFRS?

8 A few EFRAG members believe that the existing literature already requires IAS 34 to prevail over IASs 36 and 39 (in other words, they hold View 1). Those EFRAG members therefore believe that IFRIC 10—which in effect states that IASs 36 and 39 should prevail over IAS 34—is not a correct interpretation of the existing material—it is an amendment. Their reasoning is set out in paragraphs 9 and 10..

9 View 1 is based on paragraph 30(a) of IAS 34, which states that if impairment losses "are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or *by reversal of the previously recognised amount*" [emphasis added]. The purpose of this requirement is to enable the financial statements to meet the objective set out in paragraph 28 of IAS 34, which is that "the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results".

10 Thus, these paragraphs affirm IAS 34's prevalence over the prohibition on reversals set out in IASs 36 and 39. EFRAG members who hold View 1 therefore believe that there was no conflict to solve between IAS 34 on one hand and IAS 36 and 39 on the other hand. They further believe that IFRIC 10 lifts the restriction included in IAS 34 on the use of the discrete approach to interim reporting. Hence, in their view, IFRIC 10 is not interpreting existing IFRS, it is *changing it.* And, in doing so, IFRIC 10 introduces a contradiction within IFRS that was not there before.

11 As explained in Appendix 1, Mr Zielke does not believe that IFRIC 10 is an appropriate interpretation. He believes that another interpretation is both possible and preferable, as explained in his dissenting opinion.

12 However, a clear majority of EFRAG members believe that there is a conflict between IAS 34 and IASs 36 and 39 (in other words, they hold View 2). Furthermore, they believe that, bearing in mind the requirements of the existing literature, the only appropriate way of resolving that conflict is to prohibit reversals of the impairments under discussion (in other words, to state that IASs 36 and 39 prevail over IAS 34). They have therefore concluded that the consensus in IFRIC 10 is appropriate, bearing in mind the requirements of the existing literature. Their reasoning is set out in the paragraphs 13-15 below.

13 The general principle for impairments is that, when an asset is identified as impaired, it should be written down through the income statement. And, when a previously recognised impairment no longer exists (in part or in full), the relevant amount of the previously recognised impairment loss should be reversed out of the income statement. However, under existing IFRS there are three circumstances in which reversals of impairment losses are not permitted.

(a) The first circumstance involves investments in equity instruments that have been classified as available-for-sale financial assets ('available-for-sale equity investments'). Under IAS 39, all available-for-sale financial assets are measured at fair value but changes in those fair values are recognised initially in equity rather than the income statement. In other words, IAS 39 requires changes in fair values to be accounted for in a different way to the general principle for impairments. That makes it important to be able to differentiate between changes in fair value and impairments/impairment reversals. The IASB took the view when it last revised IAS 39 that, whilst it was possible to differentiate between a downwards movement in fair value of an available-for-sale equity investment and an impairment of such an investment, it was not possible in the majority of cases to differentiate between an upwards movement in the fair value of an available-for-sale equity investment and a reversal of an impairment on such an investment. It therefore required impairment losses on such assets to be recognised when an impairment arises but prohibited the reversal of those impairment losses.

(b) The second circumstance involves certain financial assets that would normally be measured at fair value but are measured at cost because fair value cannot be reliably measured (referred to here as 'unquoted equity-based instruments measured at cost'). The issue here is:

(i) whether it is possible to identify that an unquoted equity-based instruments measured at cost has been impaired and to determine the amount of that impairment when it is not possible to estimate the asset's fair value reliably. The IASB took the view that it *was* possible, primarily because there would usually be indicators that an impairment had occurred, and

(ii) whether it is possible to identify when such an asset is no longer impaired (or no longer as impaired). The IASB took the view that it would not be possible usually to identify whether (and the extent to which) such an asset is no longer impaired . It therefore prohibited the reversal of impairment losses on such assets.

(c) The third circumstance involves acquired goodwill. Under IAS 38, although acquired goodwill is recognised, internally-generated goodwill is not. For that reason, when the IASB was developing its goodwill impairment requirements, it sought to ensure that they did not result in the recognition of internally-generated goodwill. It considered in particular whether it is possible to establish the extent to which an increase in the recoverable amount of goodwill is due to the reversal of an impairment loss rather than an increase in the value of (unrecognised) internally-generated goodwill. It decided that it would seldom if ever be possible to distinguish between the two, so it prohibited the reversal of impairment losses on acquired goodwill.

14 In other words, in all three cases the IASB decided that it would not usually be possible to differentiate between the reversal of an impairment and an event that would be accounted for differently. It therefore decided to prohibit the reversal of impairment losses recognised on such assets. IFRIC 10 applies that principle to impairment losses recognised in an interim period.

15 The majority of EFRAG members believe that, bearing in mind the reasoning that the IASB applied and the conclusions the IASB reached in IASs 36 and 39, no other consensus other than the one in IFRIC 10 would have been appropriate. If it is not possible to identify when an impairment has reversed, that is the case regardless of whether the impairment was recognised for the

first time in a set of annual financial statements or in an interim financial report. It is also the case regardless of the consequences.

Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?

16 The ultimate test for IFRIC 10 is of course whether it is contrary to the true and fair principle, whether financial information resulting from its application is likely to meet the criteria of understandability, relevance, reliability and comparability, and whether its adoption is in the European interest.

17 As explained in Appendix 1, Mr Zielke does not believe that IFRIC 10 meets these criteria. A clear majority of EFRAG members however believe it does.

18 Most—but not all—of those EFRAG members believe:

(a) IFRIC is right to have concluded that, under the existing standards, reversals should be prohibited. There was no practical alternative.

(b) they believe that the alternative would be worse because it would in many cases involve companies that have previously recognised an impairment loss on certain assets recognising increases in the fair value of those assets in the income statement while other similar (but not previously impaired) assets would be accounted for differently. Thus both the consistency and the comparability of the information would be affected.

(c) it is already the case under existing endorsed IFRS that two entities that are identical in every way except that they have different reporting dates could report different gains and losses simply because of their different reporting dates[1]. Or, in other words, it is inevitable in a system that requires periodic reporting of activities that different accounting period ends will effect the comparability of the information provided. EFRAG notes that those effects are much more pervasive than the issue that Mr Zielke has raised, yet financial statements are not considered unacceptable because of them.

19 Furthermore, the majority of EFRAG members point out that were IFRIC 10 not to be endorsed for use in the EU, companies would be free to resolve the issue addressed in IFRIC 10 in their own way, which would mean that inconsistent accounting practices would continue. That would in turn mean that the existing uncertainties—for preparers and users—would persist. It would also create a divergence between the financial reporting requirements in Europe and the requirements of IFRS. EFRAG does not view this argument as conclusive in all cases—if it was conclusive it would mean, for example, that virtually all Interpretations should be endorsed without debate—but it is one of the factors that will always need to be taken into account in deciding whether endorsement is in the European interest and it is possible that in some cases it will be judged conclusive in its own right.

20 One final, more detailed point. During the course of EFRAG's deliberations as to the endorsement advice it should give on IFRIC 10, it became apparent that some commentators found the wording of consensus paragraph 8 unhelpful. The intention is that the consensus paragraph should apply only to available-

[1] Because, if in one case the impairment arises immediately before one of the entity's reporting dates and reverses immediately after and in the other the impairment and reversal take place in the same period, the gains and losses recognised will not be the same.

for-sale equity investments and unquoted equity-based instruments measured at cost. However, consensus paragraph 8 refers only to "an investment in either an equity instrument or a financial asset carried at cost". As a result, although IFRIC's intention is clear from IFRIC 10 when read as a whole, consensus paragraph 8 in isolation is confusing. EFRAG agrees that the paragraph is not well drafted and is in the process of writing to the IASB to ask it to clarify the wording as a matter of priority. However, EFRAG decided that the significance of the issue was not sufficient for it to conclude that the Interpretation did not meet the criteria for endorsement for use in the EU.