

March 2011

Summary of EFRAG meetings held in February and March 2011

On 24 February 2011, EFRAG held meetings by public conference call to discuss:

- IASB Supplementary Document *Financial Instruments: Impairment*
- EFRAG's letter to the IASB and FASB on financial instruments

From 9 to 11 March 2011, EFRAG held its monthly meeting. The first day of the meeting was held together with the European National Standard Setters in EFRAG's Consultative Forum of Standard Setters (CFSS). The following topics were discussed during the monthly meeting:

- European outreach on the IASB main projects
- IASB Exposure Draft *Hedge Accounting*
- IASB Exposure Draft *Revenue from Contracts with Customers*
- IASB Amendments to IFRS 7 *Disclosures – Transfers of Financial Assets*
- IASB Exposure Draft *Leases*
- IASB Amendments to IAS 12 *Deferred Tax: Recovery of Underlying Assets*
- EFRAG outreach on *Financial Instruments*
- EFRAG proactive project *Disclosure Framework*.

Highlights

Endorsement advice

EFRAG finalised its endorsement advice to the European Commission on the Amendments to IFRS 7 *Financial Instruments: Disclosures – Transfers of Financial Assets* (page 6).

Comment letters to the IASB

EFRAG finalised its comment letter to the IASB in response to the Exposure Draft *Hedge Accounting*. The comment letter is supportive overall of the direction of the proposals in the ED. However, concerns are raised on a number of issues, which EFRAG believes requires further consideration, as they could create an inconsistency with risk management practices. In addition, EFRAG urges the IASB, before finalising the standard, to consider all proposals related to the replacement of IAS 39 in their entirety, including the proposals on macro hedging. The comment letter also identifies certain areas for further work, including the operationality of the proposals (page 3).

Comment letters to the IASB (continued)

EFRAG invited comments on its draft comment letter in response to the IASB Supplementary Document *Financial Instruments: Impairment*. The draft comment letter welcomes the IASB and the FASB efforts in developing a common approach to accounting for the impairment of financial assets. However, the converged approach should represent a high-quality proposal and EFRAG remains to be persuaded that the proposed common approach for an open portfolio provides an acceptable simplification of the approach that we supported in our comment letter regarding the November 2009 proposals (for example, reflection of the link between the pricing of the asset and the expected credit losses). The comment deadline is 28 March 2011 (page 2).

IASB Supplementary Document *Financial Instruments: Impairment*

During its meeting held by public conference call on 24 February 2011, EFRAG finalised its draft comment letter in response to the IASB Supplementary Document *Financial Instruments: Impairment* (the Supplementary Document). The draft comment letter welcomes the IASB's efforts to find operational solutions for the difficulties identified in respect of the model exposed in the November 2009 proposals. EFRAG agrees with the IASB that the most challenging operational issue relates to the implementation of the expected cash flow approach to open portfolios of financial assets, and supports the development of a simplified approach to the expected cash flow model based on the separate allocation ('decoupling') of interest revenues and expected credit losses.

The introduction of new concepts (for example, the 'floor' and the notions of 'good book' and 'bad book') as well as the fragmented due process, make it difficult to assess these proposals in their full context. For these reasons, EFRAG believes that a 60-day comment period is insufficient. EFRAG also urges the IASB to engage in field-testing of the new concepts to assess their impact.

EFRAG welcomes the IASB's and FASB's efforts to develop a common approach to accounting for the impairment of financial assets. However, the converged approach should represent a high-quality proposal and EFRAG remains to be persuaded that the proposed common approach for open portfolio provides an acceptable simplification of the approach that we supported in our comment letter regarding the November 2009 proposals (for example, reflection of the link between the pricing of the asset and expected credit losses).

EFRAG found the Supplementary Document insufficiently clear about the benefits of the common approach to users and preparers. Also, it does not adequately explain the rationale behind the mechanics and the impacts of a number of aspects of the common model. Such clarifications are needed to help constituents understand how the proposed model provides an acceptable simplification of the original proposals.

The draft comment letter is available on EFRAG's website. The comment deadline is 28 March 2011.

EFRAG letter to the IASB and the FASB on financial instruments

During its meeting held by public conference call on 24 February 2011, EFRAG finalised a letter to the IASB and the FASB, which urges both standard setters to agree on a joint timetable to finalise a converged accounting standard on financial instruments. →

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As part of the response to the financial crisis, the G20 called on accounting standard setters to work urgently to achieve a single set of high-quality global accounting standards, with a particular focus on the accounting for financial instruments. In response to the FASB proposals on financial instruments, EFRAG had recommended that the directions set by the IASB in the first phases of the development of IFRS 9 *Financial Instruments* should form the basis for high-quality financial reporting requirements for financial instruments.

In the letter, EFRAG observes that recent developments show strong signs of the FASB's willingness to work actively towards a converged standard for the accounting for financial instruments, and notes that the IASB has not yet completed important parts of its project to revise the financial instruments standard, including general hedging, impairment of financial assets and offsetting, and has not yet defined possible requirements for portfolio hedging.

EFRAG also states that reaching agreement on a converged financial instruments standard appears again to be a realistic goal that the IASB and the FASB can achieve jointly. While it may not be possible to finalise hedge accounting requirements before the end of 2011, agreement on the classification and measurement, impairment and offsetting before the end of 2011 is certainly an achievable and desired goal. Therefore, EFRAG urges the two boards to continue their joint efforts in developing a converged high-quality financial instruments standard – with careful consideration of EFRAG's recommendations to that purpose – and to agree on a new joint timeline for the finalisation of such a standard, consistent with the G20 requirements.

The letter is available on EFRAG's website.

European outreach on the IASB main projects

The IASB intends to finalise its major projects on *Revenue, Leases, Insurance Contracts* and *Financial Instruments* by June 2011 and is, at present, busy redeliberating the proposals.

After consulting with the European National Standard Setters in EFRAG's Consultative Forum of Standard Setters, EFRAG has decided to organise outreach events throughout Europe in late April – May 2011. The objective of these events would be:

- to familiarise European constituents with the tentative decisions that the IASB had made to date in the re-deliberation phase of these major projects;
- to learn whether those tentative decisions were solving major concerns expressed by the European constituents during the consultation phase;
- to identify whether changes made to the former proposals could trigger any new major concerns; and hence
- to provide useful input to the IASB for finalisation of the standards and to ensure that the final standards are acceptable for Europe.

The outreach meetings are organised jointly with National Standard Setters in their jurisdictions and in close cooperation with the IASB. European constituents, including issuer and investor representatives, are invited to participate. The preparations for the outreach events are currently underway. As soon as the dates of individual meetings and locations are confirmed, EFRAG will publish news articles on its website to inform its constituents accordingly.

IASB Exposure Draft *Hedge Accounting*

EFRAG finalised its comment letter to the IASB in response to the Exposure Draft *Hedge Accounting* (the ED). The ED proposes significant changes to hedge accounting for hedges of individual and closed groups of items. Proposals for hedges of open portfolios (also known as macro hedging) are expected later this year.

Supported by input received from European constituents on its draft comment letter, EFRAG re-affirmed its views. Overall, EFRAG agrees with the direction of the proposals in the ED. In particular, EFRAG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities. We believe that this approach has the benefit of being consistent with the role of the business model in the classification of financial instruments. However, the comment letter recommends to the IASB to consider strengthening the objective of hedge accounting by explicitly stating that when an entity applies hedge accounting, the resulting financial reporting better reflects the economic effects of the risk management activities than would otherwise be the case. The main comments include the following:

- *Eligibility*: the proposals remove a number of the restrictions to hedge accounting in IAS 39 *Financial Instruments: Recognition and Measurement*. In EFRAG's view, there are important improvements relating to assessing hedge effectiveness - the possibility to designate derivatives, risk components and net positions as hedged items, and the possibility to apply hedge accounting to components of non-financial items. These proposals make the hedge accounting model significantly more flexible and will help to increase the appropriate use of hedge accounting. However, EFRAG believes that certain remaining restrictions, which could otherwise create inconsistencies with risk management practices, should be lifted.
- *Hedging groups of items*: while in EFRAG's view, the proposed general model for hedge accounting is a reasonable approach to hedging individual items, the comment letter notes that EFRAG is not able to comment more fully on the proposals relating to groups of items until it gains a better understanding of the IASB's direction in respect of macro hedging. Given the importance of macro hedging, EFRAG believes that the IASB should not finalise a standard on the general hedge accounting model prior to developing a model for macro hedging.
- *New concepts and definitions*: the proposals introduce an approach to hedge accounting that significantly differs from the current requirements. The proposals bring in important new concepts and definitions that are not well understood by constituents. This creates considerable uncertainty around the operationality of the new model. To address these concerns, the IASB should consider clarifying the drafting of the key concepts, making the redrafted proposals publicly available to constituents for comments, and testing the operationality of the proposals in practice.
- *Disclosures*: EFRAG believes that disclosures play a fundamental role in complementing financial information derived from the principle-based proposals in the ED. The proposed hedging model requires the application of more judgement than IAS 39. Therefore, EFRAG believes that the disclosure objectives are appropriate, but have certain concerns about their prescriptive nature and their interaction with the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.
- *Assessing IFRS 9 as a whole*: EFRAG believes that the IASB will need to consider the various phases of the IAS 39 replacement as a whole before finalising the resulting standards.

IASB Exposure Draft *Revenue from Contract with Customers*

EFRAG considered the latest tentative decisions made by the IASB in its redeliberation of the proposals included in the Exposure Draft *Revenue from Contracts with Customers* (the ED). The discussion focused on the following tentative decisions made by the IASB:

- *Transfer*: EFRAG welcomes the IASB's efforts to reconsider the control notion in relation to services and long-term contracts. Furthermore, it notes that the IASB tentative decisions may lift some of the concerns identified at the Exposure Draft stage. However, it was noted that developing separate criteria for the eligibility of percentage-of-completion accounting could effectively result in two revenue recognition models, and therefore the benefit of developing a new revenue recognition standard may not be obtained. EFRAG also discussed the criteria for application of percentage-of-completion accounting and tentatively expressed concerns that revenue might be recognised without the entity having a right to consideration for performance to date and that the reference to the "no alternative use" criterion may be both arbitrary and restrictive.
- *Breakage*: this term is used to describe situations in which a customer makes a non-refundable prepayment for future goods or services, but does not exercise the portion of its rights (for example, when a customer buys a gift card). The IASB tentatively agreed that if an entity can reasonably estimate breakage, then it should recognise the expected breakage as revenue in proportion to the pattern of transfer. Conversely, if an entity cannot reasonably estimate breakage, then it should recognise the expected breakage as revenue when the likelihood of the customer exercising its rights becomes remote. EFRAG's discussion focused on whether breakage should be considered at a contract or portfolio level. Consistently with views expressed in the past, EFRAG does not believe that the use of a weighted average estimate is relevant at individual transaction level. It believes it should apply at portfolio level only.
- *Contract modifications*: the IASB's view on contract modifications is subject to its further discussion on how an entity should determine and allocate the transaction price. However, it has tentatively decided that if a contract modification results only in the addition of a separate performance obligation (or obligations) at a price that is commensurate with that additional performance obligation, then the entity should account for the contract modification as a separate contract. Otherwise, the entity should re-evaluate the performance obligation and reallocate the transaction price to each separate performance obligation. EFRAG discussed this tentative decision and noted that accounting for an addition to a contract should also take into account the relative amount of the addition.
- *Combining contracts*: the IASB tentatively agreed that contracts should be combined when they are entered into at or near the *same time with the same* customer (or related entities), and one or more of the following criteria are met: the contracts are negotiated as a package with a single commercial objective, the amount of consideration received in one contract depends on the performance of the other contract, and the goods and services in the contracts are closely interrelated in terms of design, technology, or function. EFRAG discussed whether only contracts with the same customer could be combined, and tentatively decided that another approach would be more appropriate to reflect the fact that sometimes there are more than two parties in a contract.

IASB Amendments to IFRS 7 *Disclosures - Transfers of Financial Assets*

In December 2010, EFRAG issued an Invitation to Comment on its draft endorsement advice and a draft Effect Study Report in respect of an amendment to the derecognition disclosure requirements of IFRS 7 *Financial Instruments: Disclosure* (the Amendment), which was issued by the IASB in October 2010. The Amendment aims to help users of financial statements better evaluate the risk exposures relating to transfers of financial assets and the effects of those risks on an entity's financial position. Its objective is to promote transparency in the reporting of transfer transactions, particularly those that involve securitisation of financial assets. Based on the comments received, EFRAG agreed to issue to the European Commission both the positive endorsement advice and the Effect Study Report.

IASB Exposure Draft *Leases*

EFRAG considered the latest tentative decisions made by the IASB in its redeliberation of the proposals included in the Exposure Draft *Leases*, in relation to the definition of a lease and the accounting model for lessees:

- *Definition of a lease:* The IASB tentatively decided that an asset is a specified asset when it has both quantitative and qualitative specifications. However, an arrangement that requires the use of a specified asset that is only incidental to the provision of a service would not contain a lease. EFRAG discussed the IASB's clarification. Some members noted that a certain degree of judgement would be required to assess whether an asset was specified.
- *Type of leases:* The IASB tentatively decided to develop a principle for identifying two types of leases for both lessees and lessors with different profit and loss effects as follows: a) finance leases with a profit or loss recognition pattern consistent with the proposals in the ED; b) other-than-finance leases with a profit and loss recognition pattern consistent with operating leases. EFRAG discussed the IASB's decision, but did not form a view.

EFRAG will continue the discussion at its next meeting.

IASB Amendments to IAS 12 *Deferred Tax: Recovery of Underlying Assets*

In December 2010, the IASB published Amendments to IAS 12 *Deferred Tax: Recovery of Underlying Assets* (the Amendments). The Amendments introduce an exception to the measurement principles in IAS 12 *Income Taxes* to provide a practical approach in those cases where it is difficult or subjective to determine the manner in which an entity expects to recover the carrying amount of investment property measured at fair value under IAS 40 *Investment Property*.

EFRAG continued discussing its initial assessment of the Amendments in relation to the EU endorsement criteria and the initial study of its cost and benefits. Some EFRAG members questioned whether the application of the rebuttable presumption was clearly articulated, and raised a concern that the unclear wording could lead to diversity in determining as to when an entity would rebut the presumption.

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It was indicated that further detailed analysis may be required to assess how the Amendments would affect relevance and comparability of information.

No decisions were taken by EFRAG at this meeting. The draft endorsement advice on the Amendments is subject to further discussions by EFRAG.

EFRAG outreach on *Financial Instruments*

EFRAG received an update on the outreach activities undertaken as part of the European consultation on the IASB's proposals relating to hedge accounting, impairment and offsetting, published as part of the IAS 39 replacement project.

As part of the outreach activities, EFRAG and the IASB held a discussion forum on financial instruments on 28 February 2011 in Brussels. The participants were keen to understand the IASB's proposals and engaged in an active debate with the IASB team about the impact of these proposals. While supportive of many of the proposals, participants provided suggestions for further improvements to the IASB.

For the convenience of European constituents, EFRAG staff prepared a feedback report, which provided an overview of the feedback received during the discussion forum, outlining questions raised by constituents and the answers provided by the IASB team. The feedback report is available on EFRAG's website.

EFRAG proactive project *Disclosure Framework*

EFRAG received an update on the status of the project, and discussed some fundamental issues. EFRAG decided:

- to confirm the objective of the project;
- to amend the name of the project to “a disclosure framework for the notes to the financial statements”, which better reflects the fact that the scope of the project is limited to the notes to the financial statements and does not extend to other parts of the financial report. The amended name will be communicated later;
- to clarify that information in the notes should be limited only to what is necessary to understand the amounts in the primary statements.

EFRAG also supported the direction of the project aiming at simplifying and reducing existing disclosure requirements in IFRS.

EFRAG will continue discussions on the project with a view to releasing a discussion paper later in the year.

Future meetings

The next meeting of EFRAG TEG will take place on 6-8 April 2011.

A conference call is scheduled for 29 March 2011.