

June 2008

Summary of the EFRAG meetings in June 2008

On Wednesday 11 June 2008 EFRAG TEG (EFRAG) met with the European National Standard-Setters in EFRAG's Consultative Forum of Standard-Setters (CFSS) to discuss:

- The Credit Crunch
- Business Combinations Phase II
- IASB/FASB Memorandum of Understanding

From Wednesday 11 to Friday 13 June 2008 EFRAG held its monthly meeting and discussed:

- The Credit Crunch
- IASB/FASB Memorandum of Understanding
- Business Combinations Phase II
- IASB Discussion Paper on *Reducing the Complexity of Reporting Financial Instruments*
- IASB Discussion Paper on *Financial Instruments with Characteristics of Equity*
- IASB Conceptual Framework Project – *The Objective and Qualitative Characteristics of Financial Reporting*
- IASB Conceptual Framework Project – *The Reporting Entity*
- IASB Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*

In between its May and June meetings, EFRAG also held two meetings by public conference call - on 23 and 30 May 2008 - and discussed:

- IFRIC D23 Distribution of Non-cash Assets to Owners
- IFRS 1 and IAS 27 Cost of an Investment in a Subsidiary, Jointly-controlled Entity or Associate

The Credit Crunch

Many organisations are carrying out work to identify any weaknesses that have been highlighted by the so-called credit crunch. At the CFSS meeting, participants considered an overview of the potential accounting weaknesses that have been identified to date and a brief summary of what is being done as a result. They also updated each other on the work being carried out in their own jurisdictions and their thoughts as to what additional work should be carried out. They also heard that EFRAG was discussing with the standard-setters of France, Germany and the UK the possibility of developing a joint position on the credit crunch and of issuing a joint statement explaining that joint position. A further update was provided to EFRAG later in the week.

EFRAG Update is published as a convenience for EFRAG's constituents. All conclusions reported are tentative and may be changed or modified at future meetings.

In April a joint meeting of the IASB and FASB discussed the priorities that should be attached for the next few years to the projects mentioned in the IASB/FASB Memorandum of Understanding. As this is an issue of fundamental importance to all those jurisdictions already on IFRS, EFRAG believed it was very important that the IASB was aware of the views of those jurisdictions so it could take their views into account in deciding on its priorities. EFRAG has therefore decided to develop a comment letter on the subject. A draft of that letter was discussed with the standard-setters and, later in the week, EFRAG used that input to finalise the draft letter, which was then issued on EFRAG's website for comment.

Business Combinations Phase II

EFRAG has been discussing the revised IFRS 3 and the Amended IAS 27 (the new standards) for some time now and the indications are that the majority of EFRAG members are currently tending towards recommending endorsement of both standards. At the CFSS meeting standard-setters were asked for their views on EFRAG's initial thoughts on the endorsement of the new standards.

Later in the week, EFRAG continued its discussion of the new standards in the light of the input received from the standard-setters. EFRAG agreed that it should consult on its draft endorsement advice as soon as possible, even if that meant making it clear that the draft advice was subject to carrying out more work on the costs and benefits of implementing the new standards in the EU. EFRAG discussed in detail draft endorsement advice letters on each of the new standards and agreed various changes to the letters. It is hoped that it will be possible to issue the drafts for comment early in July.

EFRAG is also carrying out work on the costs and benefits of implementing the new standards in the EU. EFRAG is having discussions with a sample of preparers and auditors, and has already consulted with its User Panel. A public consultation on the costs and benefits is also planned.

IASB Discussion Paper on Reducing the Complexity of Reporting Financial Instruments

At the May 2008 meeting EFRAG members started debating the IASB discussion paper on reducing complexity in reporting financial instruments. That discussion focussed on the various intermediate approaches proposed in the paper. During the June meeting EFRAG discussed the paper's thoughts on a long-term solution.

The paper argues that the many ways of measuring financial instruments is an important reason why today's requirements are so complex and that the best way to eliminate the complexity would be to require all financial instruments to be measured in the same way. It then argues that that single measurement basis should be fair value. Requiring all financial instruments to be measured at fair value would also eliminate the need for fair value hedge accounting.

EFRAG members agree that current reporting for financial instruments is complex. However, in their view complexity should not be the factor that determines the long-term solution; rather, the focus should be on how to make the reporting of financial instruments more useful for users. EFRAG members thought it difficult to know what, in the long-term, would be the most useful measurement approach because much would depend on the way other issues – in particular, financial statement presentation, disclosures, what fair value means, the conceptual project on measurement and the definition of financial instruments – are resolved, which the paper acknowledges.

EFRAG members tentatively concluded that, as a result, it may even be that it is not appropriate to set any long-term objective at the current time; in which case the objective should be simply to reduce the measurement complexity mentioned in the paper by reducing the number of different ways of measuring financial assets and liabilities.

EFRAG will discuss its draft comment letter further at its July meeting, and the plan currently is to issue a draft for public comment by mid-July.

IASB Discussion Paper on Financial Instruments with Characteristics of Equity

EFRAG continued its deliberations of the IASB/FASB Discussion Paper “Financial Instruments with Characteristics of Equity”.

The paper discusses three possible approaches to distinguishing equity from liabilities. In contrast to current IAS 32— which defines an equity instrument as a financial instrument that is not a financial asset or a financial liability— all three approaches propose a standalone definition of equity.

EFRAG members think the three approaches are useful in that they highlight certain aspects about the debate that need to be carefully considered. However, they also think the paper has a number of shortcomings. For example the paper lacks a discussion on what the purpose of distinguishing between equity and liability is. Without such a discussion, it is difficult to know whether any particular approach is better than any other. A simpler approach is not always a better approach. EFRAG members also think it is essential that there are stronger links between this project and the work being carried out in the Framework project on the definitions of the elements of the financial statements. Indeed, they think that getting the definitions right is an essential first step to developing a revised standard.

EFRAG intends to issue its draft letter for public comment by the end of June.

IASB Conceptual Framework Project - The Objective and Qualitative Characteristics of Financial Reporting

This session, as well as the EFRAG session in the June meeting on the Reporting Entity, started with a presentation from Lian Li Li, IASB staff member. EFRAG members then discussed the recent IASB ED on the Objective and Qualitative Characteristics of Financial Reporting, the intention being that a draft comment letter based on those comments will be issued for comment in mid-July.

EFRAG members continued to be very concerned about the IASB’s intention to finalise the Framework chapter by chapter. In their view, the IASB has a choice: either it does not finalise any part of the Framework until all parts are ready to be finalised; or it finalises it on a piecemeal basis but in doing so identifies all the implications of the proposed changes being made so that (a) its constituents are given a chance to understand and consider fully the implications of the changes being proposed in the ED and (b) the Framework remains a coherent and consistent document. EFRAG members believe the IASB has chosen neither option because the changes to chapters 1 and 2 being proposed appear likely to have implications for later chapters that are not identified in the ED.

EFRAG had previously criticised how the IASB was proposing to deal with stewardship. EFRAG members were generally happier with how stewardship was dealt with in the ED, although some concerns remained as to the exact meaning of the term.

Other issues raised by EFRAG members included the focus in the ED on an entity’s ability to generate future net cash flows and its link to user needs, whether the ‘faithful representation’ notion was better understood than ‘reliability’, and the proposal that financial statements should be prepared from an entity perspective.

The IASB and FASB have recently issued a discussion paper on the Reporting Entity phase of their conceptual framework project, and EFRAG members discussed that paper at the June meeting in order to help staff develop a draft comment letter.

EFRAG's discussion focussed on a number of issues. One issue was how a reporting entity should be described or defined. EFRAG members had in a previous discussion expressed preference for a precise description and had suggested that the phrase proposed in the discussion paper ('circumscribed area of business activity') might be difficult to make operational. In the June some EFRAG members wondered whether there was any real benefit dealing with it in the Framework.

EFRAG also discussed the three approaches to circumscribe the area of business explored in the paper: the controlling entity model, the common control model and the risks and rewards model.

Another issue EFRAG discussed was whether both parent-only financial statements and consolidated financial statements are general purpose financial statements. EFRAG members thought consolidated financial statements provide useful information but that were not sufficient; certain parent-only financial information was also needed. Similarly, parent-only financial statements were not sufficient and needed to be supplemented by consolidated information.

Finally there was a discussion on a number of issues relating to the notion of 'control' and, in particular, on the difference, if any, between 'control' and 'joint control'.

EFRAG's discussions will continue at the July meeting, after which the intention is to issue a draft comment letter for comment.

IASB Discussion Paper Preliminary Views on Amendments to IAS 19 Employee Benefits

EFRAG members discussed the general direction that should be taken in EFRAG's draft comment letter on the Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* (the DP). Members agreed with the principle of immediate recognition of gains and losses in the balance sheet, although some members stated that a pre-requisite for this was that the measurement of the assets and liabilities should be based on assumptions that took into account the long-term nature of the items. Members had differing tentative views on the more difficult issue of how and where the changes in the values of the pension assets and liabilities should be presented. Members also expressed reservations about the proposed introduction of a category of "contribution-based promises" to replace the existing defined contribution category of benefit promise. In their view, the proposed new definition introduces a number of difficulties where no real problem is perceived at present.

The draft comment letter is expected to be finalised at the July EFRAG meeting.

IFRIC D23 Distribution of Non-cash Assets to Owners

During its conference call meeting on 23 May, EFRAG considered the comments it received in response to its draft comment letter on IFRIC D23 Distributions of Non-cash Assets to Owners. In the light of the comments received, EFRAG members agreed to make a number of changes to the draft letter, the most significant of which was to conclude that D23 was proposing the application of IAS 37 by analogy. This change also made it possible for EFRAG to argue that existing IFRS do not require the liability to pay the distribution to be recognised at the fair value of the asset to be distributed if the asset was not also measured at that amount; it was essential to avoid an accounting mismatch and, if such a mismatch could not be avoided when measuring the liability at the asset's fair value, it should not be measured at that amount. EFRAG's letter therefore argued for an amendment to IFRS to require assets to be distributed to owners to be measured at fair value.

The other main change to the draft letter related to the treatment of any difference between the liability and the asset to be distributed that arises when the liability is recognised. EFRAG members agreed that any such difference should be recognised in profit and loss. EFRAG's final letter was issued in early June.

IFRS 1 and IAS 27 Cost of an Investment in Subsidiary, Jointly-controlled Entity or Associate

On a conference call on 30 May 2008 EFRAG continued its assessment of the Amendments to IFRS 1 and IAS 27 against the EU endorsement criteria and its consideration of the costs and benefits of the implementation of the Amendments in the EU. The objective of the discussion was to finalise EFRAG's Invitation to Comment on the subject.

The main amendments being made to IFRS 1 and IAS 27 are:

- to allow a first-time adopter, in its separate financial statements, to use as the deemed cost of an investment in a subsidiary, jointly controlled entity or associate either fair value at the entity's date of transition to IFRSs or the previous GAAP carrying amount at that date.
- deletion of the definition of the 'cost method' from IAS 27, which has the effect of requiring the investor to recognise all dividends received from a subsidiary, jointly-controlled entity or associate as income in its profit and loss. In accordance with the existing IAS 36 *Impairment of Assets*, the investor is required to assess at each reporting date whether there is any indication that the investments may be impaired.
- clarification of how to determine the cost of an investment in accordance with IAS 27 when a parent reorganises the operating structure of its group by establishing a new entity as its parent and this new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent.

EFRAG has tentatively concluded that the Amendments meet the endorsement criteria. EFRAG also carried out an initial assessment of the costs and benefits expected to arise from the implementation of the Amendments in the EU. EFRAG tentatively concluded that the additional costs of implementing the Amendments will not be significant and are likely to be exceeded by the benefits resulting from its application. EFRAG's tentative view is therefore that it should recommend the Amendments' endorsement for use in the EU.

EFRAG members agreed various minor amendments to the draft Invitation to Comment and approved it for issue. It was issued at the end of May 2008. EFRAG's reasoning in reaching the tentative conclusion that that the Amendments should be endorsed for use in the EU are set out in the Invitation to Comment issued for comment. The Invitation to Comment is available on www.efrag.org and comments are requested by 1 July 2008.



Future meetings

The July meeting of EFRAG TEG will take place on 9, 10 and 11 July 2008