EFRAG
European Financial Reporting Advisory Group

September 2009

EFRAG Update

Summary of EFRAG meetings held in September 2009

From Tuesday 1 to Thursday 3 September 2009, EFRAG held its monthly meeting and discussed:

- IASB Exposure Draft *Income Tax*
- IASB Exposure Draft *Improvements to IFRSs*
- IASB Exposure Draft *Discount Rate for Employee Benefits (Proposed amendments to IAS 19)*
- IASB Discussion Paper *Credit Risk in Liability Measurement*
- IASB *Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach*
- IASB Exposure Draft *Rate-regulated Activities*
- IFRS *Additional Exemptions for First-time Adopters (Amendments to IFRS 1)*
- IASB Exposure Draft *Prepayments of a Minimum Funding Requirement (Proposed amendments to IFRIC 14)*
- IASB Exposure Draft *Classification of Rights Issues*
- IASB Exposure Draft *Management Commentary*
- Pan-European Proactive Project on Pensions

On Friday 11 September and on Wednesday 16 September 2009, EFRAG held additional meetings and by public conference call to discuss:

- IASB Exposure Draft *Financial Instruments: Classification and Measurement*
- IASB Exposure Draft *Rate-regulated Activities*
- IASB Exposure Draft *Improvements to IFRSs*
- IFRS *Group Cash-settled Share-based Payment Transactions (Amendments to IFRS 2)*
- IFRS *Improvements to IFRSs*

IASB Exposure Draft *Income Tax*

At its first meeting in September, EFRAG considered the comments received in response to its draft comment letter on the IASB's Exposure Draft *Income Tax* and, in light of those comments, finalised its comment letter to the IASB. For several reasons, EFRAG was not supportive of the proposals in the exposure draft. Its views can be summarised as follows:

- EFRAG is not convinced that the proposals in the exposure draft represent an improvement to existing IAS 12 and thus believes that the exposure draft should not be used as a basis for a revised standard on income taxes.

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- EFRAG members are very concerned that certain proposals are very rules-based and as a result, the exposure draft forsakes the benefits of having an amended income tax standard that is based on clearly articulated principles that are workable in 'real life' tax situations in jurisdictions which apply IFRSs for financial reporting purposes.

IASB Exposure Draft *Improvements to IFRSs*

At two of its meetings in September, EFRAG members discussed IASB's exposure draft *Improvements to IFRSs (issued in August 2009)*. EFRAG members tentatively agreed with all the amendments proposed, albeit with some concerns, in relation to:

- Amendment to IAS 27 *Consolidated and Separate Financial Statements*. As part of the amendment, IASB is proposing to amend a reference in IAS 27 that allows an entity that prepares separate financial statements to measure its investments in subsidiaries, jointly controlled entities and associates in accordance with IAS 39. According to the proposal, the reference to IAS 39 should be deleted and instead it should be said that the investments could be measured at fair value through profit or loss. EFRAG understands that the IASB considers the amendment to be a clarification of what has always been the intention. However, EFRAG members are concerned about the apparent elimination of the option to account for changes in the fair value of investments in subsidiaries, jointly controlled entities and associates through other comprehensive income, when an entity has availed itself of the fair value option.
- Amendment to IFRS 3 *Business Combinations*. Currently, it may not be clear whether contingent consideration for business combinations that arose prior to the adoption of the revised IFRS 3 should also be accounted for under the revised standard, or whether it should be accounted for under the 'old' IFRS 3. The purpose of the amendment is to clarify that contingent consideration arising on business combinations, whose acquisition dates preceded the application of the revised IFRS 3, should be accounted for in accordance with the old IFRS 3 rather than the revised standard. EFRAG members are concerned that the amendment refers to the paragraphs of the prior IFRS 3, which is no longer endorsed in Europe. EFRAG members are also concerned that the meaning of "prospective" and "retrospective" transition is no longer very clear.
- Amendment to IFRS 3 *Business Combinations*. EFRAG members are concerned that the need for the amendment is not clearly articulated in the Basis for Conclusions. EFRAG members are also concerned that the amendment may not capture all instruments it is intended to.
- The amendment to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The IASB proposes to amend IAS 8 to reflect the terminology used in the forthcoming chapters 1 and 2 of the amended Framework. EFRAG members find it difficult to assess the amendment until the revised Framework chapters have been published.

Based on the discussions, EFRAG issued a draft comment letter for comment by 1 November 2009.

IASB Exposure Draft *Discount Rate for Employee Benefits (Proposed amendments to IAS 19)*

At its first meeting in September, EFRAG discussed the IASB's Exposure Draft *Discount Rate for Employee Benefits*. The exposure draft would amend IAS 19 to use yields on high quality corporate bonds to determine the discount rate in all cases, even where there is no deep market for such bonds. At the September meeting, EFRAG tentatively decided to support the IASB's proposal, but recommended the use of different guidance than that contained in the exposure draft and to treat the change in the discount rate as a change in accounting estimate, rather than as a change in accounting policy as proposed in the exposure draft. EFRAG issued its draft comment letter, which is now available on EFRAG's website.

IASB Discussion Paper *Credit Risk in Liability Measurement*

Also at its first meeting in September, EFRAG discussed the comments received in response to its draft comment letter on the IASB Discussion Paper *Credit Risk in Liability Measurement.* Most of the comment letters received expressed a general support for the content of EFRAG's draft comment letter. After the meeting, EFRAG issued its comment letter to the IASB. In its letter EFRAG states that the key issue is what approach to own credit risk would result in the most useful information. Using this test, it concludes that:

- Own credit risk should only be taken into account in the initial measurement of a liability if own credit risk is priced into the transaction that gave rise to the initial recognition of the liability. In all other circumstances it should not be included.
- Changes in own credit risk should be taken into account in the subsequent measurement of a liability only if it is a financial liability that is both held by the entity for trading purposes and actively traded. In all other circumstances, changes in own credit risk should not be taken into account unless and until they are 'realised' in the form of cash flows.

IASB *Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach*

At its first meeting in September, EFRAG discussed the comments received in response to its draft comment letter on IASB's *Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach*. After the meeting EFRAG issued its comment letter to IASB on the issue. In this letter, EFRAG supports the IASB's decision to carry out the IAS 39 replacement project and, in particular, to review the Incurred Loss Model in the context of other impairment approaches.

EFRAG's view is that implementation of an Expected Cash Flow Approach will involve significant operational challenges in Europe, such as the need for systems changes and new control processes over an increased use of management judgement involved in estimating future cash flows, together with the lack of relevant historical data.

Given the operational challenges involved with the Expected Cash Flow Approach, EFRAG thinks care needs to be taken to 'get the requirements right' at the outset so that further expensive changes are not required later. For example, EFRAG thinks the IASB needs to consider the implications of the model for all preparers, not just financial institutions. This is important because EFRAG does not believe the Expected Cash Flow Approach fits well within the context of commercial short-term receivables. Accordingly, it is EFRAG's opinion that IASB needs to consider simplifications to the model for these types of financial assets.

IASB Exposure Draft *Rate-regulated Activities*

EFRAG members had an initial discussion on the IASB's Exposure Draft on rate-regulated activities at its first meeting in September and again on 16 September.

At the first meeting, EFRAG members expressed their initial thoughts on whether the economic effects of rate-regulation could result in assets and liabilities as defined in IASB's Framework. The focus of EFRAG's initial discussion was on whether rate-regulation created assets that meet the Framework's definition. The majority of EFRAG members tentatively concluded that it did not. EFRAG members briefly discussed whether rate-regulation could give rise to liabilities as defined by the Framework and the tentative indication was that it could not.

At the meeting held on 16 September, EFRAG members initially discussed an alternative model for

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accounting for rate-regulated activities, but did not think that this alternative model should be explored further by EFRAG. Some EFRAG members thought that in the case of rate-regulated activities an analogy could be drawn with IAS 11 and IFRIC 12.

The exposure draft proposes two scope criteria that the regulated activity must fulfil before the exposure draft is applicable. The first criterion necessitates the existence of an authorised body that sets prices which bind customers. In relation to this criterion it was argued that it did not address situations where the regulator granted a right to more than one entity operating in the same market. The second scope criterion only applies to cost-of-service regulation. On this second scope criterion some EFRAG members thought that this criterion was the right one for the outcome that the IASB intended. It was however argued that, because not all forms of rate-regulation methodologies had been addressed, comparability issues where bound to arise.

IFRS *Additional Exemptions for First-time Adopters (Amendments to IFRS 1)*

At its first meeting in September, EFRAG discussed the Amendments to IFRS 1. The amendments provide an additional exemption for certain oil and gas assets and a second exemption for a reassessment of a lease determination under certain circumstances. At the meeting, EFRAG completed its initial assessment of the amendments against the EU endorsement criteria and completed an initial study of the cost and benefits of the amendments. EFRAG's initial assessment is that the amendments meet the criteria for endorsement in the EU and the benefits that are expected to arise are likely to exceed the cost in implementing the amendments. EFRAG has issued its invitation to comment on its draft endorsement advice and draft effects study report, which is now available on EFRAG's website.

IASB Exposure Draft *Prepayments of a Minimum Funding Requirement (Proposed amendments to IFRIC 14)*

IFRIC 14 currently does not regard a voluntary prepayment of a minimum funding requirement (MRF) contribution relating to future service to be an asset, if the future minimum funding contributions required in respect of future service exceed future service costs. Accordingly, such voluntary prepayments will be expensed even though the entity derives future benefit from them. The proposed amendments in the IASB's exposure draft seek to address this anomaly.

At its first meeting in September, EFRAG considered the comments received in response to its draft comment letter. EFRAG had received five comment letters as of the comment deadline. None of these comment letters were against IASB's exposure draft. However, some of the comment letters thought that improvements were needed in relation to the scope of the amendment and that there were aspects of the proposal that needed clarification.

In light of those comments, EFRAG finalised its comment letter in support of the proposed amendment. In its comment letter, EFRAG notes that prepayments of MFR contributions relating to future service will meet the definition of an asset under the existing Framework. Also, the comment letter includes a few detailed comments.

IASB Exposure Draft *Classification of Rights Issues*

At its first meeting in September, EFRAG discussed the comments received in response to its draft comment letter on IASB's exposure draft *Classification of Rights Issues (Proposed Amendment to IAS 32)*. IASB's exposure draft proposes to amend IAS 32 Financial Instruments*: Presentation* so that foreign currency rights issues are classified as equity – instead of liabilities - by the issuing entity. After the
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meeting EFRAG issued its comment letter on the exposure draft. In its letter EFRAG supports the IASB making the proposed amendments to IAS 32. EFRAG agrees that most kinds of foreign currency rights issues are, in substance, equity transactions and agrees with the IASB that IAS 32 should be amended to reflect this. However EFRAG has some concerns about aspects of the proposals including:

- EFRAG does not find the IASB's arguments in the Basis for Conclusions comprehensive, for example:
  - EFRAG believes the reasoning set out in the Basis for Conclusions needs to be expanded in order to articulate more clearly the reasoning behind the proposals; in particular, how the IASB differentiates between foreign currency rights issues and similar types of transactions.
  - EFRAG believes the Basis for Conclusions should make it clear that the proposals represent an exception to the current equity/liability model in IAS 32.
- Furthermore, EFRAG believes the IASB should provide further guidance on the nature of rights issues. Without this guidance, EFRAG believes that the amendment as currently drafted could potentially apply to a broader range of instruments than the IASB envisaged and may as a result be susceptible to structuring risk.

IASB Exposure Draft *Management Commentary*

At its first meeting in September, EFRAG discussed the IASB's exposure draft *Management Commentary*. The main issues discussed by EFRAG were:

- IASB proposes that the exposure draft should result in non-mandatory guidance and not in a mandatory standard. Some EFRAG members disagreed with this as they thought a mandatory standard was necessary, because the management commentary (MC) was considered to be a very important part of the financial report. However, the majority of EFRAG members agreed with the exposure draft as they thought that – at least at this stage – it was preferable that IASB issued non-mandatory guidance on the issue. Among the arguments was that EU legislation contained requirements for management commentary. Also, EFRAG members did not think the MC currently was the right place for the IASB to place their resources.
- IASB proposes that qualitative characteristics specific to management commentary should not be developed. Accordingly, the qualitative characteristics included in Phase A of the conceptual framework should also apply to MC. Phase A of the conceptual framework has not been finalised, but EFRAG members would be concerned if it would result in the characteristics 'comparability between entities' and 'freedom from bias' to be qualitative characteristics that should apply to MC.
- IASB proposes not to include application guidance and illustrative examples in the guidance. EFRAG members agreed with this.
- IASB proposes that no placement principles (i.e. principles stating whether information should be included in the notes to the financial statements or in the MC) should be included in the guidance. EFRAG members did not agree with this, as they thought that it was important to have some guidelines on this.

Pan-European Proactive Project on Pensions

Also at its first meeting in September, EFRAG considered a report on pension accounting prepared by the UK Accounting Standards Board. The report was a reconsideration of views contained in the PAAinE Discussion Paper *The Financial Reporting of Pensions* in light of comment letters received. The purpose of the session was to consider the report and decide whether EFRAG should participate with the ASB and other standard setters in publishing the report. No decisions were reached at the September meeting and the topic will be further considered by EFRAG at a future meeting.

IASB Exposure Draft *Financial Instruments*: *Classification and Measurement*

At its last meeting in September, EFRAG considered the comment letters received in response to its draft comment letter on IASB's exposure draft, *Financial Instruments: Classification and Measurement*. The exposure draft proposes new requirements for the classification and measurement of financial assets and financial liabilities to replace the existing requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Broadly speaking, the proposal is that a financial asset or financial liability should be measured at fair value unless it both has basic loan features and is managed on a contractual yield basis, in which case it can be measured at amortised cost.

Following its discussions, EFRAG issued its comment letter on the exposure draft that explains that EFRAG:

- Understands the IASB's decision to split the IAS 39 replacement project into phases, but IASB should carefully consider ways of minimising the negative effects of such an approach on constituents.
- Agrees that a mixed measurement model should be retained.
- Agrees that the existing classification model should be simplified.
- Agrees that the classification of financial instruments should be based on whether the cash flows on an instrument have a close relation to the amount advanced under the instrument but suggests that the classification model proposed is amended so that it can be characterised as being based on whether instruments are managed on a contractual yield basis, with an exception so that instruments that do not have the appropriate characteristics, currently described as 'basic loan features' in the exposure draft, are measured at fair value.
- Disagrees on the proposed treatment of embedded derivatives.
- Disagrees on the proposal to prohibit reclassification of instruments from one category to another.
- Disagrees on the proposal to omit the reliability exemption from the requirement to measure all equity investments (and all derivatives on such investments) at fair value.
- Disagrees on the proposal to require an entity choosing not to account for an equity investment at fair value through profit or loss to present the total return on the instrument in other comprehensive income and to prohibit the recycling from other comprehensive income to profit or loss of any part of that total return.

IFRS *Group Cash-settled Share-based Payment Transactions (Amendments to IFRS 2)*

At its 11 September meeting, EFRAG discussed the comments received on the draft endorsement advice and effects study report of the amendments to IFRS 2. All respondents supported the amendment. EFRAG approved the final endorsement advice and effects study report that were released on 14 September 2009.

IFRS *Improvements to IFRSs*

EFRAG considered the comments it received in response to its draft endorsement advice and draft effects study report on *Improvements to IFRSs (issued in April 2009)* at the public conference call on 11 September 2009. Respondents agreed with EFRAG's tentative decision to recommend endorsement, as well as with its initial assessment of the costs and benefits thereof. Accordingly, EFRAG members recommended the *Improvements to IFRSs (issued in April 2009)* for endorsement in the EU.