

ICAEW REP 03/05

ACHIEVING CONSISTENT APPLICATION OF IFRS IN THE EU

Memorandum of comment submitted in October 2005 to EFRAG concerning the discussion paper on 'Achieving Consistent Application of IFRS in the EU'.

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales welcomes the opportunity to comment on the discussion paper '*Achieving Consistent Application of IFRS in the EU*', published for comment by the EFRAG Supervisory Board in July 2005. The Institute is the largest accountancy body in Europe, with more than 126,000 members operating in business, public practice and within the investor community. The Institute operates under a Royal Charter, working in the public interest.
2. We have reviewed the discussion paper and set out below a number of comments and suggestions for consideration by the Board. We deal first with significant matters before commenting on the specific issues highlighted in the discussion paper.

MAJOR POINTS

High Quality Financial Reporting or Consistency?

3. European companies implementing IFRS for the first time face many challenges, particularly in jurisdictions where the existing accounting framework relies on a detailed body of rules rather than on principles-based standards. Demand for guidance and advice from professional advisers, regulators and standard-setters regarding the most appropriate way to apply unfamiliar standards to particular transactions is likely to run high, especially in the year of transition. However, few of the issues involved are likely to merit the publication of formal interpretations. Good practice and common understandings emerge over time, through *inter alia* discussions between auditor and client, between companies in the same sector and between and within audit firms and their technical groups. A rush to formal interpretations and quasi-interpretations in the form of implementation/application guidance would stymie this evolutionary process and hinder improvements in reporting practices.
4. All participants in the financial reporting process must therefore recognise the tension between demands for guidance and the need to preserve the primarily principles-based nature of IFRS. A degree of consistency in financial reporting is desirable, especially within individual companies and specific sectors, but uniformity is no guarantee of high quality financial information. Companies and their auditors need to apply the standards to unusual and complex transactions and to problems identified at a late stage through the exercise of professional judgment, without frequent requests to standard-setters to elaborate additional rules and implementation guidance.
5. At the same time, securities regulators and other users of financial information must recognise that absolute consistency is not compatible with principles-based standards. Indeed, it is questionable whether substantial consistency has been achieved in practice even under more rules-based frameworks. In the period of transition in particular, European regulators must not through their actions undermine the willingness of companies and auditors to exercise

appropriate judgment when seeking in difficult circumstances to ensure that published financial information both portrays economic reality and complies in full with IFRS. More vigorous and detailed enforcement activity is likely to result in European financial reporting of a consistent but mediocre quality, with an emphasis on regulatory precedents likely to result in transactions that are only superficially similar being accounted for - inappropriately - on a similar basis.

The Case for a European Mechanism

6. We are not convinced on the evidence currently available that the number of issues meriting an interpretation is sufficient justification for the establishment of a new mechanism in Europe. However, we recognise that such a mechanism might provide an effective means of highlighting complex issues of concern to Europe as a whole on which a consensus cannot be reached. It might also improve understanding of the sort of issues that merit formal interpretation; in many cases modified standards, application guidance or improved education and training are more suitable solutions to issues on which interpretations are sought. Accordingly, we would not oppose the creation of a suitable mechanism, particularly if the results of EFRAG's consultation - or subsequent events - confirm that IFRIC may welcome assistance to deal with issues of interpretation of importance in Europe.
7. If a decision is taken to establish a mechanism, we recommend that:
 - Its terms of reference should be agreed in advance with IFRIC. They should be narrow and unambiguous, eschewing any role regarding the development of application or implementation guidance or separate European interpretations;
 - To avoid inefficiencies, the criteria for determining which items should be addressed by the mechanism should be modelled on IFRIC's procedures, and analysis and any proposed solutions should be developed using similar working methods;
 - The status of the outputs of the mechanism should be clear and well-understood by participants and constituents. Analysis and proposed solutions rejected by IFRIC should have no subsequent status other than as one potential source of guidance for those seeking to exercise professional judgement in relation to the issues involved, recognising that the proposed solutions were not subject to rigorous due process;
 - Although the mechanism should operate under the auspices of EFRAG, it is essential that all key European regulators (including CESR), as well as standard-setters and interpretation bodies, should be involved
 - All participants should agree to participate on the basis that local interpretations will be developed only on receipt of a formal recommendation from the mechanism;

- Key regulators and standard-setters from outside the EU with an interest in IFRS issues, including the SEC, should be invited to attend meetings of the mechanism as observers. This should encourage the sharing of experience and ideas on IFRS issues and might hasten the development of a common approach to the setting, interpretation and enforcement of accounting standards; and
- Its structure should not be elaborate and the case for its continued operation should be reviewed on a regular basis.

RESPONSES TO SPECIFIC QUESTIONS

4.2 *As explained in paragraph 2.4, although a number of claims are being made about the position in Europe, we need to understand the nature and number of the implementation issues that are arising in Europe if we are to understand the true position. With that objective in mind, please could you provide details of the real-life IFRS implementation issues that are concerning you.*

8. As discussed above, although the application of IFRS for the first time will give rise to a large number of questions over the most appropriate accounting treatments, it is unlikely that many of these issues will merit formal interpretations.

4.3 *As explained in paragraph 2.5, it has been suggested by some commentators that, in order for Europe to be implement IFRS consistently, there will need to be a considerable increase in the number of IFRIC interpretations issued.*

(a) *Do you believe there is a need for a substantial increase in the number of interpretations?*

(b) *If you do, which of the real-life issues identified by you in response to paragraph 4.2 do you believe are significant enough to merit an interpretation?*

(c) *The IFRIC has stated that it is not currently inundated with requests for interpretations and that a capability to issue 12 interpretations a year is currently sufficient to meet demand. Others have asserted that the number of issues meriting an interpretation is much greater than that, which suggests that issues are arising that are not being brought to the IFRIC's attention.*

(i) *Which of the issues that have been highlighted in response to paragraph (b) have been brought to the IFRIC's attention?*

(ii) *If some of the issues have not been brought to the IFRIC's attention, why have they not been?*

9. We advocate a strategy that leads wherever possible to the modification of standards as significant issues arise, rather than the development of a supplementary layer of interpretative material set out in a variety of places. A single set of robust and well-understood standards is far more effective in

promoting high quality financial reporting than a complex body of accounting literature. A proliferation of interpretations and similar material will result in complexity for IFRS users and a dilution of the primarily principles-based nature of IFRS, limiting the ability of companies and their advisors to exercise judgement when seeking to ensure that financial statements reflect the economic substance of the underlying transactions. In our view 8-12 interpretations per annum (IFRIC's estimate of its current capacity) should be an upper limit. If there are indications that a very large number of interpretations or modifications are required, the response should be a further, thorough-going review of the standard-setting process at an early stage.

10. Our understanding is that European issues that *prima facie* merit consideration by IFRIC are being referred to the IFRIC agenda committee and are duly considered in accordance with IFRIC's recently-revised procedures.

4.4 *One much debated issue (see paragraph 2.6) is whether some of the IFRS implementation issues arising in Europe are urgent issues that merit a quick response (in other words, that merit a formal response more quickly than the processes of the IFRIC permit).*

(a) *If you have provided some real-life implementation issues in response to question 4.3(b) above, could you please state whether you believe any of them are urgent issues that merit a quick response.*

(b) *Could you also please explain what it is about the issue that leads you to conclude that they are urgent issues that merit a quick response?*

11. We agree that the limitation on due process in the interests of providing early guidance on complex issues - however urgent - is unacceptable. IFRIC should remain the sole source of such guidance and should not operate as an urgent issues body. It is important that IFRIC has sufficient time to consider the issues and seek constituent comments, and it is therefore incumbent on those who identify potential issues for IFRIC to deal with to submit them on a timely basis. However, within these constraints, IFRIC should react swiftly to counter unforeseen abuses or uncertainties. Long delays will increase the likelihood of other bodies providing clarification in the interim, which will in the longer-term add to complexity and discourage companies and their auditors from exercising appropriate judgement.

4.5 *This paper takes the view (in paragraph 3.5) that enforcement/audit and standard setting should be kept separate and that, as a result, although the audit and enforcement functions play a very important role in ensuring that IFRS are applied consistently, it would not be appropriate for those functions to be the main way of addressing potential IFRS implementation issues. Do you agree? If you do not, please could you explain your reasoning.*

12. We agree that the enforcement and audit functions play a key role in ensuring that principles-based standards are applied with an appropriate degree of consistency, but should not be the main way of addressing potential IFRS implementation issues.

13. We have called on European enforcers to avoid straying into the areas of general interpretation or application guidance of IFRS. This would contribute to the creation of a patchwork of diverse and inconsistent precedents that will undermine the credibility of IFRS financial reporting. For the same reason, we have concerns over the continued operation in Europe of systems of ‘pre-clearance’. Similarly, whilst firms of accountants have an important part to play though informal consensus-finding discussions and the development of high quality technical publications and training material, any cross-over into standard-setting would be inappropriate given the need for transparent and rigorous due process.

4.6 *This paper suggests (in paragraph 3.8) that Europe should proceed on the basis that the IFRIC will ensure that it is at all times resourced sufficiently to prevent a backlog of European issues meriting an interpretation arising. Do you agree with this suggestion? If you do not, please could you explain your reasoning.*

14. IFRIC has yet to establish its credibility as the single authoritative international body with responsibility for interpretations of IFRS. Well-founded concerns regarding the pace and, importantly, the quality of the work of IFRIC have not yet abated. For example, it is questionable whether a convincing case was made for the recent decision not to address concerns regarding accounting for operating lease incentives (SIC 15). Potential agenda items should not be rejected simply because they will in due course form part of a convergence project.
15. However, in general we support the analysis of IFRIC’s operations, their shortcomings and potential improvements set out in the recent IASCF paper *IFRIC - Review of Operations: Consultative Document*, and have urged IFRIC to implement the changes required as a matter of priority. Accordingly, we agree that Europe should proceed on the basis that IFRIC will have the resources required to ensure that its analysis and conclusions of issues that merit its attention are timely and invariably of high quality. However, this assumption should be kept under close review.

4.7 *This paper concludes (in paragraph 3.14) that, if the proposition referred to in paragraph 4.6 is accepted, Europe should not issue interpretative guidance—not even if there is a substantial increase in demand from Europe for interpretations. Do you agree? If you do not, please could you explain your reasoning.*

16. Yes, we strongly agree. IFRIC should retain sole responsibility for issues that are - or might be, or might become - of relevance in more than one jurisdiction. Local interpretations should deal exclusively with local issues, without IFRS implications outside of the jurisdiction concerned. On this basis, local - or regional - interpretations should be very few and far between.

4.8 *This paper suggests (in paragraph 3.16) that, if the proposition referred to in paragraph 4.6 is accepted, Europe should not issue implementation guidance. Do you agree? If you do not, please could you explain your reasoning*

17. Yes, we strongly agree. We are not convinced that a clear distinction can be drawn between interpretations and implementation guidance. European implementation/application guidance would add a new layer of complexity to IFRS literature and would not be subject to the level of due process accorded to IASB and IFRIC pronouncements.
- 4.9 Paragraphs 3.17-3.20 discuss the possibility of Europe setting up an urgent issues mechanism should the responses to paragraphs 4.2-4.4 show that there are genuinely urgent issues arising in Europe that merit a quick response. The discussion concludes that a European urgent issues mechanism should not be set up even if there are genuinely urgent issues arising in Europe. Do you agree? If you do not, please could you explain your reasoning.**
18. Yes, we strongly agree, as discussed above in paragraph 11. The number of sources of European GAAP should be kept to a minimum.
- 4.10 This paper suggests (in paragraphs 3.21-3.29) that Europe should set up an 'IFRIC support mechanism' of the type described in those paragraphs if the responses to paragraphs 4.2-4.4 were to suggest a need for it. Do you agree? If not, please give your reasoning.**
19. As discussed above, we are not convinced on the evidence currently available that the number of issues meriting an interpretation is sufficient justification for the establishment of a new mechanism in Europe. However, we would not oppose the creation of a suitable mechanism if the results of EFRAG's consultation - or subsequent events – confirm that IFRIC may welcome assistance to deal with issues of interpretation of importance in Europe.
- 4.11 The appendix to the paper discusses one particular aspect of the IFRIC support mechanism suggestion—whether the mechanism would publish the suggested solutions it would send to the IFRIC. The tentative conclusion of the discussion is that the suggested solutions should not be published. Do you agree? If you do not, please could you explain your reasoning.**
20. On balance, we believe that all material published by any mechanism should be made public. We acknowledge the risk that suggested solutions might become part of European GAAP, adding complexity to the body of IFRS accounting literature. However, this risk can be mitigated by a clear explanation of the status of the proposed solutions, emphasising that they are no sense binding on constituents. Further, the risk of creating European GAAP through the publication of official documents seems no less than the risk that, in practice, a number of different accounts – not always accurate or consistent - of the decisions taken at the public meetings would be circulated. The risk also seems comparable with that posed by the publication of IASB discussion papers and publications such as *Insight* and *Update*.