EFRAG
European Financial Reporting Advisory Group

December

EFRAG Update

# Summary of EFRAG meetings held in December 2009

On 4 December 2009, EFRAG held a meeting by public conference call to discuss:

- IASB Exposure Draft *IFRS 1 Proposed Amendments to IFRS 1 Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters*

On 9 December 2009, EFRAG TEG (EFRAG) met with the European National Standard Setters in EFRAG's Consultative Forum (CFSS) to discuss:

- IFRS for SMEs and the European Council Directives
- European Commission consultation on IFRS for SMEs
- IASB Exposure Draft *Conceptual Framework – The Reporting Entity*
- IASB Exposure Draft *IFRS 1 Proposed Amendments to IFRS 1 Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters*
- IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

Following the CFSS meeting, EFRAG held its monthly meeting on 9-11 December and discussed:

- IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment*
- IASB request on *Derecognition*
- IASB Exposure Draft *Rate-regulated Activities*
- IASB Amendment to IFRIC 14 *Prepayment of a Minimum Funding Requirement*
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*
- IASB Exposure Draft *Measurement guidance for liabilities in IAS 37 Provisions, Contingent Liabilities and Contingent Assets*
- IASB project *Hedge Accounting*

## Highlights

**Endorsement advice**

EFRAG agreed to issue for public comment its draft endorsement advice to the European Commission on the following:

- IASB Amendment to IFRIC 14 *Prepayment of a Minimum Funding Requirement*
  IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

**Comment letters to the IASB**

- EFRAG approved its final comment letter to the IASB on the Exposure Draft *Rate-regulated Activities*. The letter is not supportive of the proposals in the ED and urges strongly to undertake further work in this area.
- EFRAG invited comments on its draft comment letter to the IASB on the Exposure Draft *IFRS 1 Proposed Amendments to IFRS 1 Limited Exemption from Comparative IFRS 7 Disclosures for First time Adopters*. The draft comment letter is supportive of the proposal. The comments deadline was 21 December 2009.

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## IFRS for SMEs and the European Council Directives

The European Commission asked EFRAG to provide a report on the aspects of IFRS for SMEs that could be incompatible with the EU Accounting Directives. Although some recognition and measurement requirements in IFRS for SMEs are based on and broadly consistent with (full) IFRS as adopted by the EU, this does not necessarily lead to the conclusion that these requirements are compatible with the EU Accounting Directives. At the December 2009 CFSS meeting, members discussed whether there were any conflicts between IFRS for SMEs and the EU Accounting Directives in relation to reversal of goodwill impairment losses, recognition of contingent liabilities acquired in a business combination, and the prudence principle. Members of CFSS were split in their views on these issues.

## European Commission consultation on IFRS for SMEs

At the December 2009 CFSS meeting, members also discussed the European Commission's consultation on IFRS for SMEs. Some of the key points raised were:

- The decision as to whether to require or permit to use IFRS for SMEs should be made at the Member States level rather than by each individual entity.
- The European Commission should distinguish between requirements related to the preparation of the financial statements and requirements related to public reporting as some jurisdictions may require IFRS financial statements to be prepared but do not necessarily require them to be made publicly available.
- It may also be useful to consider whether instead of using the IFRS for SMEs entities should have an option of preparing financial statements based on the recognition and measurement requirements of (full) IFRSs, but without providing all disclosures required by (full) IFRS.
- It was not clear from the consultation paper whether it dealt with consolidated or individual financial statements, or both. As this could be important in some jurisdictions, the basis should be clarified.

## IASB Exposure Draft *Conceptual Framework – The Reporting Entity*

At the December 2009 CFSS meeting, the FASB staff updated the members on the latest developments of the joint IASB/FASB *Conceptual Framework project Phase D The Reporting Entity*, including the definitions and descriptions expected to be incorporated in the forthcoming joint IASB and FASB exposure draft.

Members provided their views on how broad the definition of a reporting entity should be and discussed some features of the proposed definition of a reporting entity. They also discussed the interaction of this project with other IASB's projects, including *Consolidations* and *Phase A of the Conceptual Framework*.

An Exposure Draft *The Reporting Entity* (the ED) is expected before the end of 2009. EFRAG is planning to discuss this ED in more detail at its meeting in January 2010.

## IASB Exposure Draft *Proposed Amendments to IFRS 1 Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters*

At a conference call held on 4 December 2009, EFRAG discussed and approved for issuance on its website EFRAG's draft comment letter on the IASB Exposure *Draft Proposed Amendment to IFRS 1 "Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters"* (the ED). →

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The ED proposes that a first-time adopter may use an exemption from certain disclosures in IFRS 7 *Financial Instruments: Disclosures* that were issued by the IASB in March 2009 to the extent that the entity's first IFRS reporting period starts earlier than 1 January 2010. The effective date of the amendment is annual periods starting on 1 July 2010 with a possibility to apply the amendment early.

EFRAG supported the amendment. However, EFRAG noted a contradiction between the effective date and what the amendment tries to achieve. Thus, it is impossible to apply the relief from restatement of the comparatives in line with the effective date for annual periods starting on or after 1 July 2010 because the relief is available for periods that start earlier than 1 January 2010. The only way entities could make use of the relief is by adopting it early. EFRAG suggested aligning the effective date with the timeframe of the applicability of the amendment. EFRAG invited comments on its draft comment letter by 21 December 2009. The draft comment letter is available on EFRAG's website.

At the CFSS meeting on 9 December 2009, EFRAG noted that the timing of the endorsement of the final amendment would have an effect on when European companies would be able to make use of the relief. National Standard Setters were asked for input with regard to importance of the amendment in their jurisdictions in order to determine whether fast-track endorsement should be pursued.

## IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

At the December 2009 CFSS meeting, members discussed the IASB's Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED) as well as the EFRAG's draft project plan for responding to the proposals. The ED proposes to clearly set out the objective of amortised cost measurement and how it should be calculated. Impairment of financial assets forms an integral component of the amortised cost measurement model. The ED proposes an "expected loss" impairment model, under which expected credit losses are taken into account in the initial calculation of the effective interest rate and in subsequent estimates of future cash flows. Certain issues will be discussed by the IASB's Impairment Expert Advisory Panel (EAP) rather than being included as guidance in the ED.

At its December 2009 meeting, EFRAG also discussed and approved the project plan for its work in responding the IASB's proposals. The key aspect of the plan is that EFRAG will issue its draft comment letter in two phases. The first phase will cover a technical assessment of the proposals in the ED and will be followed by the second phase focusing on operational issues.

EFRAG also held an initial discussion on the draft comment letter in response to the ED. The draft for discussion was overall supportive of the proposals, however it was noted that the ED was largely focussed on financial institutions. The initial view conveyed in the draft urges the IASB to consider further practical expedients, as well as scope limitations relating to the presentation and disclosure requirements, particularly for non-financial institutions. In line with the agreed project plan, EFRAG focused its discussion of the draft comment letter on the technical assessment of the proposals while considering only those practical elements that were clearly developed at this stage. EFRAG will continue to discuss the draft comment letter in January 2010 with the objective of issuing this letter for public consultation shortly afterwards.

## IASB request on *Derecognition*

The IASB's chairman asked EFRAG's representatives to provide their views on the accounting model being considered as part of the IASB's derecognition project. The model is based on the notion of control in the working definition of an asset, which refers to "present access to the cash flows". This

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model was included as an alternative view in Appendix to the IASB's Exposure Draft *Derecognition: Proposed amendments to IAS 39 and IFRS 7* (the ED). At previous meetings, EFRAG members decided that the response to the IASB should follow the normal due process. At its December 2009 meeting, EFRAG members continued its discussion of the response to the IASB.

EFRAG members tentatively concluded that although the derecognition model under discussion was worthy of consideration as a long-term project, it should not be the basis of a new standard in the current phase. This tentative conclusion was consistent with the view previously expressed in the EFRAG's comment letter on the ED.

EFRAG members considered that it would not be useful to repeat the message of the comment letter at this stage. Instead, they decided to start preparing a more comprehensive response to the likely-to-be-issued new exposure draft on derecognition. EFRAG members will discuss this project further at future meetings.

## IASB Exposure Draft *Rate-regulated Activities*

EFRAG members continued discussing the IASB's Rate-regulated activities project with a view to finalising its response to the IASB on the Exposure Draft *Rate-regulated Activities* (the ED). EFRAG considered comments, which it received from constituents in response to its draft comment letter on the ED. In EFRAG's draft response, EFRAG members were split in views as to whether rate regulation creates assets and liabilities that should be recognised and whether the scope of the ED was appropriately defined. EFRAG received sixteen responses to its draft letter, and many comment letters expressed significant concerns about the proposals in the ED.

EFRAG members agreed various changes to its draft letter in light of the comments received and approved the final letter for issue. Overall, EFRAG was not supportive of the proposals in the ED and therefore did not support the issuance of a standard based on those proposals. EFRAG believed that the accounting model proposed in the ED was conceptually flawed and that presented proposals were unclear and difficult to follow. EFRAG's views and rationale were as follows:

- EFRAG disagrees with the proposed scope in the ED. EFRAG believes that it is very narrow as it addresses only cost-of-service regulation and does not consider other methodologies, which are widely used in European jurisdictions (e.g., performance-/incentive-based schemes). The economic outcome of these methodologies may be similar to that described in the ED. Because of the narrow scope of the ED, a large number of rate-regulated activities will be left out without principles-based guidance even though the title of the proposed standard suggests that it applies generally to rate-regulated activities.
- In relation to whether rate regulation gives rise to assets and liabilities as defined in the existing IASB *Framework*, EFRAG believes that there may be situations, in which that is the case; however, EFRAG members are not convinced that the arguments presented in the ED are sufficiently persuasive to support the recognition of regulatory assets and liabilities. In EFRAG's view, the economic impact of rate regulation on the financial performance and position of an entity is an area that warrants further investigation before EFRAG can reasonably assess as to whether rate regulation gives rise to assets and liabilities under the existing Framework.
- EFRAG is also not supportive of the proposals in relation to recognition and measurement of regulatory assets and liabilities. With regards to recognition, EFRAG does not support the proposal to remove the recognition threshold as this is inconsistent with the *Framework*. In addition, EFRAG is not supportive of the expected value model proposed for measurement in the ED. EFRAG believes that measurement of regulatory assets and liabilities should be based on the management's best estimate of the cash flows that are expected to occur ('most likely outcome' approach).

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- Finally, EFRAG believes that the ED fails to articulate clearly how an impairment trigger might affect the assets in a cash-generating unit (CGU) in which the regulatory assets and liabilities are included. It would not seem appropriate to require impairment testing of the regulatory asset given that the asset is measured at its expected present value at each reporting period.

In its comment letter, EFRAG strongly urges the IASB to undertake further research on the rate-regulation and develop an outreach strategy to explore whether there are sufficient grounds to justify the existence of assets and liabilities under the current *Framework* and whether those are consistent with existing IFRSs. In doing so, the IASB will need to consider all rate-regulated methodologies which have a similar economic outcome.

## IASB Amendment to IFRIC 14 *Prepayment of a Minimum Funding Requirement*

Amendments to IFRIC 14 were issued by the IASB in November 2009 to eliminate an unintended consequence of the interpretation and changes the accounting for certain prepayments of a pension scheme's minimum funding requirement. At its December 2009 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. Based on the meeting, EFRAG has issued its Invitation to Comment on its draft endorsement advice and a draft effects study report which are both available on EFRAG's website.

## IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

IFRIC 19, which was issued in November 2009, provides guidance on how an issuer of an equity instrument should account for a debt-for-equity swap, i.e., it addresses situation, in which a debtor and creditor renegotiate the terms of a financial liability and as a result the liability is fully or partially extinguished by the debtor by issuing equity instruments to the creditor. At its December 2009 meeting, EFRAG concluded that based on its initial assessment IFRIC 19 meets the criteria for EU endorsement and that the benefits that will arise from its implementation in the EU are likely to exceed the costs incurred in implementing it. EFRAG agreed to issue for public comment its draft endorsement advice to the European Commission. The draft endorsement advice is available on EFRAG's website.

## IASB project *Hedge Accounting*

At its December 2009 meeting, EFRAG considered the IASB's tentative decisions to date with regard to Phase III of IAS 39 Replacement Project: Hedge Accounting.

EFRAG stressed an importance of developing a principles-based solution to hedge accounting to ensure useful information was presented without hedge accounting requirements being unnecessarily prohibitive. EFRAG further noted that the IASB should better align hedge accounting requirements with an entity's asset-liability risk management practices as this would enhance the existing rules under IAS 39.

## IASB Exposure Draft *Measurement guidance for liabilities in IAS 37 Provisions, Contingent Liabilities and Contingent Assets*

EFRAG discussed the forthcoming IASB Exposure Draft *Measurement of Liabilities* (proposed amendments to IAS 37) (the ED). The ED is expected to be issued at the end of December 2009 and it is expected to address only a limited number of issues related to guidance on the measurement of liabilities that are in scope of the new Standard that will replace IAS 37. The major proposals are expected to include the following:

- A "value" approach for measuring liabilities as opposed to the "cost" approach, which is currently used under IAS 37. Under the proposed value approach, liabilities would be measured at the amount, which would reflect its effect on the overall value of the entity.
- An expected value measurement basis (probability-weighted outflows) for all liabilities, including single items (e.g., legal obligations).
- Measurement of liabilities that are fulfilled by undertaking a service (e.g., decommissioning obligations), by reference to a contractor's price, which includes a profit margin, regardless of whether the entity intends to perform this service in-house or to hire a contractor.

EFRAG members, in their preliminary assessment, were split on the proposed guidance. Some members did not support the proposed "value" approach because they did not believe that it would result in useful information. They were also concerned that the expected value approach adds unnecessary complexity. Other members thought that the expected value model was conceptually appropriate although there may be concerns when this model is applied to single liabilities that have potentially high outflows with a low probability.

EFRAG members noted that the recognition and measurement issues are closely related, so when they discuss the EFRAG comment letter at a future meeting they are likely to consider both together.

## Future meetings

The next meeting of EFRAG TEG will take place on 27 - 29 January 2010.

Conference calls are scheduled for 7 and 21 January 2010.