Basis for Conclusions on
Exposure Draft

ED 1 FIRST-TIME APPLICATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Comments to be received by 31 October 2002

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in ED 1 *First-time Application of International Financial Reporting Standards* (see separate booklet).

Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **31 October 2002**.

All replies will be put on the public record unless confidentiality is requested by the commentator. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

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This Basis for Conclusions is not part of the draft IFRS. It summarises the Board's considerations in reaching the conclusions in the draft IFRS. Individual Board members gave greater weight to some factors than to others. Appendix A of the draft IFRS lists all defined terms.

REASONS FOR ISSUING THE EXPOSURE DRAFT

BC1 SIC-8 *First-time Application of IASs as the Primary Basis of Accounting,* issued in 1998, dealt with the issues that arise when an entity adopts IASs for the first time as its basis of accounting. In 2001, the Board began a project to review SIC-8.

BC2 This project took on added significance because of the requirement that listed companies in the European Union (around 7,000 companies at present) should adopt International Financial Reporting Standards (IFRSs) in their consolidated financial statements by 2005. However, the Board's aim in developing the Exposure Draft was to find solutions that will be appropriate for any entity, in any part of the world, regardless of whether adoption occurs in 2005 or at a different time.

Changes to previous requirements

BC3 Like SIC-8, the Exposure Draft proposes retrospective application in most areas. The Exposure Draft differs from SIC-8 in:

(a) creating targeted exemptions, notably in specified areas where retrospective application is likely to cause undue cost or effort (see paragraphs BC11-BC78). SIC-8 contained less specific exemptions that applied when retrospective application would be 'impracticable';

(b) clarifying that an entity applies the latest version of IFRSs and specifying that the transitional provisions in other IFRSs do not apply to a first-time adopter (see paragraphs BC79-BC88);

(c) clarifying how a first-time adopter's estimates under IFRSs relate to the estimates it made for the same date under its previous GAAP (see paragraph BC89); and

(d) requiring enhanced disclosure about how the transition to IFRSs affected an entity's reported financial position, financial performance and cash flows (see paragraphs BC90-BC97).

SCOPE

BC4 The Exposure Draft applies to an entity that presents its first IFRS financial statements (a first-time adopter). In most cases, it is clear whether an entity's financial statements are its first IFRS financial statements. However, difficulties arise if an entity's previous IFRS financial statements:

(a) complied with some, but not all, requirements of IFRSs; or

(b) contained erroneous or misleading statements of compliance with IFRSs.

The following paragraphs discuss the Board's approach to these difficulties.

Partial compliance with IFRSs

BC5 Some have suggested that an entity should not be regarded as a first-time adopter if its previous financial statements contained an explicit statement of compliance with IFRSs, except for specified (and explicit) departures. Supporters of this view argued that an explicit statement of compliance establishes that an entity regards IFRSs as its basis of accounting, even if the entity does not comply with every requirement of every IFRS. Some considered that this argument is especially strong if an entity previously complied with all recognition and measurement requirements of IFRSs, but did not give some required disclosures—for example, segmental disclosures.

BC6 In particular, some took the view that an entity has adopted IFRSs as its basis of accounting if its financial statements comply with IFRSs in all respects, except that they do not contain the explicit statement of compliance with IFRSs that IAS 1 *Presentation of Financial Statements* requires. Proponents of this view considered that omission of this one disclosure does not undermine the use of IFRSs as the basis of accounting.

BC7 To support a conclusion that IFRSs are the basis of accounting in the event of partial non-compliance, it would be necessary to establish how many departures are needed—and how serious they must be—before IFRSs are no longer regarded as the basis of accounting. Some suggested that the test for concluding whether the basis was IFRSs should be similar to an auditor's thought process in deciding whether to issue an 'except for' opinion or an adverse opinion. In other words, if the departures were so pervasive that an auditor would issue an adverse opinion, an entity would conclude that its basis of

accounting was not IFRSs.

BC8 The Board considered the arguments discussed in paragraphs BC5-BC7, but concluded that any attempt to distinguish IFRS-compliant aspects of an entity's accounting would lead to complexity and, possibly, opportunities for accounting arbitrage. Also, an entity's basis of accounting should not be regarded as IFRSs if it does not give the disclosures required by IFRSs, because that approach would diminish the importance of disclosures and undermine efforts to promote full compliance with IFRSs.

BC9 In the Board's view, the simplest and most workable approach refers solely to an explicit and unreserved statement of compliance with IFRSs, as required by IAS 1 (paragraph 2 of the Exposure Draft). This test gives an unambiguous answer: if financial statements do not contain this statement, the basis of accounting is not IFRSs, regardless of how similar the accounting is to IFRSs. Drawing the line anywhere else would cause uncertainty and ambiguity.

Erroneous or misleading statements of compliance with IFRSs

BC10 Some suggested that an entity should be regarded as a first-time adopter if its previous financial statements contained material disclosed or undisclosed departures from IFRSs, despite an explicit and unreserved statement of compliance with IFRSs. However, in the Board's view, it would cause too much uncertainty to make a distinction based on whether financial statements actually complied in full with IFRSs. If an entity's financial statements in previous years contained an explicit and unreserved statement that they complied with IFRSs, any material disclosed or undisclosed departures from the recognition and measurement requirements of IFRSs are errors and the entity applies IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in correcting them.

BASIC CONCEPTS

BC11 In developing recognition and measurement requirements for an entity's opening IFRS balance sheet, the Board referred to the objective of financial statements, as set out in the *Framework for the Preparation and Presentation of Financial Statements*. The *Framework* states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

BC12 The *Framework* identifies four qualitative characteristics that make information in financial statements useful to users, and notes the need for a balancing, or trade-off, between these four characteristics. In summary, the information should be:

(a) readily understandable by users.

(b) relevant to the decision-making needs of users. Information is relevant to their decision-making needs when it helps them to evaluate past, present or future events or confirm, or correct, their past evaluations. For example, information about the current financial position and past performance and cash flows has value to users when they evaluate the ability of an entity to generate cash and cash equivalents.

(c) reliable, in other words it should:

(i) represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent;

(ii) represent transactions and other events in accordance with their substance and economic reality and not merely their legal form;

(iii) be neutral, that is to say, free from bias;

(iv) contend with the uncertainties that inevitably surround many events and circumstances by the exercise of prudence; and

(v) be complete within the bounds of materiality and cost.

(d) comparable with information provided by the entity in its financial statements through time and with information provided in the financial statements of other entities.

Benefits and costs

BC13 The *Framework* recognises that the provision of relevant and reliable information may be constrained by the need for timely reporting and for a balance between the benefits of the information and the cost of providing it. The Board expects that most first-time adopters will begin planning on a timely basis for the transition to IFRSs. Accordingly, in balancing benefits and costs, the Board's benchmark was an entity that plans the transition well in advance and is able to collect most of the information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs. When the Exposure Draft uses the term 'undue cost or effort', it is in this context.

Comparability

BC14 Ideally, a regime for first-time application of IFRSs would achieve comparability:

(a) within an entity over time;

(b) between different first-time adopters; and

(c) between first-time adopters and entities that already apply IFRSs.

BC15 SIC-8 gave priority to ensuring comparability between a first-time adopter and entities that already apply IASs. It was based on the principle that a first-time adopter should comply with the same Standards as an entity that already applies IASs.

BC16 However, the Board concluded that the Exposure Draft should concentrate on achieving comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date; achieving comparability between first-time adopters and entities that already apply IFRSs is desirable, but is a secondary objective.

OPENING IFRS BALANCE SHEET

BC17 An entity's opening IFRS balance sheet plays a vital role because it is the starting point for the entity's subsequent accounting under IFRSs. The following paragraphs explain how the Board used the *Framework* in developing recognition and measurement requirements for the opening IFRS balance sheet.

Recognition

BC18 The Board considered a suggestion that the Exposure Draft should not require a first-time adopter to investigate transactions that occurred before the beginning of a 'look back' period of, say, three to five years before the date of transition to IFRSs. Some argue that this would be a practical way for a first-time adopter to prepare an opening IFRS balance sheet that gives a high level of transparency and comparability, without incurring the cost of investigating very old transactions.

BC19 However, limiting the look back period could lead to the omission of material assets or liabilities from an entity's opening IFRS balance sheet. Material omissions would undermine the understandability, relevance, reliability and comparability of an entity's first IFRS financial statements. Therefore, the Board concluded that an entity's opening IFRS balance sheet should, with specified and strictly limited exceptions:

(a) include all assets and liabilities whose recognition is required by IFRSs; and

(b) not report items as assets or liabilities if they do not qualify for recognition under IFRSs.

BC20 The Board considered two particular precedents for transitional provisions that have permitted an entity to omit some assets and liabilities from its balance sheet.

(a) IAS 39 *Financial Instruments: Recognition and Measurement* prohibits restatement of securitisation, transfer or other derecognition transactions entered into before the beginning of the financial year in which IAS 39 is initially applied (paragraph 172(g)).

(b) Some national accounting standards and IAS 17 *Accounting for Leases* (superseded in 1997 by IAS 17 *Leases*) permitted prospective application of a requirement for lessees to capitalise finance leases. Under this approach, a lessee would not be required to recognise finance lease obligations and the related leased assets for leases that began before a specified date.

BC21 The Board decided not to apply these precedents for a first-time adopter, as they could lead to an unjustifiable omission of material assets or liabilities from the opening IFRS balance sheet. Furthermore, these precedents are inconsistent with the June 2002 Exposure Draft of improvements to IAS 39. That Exposure Draft proposes reinstatement of previously derecognised financial assets and financial liabilities if the original transaction did not qualify for derecognition under the revised criteria proposed in that Exposure Draft.

Measurement

BC22 The Board considered whether it should require a first-time adopter to measure all assets and liabilities at fair value in the opening IFRS balance sheet. Some argue that this would result in information that is more relevant than an aggregation of costs incurred at different dates, or of costs incurred at different dates together with fair values established at the date of transition to IFRSs.

BC23 However, the Board concluded that requiring a first-time adopter to measure all assets and liabilities at fair value in the opening balance sheet would impose unreasonable costs, given that:

(a) IFRSs permit or require a cost-based approach for some items; and

(b) some first-time adopters may have previously followed accounting that was very close to IFRSs. It would be unreasonable to require a first-time adopter to incur the cost of determining the fair value of assets (and liabilities) at the date of transition to IFRSs if the first-time adopter used an IFRS-compliant cost-based measurement up to that date and will continue to use a cost basis after that date.

BC24 Because the Board's policy is not to issue IFRSs that permit options, the Board decided not to permit an option for an entity to measure all assets and liabilities at fair value in its opening IFRS balance sheet.

BC25 The Board decided as a general principle that a first-time adopter should measure all assets and liabilities recognised in its opening IFRS balance sheet on the basis required by the relevant IFRSs. This approach allows an entity's first IFRS financial statements to present information that possesses the qualitative characteristics of useful financial information set out in the *Framework* (paragraph BC12).

BC26 However, the Board acknowledged the need to limit this general principle on cost-benefit grounds. In assessing cost-benefit issues, the Board considered two types of measurement:

(a) measurements at fair value, net realisable value or other forms of current value that reflect explicit current projections of future cash flows; and

(b) cost-based measurements.

Fair value and other forms of current value

BC27 IFRSs require an entity to measure some assets and liabilities at fair value, and some others (for example, pension liabilities) at net realisable value or other forms of current value that reflect explicit current projections of future cash flows. The Board saw no reason to require or permit first-time adopters to measure these assets and liabilities differently in their opening IFRS balance sheet, given the Board's assumption that first-time adopters will begin planning on a timely basis for the transition to IFRSs (paragraph BC13).

Cost-based measurements

BC28 Some measurements under IFRSs are based on an accumulation of past costs or other transaction data. If an entity has not previously collected such data, it may sometimes be costly or burdensome to collect or estimate the data retrospectively. Similar costs and burdens may arise if an entity collected cost data that differ materially from the amounts required to comply with IFRSs. The Board considered the following approaches to mitigate the resulting practical problems:

(a) use existing cost-based balances determined using previous GAAP as deemed cost under IFRSs at the date of transition to IFRSs (see paragraphs BC29-BC31); or

(b) measure particular assets or liabilities at fair value at the date of transition to IFRSs if determining cost-based IFRS measurements would involve undue cost or effort (see paragraphs BC32-BC37).

Previous GAAP balances as deemed cost

BC29 The Board considered whether it should require or permit an entity to use amounts determined using previous GAAP as deemed cost for IFRSs at the date of transition to IFRSs. This would be simple, minimise administrative costs and burdens, and maintain continuity with previously reported data. However, extensive use of previous

GAAP cost-based measurements as deemed cost under IFRSs could result in an unacceptable lack of comparability. For example, in an extreme case, previous GAAP might have permitted or required a cash basis, in which case it could be argued that the cost basis would be zero.

BC30 The Board noted that some amounts determined under previous GAAP might be based on a revaluation that may be more relevant to users than original cost. In such cases, it would not be reasonable to require time-consuming and expensive reconstruction of a cost that complies with IFRSs, but is less relevant than the more recent revaluation. In consequence, the Board decided to permit (and for (b) below, require) an entity to use amounts determined using previous GAAP as deemed cost for IFRSs in the following cases:

(a) if an entity revalued an item of property, plant and equipment using its previous GAAP, by applying, for example, a general or specific price index to a cost that is broadly comparable to cost determined under IFRSs, or revalued an item to an amount that is broadly comparable to fair value determined under IFRSs (paragraph 17); and

(b) if an entity established a deemed cost under previous GAAP for some or all of its assets and liabilities by measuring them at their fair value at one particular date because of an event such as a privatisation or initial public offering (paragraph 19).

BC31 For reasons discussed below, the Board also decided to permit the use of previous GAAP carrying amounts as deemed cost for business combinations (paragraphs BC38-BC45) and cumulative translation adjustments (paragraphs BC51 and BC52). The Board concluded that cost-benefit considerations did not justify this approach in other areas.

Fair value as deemed cost

BC32 In some cases, the cost of reconstructing an IFRS-compliant cost might exceed the benefits to users. The Board concluded that an entity should use fair value at the date of transition to IFRSs as deemed cost at that date in some of these cases, as discussed below. In assessing when this would be appropriate, the Board concentrated on both costs and benefits. The reconstruction of cost data might be costly and difficult. Furthermore, reconstructed cost data might be less relevant to users, and less reliable, than current fair value data. For these reasons, the Board concluded that it should not place excessive restrictions on the use of fair value as deemed cost.

BC33 SIC-8 provided exemptions from (a) retrospective adjustments to the opening balance of retained earnings "when the amount of the adjustment relating to prior periods cannot be reasonably determined" and (b) provision of comparative information when it is "impracticable" to provide such information. However, the Board noted that in some cases reconstruction of IFRS-compliant costs might be costly and disproportionate to the benefits to users, but not impracticable. Accordingly, the Board decided to set a criterion based on 'undue cost or effort', rather than 'impracticability'.

BC34 Some may regard the reference to 'undue cost or effort' as creating an implicit option to use fair value rather than an IFRS-compliant cost-based measurement. However, cost is generally equivalent to fair value at the date of acquisition. Therefore, the use of fair value as deemed cost means that an entity will report the same cost data as if it had acquired some assets (with the same remaining service potential) at the date of transition to IFRSs. If there is any lack of comparability, it arises from the aggregation of costs incurred at different dates, rather than from the targeted use of fair value as deemed cost for some assets. The Board concluded that this approach is justified to solve the unique problem of bringing entities onto IFRSs in a cost-effective way without damaging transparency.

BC35 Some suggested an alternative approach intended to avoid a practical problem that could arise in cross-border securities filings if one regulator accepts that determining a cost-based measure would involve undue cost or effort but another regulator subsequently reaches the opposite conclusion. They suggested that the Board should permit an explicit option to use fair value as deemed cost, without restricting this approach to cases of undue cost or effort. However, the Board concluded that the targeted use of the criterion of undue cost or effort was more appropriate than an unrestricted option to use fair value as deemed cost.

BC36 The Board did not accept that determining a cost-based measurement would ever involve undue cost or effort for some types of asset or liability—for example, inventories, construction contract balances or financial instruments—because, in the Board's view, the benefits of reporting such a measurement for these assets and liabilities would typically exceed the cost of providing it. Therefore, the Board decided to restrict the use of fair value as deemed cost to those classes of asset for which reconstructing costs is likely to be particularly onerous and of limited benefit to users: property, plant and equipment and (when an entity elects to use the cost method in IAS 40 *Investment Property*) investment property (paragraphs 16 and 18 of the Exposure Draft).

BC37 Under the allowed alternative treatment in IAS 16 *Property, Plant and*

Equipment, if an entity revalues an asset, it must revalue all assets in that class. This restriction prevents 'cherry-picking'—selective revaluation of only those assets whose revaluation would lead to a particular result. Some have suggested a similar restriction on the use of fair value as deemed cost. However, the Board concluded that such a restriction is not needed, for the following reason. Although some see a requirement based on 'undue cost or effort' as an implicit option, it is not totally unrestricted. An entity will need to be consistent in concluding whether cost-based measurements involve undue cost or effort. This limits the scope for cherry-picking.

Business combinations

BC38 The following paragraphs discuss various aspects of accounting for business combinations that an entity recognised under previous GAAP before the date of transition to IFRSs:

(a) the use of amounts assigned under previous GAAP as deemed cost (paragraph BC39);

(b) whether an entity should restate amounts assigned using a previous GAAP method that brings forward unchanged the pre-combination carrying amounts of the combining entities (paragraphs BC40 and BC41);

(c) whether an entity should restate amounts assigned under previous GAAP for business combinations that occurred during a look-back period before the date of transition to IFRSs (paragraph BC42); and

(d) whether an entity should restate goodwill for adjustments made in its opening IFRS balance sheet to the carrying amounts of assets and liabilities acquired in past business combinations (paragraphs BC43-BC45).

BC39 The principle in paragraph 7 of the Exposure Draft would require a first-time adopter to apply the most recent version of IAS 22 *Business Combinations* retrospectively to past business combinations when it prepares its opening IFRS balance sheet. Some have argued that the Board should follow this approach, to increase comparability. However, retrospective application could require an entity to recreate data that it did not capture at the date of a past business combination and make subjective estimates about conditions that existed at that date. These factors could reduce the relevance and reliability of the entity's first IFRS financial statements. Therefore, the Board concluded that the costs of restatement would be likely to exceed the benefits. As a result, the Exposure Draft treats amounts an entity assigned under previous GAAP to goodwill and other assets and liabilities acquired in a past business combination as their deemed cost under IFRSs at the date of the business combination (paragraph 20).

BC40 Under previous GAAP, an entity might have used a method of accounting that brings forward unchanged the pre-combination carrying amounts of the combining entities. Some argued that it would be inconsistent to use these carrying amounts as deemed cost under IFRSs, given that the Board rejected the use of similar carrying amounts as deemed cost for assets and liabilities that were not acquired in a business combination. However, the Board was unable to identify any specific form of past business combination, or any specific form of accounting for past business combinations, for which it would not be appropriate to bring forward cost-based measurements made under previous GAAP. Therefore, the Exposure Draft would prohibit restatement of cost-based measurements for assets and liabilities that an entity acquired through any past business combination.[1]

BC41 If an entity did not recognise a particular asset or liability under previous GAAP at the date of the business combination, its deemed cost under IFRSs will be zero. As a result, the entity's opening IFRS balance sheet will not include that asset or liability if IFRSs permit or require a cost-based measurement. The Board acknowledges that this result is a departure from the principle that the opening IFRS balance sheet should include all assets and liabilities. However, the most likely assets to remain unrecognised because of this departure are goodwill and intangible assets and these are assets that often remain unrecognised in other circumstances, namely if they were generated internally.

BC42 Some suggested that IAS 22 should be applied in full not only for the periods presented in the primary financial statements, but also for an additional look-back period of, perhaps, three to five years. Using that approach, an entity would restate amounts assigned under previous GAAP at the date of the business combination. However, the Board concluded that the costs of restating past business combinations, even for a limited period, would exceed the benefits to users.

BC43 Although the Exposure Draft treats amounts assigned under previous GAAP to goodwill and other assets and liabilities acquired in a past business combination as their deemed cost under IFRSs at the date of the business combination, an entity needs to adjust their carrying amounts in its opening IFRS balance sheet, as follows.

(a) Assets and liabilities measured under IFRSs at fair value or other forms of current value: remeasure to fair value or that other current value.

(b) Assets and liabilities for which IFRSs apply a cost-based measurement: adjust the accumulated depreciation or amortisation since the date of the business combination if it does not comply with IFRSs. Depreciation is based on deemed cost, which is the carrying amount under previous GAAP immediately following the business combination.

(c) Items that do not qualify for recognition as assets and liabilities under IFRSs: eliminated from the opening IFRS balance sheet.

BC44 The Board considered whether a first-time adopter should recognise the resulting adjustments by restating goodwill. This would be consistent with retrospective application of IAS 22 *Business Combinations*.[2] Because intangible assets and goodwill are closely related, the Board decided to require the restatement of goodwill on eliminating an item that was recognised under previous GAAP (in a business combination classified as an acquisition) as an intangible asset but does not qualify for separate recognition under IFRSs. However, the Board decided to prohibit restatement of goodwill for other adjustments reflected in the opening IFRS balance sheet, because of the Board's conclusion that full

[1] Except when an entity elects not to use any of the exemptions in paragraphs 14-24 of the Exposure Draft (see paragraph 13).

[2] IAS 22 prohibits restatement of goodwill for most adjustments made after the end of the first annual accounting period beginning after acquisition. However, that restriction applies to an entity that already applies IFRSs. It is, arguably, not relevant when considering the appropriate treatment when an entity first adopts IFRSs.

restatement of past business combinations would involve undue cost or effort (paragraph BC39).

BC45 To minimise the possibility of double-counting an item that was included in goodwill under previous GAAP, and is included under IFRSs either within the measurement of another asset or as a deduction from a liability, the Board decided that an entity should carry out an impairment test on goodwill recognised in its opening IFRS balance sheet (paragraph 20(b)(ii) of the Exposure Draft). This could not prevent the implicit recognition of internally generated goodwill that arose after the date of the business combination. However, the Board concluded that an attempt to exclude such internally generated goodwill would involve undue cost or effort.

Employee benefits

BC46 If an entity elects to use the 'corridor' approach in IAS 19 *Employee Benefits*, full retrospective application of IAS 19 would, in principle, require the entity to determine actuarial gains or losses for each year since the inception of the plan in order to determine the net cumulative unrecognised gains or losses at the date of transition to IFRSs. The Board concluded that this exercise would involve undue cost or effort. Therefore, the Board decided to require a 'fresh start' approach that eliminates unrecognised actuarial gains or losses at that date (paragraph 22).

BC47 An entity may previously have accounted for post-employment benefit costs in a way that is identical (or virtually identical) to the basis required by IAS 19. If the entity elects to use the 'corridor' approach in IAS 19, it will almost certainly have unrecognised actuarial gains or losses at the date of transition to IFRSs. The 'fresh start' in the Exposure Draft eliminates previously unrecognised actuarial gains or losses. To avoid a discontinuity at this point, some would permit or require the entity to continue the IFRS-compliant aspects of its previous accounting, without applying the 'fresh start'. However, the Board concluded that it would take an arbitrary decision to determine when the previous accounting was sufficiently similar to that required by IAS 19 for a fresh start to be inappropriate. The Exposure Draft would require the 'fresh start', except when an entity elects not to use any of the exemptions in paragraphs 14-24 of the Exposure Draft (see paragraph BC60).

BC48 The 1999 revision of IAS 19 increased the reported employee benefit liabilities of some entities. IAS 19 permitted entities to amortise that increase over up to five years. Some suggested a similar transitional treatment for first-time adopters. However, as explained in paragraph BC83, the Board confirmed in paragraph 21 of the *Preface to*

International Financial Reporting Standards that it has no general policy of exempting transactions occurring before a specific date from the requirements of new IFRSs. Therefore, the Board decided not to include a similar transitional requirement for first-time adopters.

BC49 An entity's first IFRS financial statements may reflect measurements of pension liabilities at three dates: the reporting date, the end of the comparative year and the date of transition to IFRSs. Some suggested that obtaining three separate actuarial valuations for a single set of financial statements would involve undue cost or effort. Therefore, they proposed that the Board should permit an entity to use one single actuarial valuation, based, for example, on assumptions valid at the reporting date, with service costs and interest costs based on those assumptions for each of the periods presented.

BC50 The Board concluded that a general exemption from the principle of measurement at each date would conflict with the objective of providing useful and transparent information for users. If an entity obtains a full actuarial valuation at one or two of these dates and rolls that (those) valuation(s) forward or back to the other date(s), any such roll forward or roll back needs to reflect material transactions and other material events (including changes in market prices and interest rates) between those dates (IAS 19, paragraph 57).

Cumulative translation differences

BC51 IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to classify some cumulative translation differences (CTD) relating to a net investment in a foreign operation as a separate component of equity. The entity transfers the CTD to the income statement on subsequent disposal of the foreign operation.

BC52 The Board concluded that the benefits of this separate classification (and transfer to the income statement on subsequent disposal) are not sufficient to justify the cost and effort that could be involved in reconstructing CTD on a basis that complies with IAS 21 if, under previous GAAP, the entity did not track CTD or determined CTD on a different basis. Therefore, if determining CTD for a foreign operation would involve undue cost or effort, the Exposure Draft would require a first-time adopter to use the CTD, if any, determined for the foreign operation at the date of transition to IFRSs under previous GAAP as the deemed CTD under IFRSs at that date.

Retrospective designation

BC53 The Board considered practical implementation difficulties that could arise from the retrospective application of two aspects of

IAS 39 *Financial Instruments: Recognition and Measurement*:

(a) the treatment of cumulative fair value changes on available-for-sale financial assets at the date of transition to IFRSs; and

(b) hedge accounting.

Available-for-sale financial assets

BC54 Retrospective application of IAS 39 to available-for-sale financial assets requires first-time adopters to recognise the cumulative fair value changes in a separate component of equity in the opening IFRS balance sheet, and recycle those fair value changes into the income statement on subsequent disposal or impairment of the asset. This could allow, for example, selective classification of assets with cumulative gains as available-for-sale (with subsequent recycling on disposal) and assets with cumulative losses as held for trading (with no recycling).

BC55 The Board's proposed improvements to IAS 39[3] would create an extra ingredient that did not exist when IAS 39 became effective and that could increase the scope for selective classification of this kind by first-time adopters. That ingredient is the proposed option to designate any financial asset as held for trading on first adopting the proposed improvements to IAS 39. However, the Board noted that an entity could also achieve a similar result by selective disposal of some assets before the date of transition to IFRSs. Therefore, the Board concluded that it should treat first-time adopters in the same way as entities that already apply IFRSs by requiring retrospective application.

Hedging: financial instruments

BC56 It is unlikely that most entities would have adopted IAS 39's criteria for documenting hedges at their inception and testing the hedges for effectiveness before they adopted IAS 39 (or a local standard based on IAS 39), even if they intended to continue the same hedging strategies after adopting IAS 39. Furthermore, retrospective designation of hedges (or retrospective reversal of their designation) could lead to selective designation of some hedges to report a particular result.

BC57 To overcome these problems, the transitional requirements in IAS 39 require prospective application of the hedging requirements when an entity adopts IAS 39. The Board decided that prospective application is also appropriate for a first-time adopter.

[3] See Exposure Draft *Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement*, published in June 2002.

BC58 The transitional requirements in IAS 39 are complex and may be difficult to interpret in practice. The IAS 39 Implementation Guidance Committee issued extensive guidance on them in the form of Questions and Answers (Q&A). To help readers of the Exposure Draft, the Board decided to include a redrafted version of those transitional requirements and related Q&A (paragraph 24 and Appendix C of the Exposure Draft). The Board did not intend the redrafting to create substantive changes to those existing transitional requirements and Q&A.

Continuation of existing accounting

BC59 Paragraph 13 of the Exposure Draft would permit some first-time adopters to continue existing accounting that complied in full with the recognition and measurement requirements of IFRSs. For example, consider an entity that has been preparing IFRS data internally without presenting financial statements that contain an explicit and unreserved statement of compliance with IFRSs. In the absence of paragraph 13, paragraph 20 would require the entity to carry forward previous GAAP carrying amounts of assets and liabilities acquired in a past business combination as deemed cost under IFRSs, even if the entity has the data needed to apply the version of IAS 22 that was effective at the date of the business combination.

BC60 The Board concluded that this would be unreasonable and not beneficial to users. Therefore, paragraph 13 states that an entity would not be required to use the exemptions in paragraphs 14-24 of the Exposure Draft. However, to prevent selective application of some exemptions to achieve a desired result, paragraph 13 states that an entity must use either all the exemptions that are applicable or none of them. If an entity does not use the exemptions, the most significant consequences are that it:

(a) accounts for past business combinations in accordance with IAS 22 *Business Combinations*, instead of using amounts determined under previous GAAP as deemed cost (see paragraphs BC38-BC45);

(b) does not eliminate unrecognised actuarial gains and losses arising from defined benefit plans (see paragraphs BC46-BC50); and

(c) uses earlier versions of IFRSs if subsequent versions contained transitional provisions that permitted or required prospective application (see paragraphs BC79 and BC80).

BC61 Even if an entity does not use the exemptions in paragraphs 14-24 of the Exposure Draft, it must still give the same disclosures as other first-time adopters about the effect of the transition from previous GAAP.

BC62 A subsidiary may have reported to its parent in the previous period using IFRSs without presenting a full set of financial statements under IFRSs. If the subsidiary subsequently begins to present financial statements that contain an explicit and unreserved statement of compliance with IFRSs, it becomes a first-time adopter at that time. The Board concluded that it would be burdensome—and not be beneficial to users—to compel the subsidiary to keep two parallel sets of accounting records based on different dates of transition to IFRSs.

BC63 Under paragraph 13 of the Exposure Draft, the subsidiary could elect not to use any of the exemptions in paragraphs 14-24. For example, consider a parent that presents its first IFRS financial statements in 2005 (with 1 January 2004 as the date of transition to IFRSs) and has a foreign subsidiary that reports to the parent under IFRSs from 2005 but does not present its own first IFRS financial statements until 2007. Paragraph 13 would permit the subsidiary to present its own first IFRS financial statements in 2007 as if it had always applied IFRSs. However, although 1 January 2004 is the subsidiary's date of transition to IFRSs for reporting to the parent, paragraph 13 would not permit the subsidiary to use 1 January 2004 as the date of transition to IFRSs when it presents its own first IFRS financial statements. Thus, paragraph 13 would not necessarily solve the problem discussed in paragraph BC62. Therefore, paragraph 5 of the Exposure Draft proposes that the subsidiary would not be treated as a first-time adopter for recognition and measurement in 2007, subject to various conditions. However, the subsidiary must still give the same

disclosures as other first-time adopters about the effect of the transition from previous GAAP.

Other possible exemptions rejected

BC64 Paragraphs BC65-BC78 discuss other limited exemptions that the Board considered, but rejected, for borrowing costs, decommissioning and site restoration costs, depreciation, hyperinflation, intangible assets and finance lease income. Each such exemption would have moved the Exposure Draft away from a principle-based approach, and the Board found no compelling reason for exemptions in these areas.

Borrowing costs

BC65 Some argued that restatement of past borrowing costs may be costly, and that the benefit to users of such restatements is questionable. Indeed, IAS 23 *Borrowing Costs* permitted entities following the allowed alternative treatment in IAS 23 (capitalisation of borrowing costs) not to capitalise borrowing costs incurred before the effective date of IAS 23, although IAS 23 did encourage retrospective adoption. However, the Board concluded that prospective application of IAS 23 by first-time adopters would diminish transparency for users and create additional complexity, and that any cost savings would not outweigh these disadvantages.

Decommissioning and site restoration costs

BC66 A first-time adopter may have an obligation for decommissioning costs, site restoration costs or similar items that qualifies for recognition as a liability under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, but was not recognised under previous GAAP. Under the Exposure Draft, the amount recognised as a provision in the opening IFRS balance sheet differs from the amount capitalised as part of the cost of the related asset. Reasons for the difference include depreciation of the asset and the unwinding of the discount because of the passage of time.

BC67 Some argued that it may be onerous to determine the effect of these differences. They suggested that the Board should permit or require entities to capitalise as part of the cost of the asset an amount that equals the amount recognised as a provision at the date of transition to IFRSs. They noted that the use of fair value as deemed cost might also have the same effect, although this would require a first-time adopter to determine the fair value of all components of the asset, and not just of the component represented by these particular costs.

BC68 The transitional requirements in IAS 37 do not contain such an exemption, and the Board saw no reason to include such an exemption for first-time adopters.

Depreciation

BC69 In some cases, accumulated depreciation under previous GAAP at the date of transition to IFRSs differs materially from accumulated depreciation at that date under IFRSs. This is most likely to occur in countries where depreciation rates or methods are heavily influenced by tax considerations. Some argued that the Board should permit or require a first-time adopter to measure the asset in its opening IFRS balance sheet at the carrying amount determined under previous GAAP. This is consistent with the treatment of changes in useful life or depreciation pattern under IAS 16 *Property, Plant and Equipment*. Supporters of this treatment argue that restatement of past depreciation under IAS 16 would be costly, involve hindsight and be of limited relevance to users.

BC70 In the Board's view, retaining the accumulated depreciation under previous GAAP without restatement would damage comparability and transparency. Therefore, the Exposure Draft would require restatement of accumulated depreciation. In many cases, an entity may conclude that the difference is not material, in which case restatement is not required. Also, if restatement of an item of property, plant and equipment would cause undue cost or effort, an entity can use fair value at the date of transition to IFRSs as deemed cost at that date.

Hyperinflation

BC71 Some argued that restating financial statements for the effects of hyperinflation in periods before the date of transition to IFRSs might involve undue cost or effort, particularly if the currency is no longer hyperinflationary. However, the Board concluded that such restatement should be required, because hyperinflation can make unadjusted financial statements meaningless or misleading.

Intangible assets

BC72 For the following reasons, some proposed that a first-time adopter's opening IFRS balance sheet should exclude intangible assets that it did not recognise under previous GAAP:

(a) using hindsight to assess retrospectively when the recognition criteria for intangible assets were met could be subjective, open up possibilities for manipulation and involve administrative cost and effort that might exceed the benefits to users.

(b) the benefits expected from intangible assets are often not related directly to the costs incurred. Therefore, capitalising the costs incurred is of limited benefit to users, particularly if the costs were incurred in the distant past.

(c) such an exclusion would be consistent with the transitional provisions in IAS 38 *Intangible Assets*. These encourage (but do not require) the recognition of intangible assets acquired in a previous business combination that was an acquisition and prohibit the recognition of all other previously unrecognised intangible assets.

BC73 In many cases intangible assets do not qualify for recognition under IAS 38 because an entity did not, under previous GAAP, accumulate cost information or did not carry out contemporaneous assessments of future economic benefits. In these cases, there is no need for a specific requirement to exclude those assets.

BC74 In other cases, an entity may have accumulated and retained sufficient information about costs and future economic benefits to determine which internally generated intangible assets qualify under IAS 38 for recognition in its opening IFRS balance sheet. In such cases, the information is available without undue cost or effort and no exclusion is justified.

BC75 Some argued that fair value should be used as deemed cost for intangible assets in the opening IFRS balance sheet (by analogy with a business combination). However, this would require an exemption from IAS 38. In the Board's view, such an exemption would cause costs for preparers and additional complexity that are not justified by possible benefits to users. Also, IAS 38 permits intangible assets to be measured at fair value only if fair value is determined by reference to a (strictly defined) active market, except in a business combination.

BC76 IAS 38 prohibits the recognition of intangible assets for which cost cannot be determined reliably, even if an entity can determine their fair value reliably. Moreover, the Exposure Draft would not permit the use of fair value as deemed cost for intangible assets. Therefore, a first-time adopter cannot recognise intangible assets if it cannot determine their cost reliably.

Finance lease income

BC77 Some entities may have recognised finance lease income under previous GAAP on a basis that does not comply with IAS 17 *Leases*. Some argued that it would be burdensome for a lessor to apply a new pattern of lease income recognition retrospectively for existing leases. They noted that IAS 17 permitted prospective application when it was revised in 1997 to eliminate the net cash investment method for recognising finance income of lessors.

BC78 However, the Board concluded that reporting finance lease income on one basis for old leases and a different basis for new leases would diminish the relevance and reliability of a lessor's financial statements. Therefore, the Exposure Draft would not permit prospective application of any aspect of IAS 17. Among other things, this means that a finance lessor measures finance lease receivables in its opening IFRS balance sheet as if the net cash investment method had never been permitted.

Different versions of an IFRS

BC79 Some suggested that retrospective application requires a first-time adopter to apply different versions of an IFRS in its first IFRS financial statements if a new or amended version of the IFRS required prospective application by entities that already applied IFRS at the time of its introduction. In other words, a first-time adopter might have two different conversions in its first financial statements—from previous GAAP to an old version of an IFRS and then from the old version to a new version of the IFRS. However, the Board decided that an entity should apply a single version of IFRSs in its opening IFRS financial statements, without considering superseded or amended versions of IFRSs. In the Board's view, this:

(a) enhances comparability, because the information in a first-time adopter's first IFRS financial statements is prepared on a consistent basis over time;

(b) gives users comparative information prepared using later versions of IFRSs that the Board regards as superior to superseded versions; and

(c) avoids unnecessary costs for preparers.

BC80 As discussed in paragraphs BC59-BC61, the Board decided that a first-time adopter could elect not to use any of the exemptions in paragraphs 14-24 of the Exposure Draft, in order to continue to apply IFRS recognition and measurement requirements. To achieve this objective, if a first-time adopter makes this election, paragraph 13 of the Exposure Draft would require it to continue to apply the IFRSs that were effective in each period. Therefore, the first-time adopter may need to consider superseded versions of IFRSs if later versions require prospective application.

BC81 The transitional requirements of some IFRSs require or permit prospective application. The Board considered whether it should require prospective application by first-time adopters in these cases. Requirements for prospective application generally reflect a conclusion that one or more of the following factors is present in a particular case:

(a) retrospective application may be difficult or involve costs exceeding the likely benefits;

(b) there is a danger of abuse if retrospective application would require decisions by management about past conditions at a time when the outcome of a particular transaction is already known; or

(c) retrospective application may lead to difficult distinctions between changes in estimates and changes in the basis for making estimates.

BC82 The Board decided that the Exposure Draft should specify a particular accounting treatment in specified cases where the Board concluded that retrospective application might involve undue cost or effort (paragraphs BC32-BC52), or where retrospective designation by management could lead to abuse (paragraphs BC53-BC58).

BC83 When a new IFRS introduces a new basis of measurement, it may be difficult to distinguish changes in estimates from changes in the basis for making estimates. For this reason, some existing Standards required prospective application by entities that already apply IFRSs. For example:

(a) IAS 36 *Impairment of Assets* required prospective application because of the difficulty in determining whether an impairment loss results from a change in accounting policies or a change in circumstances. Most additional impairment losses resulting from the adoption of IAS 36 are recognised in the income statement.

(b) IAS 39 *Financial Instruments: Recognition and Measurement* required an entity to introduce fair value measurements prospectively at the beginning of the financial year in which the entity adopted IAS 39. This requirement reflects the difficulty of determining fair values retrospectively.

(c) IAS 40 *Investment Property* required an entity adopting the fair value model to do so prospectively at the beginning of the financial year in which the entity adopted the Standard. IAS 40 permitted retrospective application if, and only if, the entity had previously disclosed publicly (in financial statements or otherwise) the fair value of its investment property in earlier periods.

BC84 As explained in paragraph BC13, the Board's benchmark for cost-benefit assessments was an entity that collects most of the information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs. Accordingly, when a first-time adopter prepares its opening IFRS balance sheet, it should be able to distinguish changes in estimates from changes in the basis of making estimates. Therefore, the Board concluded that the need for such distinctions does not create obstacles to retrospective application by first-time adopters.

BC85 Some suggested a further reason for permitting or requiring prospective application: to alleviate consequences of a new IFRS that were not foreseen when an entity finalised a contract or agreement if another party uses financial statements to monitor compliance with the contract or agreement. For example, covenants in banking and loan agreements may impose limits based on amounts in a borrower's financial statements. However, in the Board's view, it is up to the parties to an agreement to determine whether to insulate the agreement from the effects of a future IFRS and, if not, the manner in which it might be renegotiated to reflect changes in reporting rather than changes in the underlying financial condition (paragraph 21 of the *Preface to International Financial Reporting Standards*).

BC86 Some suggested that transitional requirements of other existing or future IFRSs should give a first-time adopter the same accounting options as an entity that already applies IFRSs. This approach was apparent in SIC-8. For example, under IAS 22 *Business Combinations* an entity already applying IASs was permitted to charge goodwill that arose before 1995 directly to equity, without capitalising it. SIC-8 granted first-time adopters the same option for pre-1995 goodwill, regardless of the treatment adopted for previous GAAP.

BC87 However, as noted in paragraph BC16, the Board's primary objective

was to achieve comparability over time within an entity's first IFRS financial statements. Permitting prospective application by a first-time adopter would conflict with that primary objective, even if prospective application were available to entities already applying IFRSs. Therefore, the Board decided not to adopt a general policy of giving first-time adopters the same accounting options of prospective application that existing IFRSs give to entities that already apply IFRSs.

BC88 The Board also decided that it will consider case by case whenever it issues a new IFRS whether a first-time adopter should apply that IFRS retrospectively or prospectively. The Board expects that retrospective application will be appropriate in most cases, given its primary objective of comparability over time within a first-time adopter's first IFRS financial statements. However, if the Board concludes in a particular case that prospective application by a first-time adopter is justified, it will amend the [draft] IFRS on first-time application of IFRSs. As a result, this [draft] IFRS will contain all material on first-time application and other IFRSs will not refer to first-time adopters (except, when needed, in the Basis for Conclusions and consequential amendments).

ESTIMATES

BC89 An entity will have made estimates under previous GAAP at the date of transition to IFRSs. Events between that date and the reporting date for the entity's first IFRS financial statements might suggest a need to correct those estimates. Some of those events might qualify as adjusting events under IAS 10 *Events After the Balance Sheet Date*. However, provided that the entity made those estimates on a basis consistent with IFRSs, the Board concluded that it would be more helpful to users—and more consistent with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*—to recognise the revision of those estimates as income or expense in the period when the entity made the revision, rather than in preparing the opening IFRS balance sheet (paragraphs 25-27 of the Exposure Draft).

PRESENTATION AND DISCLOSURE

Comparative information

BC90 IAS 1 *Presentation of Financial Statements* requires an entity to disclose comparative information for the previous period. Some suggested that a first-time adopter should disclose comparative information for more than one previous period. For entities that already apply IFRSs, users normally have access to financial statements prepared on a comparable basis for several years. However, this is not the case for a first-time adopter.

BC91 Nevertheless, the Board decided not to require a first-time adopter to present more comparative information than IAS 1 requires, because such a requirement would impose costs out of proportion to the benefits to users, and increase the risk that preparers might need to make arbitrary assumptions in applying hindsight.

Reconciliation to previous GAAP

BC92 Some argued that the Exposure Draft should not require disclosures about the effect of the transition from previous GAAP to IFRSs. In their view, such disclosures include information about another basis of accounting that is not relevant in IFRS financial statements. Others argued that a disclosure requirement would be redundant, because market pressure will compel entities to release such information.

BC93 However, the Board concluded that such disclosures are essential, in the first (annual) IFRS financial statements as well as in interim financial reports (if any), because they help users understand the effect and implications of the transition to IFRSs and how they need to change their analytical models to make the best use of information presented using IFRSs. The required disclosures relate to both:

(a) the most recent information published under previous GAAP, so that users have the most up-to-date information; and

(b) the date of transition to IFRSs. This is an important focus of attention for preparers, auditors and users because the opening IFRS balance sheet is the starting point for accounting under IFRSs.

BC94 Paragraph 31(a) and (b) requires reconciliations of equity and reported profit or loss. The Board concluded that users would also find it helpful to have information about the other adjustments that affect the opening IFRS balance sheet but do not appear in these reconciliations. Because a reconciliation could be voluminous, the Exposure Draft would require disclosure of narrative information about these adjustments, as well as about adjustments to the cash flow statement (paragraph 32).

BC95 For impairment losses (and reversals) recognised in preparing the opening IFRS balance sheet, paragraph 31(c) requires the disclosures that IAS 36 *Impairment of Assets* would require if those impairment losses (and reversals) were recognised during the period beginning

with the date of transition to IFRSs. The rationale for this requirement is that there is inevitably subjectivity about impairment losses. This disclosure provides transparency about impairment losses recognised on transition to IFRSs. These losses might otherwise receive less attention than impairment losses recognised in earlier or later periods.

BC96 IAS 34 *Interim Financial Reports* states that the “interim financial report is intended to provide an update on the latest complete set of annual financial statements” (paragraph 6 of IAS 34). Thus, IAS 34 requires less disclosure in interim financial statements than IFRSs require in annual financial statements. However, an entity’s interim financial report under IAS 34 is less helpful to users if the entity’s latest annual financial statements were prepared using previous GAAP than if they were prepared under IFRSs. Therefore, the Board concluded that a first-time adopter’s first interim financial report under IAS 34 should include sufficient information to enable users to understand how the transition to IFRSs affected previously reported annual, as well as interim, figures (paragraph 37).

Historical summaries

BC97 Some entities choose, or are required, to present in their financial statements historical summaries of selected data covering periods before the first period for which they present full comparative information. Some argued that an entity should present this information under IFRSs, to ensure comparability over time. However, the Board concluded that such a requirement would cause costs out of proportion to the benefit to users. The Exposure Draft would require disclosure of adjustments that would be needed to make historical summaries included in financial statements or interim financial reports compatible with IFRSs (paragraph 36 of the Exposure Draft). Historical summaries published outside financial statements or interim financial reports are beyond the scope of the Exposure Draft.