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Accounting

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Endorsement of the Amendments to IFRS 7 *Financial Instruments: Disclosures* "Improving Disclosures about Financial Instruments"

Introduction, background and conclusions

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by EFRAG

1. EFFECT STUDY

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an Effect Study for the Amendments to IFRS 7 *International Financial Reporting Standard* "Improving Disclosures about Financial Instruments" (attached). As the EFRAG Effect Study refers to the Endorsement Advice, we also included it in attachments.

This cover note contains background information, comments and a conclusion by the Commission Services.

2. BACKGROUND ON THE AMENDMENTS TO IFRS 7

Explanation of the issue

The IASB started to discuss the Amendment of IFRS 7 in September 2008 as part of the IASB´s response to the financial crisis and to the demand from users for enhanced disclosures on financial instruments.

The IASB published an Exposure Draft in October 2008 and the final document was published in March 2009.

The current crisis has highlighted the need to improve the disclosures on fair value. The Financial Stability Forum (FSF) recommended that the IASB should strengthen its standards to achieve better disclosures about valuations, methodologies, and uncertainties associated with valuations[1].

With this Amendment the IASB gives response to some issues raised during the credit crisis and also responds to some questions following the first year of mandatory application of the Standard. The objective of the Amendment is to clarify and enhance disclosures about fair value measurements and the liquidity risk of financial instruments.

How is the issue dealt with currently?

Existing IFRS 7 already requires entities to provide some information about the use of fair value. The Amendment will add some new fair value information.

Existing IFRS 7 requires some disclosures about liquidity risk. Among other aspects, it requires disclosure of a maturity analysis of all financial liabilities by reference to the contractual cash flows. However, some of these disclosures are unclear and difficult to apply and do not always result in useful information.

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[1] Report of the Financial Stability Forum on enhancing market and institutional resilience, 7 April 2008

How do the amended IFRS 7 suggest dealing with the issue?

The document proposes the following amendments:

- Fair value disclosures: The Amendment requires entities to classify their financial instruments measured at fair value into three levels (the fair value hierarchy) depending on the type of input used for the valuation of those instruments. The Amendment will also require additional information divided by level into the fair value hierarchy and, in particular, it will reinforce level 3 disclosures[2]. These disclosures are expected to provide more information about the relative reliability of fair value measurements and will increase convergence of IFRS and US GAAP.

- Disclosures about the nature and extent of liquidity risk arising from financial instruments: The amendment will change current requirements for derivative financial liabilities and instead of requiring a contractual cash flows maturity analysis it will allow management to use a different approach. The amendments are expected to clarify current requirements to address application issues. The Amendment will also reinforce current principles of IFRS 7 to improve the information about liquidity risk.

Entities will have to apply the amendments for annual periods beginning on or after 1 January 2009. In the first year of application, an entity does not need to provide comparative information for the disclosures required by the amendments.

IASB and EFRAG consultations

The IASB carried out a consultation according to its due process. The IASB published the Exposure Draft on October 2008 and received 89 comment letters. Most respondents supported the IASB purpose to enhance fair value and liquidity risk disclosures although they also sent different views of how the improvements could be achieved. The final document with the amendments was published in March 2009.

Commentators to the EFRAG consultation unanimously shared EFRAG´s assessment of the costs and benefits associated with the implementation of these amendments.

3. EFFECT ANALYSIS

Main points identified in the EFRAG Effect Analysis

Usefulness of accounting information provided in the financial statements

EFRAG's analysis noted that the IASB is responding with this amendment to a strong and urgent call from users for better disclosures about fair value and liquidity risk.

[2] Level 3 refer to those of financial instruments whose fair values are based on unobservable inputs.

The Amendment on fair value disclosures will help users to understand better the uncertainties surrounding fair value measures used in the financial statements. EFRAG also pointed out that the value of some of the fair value measurement disclosures is highlighted by the fact that some entities already provide the information required by the Amendment on a voluntary basis.

Regarding liquidity risk disclosures, EFRAG noted that the Amendment will allow management to provide maturity analysis in a way that better explains how liquidity risk is managed.

EFRAG concluded that the amendment will improve the quality of the information provided in two areas (fair value and liquidity risk disclosures) where such improvements are much needed. EFRAG also mentioned that the benefits arising from the implementation of the Amendment are therefore likely to be significant.

The Commission Services agree with the EFRAG analysis and conclude that the amendments to IFRS 7 will improve the quality of the financial information and therefore will benefit users.

Costs for preparers and users

EFRAG's analysis gives an overview of the expected incremental costs for preparers and users. With regard to preparers, EFRAG considered the cost of providing the proposed fair value and liquidity risk disclosures. EFRAG concluded that for some preparers, the additional year one and ongoing costs of implementing the amendment is likely to be insignificant. However, for some other preparers the ongoing cost will not be insignificant. The main reason for these costs is the requirement in the amendments to disclose a reconciliation from the opening to the closing balance of level 3 fair value measurements.

EFRAG concluded that the Amendment will not increase the costs users incur in analysing the financial statements.

EFRAG notes that for some preparers the costs will be insignificant and for some others the costs are likely to be greater than that. Users will not incur in additional costs. The Commission Services share this analysis.

4. OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS

On the basis of EFRAG's Effect Study, the Commission Services have considered the main costs and benefits of endorsing the amendments to IFRS 7 and concluded that the benefits of adopting the amendments outweigh the costs incurred.

The Commission Services believe that the amendments to IFRS 7 will have positive cost-benefits effects and that it should therefore be endorsed in the EU without delay.

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

EFRAG
European Financial Reporting Advisory Group

The costs and benefits of implementing of the Amendment to IFRS 7 *Improving Disclosures about Financial Instruments*

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IFRS 7 *Improving Disclosures about Financial Instruments* (the Amendment).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A summary of the Amendment

4 The objective of IFRS 7 *Financial Instruments: Disclosures* is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

5 The Amendment amends and adds to the existing disclosure requirements. It does so in response to the demand from users for enhanced disclosures on financial instruments, primarily in the light the current market conditions. These enhanced disclosures cover two topics: fair value measurement and liquidity risk.

Fair value measurement

6 Existing IFRS 7 already requires entities to provide some information about their use of fair value measures. The Amendment adds to those requirements by requiring entities to classify the fair value measures they use into three levels (the fair value hierarchy) and to provide additional information on each measure used depending on its level.

7 The levels of the fair value hierarchy depend on the type of input used for the valuation of those instruments. There are three levels:

(a) quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);

(b) inputs other than quoted prices included under Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

(c) inputs for the asset or liability that are not based on observable market data (unobservable input) (Level 3).

This hierarchy is similar to the one used for similar purposes in US GAAP.

8 The additional disclosures to be provided are:

(a) an analysis of the fair value amounts used by level;

(b) any significant transfers between Level 1 and Level 2, and the reasons for those transfers;

(c) for Level 3 valuations, an analysis of the movement between the opening and closing balances disclosing separately various prescribed items (such as total gains and losses recognised in profit or loss, total gains and losses recognised in other comprehensive income, transfers into and out of Level 3, etc); and

(d) for Level 3 valuations, certain information about the sensitivity of the fair value amounts.

Liquidity risk

9 Existing IFRS 7 requires disclosure of a maturity analysis of all financial liabilities by reference to the contractual cash flows. The Amendment changes the requirement for

derivative financial liabilities by allowing management to use a different approach unless the contractual maturities are essential for an understanding of the timing of the cash flows associated with those instruments.

EFRAG's initial analysis of the costs and benefits of the Amendment and stakeholders' views on it

10 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users both in year one and in subsequent years from implementing the Amendment in the EU. The tentative conclusions reached as a result of that initial assessment were that:

(a) for some preparers, the additional year one and ongoing costs of implementing the Amendment are likely to be insignificant. For some other preparers, the ongoing costs are likely to be greater than that;

(b) it is unlikely that the Amendment will result in an increase in the costs users will incur;

(c) the benefits arising from the implementation of the Amendment are likely to be significant; and

(d) those benefits are likely to exceed the costs involved.

11 EFRAG published its initial assessment and supporting analysis on 3 April 2009. It invited comments on the material by 15 May 2009. The results of this consultation can be summarised as follows. Where specific responses to the questions posed were provided by respondents:

(a) All respondents agreed with EFRAG's assessment of the costs involved for users and preparers.

(b) All respondents agreed with EFRAG's assessment of the benefits associated with implementing the Amendment.

(c) All respondents agreed with EFRAG's assessment that the benefits to be derived from application of the Amendment are likely to exceed the costs involved.

EFRAG's final analysis of the costs and benefits of the IFRS 7 Amendments

12 Based on its initial analysis and on stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of implementing the Amendment in the EU is presented in the paragraphs below.

Cost for preparers

<u>Fair value measurement disclosures</u>

13 EFRAG's assessment is that the Amendment could involve preparers in additional costs in two areas:

(a) Breaking down the fair value measurement disclosures into the three levels. EFRAG's assessment is however that the information necessary to meet these requirements already exists and therefore the cost of meeting the new requirements—which would be an ongoing cost—is likely to be insignificant in most cases, because it can be collected through existing reporting systems.

(b) Preparation of the reconciliation from the opening balance to the closing balance of Level 3 fair value measurements and disclosure of specific information on the movements in the period. EFRAG understands that implementing these reconciliation requirements could require preparers to monitor a large quantity of additional information, such as the purchases and sales of assets measured using Level 3 techniques within a specific book of business. When the number of corresponding books of business is large and spread among various subsidiaries, this ongoing cost would not be insignificant.

<u>Liquidity risk disclosures</u>

14 The existing requirements concerning liquidity risks disclosures require entities to provide specific disclosures on liquidity risk for all financial liabilities. As previously explained, under the Amendment an entity is no longer required to provide a maturity analysis on liquidity risk that includes the remaining contractual maturities for derivative financial liabilities, unless such information is essential to the understanding of the cash flows associated with the instruments. Therefore, EFRAG's assessment is that this part of the Amendment will have no cost implications.

<u>Overall assessment</u>

15 EFRAG's overall assessment is that, for some preparers, the additional year one and ongoing costs of implementing the Amendment is likely to be insignificant, but for some other preparers the ongoing costs are likely to be greater than that (mainly because of the costs involved in disclosing a reconciliation of the opening to closing balance Level 3 fair value measures).

Costs for users

16 EFRAG is not aware of any aspect of the Amendment that will increase the costs users incur in analysing the financial statements as a result of its adoption.

Benefits of the Amendment

17 In issuing the Amendment, the IASB is responding to a strong and urgent call from users for better disclosures about the use of, and uncertainties arising from, fair value measures of financial instruments and about the liquidity risk to which the entity is exposed and how it is managing that risk. The value of some of the fair value measurement disclosures is highlighted by the fact that some entities already provide some of the information required by the Amendment on a voluntary basis.

18 EFRAG's assessment is that the Amendment will improve the quality of the information provided in two areas where such improvements are much needed. The benefits arising from the implementation of the Amendment are therefore likely to be significant.

Conclusion

19 To summarise, EFRAG believes that for some entities implementation of the Amendment will result in some not insignificant ongoing costs. On the other hand, the benefits are likely to be significant and therefore to exceed the costs involved.

Stig Enevoldsen

EFRAG Chairman

27 May 2009

Attachment 2: Endorsement advice prepared by EFRAG

Jörgen Holmquist

Director General

European Commission

Directorate General for the Internal Market

1049 Brussels

27 May 2009

Dear Mr Holmquist

Adoption of the Amendment to IAS 7 *Improving Disclosures about Financial Instruments*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IFRS 7 *Improving Disclosures about Financial Instruments* (the Amendment), which was published by the IASB in March 2009. It was issued as an Exposure Draft in October 2008 and EFRAG commented on that draft.

The Amendment is intended to improve disclosures about fair value measurements and liquidity risk management associated with financial instruments.

EFRAG has carried out an evaluation of the Amendment. As part of that process, EFRAG issued an initial evaluation of the Amendment against the EU endorsement criteria for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendment and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendment and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached Appendix.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

Appendix

Basis for conclusion

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendment to IFRS 7 Improving Disclosures about Financial Instruments *(the Amendment).*

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Introduction

1 When evaluating the merits of the Amendment, EFRAG considered whether the accounting that results from its application meet the criteria for EU endorsement.

2 Having formed tentative views on the issues and prepared a draft assessment, EFRAG issued that draft assessment on 3 April 2009 and asked for comments on it by 15 May 2009. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

Does the accounting that results from the application of the Amendment meet the criteria for EU endorsement?

Relevance

3 According to the IASB's Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether the Amendment would result in the provision of relevant information—information that has predictive value, confirmatory value or both—and whether it might result in the omission of any information that is relevant.

4 EFRAG's assessment is that the additional and amended fair value measurement disclosures for financial instruments that the Amendment requires will help users to understand better the uncertainties surrounding fair value measures used in the financial statements.

5 Regarding liquidity risk disclosures, EFRAG notes that the effect of the Amendment is to allow management greater flexibility to provide maturity analyses for derivative financial liabilities in a way that management believes meets the overall objective (of providing disclosures that enable users to evaluate the nature and extent of the entity's

exposure to risks and how it is managing those risks). The focus is still though on the provision of relevant information. EFRAG's assessment is that the Amendment will help entities to meet the objective more effectively.

6 As a result, EFRAG believes that the information that will result from applying the Amendment will meet the EU endorsement criteria of relevance.

Reliability

7 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has considered whether information resulting from the application of the Amendment exhibits those qualities.

8 Regarding the fair value measurement disclosures, the Amendment requires disclosure of the components (input from each category) of numbers that are already required to be disclosed by the current standard. As a result, EFRAG's assessment is that the Amendment does not require additional calculations and therefore has no additional reliability implications.

9 Regarding disclosures about the liquidity risk an entity is exposed to, the Amendment requires that the maturity analysis an entity provides in respect to derivative financial liabilities only include the remaining contractual maturities if the latter is essential for an understanding of the timing of the cash flows. Presently, IFRS 7 requires that the remaining contractual maturities be provided for all financial liabilities. EFRAG considered whether allowing management to use a different approach in some cases would create reliability concerns. EFRAG concluded that it would not, because entities would need to disclose information about the remaining contractual maturities if such information was essential to the understanding of the cash flows.

10 EFRAG has therefore concluded that the information that results from the application of the disclosures in the Amendment meets the reliability criterion.

Comparability

11 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

12 The Amendment requires a new three-level fair value measurement hierarchy to be used for the purpose of disclosure. EFRAG considered whether the introduction of a new fair value hierarchy in the Amendment might result in diversity in practice (because of the subjectivity of certain notions used in the definitions of the hierarchy). EFRAG also considered whether there would be divergent application of the fair value measurement hierarchy described in the Amendment and the one used in the existing IAS 39 *Financial Instruments: Recognition and Measurement* and, if so, whether such divergence may create a comparability concern. Judgement is required when categorising financial instruments under the Amendment and under the requirements in IAS 39. However, EFRAG believes that the potential comparability issues in this case are no more significant than those in other IFRS literature that involve the application of judgment.

13 As previously explained, the Amendment requires that information about the remaining contractual maturities arising from derivative financial liabilities be provided only if such information is essential for an understanding of the timing of cash flows. EFRAG

believes that, although permitting some management discretion in this way might result in a wider range of numbers being disclosed for similar instruments, this would not involve a decrease in comparability; rather, it would reflect the diversity of liquidity risk management.

14 EFRAG has therefore concluded that the information that results from the application of the disclosures in the Amendment meets the comparability criterion.

Understandability

15 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

16 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability (because, for example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable). As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendment is understandable is whether that information will be unduly complex.

17 Regarding fair value measurement disclosures, EFRAG understands that some entities already provide some of the disclosures required by the Amendment on a voluntary basis in their IFRS financial statements. Other disclosures are new, but do not seem overly complex. As a result, EFRAG's assessment is that the information that will result from the application of the fair value measurement disclosures in the Amendment will be understood by users.

18 EFRAG's assessment is that the changes made by the Amendment to the liquidity risk disclosures will better reflect the manner in which entities manage liquidity risk relating to their derivative financial liabilities and therefore provide users with information that is more meaningful and understandable.

19 Having considered the above reasoning, EFRAG believes that the information that will result from the application of the Amendment will meet the understandability characteristic.

True and Fair

20 Having concluded that the information that results from the application of the Amendment will meet the criteria of relevance, reliability, comparability and understandability and being unaware of any other reason to be concerned about the accounting effect of the Amendment, EFRAG sees no reason to believe that the Amendment is inconsistent with the true and fair view requirement.

European Interest

21 EFRAG has considered whether the benefits of implementing the Amendment in the EU exceed the costs of doing so. Its assessment is that, although implementation of the Amendment would involve some costs, they are likely to be outweighed by the benefits.

Conclusion

22 EFRAG's overall conclusion is that the Amendment satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.