KPMG IFRG Limited
15 Canada Square
London E14 5GL
United Kingdom

Tel +44 (0) 20 7694 8871
Fax +44 (0) 20 7694 8429

mark.vaessen@kpmgifrg.com

Mr Hans Hoogervorst
Chairman of the IASB
International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Our ref MV/288

12 April 2017

Dear Mr Hoogervorst

Comment letter on ED/2017/1 *Annual Improvements to IFRSs 2015–2017 Cycle*

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB) ED/2017/1 *Annual Improvements to IFRS Standards 2015–2017 Cycle*. We have consulted with, and this letter represents the views of, the KPMG network.

We support the Board's efforts to address the issues identified. We agree that these issues cause diversity in practice and that resolving them would improve financial reporting. However, we do not believe that the proposals, as they stand, would resolve the issues. One of the reasons is that all three questions raised, in our view, require more substantive consideration and analysis, possibly more than could be done within the confines of an annual improvement project. Therefore, we believe that further work is necessary in relation to all three issues.

IAS 12 Income Taxes – Income tax consequences of payments on financial instruments classified as equity

We support the Board's efforts to address the existing diversity in practice of accounting for the tax consequences of payments on financial instruments classified as equity for accounting purposes and as liabilities for tax purposes.

However, we believe that the proposed amendments would not resolve the problem because they simply change the geography of the existing guidance, which is not clear. The diversity and challenges encountered in practice are likely to remain until the underlying issue is addressed – i.e. how to determine if a payment represents a distribution of profits. Examples of some practical challenges are highlighted in the Appendix to this letter. Pending further debate on the fundamental issue, we suggest that the Board clarify the issues highlighted to reduce the existing diversity in practice.

IAS 23 Borrowing Costs – Borrowing costs eligible for capitalisation

We do not support the amendment as currently proposed because it does not address the problem comprehensively and would introduce an additional rule without consideration of the core principle of the standard. We do not believe that the Board has provided a convincing argument as to why a borrowing originally made specifically for the purpose of acquiring a particular asset should become part of general borrowings as soon as that asset is ready for its intended use or sale; unless the qualifying asset has been sold, completing the asset does not generate funds to repay the borrowings or change their purpose.

We believe that, conceptually, there are two possible options for the Board in defining general borrowings for the purposes of paragraph 14 and we explore these in the Appendix. We prefer an approach that excludes from the general pool borrowings made specifically to finance an asset that does not meet the criteria for interest capitalisation under IAS 23; this approach would represent more faithfully how an entity funds its operations. We believe that the Board should clarify that this issue impacts not only on the capitalisation rate but also on the total amount of borrowing costs that may be capitalised.

IAS 28 Investments in Associates and Joint Ventures – Long-term interests in an associate or joint venture

We believe that the proposed amendment to IAS 28 does not resolve the conflict between IAS 28 and IFRS 9 *Financial Instruments* in accounting for 'long-term interests in an associate or joint venture that, in substance, form part of the net investment' (LTI), although the confusing terminology in paragraph 14A may give the impression that it does. We are concerned that the proposal only reinforces the original problem, because it maintains that two measurement standards – the IAS 28 equity loss absorption/impairment and IFRS 9 requirements – continue to apply to LTI. Therefore, several original practical challenges of dual application of conflicting standards remain, as highlighted in the Appendix to this letter.

We therefore ask the Board not to proceed with the proposal, and to instead make an amendment to ensure that LTI are in the scope of one single standard only. The Appendix summarises our considerations of an IFRS 9 only approach or an IAS 28 only approach. However, we recommend that the IASB perform its own analysis to determine which solution is the most appropriate.

Considering the time pressure due to the effective date of IFRS 9 being 1 January 2018, we strongly recommend that the IASB work on resolving the LTI issue as the highest priority.

Please contact Mark Vaessen +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited

Appendix: Responses to specific questions

This appendix contains our detailed responses to the proposals.

Question 1— Proposed amendments

Do you agree with the Board's proposal to amend the Standards in the manner described in the Exposure Draft?

If not, why, and what alternative do you propose?

IAS 12 *Income Taxes* – Income tax consequences of payments on financial instruments classified as equity

We support the Board's efforts to address the existing diversity in practice of accounting for the tax consequences of payments on financial instruments classified as equity for accounting purposes and as liabilities for tax purposes.

However, we believe that the proposed amendments would not resolve the problem because they simply change the geography of the existing guidance, which is not clear. The diversity and challenges encountered in practice are likely to remain until the underlying issue is addressed – i.e. how to determine if a payment represents a distribution of profits.

Examples of some practical challenges include the following.

- *Definition:* Some argue that an entity should consider what constitutes a distribution of profits under its local law, whilst others argue that it is purely the accounting that drives the presentation of the tax impact either in profit or loss, or in equity. For example, in some countries entities are allowed to make distributions regardless of whether they have any accumulated profits, as long as they are solvent.

- *Perspective:* Some argue that depending on whether the entity's separate or consolidated financial statements are considered, the same payment may or may not constitute a distribution of profits. For example, in some countries local laws require entities to declare distributions only based on the accumulated profits recognised in the separate financial statements prepared under the local GAAP. The local GAAP may not necessarily have Other Comprehensive Income as a separate statement (section) and some amounts that are recognised in Other Comprehensive Income under IFRS – e.g. remeasurement of pensions – are recognised in profit or loss under local GAAP.

- *Timing:* Some argue that it is not clear whether 'distribution of profits' refers only to profits generated in the current year or includes accumulated profits for prior periods as well. For example, we are aware that in some jurisdictions 'distribution of profits' is interpreted narrowly with reference to the current year profits only.

- *Tracing to original transactions:* It is not clear whether an entity needs to trace each distribution to its origin(s) in order to recognise the tax impact in profit or loss, or in equity, or to split it between profit or loss and equity. For example, if part of the payment is attributed to transactions recognised in profit or loss and part is attributed to revaluations of property, plant and equipment – which are not recycled through profit or loss – then our understanding is that, under the proposals, the entity would be required to split the tax impact and recognise it proportionally in profit or loss and in equity. This introduces new complexities for entities that interpreted the scope of the application of paragraph 52B narrowly in the past and would be rather challenging, if not impossible, to implement in practice because not all entities may have sufficiently detailed historical records.

- *Linkage:* Some argue that it is unclear what contractual terms of equity instruments would link payments on them to previous profit-bearing transactions – e.g. whether payments that are made regardless of the availability of distributable profits or distributions to holders of ordinary shares could be regarded as 'dividends'.

We note that the issue of 'distribution of profits' relates to a broader debate about the dividing line between equity and liabilities. Therefore, we understand why the Board has decided not to attempt to resolve this issue at present, as mentioned in paragraph BC6 of the proposed amendments. However, we urge the Board to address the distinction between 'distribution of profits' and 'other distributions' as part of another active project – e.g. Financial Instruments with Characteristics of Equity. Pending further debate on the fundamental issue, we suggest that the Board clarify the points highlighted above to reduce the existing diversity in practice.

In addition, we note that the wording in paragraph 58A is not clear, especially in the way in which it refers to paragraph 58. We believe that paragraph BC2(b) better highlights the link to be made between the distribution of profits and the past transactions and events that generated distributable profits. Therefore, we suggest that the Board consider redrafting paragraph 58A using wording based on that in paragraph BC2(b) and provide an example of how this requirement will be applied in a situation when the tax implications need to be presented in both profit or loss and equity.

IAS 23 Borrowing Costs – Borrowing costs eligible for capitalisation

As mentioned in the cover letter, we do not support the amendment as currently proposed because it does not address the problem comprehensively and would introduce an additional rule without consideration of the core principle of the standard. We do not believe that it is possible to develop a set of prescriptive rules to cater for all different circumstances and think that it is better to strengthen the overall principles in the standard.

If an entity has taken a borrowing specifically to fund an acquisition of a qualifying asset, then it is not clear why it is fair or accurate to say that those funds should, as soon as the qualifying asset becomes ready for use, now be considered to have been – in the words of paragraph 14 of IAS 23 – borrowed generally and used for the purpose of acquiring other qualifying assets. Unless the qualifying asset has been sold, completing the asset does not generate funds to repay the borrowings. Furthermore, the proposed amendments do not address explicitly the treatment of borrowing costs on borrowings made specifically to fund assets that were never qualifying. In November 2009, the IFRS Interpretations Committee discussed this question and noted that there were different views and that judgement was required in the application of the standard. Although the Board discussed this issue at the time, its substantive view on the matter was not subject to full due process, referred only to the capitalisation rate, and was not incorporated into the authoritative text of IAS 23.

We believe that, conceptually, there are two possible options for defining general borrowings for the purposes of paragraph 14.

- _Option 1:_ All borrowings other than those for which interest is currently being capitalised under paragraph 12 of IAS 23 or which are scoped out because they are specifically attributable to assets listed in paragraph 4 of IAS 23. This option views the principle in paragraph 8 of IAS 23 as meaning that borrowing costs are directly attributable to qualifying assets if the borrowings could theoretically have been repaid if the qualifying expenditure had not been incurred. This approach appears to be the intention of the proposed amendments to paragraph 14 of IAS 23.

- _Option 2:_ A residual pool of borrowings after excluding borrowings that an entity regards as specifically attributable to the acquisition, construction or production of particular qualifying and non-qualifying assets, including assets that were previously qualifying but are no longer qualifying. This option views the principle in paragraph 8 of IAS 23 as meaning that borrowing costs are directly attributable to qualifying assets if the borrowings are actually used in funding those assets, either specifically in accordance with paragraph 12 of IAS 23, or as part of a general pool. This approach seems to be more consistent with paragraph 14 of IAS 23, which describes general borrowings as funds borrowed generally and used for the purpose of obtaining a qualifying asset. Application of this option may require wider exercise of judgement. This is because, in addition to determining what funds have been borrowed specifically for the purpose of funding a qualifying asset (which is also required under Option 1), an entity would need to determine what borrowings it regards as being attributable to non-qualifying assets.

Each option has its strengths and weaknesses as follows.

Option 1

- *Strengths:* Less complex and easier to implement in many cases; involves less judgement and therefore outcomes are more predictable; and more comparability between entities that acquire assets ready for use and those that carry out activities themselves to make such assets ready for use.

- *Weaknesses:* Not reflecting how an entity funds its operations; not the best solution for some entities, such as those in the financial sector, that have many different borrowings at many different interest rates (e.g. customer accounts, securities sale and repurchase agreements) that are held to fund financial assets that are not qualifying assets.

Option 2

- *Strengths:* More faithful representation of how an entity funds its operations.

- *Weaknesses:* Involve application of judgement to more borrowings than Option 1.

We prefer Option 2 for the reasons given above. Although applying Option 2 involves more judgement, the analysis required under either option already involves similar judgement in order to apply paragraphs 4, 12 and 15 of IAS 23.

Whatever option is selected by the Board, the general principle in the standard should be clarified – i.e. whether the general principle is that:

- borrowing costs are directly attributable to qualifying assets if the borrowings could *theoretically* have been repaid if the qualifying expenditure had not been incurred (this condition might always be met as long as borrowings exist); or

- borrowing costs are directly attributable to qualifying assets if they are *actually* used in funding those assets, either specifically, or as part of a general pool – i.e. if they are not specifically attributable to funding non-qualifying assets.

If Option 1 is selected, then we believe that guidance should be provided as to:

- how financial sector entities, such as banks, should apply the requirements to liabilities, such as customer accounts, trading positions and securities sale and repurchase agreements; and

- whether specific borrowings for which interest capitalisation is suspended because of the suspension of active development of a qualifying asset should be included in the general borrowings pool in the period of suspension of capitalisation.

Other comments

We suggest that the last sentence of paragraph 14 of IAS 23 – in relation to the limit of borrowing costs that can be capitalised – be amended to clarify:

- whether it relates to the amount of general borrowing costs or total borrowing costs. As currently drafted, two interpretations are possible – i.e. that it relates to:

    - total borrowing costs, based on a plain reading of the text; or

    - general borrowing costs, based on the fact that paragraph 14 of IAS 23 discusses general borrowing costs; and

- that it should be applied in a way consistent with calculating the capitalisation rate(s) – i.e. borrowing costs than an entity calculates for capitalisation using a capitalisation rate shall not exceed the borrowing costs it incurred in relation to borrowings used to calculate that capitalisation rate. For example, if there are restrictions on the use of borrowings issued by a subsidiary and so they cannot be used for a qualifying asset outside of that subsidiary, an entity might conclude that it is appropriate to calculate a separate capitalisation rate for that subsidiary using the general borrowings of that subsidiary in accordance with paragraph 15 of IAS 23. If there are no qualifying assets in that subsidiary then no borrowing costs would be capitalised in relation to that subsidiary's borrowings – i.e. those borrowing costs would not be used in calculating limits for capitalisation outside of that subsidiary.

Transitional provisions

In principle, we agree with the proposed prospective application of the changes. However:

- we suggest that the Board clarify whether earlier application is permitted in interim or only in annual periods; and

- there seems to be a contradiction between paragraphs 28A and 29D in the amendments. For example, if the effective date is decided to be 1 January 2019, then it will not, in effect, be possible for an entity to apply the amendments before that date (even if paragraph 29D allows early application), because paragraph 28A would require the amendments to be applied only to borrowing costs incurred on or after 1 January 2019. The contradiction could be avoided by amending the last sentence in paragraph 28A to read as follows: "*An entity shall apply those amendments to borrowing costs incurred on or after the beginning of the annual period in which this amendment is applied.*"

IAS 28 Investments in Associates and Joint Ventures – Long-term interests in an associate or joint venture

Terminology vs substance – Paragraph 14A versus BC5

On the face of the matter, paragraph 14A appears to resolve the conflict because it says that the equity method is not applied to 'long-term interests in an associate or joint venture that, in substance, form part of the net investment' (LTI). However, paragraph BC5 makes clear that this is a matter of terminology only: the equity loss absorption and impairment rules of IAS 28 *do* apply to LTI, even though those rules have been labelled as *not* being an application of the equity method. We find that label unconvincing and confusing and noticed that some readers have mistakenly concluded that paragraph 14A resolves the conflict. What matters, however, is not the terminology, but the substance – i.e. BC5 confirms that the equity loss absorption and impairment rules of IAS 28 apply to LTI, which are also fully in the scope of IFRS 9.

So it remains unclear which standard should take precedence over the other or how they should both apply together. The proposals do not address the known application problems, extending through to double counting of losses under certain circumstances and presentation issues. We therefore strongly recommend that the IASB re-think its approach to the conflict between IFRS 9 and IAS 28. We also think that the most appropriate treatment of LTI would be a 'one standard only' approach consistent with the dissenting view expressed by Mr. Ochi in paragraph AV2.

Unresolved practical challenges

The proposals do not solve the issues and add further complexity to an area already prone to diversity in practice – e.g. with regard to IAS 28 impairment requirements. A basic example illustrates some of the issues.

> Example
>
> Entity P's investment in associate A comprises CU50 of shares and CU100 of an LTI loan. The LTI is carried at amortised cost with a carrying amount of CU98 at the beginning of year 20X1, as a result of expected credit losses ('ECL') of CU2.
>
> In year 20X1, P's share of A's losses was CU140 – in line with forecast, as A is a start-up. In addition to the losses, P determines that the loan to A has experienced a significant increase in credit risk and the lifetime ECL to be recognised is CU30 (cumulative).

The proposals are silent about the sequence of application of IFRS 9 and paragraph 38 of IAS 28 to LTI and whether the requirement in paragraph 39 of IAS 28 prohibiting the recognition of a negative balance takes precedence over the requirements of IFRS 9. As a result, depending on the assumptions P makes, the following outcomes are possible.

- *Outcome 1:* On the basis that paragraph 38 of IAS 28 applies first, but without affecting the application of paragraph 5.5.8 of IFRS 9, P absorbs CU90 equity losses on LTI – i.e. CU140 minus CU50 allocated to P's shares in A – and records the full ECL of CU28. The resulting LTI is minus CU20. This negative outcome does not comply with paragraph 39 of IAS 28, but P argues that paragraph 5.5.8 of IFRS 9 takes precedence.

- *Outcome 2:* P believes that paragraph 38 of IAS 28 applies first and limits the application of paragraph 5.5.8 of IFRS 9. Therefore, P first absorbs CU90 equity losses on the LTI, bringing its carrying amount to CU8, followed by limited ECL of CU8 to leave LTI at nil.

- *Outcome 3:* P believes that paragraph 5.5.8 of IFRS 9 applies first and limits the application of paragraph 38 of IAS 28 to be compliant with paragraph 39 of IAS 28. So P first records the full ECL of CU28, followed by CU 70 of equity losses, leaving LTI at nil. This is the same balance sheet outcome as under Outcome 2, but here the cumulative unrecognised equity losses are CU20, whereas under Outcome 2, there are no unrecognised equity losses, but instead an unrecognised ECL of CU20. Outcome 3 might also be rationalised as applying paragraph 38 of IAS 28 first, before allocating CU28 to the LTI to account for the ECL measurement in accordance with paragraph 5.5.8 of IFRS 9 – i.e. without regard to IAS 28. In a third step, P then reverses CU20 of equity losses in order to respect the requirements in paragraph 39 of IAS 28.

Applying the proposal to the basic fact pattern above shows the circularity of the interaction between the two measurements and the existence of multiple outcomes depending on the assumptions made about the order of precedence of IAS 28 versus IFRS 9 requirements. Further application issues include the following.

- In the above example, the CU140 of equity losses and additional CU28 of ECL occur in the same period. In other cases, they may arise in different periods. Should the outcome differ depending on the order of events? To achieve the same outcome – e.g. if ECL occur later – should losses recognised under paragraph 38 of IAS 28 in previous periods be reversed so that the additional ECL can be recognised?

- In the case of impairment, how would the impairment requirements in paragraph 42 of IAS 28 and in IAS 36 interact with the requirements in paragraph 38 of IAS 28 and IFRS 9?

- If the economic situation of the entity improves, what would be the priority between reversing prior year losses recognised under paragraph 38 of IAS 28 and ECL?

- If the IFRS 9 balance recovers, should an equivalent amount be offset against any unrecognised IAS 28 losses carried forward?

- Are IAS 28 losses (profits) and gains from IAS 36 impairment reversals to be ignored when applying IFRS 9 in subsequent periods – e.g. in calculating interest?

- How does the IFRS 9 requirement on credit-impaired assets interact with the requirement in paragraph 38 of IAS 28 on loss allocation?

Overlap and double counting of losses

We are concerned about the potential overlap and/or double counting of losses which would result from applying the proposals to scenarios involving IAS 28 losses as well as IFRS 9 and IAS 36 impairments.

The IFRS 9 impairment assessment for an LTI carried at amortised cost would be based on an ECL model, whereas the triggers defined in paragraph 41A of IAS 28 are indications of incurred losses. Therefore, an LTI might experience a significant increase in credit risk and therefore an increase in ECL prior to losses actually occurring. These losses might then be allocated to the LTI under paragraph 38 of IAS 28 if and when they occur. In such a situation, the same loss may be captured through the ECL measurement and the loss allocation.

The existence of potential overlap and double counting was acknowledged in the paper presented by the staff at the May 2016 meeting of the IFRS Interpretations Committee[1]. To address these concerns, they suggested that the "Board would need to amend IAS 28 so that long-term interests would be within the scope of either IFRS 9 or IAS 28, and not both"[2]. This suggestion is consistent with the 'one standard only' approach we are advocating.

Presentation issues

Applying two standards to the same asset raises presentation and transparency issues, the main one being whether LTI should be presented net or using one or more separate loss allowance account(s). Further guidance about the presentation and disclosure of LTI would be needed from the Board to ensure that users of financial statements can reconcile and distinguish the IAS 28 allocated losses from the IAS 36 and IFRS 9 impairment amounts. The following aspects would require clarification.

- Would the allocated losses from the requirements in paragraph 38 of IAS 28 and the IAS 36 impairment loss be deducted from the carrying amount of the long-term interest, and would the loss allowance only show the IFRS 9 impairment or would it be a mixture of the IAS 28 allocated loss, IAS 36 impairment loss and IFRS 9 allowance?

- If the asset is carried at fair value and there is an IAS 36 impairment loss on the net investment, which includes such instruments, should the IFRS 9/13 fair value amount be presented with a separate allocation of IAS 28 losses and should IAS 36 impairment show the net carrying amount?

- Similar considerations apply to a credit-impaired asset.

'One standard only' approach

We recommend that the Board address the conflict between IFRS 9 and IAS 28 by amending IFRSs so that LTI are in the scope only of either IFRS 9 or IAS 28. We have outlined our considerations for each option below.

IFRS 9-only approach

We believe that the main advantage of this approach is its apparent simplicity for preparers. It would also result in a consistent application of IFRS 9 requirements and ensure that LTI included in the fair value through profit or loss caption are measured at fair value as required by IFRS 9; whereas under the proposals they might be measured

[1] Agenda paper 2, May 2016 IFRIC meeting, paragraphs 48 and 51.
[2] Agenda paper 2, May 2016 IFRIC meeting, paragraph 51.

at less than their fair value if IAS 28 losses and/or IAS 36 impairment losses were allocated to them.

However, there are some aspects that speak against an IFRS 9-only solution.

- Applying IFRS 9 ECL requirements to LTI might be challenging, because it would require a calculation of cash shortfalls if settlement is neither planned, nor likely to occur in the foreseeable future. The Board might need to provide additional guidance on how cash shortfalls would be determined.

- The loss allocation under paragraph 38 was introduced by IAS 28 (2003) to prevent structuring opportunities between equity and loan interest to avoid recognising losses. Applying IFRS 9 to LTI at amortised cost might not achieve the same effect given the judgement involved in the ECL determination.

IAS 28-only approach

We believe that the main advantage of the IAS 28-only approach is that there is a broad consensus about the usefulness of applying an IAS 28-only approach to LTI in thinly capitalised entities as this would better reflect substance of the interest being part of the equity investment.

We believe that the biggest challenge for an IAS 28-only approach is that the Board would need to develop a clear definition and accounting model that distinguishes LTI from other loans to which IFRS 9 still applies. This accounting model would need to address the definition of LTI and their initial and subsequent measurement, as well as provide guidance for any classification and reclassification of LTI.

We acknowledge that neither approach may be within the boundaries of an Annual Improvement amendment. However, even if that is the case, the need to address this conflict is sufficiently urgent considering that the effective date of IFRS 9 is fast approaching.

Question 2— Effective date of the proposed amendments to IAS 28 *Investments in Associates and Joint Ventures*

The Board is proposing an effective date of 1 January 2018 for the proposed amendments to IAS 28. The reasons for that proposal are explained in paragraphs BC7–BC9 of the Basis for Conclusions on the proposed amendments to IAS 28.

Do you agree with the effective date for those proposed amendments?

If not, why, and what alternative do you propose?

As outlined in Question 1, we disagree with the Board's proposed amendments and suggest a one standard only solution. We are aware that the timeline to get this issue resolved is very tight because IFRS 9 is effective for annual periods beginning on or after 1 January 2018. In light of this urgency and the due process steps required for amending standards, we recommend that the IASB resume its work on the LTI issues as soon as possible and assign the highest priority to the resolution.

We agree that the effective date for the amendments should be aligned with the effective date of IFRS 9. However, we would highlight that any amendment should provide guidance for early adopters of IFRS 9 and insurers that are using the deferral approach under IFRS 4 *Insurance Contracts*.

With regard to insurers, the new paragraph 45F addresses the restatement of comparatives when the deferral approach under IFRS 4 has been applied, but does not state whether the effective date of the IAS 28 amendments would also be deferred if insurers defer the application of IFRS 9. We therefore propose that the Board clarify that the effective date for insurers using the deferral approach would be the later of 1 January 2018 and the date of first-time application of IFRS 9.