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Dear IASB members,

Invitation to comment – Exposure Draft ED/2019/2 *Annual Improvements to IFRS Standards 2018-2020*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the Exposure Draft *Annual Improvements to IFRS Standards 2018-2020* (the ED).

As part of its Annual Improvements process, the IASB (or Board) is proposing amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*, IFRS 9 *Financial Instruments*, the Illustrative Examples accompanying IFRS 16 *Leases*, and IAS 41 *Agriculture*.

We support the Board's efforts to improve IFRS standards through a series of narrow scope amendments and we generally agree with the proposed amendments in the ED. However, we have some specific concerns that we believe the Board should address when finalising these amendments. In particular:

- The proposed amendment to IFRS 1, as worded, seems to remove the ability for a subsidiary that is a first-time adopter to reset its cumulative translation differences to zero at the date of transition to IFRSs, as permitted under paragraph D13 of IFRS 1, when that subsidiary applies paragraph D16(a) of IFRS 1. Removing this ability might have unintended consequences when the subsidiary does not use the same presentation currency as the parent.
- The proposed amendment to IFRS 9 begs the question whether there is a distinction between 'fees' and 'costs', or whether those terms mean the same and can be used interchangeably, in the context of the 10% test for derecognition of financial liabilities.
- The reference to 'fees paid or received on the other's behalf' in the proposed amendment to IFRS 9 is capable of being read in different ways and might leave room for structuring.

- While we appreciate the arguments against it, we believe the Board should make an equivalent amendment to IAS 39, as that which it is currently proposing for IFRS 9. This is important because not changing IAS 39 might set a precedent for future possible amendments (or non-amendments) and because IAS 39 continues to be relevant for insurance entities and entities applying IFRS for Small and Medium-sized Entities (IFRS for SMEs).
- While we agree with the proposed amendment to the Illustrative Examples accompanying IFRS 16, we do not support including a potentially contentious technical position of the Board in the Basis for Conclusions. Doing so, in our view, would not be consistent with the purpose of the Basis for Conclusions, as described in the Due Process Handbook.

In addition, we have a few more minor comments related to the explanation of the proposed amendments and the basis for the Board's conclusions in proposing the amendments, as included in the ED. We also note that a consequential amendment is needed to one of the examples in the implementation guidance accompanying IFRS 1, when that standard is amended.

Lastly, while beyond the scope of the Annual Improvements process, we encourage the Board to consider developing specific guidance on how to determine whether a modification of a financial asset should lead to derecognition.

Our detailed responses to the questions in the ED are set out in the Appendix to this letter.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152.

Yours faithfully

Ernst & Young Global Limited

Appendix – Responses to questions in ED/2019/2

Questions for respondents *Proposed amendments (please answer individually for each proposed amendment)* Do you agree with the Board's proposal to amend the Standards and accompanying documents in the manner described in the Exposure Draft? If not, why not, and what do you recommend instead?

Proposed amendment to IFRS 1 — Subsidiary as a first-time adopter
We agree in general with the proposed amendment to provide cost and effort relief for first-time adopters. We also support the extension of the proposed amendment to associates and joint ventures for the same reason. However, we would like to raise the following points:

- In our view, the Board should clarify whether the proposed amendment removes the ability for a subsidiary that is a first-time adopter to reset cumulative translation differences to nil, in accordance with paragraph D13 of IFRS 1, when that subsidiary applies paragraph D16(a) of IFRS 1. The election to apply paragraph D16(a) precludes the subsidiary from electing to use other exemptions in Appendix D of IFRS 1 for assets and liabilities, because a subsidiary that applies paragraph D16(a) measures its assets and liabilities using the amounts reported by the parent. The wording of the proposed amendment suggests the same for cumulative translation differences.
- If so, then the proposed amendment provides relief only to a subsidiary that uses the same presentation currency as the parent. Where the subsidiary's presentation currency is different from the parent's presentation currency, the proposed amendment could present a burden for the subsidiary to measure its own cumulative translation differences from the parent's date of transition to IFRS, which could be many years before. In line with the rationale in paragraph BC3 in the ED, we recommend that a subsidiary is given the choice of applying the exemption for cumulative translation differences in paragraph D13 of IFRS 1 when it applies paragraph D16(a) of IFRS 1, post-amendment.
- Paragraph BC4 in the ED states: *"The Board concluded that extending the exemption in paragraph D16(a) to other components of equity is unnecessary because, for example, no difference between the amounts reported by a subsidiary and its parent would arise for those components, or a subsidiary would be able to avoid any potential difference by applying (or not applying) some exemptions in IFRS 1"*

  In our view, this statement could cause confusion because paragraph D16(a) of IFRS 1 restricts the ability to apply other exemptions normally available in that standard. The above wording seems to have been derived from the analysis in agenda paper 12C from the December 2017 IASB meeting. However, in that agenda paper, the staff pointed out that for compound financial instruments, potential differences were noted (although they may be insignificant), and for non-controlling interests (NCI), a subsidiary would need to apply IFRS 3 from the same date as the parent applies it. Furthermore, given restrictions on applying other exemptions in IFRS 1, the statement above might cause unintended consequences. Therefore, we recommend that the Board reconsider the wording 'a subsidiary would be able to avoid any potential difference by applying (or not applying) some exemptions in IFRS 1'.

- We note that IG Example 8 in paragraph IG29 of the implementation guidance accompanying IFRS 1, in which a parent adopts IFRS before its subsidiary, should also be revised, in line with paragraph D16 of IFRS 1, since it deals with paragraph D16(a) and a foreign subsidiary. In addition, as recommended above, we suggest that the choice of applying the exemption in paragraph D13 of IFRS 1 is included in the example. We therefore suggest the following changes to IG Example 8 (new text underlined and deleted text struck through):

  "If subsidiary O applies paragraph D16(a) of the IFRS, the carrying amounts of its assets, ~~and~~ liabilities and cumulative translation differences are the same in both its opening IFRS statement of financial position at 1 January 20X6 and parent N's consolidated statement of financial position (except for adjustments for consolidation procedures) and are based on parent N's date of transition to IFRSs. However, if Subsidiary O chooses to apply the exemption for cumulative translation differences in paragraph D13 of the IFRS, the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to IFRSs.

  Alternatively, subsidiary O may, in accordance with paragraph D16(b) of the IFRS, measure all its assets, ~~or~~ liabilities and cumulative translation differences based on its own date of transition to IFRSs (1 January 20X6). However, the fact that subsidiary O becomes a first-time adopter in 20X7 does not change the carrying amounts of its assets, ~~and~~ liabilities and cumulative translation differences in parent N's consolidated financial statements."

Proposed amendment to IFRS 9 — Fees included in the '10 per cent' test for derecognition of financial liabilities

We agree in general with the objective of the proposed amendment and welcome the guidance on which fees should be considered in performing the '10% test' for derecognition of financial liabilities. However, we would like to raise the following points:

- IFRS 9 does not explicitly prohibit extinguishment accounting for an exchange or modification of a financial liability where the net present value of the cash flows under the new terms differs by less than 10% from the discounted present value of the remaining cash flows of the original debt instrument. For example, the introduction of an equity-linked feature or a change in currency could significantly alter the future economic risk exposure of the instrument, irrespective of the 10% test. Therefore, if carried forward into the final amendment, we suggest aligning the text of the explanation of the proposed amendment (i.e., the introduction on page 12 of the ED) to the heading *"Fees included in the '10 per cent' test for derecognition of financial liabilities"*, to explicitly refer to the 10% test. This would clarify that it is not the intention of this explanation to imply that the 10% test is the only appropriate method for assessing whether a modification of a financial liability is substantial.
- It is not clear to us why the proposed wording to paragraph B3.3.6 of IFRS 9 refers only to 'fees' when discussing the 10% test, but to 'fees and costs' in paragraph BC1 in the ED. Likewise, the existing text in re-numbered paragraph B3.3.6A refers to 'costs or fees'. If the intention of the proposed amendment is to distinguish between fees and costs, in our view, this should be clarified in the final amendment. If not, then we recommend using consistent wording.
- Paragraph BC2 in the ED states: *"This clarification aligns with the objective of the 10 per cent test, that is, to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows between the borrower and lender. Including cash flows paid to or received from parties other than the borrower and lender would go beyond assessing the difference between the old and new contractual terms."*

  The reference to fees and costs incurred between the borrower and lender being 'part of the contractual cash flows' seems to conflict with the requirements in IFRS 9, dealing with how to account for modifications, that changes in contractual cash flows are treated differently from fees and costs incurred. For example, paragraph B3.3.6A in the ED and paragraphs 5.4.3 and B5.4.6 of IFRS 9 all contain separate requirements for the treatment of changes in contractual cash flows versus related fees and costs. We believe that the above wording in paragraph BC2 should be revised to avoid this interpretation, unless this outcome is intentional.
- The proposed amendment focuses on the difference between 'fees' which are incurred directly between the borrower and lender and those which are not. The proposed wording for paragraph B3.3.6 of IFRS 9 also states that *"a borrower includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf"*. As worded, the reference to 'fees paid or

received on the other's behalf' is capable of being read in different ways and seems to leave room for structuring, as it would allow costs which are not incurred directly between the borrower and the lender to be included in the 10% test if they are paid on behalf of the other party, but would require them to be excluded if paid directly by the party who incurred them. This concern is illustrated by two contrasting examples:

<u>Example 1:</u>
A loan is modified and the borrower will incur costs of CU200 to the lender and CU100 to its solicitors. The borrower is invoiced by the solicitors for the CU100 and pays the amount to the solicitor. It appears that only the CU200 should be included in the 10% test based on the requirements in the proposed amendment.

<u>Example 2:</u>
A loan is modified and the borrower will incur costs of CU200 to the lender and CU100 to its solicitors. The lender and borrower agree that the lender will engage the solicitor on the borrower's behalf and that the solicitor will invoice and be paid by the lender. The lender will on-charge the CU100 to the borrower. In this case, the direct fee between borrower and lender is CU300. Would the reference to 'fees paid or received on the other's behalf' just clarify that the amount to be classed as fees is now CU300, or should it be read to mean that the CU100 incurred on the borrower's behalf by the lender should be *deducted* from the CU300, such that the net fee for the 10% test would be CU200?

Similar structuring could occur in the opposite direction. We believe that the wording 'incurred on behalf of' should be clarified to avoid confusion and potential structuring opportunities.

- We note the reasons provided for not making equivalent changes to IAS 39. We believe that the original intention in drafting IFRS 9 was to achieve alignment in respect of the treatment of modification fees for the purposes of performing the 10% test. From a conceptual standpoint, IAS 39 should be amended so that the two standards remain aligned in this regard. While we understand the practical arguments put forward to support not making changes to IAS 39, we question whether this will set a precedent for future possible amendments (or non-amendments), for example, IBOR phase two amendments to the portions of IAS 39 not currently contained in the IFRS Books. While insurance companies continue to be permitted to apply IAS 39, it is not feasible to totally 'freeze' IAS 39 in its 2017 form. In addition, we note that IAS 39 continues to be relevant for entities applying IFRS for SMEs.
- We appreciate the additional guidance on modification of financial liabilities. We would also welcome specific guidance on how to determine whether a modification of a

financial asset should lead to derecognition. However, we acknowledge that such a project is likely to be broader than the scope of this amendment.

Proposed amendment to Illustrative Examples accompanying IFRS 16 — Lease incentives
We agree with the proposed amendment to remove the reference to the reimbursement of leasehold improvements from Illustrative Example 13, as the information was confusing in the context of the example. However, we would like to raise the following point:

- We consider that paragraph BC2 in the ED is not the appropriate place to raise a potentially contentious technical position of the Board (i.e., whether specific payments meet the definition of a lease incentive). According to paragraph 3.77 of the Due Process Handbook, the Basis for Conclusions is intended to include the Board's rationale behind the decisions it reached in developing or changing a Standard. This may include alternative solutions considered but rejected by the Board, but should not include a potentially contentious technical position of the Board that is not already included in the standard itself, as this would result in further confusion. We therefore recommend the following changes if the text of paragraph BC2 is included in the Basis for Conclusions on IFRS 16 when the amendment is finalised (new text underlined and deleted text struck through):

  "The Board developed Illustrative Example 13 to illustrate requirements in IFRS 16 for initial and subsequent measurement of a right-of-use asset and lease liability. The inclusion in the example of payments from the lessor to the lessee (in relation to both real estate commission and leasehold improvements) was intended to illustrate when such payments meet the definition of lease incentives and when they do not. Illustrative Example 13 concludes that the lessee does not account for payments relating to leasehold improvements as a lease incentive but applies other relevant Standards. The explanation provided —'because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset'—implies that these payments are not associated with the lease. ~~However, to be sufficiently precise, Illustrative Example 13 should have stated more clearly that these payments did not meet the definition of lease incentives in IFRS 16 (that is, the payments were not associated with the lease and were not the reimbursement or assumption by the lessor of costs of the lessee because, for example, the payments reimbursed the lessee for improvements made to the lessor's asset).~~ <u>Certain stakeholders were concerned that the Illustrative Example 13 did not clearly illustrate why the arrangement is not a lease incentive.</u>"

Proposed amendment to IAS 41 — Taxation in fair value measurements
We support the proposed amendment regarding taxation in fair value measurements. We believe that this amendment will help to align more closely with the requirements of IFRS 13 *Fair Value Measurement* and clarify that fair value can be measured on a post-tax basis under

IAS 41. We agree with the Board's rationale and reminders about the need for consistency in fair value measurements stated in paragraphs BC1 and BC2(a) in the ED. We believe these paragraphs are helpful and recommend including them in the Basis for Conclusions on IAS 41 when the amendment is finalised.