

January 2011

Summary of EFRAG meetings held in January 2011

On 12-14 January 2011, EFRAG held its monthly meeting and discussed:

- IASB Exposure Draft *Hedge Accounting*
- IASB project *IFRS 9: Financial Instruments Phase II – Amortised Cost and Impairment of Financial Assets*
- IASB Exposure Draft *Insurance Contracts*
- EFRAG Outreach Activities on *Financial Statement Presentation*
- IASB Exposure Draft *Revenue from Contracts with Customers*
- IASB project *IFRS 9: Financial Instruments – Asset and Liability Offsetting*
- EFRAG project *Hybrid Financial Instruments*.

Highlights

Comment letters to the IASB

EFRAG invited comments on its draft comment letter to the IASB on the Exposure Draft *Hedge Accounting*. The comment letter is supportive overall of the direction of the proposals in the ED. However, it outlines concerns on a number of issues, which require 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 field-testing of proposals for their operability. The comment deadline is 2 March 2011 (page 1).

IASB Exposure Draft Hedge Accounting

EFRAG finalised its draft comment letter to the IASB in response to the Exposure Draft *Hedge Accounting* (the ED), issued in December 2010. The ED proposes significant changes to 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.

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. In EFRAG's view, the hedge accounting model proposed in the ED provides a number of significant improvements that will make hedge accounting more accessible, including the following: →

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- 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.
- The treatment of the time value of options and the rebalancing of hedge relationships assist greatly in reflecting an entity's hedging strategies. While they introduce new complexities, EFRAG believes that the benefits of these proposals outweigh their cost and complexity.
- We believe that the proposed disclosure objectives are appropriate, but have certain concerns about the detailed requirements.

EFRAG also has a number of concerns. The most significant of these are, as follows:

- We believe that the IASB will need to consider the various phases of the IAS 39 replacement as a whole before finalising the resulting standards.
- We believe that a number of issues require further consideration because they could create an inconsistency with risk management practices. These include the eligibility of instruments at amortised cost as hedging instruments; non-contractually specified inflation risk as a hedged item; credit risk as a risk component; hedging of risks not affecting profit or loss; and a benchmark component in hedging a debt instrument with a negative indexation to the benchmark (the sub-LIBOR issue).
- The proposals rely heavily on judgement and the link to risk management. To ensure that this link is truly achieved, we believe that the IASB should conduct field-tests and outreach activities to ensure that proposals are operational.
- Given the importance of macro hedging, we believe that the IASB should not finalise a standard on the general hedge accounting model, before developing a model for macro hedging.

The draft comment letter is available on EFRAG's website. The comment deadline is 2 March 2011.

IASB project *IFRS 9: Financial Instruments Phase II - Amortised Cost and Impairment of Financial Assets*

After analysing comments on the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED), issued in November 2009, the IASB and the FASB decided at their joint December 2010 meeting to expose for public comment a joint document, which will consider a converged impairment model and will focus on an operational interpretation of the model proposed in the ED, specifically in the context of open portfolios. The consultation document is expected to be issued by the end of January 2011. EFRAG considered the expected proposals in light of its key concerns raised in its comment letter on the ED. EFRAG did not make any decisions at its January meeting. EFRAG is planning to discuss a draft comment letter on the expected consultation document at its February 2011 meeting.

IASB Exposure Draft *Insurance Contracts*

On 14 December 2010, EFRAG issued its comment letter to the IASB in response to the Exposure Draft *Insurance Contracts* (the ED). In its comment letter, EFRAG noted that the IASB had not sufficiently considered the interaction of the proposals in the ED and the requirements in other standards (e.g. IFRS 9 *Financial Instruments*), which could lead to accounting mismatches. EFRAG also noted that the IASB has not sufficiently explored the issues around the performance of an insurer and offered assistance to the IASB in addressing these issues. At its January 2011 meeting, EFRAG discussed the following: →

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- *Discount rates* – EFRAG discussed the advantages and disadvantages of various alternative approaches proposed by constituents for determining the discount rate applicable to insurance liabilities. Due to the time constraints, it was impracticable for EFRAG to carry out this assessment prior to issuing its comment letter. The alternative approaches intended to address concerns about volatility in the performance reporting due to accounting mismatches resulting from the long-term nature of the insurance business. None of the approaches proposed by constituents received tentative support from EFRAG members. EFRAG decided to assess whether constituents' proposals on the use of other comprehensive income (OCI) have the potential to alleviate concerns about accounting mismatches at its February 2011 meeting.
- *Presentation in the statement of comprehensive income* – in its comment letter on the ED, EFRAG disagreed with the proposals for presentation in the statement of comprehensive income and suggested developing an alternative presentation approach. However the alternative proposals had not been finalised at the time of submitting the comment letter. At this meeting, EFRAG discussed various aspects of the alternative approach and directed the staff to perform further work.

EFRAG is planning to discuss these and other issues related to concerns about accounting mismatches and the performance of an insurer at its February 2011 meeting. Once finalised, the alternative proposals will be shared with the IASB.

EFRAG Outreach Activities on *Financial Statement Presentation*

To assist the IASB in gathering views of the European constituents on the tentative decisions included in the staff draft of the Exposure Draft *Financial Statement Presentation* (the Draft ED), EFRAG and the European National Standard Setters jointly organised meetings with European constituents in ten European cities (Amsterdam, Helsinki, Oslo, Stockholm, Madrid, Rome, Warsaw, Frankfurt, London and Paris). A separate meeting was also held with SwissHoldings in Basel. These meetings were held from September to early December 2010.

EFRAG members received an update on the feedback received during these meetings and reviewed the draft feedback report that summarised views of the European constituents. Overall, the feedback received from the European constituents on individual issues was generally consistent with EFRAG's preliminary views outlined in the Paper on *Financial Statement Presentation* (the Paper) issued for comments in October 2010. The main messages received during the outreach meetings included the following:

- *New model needed?* – in all locations, constituents consistently questioned whether a new presentation model was really needed, especially considering the costs involved. The majority favoured an “evolution” of presentation requirements, rather than a “revolution.”
- *Need for a debate on fundamental issues underlying performance reporting* – a very strong view was expressed, consistently in all locations, that prior to proceeding with presentational matters, the IASB should address the fundamental issues related to performance reporting, namely, what constitutes performance and what is the impact of business model on it; where and how the line should be drawn between profit or loss and other comprehensive income (OCI); and whether reclassification of OCI items (recycling) is needed.
- *One model fits all?* – views across Europe were generally split as to whether or not the IASB should develop one generic presentation model for all industries or consider developing industry-specific models. Constituents from the financial institutions (i.e. banking and insurance), generally favoured industry-specific models, whilst representatives of large groups that include entities from different industries (e.g. conglomerates), were in favour of a single model that would ensure consistency of presentation between different entities in the group. →

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- *Most contentious and most cost intensive proposals* – the most contentious proposals of the Draft ED, which appear also to be the most cost intensive, included disaggregation requirements and mandating the direct method for presenting operating cash flows. It was largely believed that these proposals would not improve financial reporting, and the implementation costs of the proposals would be comparable to the costs of adopting IFRSs in the first place, requiring system re-design to capture certain information at the transaction component level.
- *Areas of support as potential improvements to current IAS 1 and IAS 7* – two areas of the Draft ED were generally supported by constituents, subject to addressing some application issues. Those included the starting point for the indirect reconciliation of operating income to operating cash flow, and cohesiveness as a principle for achieving greater consistency and transparency between the primary statements.
- *Areas of divergence* – views on the definition and content of the financing section varied. In some European countries, especially those with an established practice of using “net debt” in managing an entity’s treasury function and in communication with the stakeholders, similar to EFRAG, constituents had strong preferences for aligning the definition of the financing section with the notion of net debt, but this view was not universally shared.
- *Areas for further work* – the proposed requirement to disclose remeasurements in a separate note raised some concerns about the definition of remeasurements, which seemed to be lacking an underlying principle. This was identified as an area for further work by the IASB. There also were concerns about duplication of disclosure requirements as some information about remeasurements is already provided in the financial statements.

The feedback report is expected to be finalised during the TEG conference call scheduled for 28 January 2011. The feedback report will be provided to the IASB and will be published on EFRAG’s website. As a next step on this project, EFRAG will consider comments from constituents on the Paper once the comment period ends on 30 April 2011. The Paper is also available on EFRAG’s website.

IASB Exposure Draft *Revenue from Contracts with Customers*

The EFRAG members received an update on developments relating to the IASB Exposure Draft *Revenue from Contracts with Customers* (the ED). The comment letter period on the ED ended on 22 October 2010 and the IASB is in the process of analysing the comments received. The update focused on the IASB discussions on the project in November and December 2010 and on some concerns raised by European constituents and others, who appear to be significantly affected by the proposals.

EFRAG did not make any decisions at its January meeting. EFRAG will monitor the IASB’s redeliberations on this project and will consider those at its next meetings.

IASB project *IFRS 9: Financial Instruments - Asset and Liability Offsetting*

The EFRAG members received an update on the discussions and tentative decisions taken by the IASB and the FASB at their joint meetings in November and December 2010, in respect of asset and liability offsetting in the financial instruments project.

EFRAG considered the Boards’ decision to adopt, as converged requirements for offsetting of financial assets and liabilities, the main principles in IAS 32 *Financial Instruments: Presentation*, and to require the offsetting of a recognised financial asset against a financial liability when and an entity has an unconditional right to offset and intends to either net settle or settle simultaneously. EFRAG expressed, as a preliminary view, support for this tentative decision of the Boards. →

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The exposure draft is expected to be issued by the IASB before the end of January 2011. EFRAG is planning to discuss its draft comment letter on the exposure draft at its February 2011 meeting.

EFRAG project *Hybrid Financial Instruments*

EFRAG received an update on the project, which is aimed at exploring opportunities for developing proposals to address concerns raised by European constituents with regard to the requirements in IFRS 9 *Financial Instruments* on the classification of hybrid financial instruments. EFRAG is considering these concerns in the context of decisions made by the IASB in later phases of the IASB's project to revise IAS 39 *Financial Instruments: Recognition and Measurement*, i.e. classification and measurement of financial liabilities, impairment of financial assets carried at cost and hedge accounting. While eliminating the bifurcation of non-closely related embedded derivatives of financial assets, the classification requirements in IFRS 9 have retained the guidance of IAS 39 for financial liabilities. Under IFRS 9, if contractual cash flows of a financial asset are *not* solely payments of principal and interest on the principal amount outstanding, the entire financial instrument is required to be measured at fair value.

As part of the activities on the project, EFRAG staff surveyed 16 leading European financial institutions to collect practical examples of how the issuers and holders of hybrid financial instruments employ them in their businesses, and to obtain an understanding of the anticipated consequences of the classification requirements in IFRS 9. In addition, EFRAG staff analysed the comments on accounting for hybrid instruments in 47 comment letters that were submitted to the FASB in response to their exposure draft on accounting for financial instruments.

The following issues were discussed at this meeting:

- the use of the bifurcation requirements for non-closely related embedded derivatives as a way for aligning the unit of account for financial instruments with the business model applied to identified components within the contractual cash flows;
- the use of the bifurcation requirements for non-closely related embedded derivatives and the effect of bifurcation in reducing certain accounting mismatches as an alternative to the fair value option;
- the concerns of the financial institutions, which participated in the survey, about the impossibility under IFRS 9 to continue measuring at amortised cost certain financial assets, when the majority of cash flows are expected from a loan component that is managed on an accrual basis. This would happen, in particular, when an instrument contains certain closely-related embedded derivatives. Under IAS 39, such an embedded derivative is currently not bifurcated and the entire contract is measured at amortised cost (e.g. interest rate features with limited leverage are not required to be separated). Under IFRS 9, the cash flows from such instruments would not meet the 'solely payment of principal and interest' test and the instruments would need to be measured at fair value in their entirety.

EFRAG is planning to discuss activities and findings on this project with the IASB and the National Standard Setters outside Europe.

Future meetings

The next meeting of EFRAG TEG will take place on 8, 10 and 11 February 2011.

Conference calls are scheduled for 28 January and 1 February 2011.