Summary of Capital Markets Advisory Committee Meeting

This is a summary of the topics discussed at the Capital Markets Advisory Committee meeting on 22 February 2012, prepared by the staff of the IFRS Foundation. For more detailed information about the meeting, please visit http://www.ifrs.org/Meetings/CMAC+meeting+february+2012.htm.

Introduction

1. The Capital Markets Advisory Committee (CMAC, formerly the Analyst Representative Group) held a meeting in London on 22 February 2012. Five IASB members and some staff were in attendance.

2. IASB member Stephen Cooper welcomed the CMAC members and introduced Hans Hoogervorst (IASB chair), Mark Prentice and Martijn Bos (new CMAC members), who attended the meeting for the first time. Mr Prentice and Mr Bos then provided the group with some information about their professional backgrounds. After that, Stephen Cooper gave some information about the IFRS Advisory Council meeting on 20 and 21 February and mentioned that in that meeting there was a broad consensus on the importance of materiality in disclosures.

3. The CMAC discussed the following topics:
   (a) EFRAG/FASB disclosure framework projects
   (b) Financial instruments
   (c) Leases
   (d) ESMA’s materiality consultation paper
   (e) Investment entities
   (f) Revenue recognition
   (g) Post-implementation review of IFRS 8
   (h) IFRSs 10-12 effective date

Information about the Capital Markets Advisory Committee (CMAC) is available at http://www.ifrs.org/The+organisation/Advisory+bodies/CMAC/
EFRAG’s and FASB’s disclosure framework projects

4. Mario Abela, Research Director of the European Financial Reporting Advisory Group (EFRAG), and Ron Lott, Research Director of the Financial Accounting Standards Board (FASB), presented the status of the EFRAG’s and the FASB’s work on their respective disclosure framework projects. Both organisations emphasised that the objective of their projects is to improve the quality of disclosures, with the primary scope being the information given in the notes to financial statements. Mr Abela emphasised that EFRAG aims to develop a framework for well-co-ordinated and effective disclosures, with a focus on improving quality and not simply on reducing volume. In addition, Mr Lott noted that the disclosure framework should also provide a conceptual basis for the standard-setter to facilitate consistent and well-reasoned decisions relating to disclosure requirements. Although both the EFRAG staff and the FASB staff had contributed jointly to these projects, the FASB and EFRAG would nevertheless publish separate discussion papers in the second quarter of 2012.

5. After the presentation, Mr Cooper asked the group whether the IASB should start a disclosure framework project and whether it should be given a high priority. Furthermore, he was asking whether this project should have both short-term and long-term objectives. CMAC members indicated that a disclosure project should have a high priority. CMAC also indicated that the IASB might benefit from the work of EFRAG and the FASB.

6. However, there was general consensus among CMAC members that improving the quality of disclosures may not be achieved by simply reducing the disclosure requirements. Some CMAC members indicated that today’s problem with disclosures may not be the accounting standard’s disclosure requirements but the behaviour and judgement relating to the concept of materiality. There is a concern that preparers are not exercising enough judgement when determining what information to disclose. The work of the auditor and regulator plays an important factor. In response to this concern, Mr Abela highlighted that the disclosure framework project would give more guidance in this context. Furthermore, he indicated that there is a need for new terminology that would better reflect the necessary judgement by preparers.
7. There were different views about whether a disclosure project could have short-term vs. long-term objectives. Some CMAC members talked about whether there should be only a framework project, or an individual IFRS with disclosures. Some CMAC members highlighted that the IASB has already received information from users of financial statements about which current IFRS disclosures could be improved as ‘quick wins’. They also discussed the need to address the issue of what should be on the face of the financial statements and what should be in the notes. Furthermore, CMAC members discussed whether the IASB could explore new approaches to disclosures; for example, layering of information.

8. CMAC members concluded by stating the importance of involving users of financial statements in all future disclosure project efforts to make sure that the disclosures provided are relevant to their work.

Financial Instruments

9. Sara Glen, IASB staff member, described the IASB’s and FASB’s current tentative decisions about the ‘three-bucket’ approach for the impairment of financial assets measured at amortised cost. She asked CMAC members for their views on the presentation of impairment allowances for originated versus purchased loans.

10. For purchased and originated assets, CMAC members said they wanted information about each group, rather than about the comparability between the two groups. For example, CMAC members said that they need to know the gross amount and the duration of the contract. They were also interested in information on the yield and organic income, and separate disclosure of interest income. One CMAC member said that information about the asset when it was originated is less important than the path it will follow. Investors would be mainly interested in the ultimate collectible amount and the current standing. In addition, having information on the characteristics of purchased assets makes it possible to stress test them. Another CMAC member said that he would be interested to know how much release of reserves is related to originated versus purchased assets.
11. One CMAC member added that data should be sufficiently disaggregated that variations within an asset class can be seen.

12. Some members of the committee thought that the distinction between Bucket 2 and Bucket 3 might confuse investors and analysts. In their view, because of the terminology used, Bucket 3 would always seem to be of worse credit quality than Bucket 2. Ms Glen said that the buckets are not meant to be a hierarchy. Consequently, one CMAC member suggested renaming the buckets, because people automatically associate numbers with a progression. The group also mentioned that they believe that Bucket 3 would have more cost associated with managing it, because those assets are assessed on an individual basis.

13. Some CMAC members suggested that the disclosures about transfers between buckets should include the amounts transferred and differentiate between originated and purchased assets, if applicable.

**Leases**

14. Patrina Buchanan and Aida Vatrenjak, IASB staff members, asked CMAC members for their views on the appropriateness of three possible ways of subsequently measuring lessee’s right-of-use (ROU) asset:

(a) **Approach A**: the boards’ current tentative decisions. Approach A treats a lease contract as being equivalent to the purchase of a non-financial asset, which is financed separately. This approach assumes that the lessee amortises the asset on a straight-line basis and, because the liability is measured on an effective interest method, interest expense decreases during the lease term which results in ‘front-loading’ of lease expenses at the beginning of the lease term.

(b) **Approach B**: the ‘interest-based amortisation’ (IBA) approach. Approach B treats a lease contract, and the resulting ROU assets, differently from the purchase of a non-financial asset, which is financed separately. The amortisation expense in Approach B reflects the time value of money of the ROU asset and, consequently, would result in an increasing amortisation expense as the lease term matures. The interest method is the same as Approach A, and consequently, the lease expense
would typically be on a straight-line basis. Amortisation and interest expense will be presented as a net amount.

(c) **Approach C**: the ‘underlying asset’ (UA) approach. Approach C treats a lease contract as being equivalent to the purchase of the underlying asset being leased (typically an item of property, plant and equipment (PPE)) which is financed separately. Applying Approach C, amortisation of the asset is calculated for (i) as if the lessee has the underlying asset—but only amortises the portion of the underlying asset that it has consumed, and (ii) interest charged for the use of the unused portion of the asset. Lease expense in Approach C will differ depending upon how much the lessee is expected to use (or consume) the underlying asset. Interest on lease liability would be presented separately.

15. Several CMAC members preferred Approach C, the underlying asset approach, because it is most similar to the whole asset approach that some of them use in making adjustments to operating leases today. Some CMAC members thought that it was more operational than the whole asset approach, while others objected that, for example, in a lease of land you would show amortisation according to Approach C, which you would not have in the whole asset approach. Because Approach C combines interest on residual with amortisation in one amount, it would not give users who use the whole asset approach all information needed.

16. A couple of members preferred Approach B, the interest based amortisation approach, because it was easy to understand. However, they wanted interest to be shown separately. Other members thought Approach B would not be appropriate, especially in cases of longer-term leases.

17. Several members preferred Approach A, the boards’ current decisions, because it was simple and easy to understand. They were not concerned about the expense pattern, because the total expense overall lease term was the same. Those members struggled with the logic and complexities of Approach B and C.

18. After that, Mr Cooper asked the CMAC members to vote for an approach. Five members voted for Approach A, two members voted for Approach B and five members voted for Approach C. The second choice of members who voted for Approach B in the first round was Approach C.
19. One CMAC member said that if the amount in the income statement is different from what the company is actually paying, users of financial statements need to know the amount of lease payments made during the period. That is because many use earnings before interest, taxes, depreciation and amortisation (EBITDA) as a proxy for cash flow.

ESMA’s Materiality Consultation Paper

20. Roxana Damianov and Michael Kavanagh of the European Securities and Markets Authority (ESMA) gave a presentation about their November 2011 consultation paper Considerations of materiality in financial reporting (which was available for public comment until 29 February 2012). Michael Kavanagh suggested that there should not be a focus on a quantitative assessment of materiality, but rather on the usefulness of the information being provided. He said that materiality would often be based on a percentage figure of the balance sheet or the profit and loss account.

21. Mr Kavanagh then described how materiality should be assessed from the perspective of those who could be influenced by the amount in question, rather than of those who would be influenced. He noted the shift from a wider range of users in the old version of the Conceptual Framework to a focus on investors and creditors in the new version. However, the CMAC members appreciated the focus on investors.

22. Mr Kavanagh also observed that preparers, auditors and regulators have different understandings of materiality. He explained that the rationale behind ESMA’s project is to be helpful in implementing a principle-based standard by preventing misconceptions in different jurisdictions throughout Europe. Although the CMAC was sympathetic to having consistent and comparable information, members expressed their concerns about the danger of materiality guidance being a means to challenge existing accounting requirements. They suggested that the IASB and the International Auditing and Assurance Standards Board (IAASB) should work together on this topic. Mr Kavanagh stated that it is not ESMA’s intention to give technical advice, but rather to provide a common framework that informs the market on what is acceptable.
23. One CMAC member stated that anything that is being done to improve and enhance consistency across companies is helpful to investors and analysts. Ian Mackintosh responded that the intention should be to achieve consistency and provide guidance without creating a book of rules.

**Investment Entities**

24. Sarah Geisman, IASB staff member, gave an overview of the proposals on investment entities and asked CMAC members for their views on them, in particular on the proposal that investment entities could measure their investees at fair value if specified criteria are met.

25. The CMAC members agreed with the exception from consolidation for the controlled investees of investment companies, because the purpose of such entities is different from normal operating entities and investors assess the performance of investment entities through fair value information. However, they were worried about the presentation of and disclosure about fair value information. One CMAC member argued that simply having a single fair value number would not be useful without any supplementary information about individual investments.

26. The group concluded that, to prevent structuring opportunities, there must be robust criteria in order to determine when an entity qualifies as an investment. The group expressed their concerns especially when a conglomerate might set up an investment entity subsidiary alongside its operating entity subsidiaries. In this regard, CMAC members discussed the accounting treatment when the investment entity has a non-investment entity parent and whether the exemption from the consolidation requirements would extend to the non-investment entity parent. CMAC views on this subject were mixed, although many CMAC members did think that a non-investment entity parent should retain the specialised fair value accounting used by an investment entity subsidiary.

**Revenue Recognition**

27. Glenn Brady, IASB staff member, updated the CMAC members on the status of the revenue recognition project. He then presented illustrative examples of the
proposed disclosures and discussed a survey provided by the Securities Analysts Association of Japan. Mr Brady summarised the concerns of preparers, accounting standard setters, professional bodies and audit firms about the costs and complexity of preparing the new disclosure requirements. He noted that some preparers had said that they may not currently have access in their systems to all the required information. Other preparers were concerned about the information overload that the new disclosures would create.

28. Consequently, the boards need to get a better understanding of the types of information about revenue that entities can provide at a reasonable cost. Mr Brady asked CMAC members which of the proposed disclosure requirements would be most important for users to understand and analyse revenue from contracts with customers and to what extent users need that information to be available in the interim financial statements as well as annual financial statements.

29. One CMAC member asked whether there are particular sectors in which users have indicated that not enough information about revenue transactions is disclosed and, if so, what type of information is missing. Mr Brady said that, throughout the life of the revenue project, users of financial statements have consistently expressed the view that existing disclosures about revenue are generally inadequate. They would like disclosures that show the relationship between the revenue recognised and cash flows (including whether the entity typically receives payment before or after transferring goods or services to the customer) as well as improved disaggregation of revenue, because information provided in segment reporting is not always sufficient.

30. One CMAC member suggested a matrix disclosure to get a better understanding of the different business units within a company. Mr Cooper clarified that the boards’ proposals do not prohibit such a matrix, but also would not require it.

31. Another CMAC member said that all of the disclosure proposals are essential for investors and that he would also like disclosures that show gross margins for different businesses and cash flows for different product lines. Mr Cooper responded that the disclosure of that information would be outside the scope of the revenue project. One CMAC member questioned why the exposure draft includes in its disclosure objective that information should be disclosed to enable users to understand the amount and timing of cash flows from contracts with
customers. Mr Cooper said that the IFRS in revenue recognition would clarify that the reference to cash flows links to the overall objective of general purpose financial reporting (as specified in the framework) rather than indicating that an entity should disclose detailed cash flow information.

32. In commenting on the proposed disaggregation of revenue disclosure, one CMAC member said that revenue should be disaggregated on the basis that reflects how management generates revenue, rather than disaggregating revenue based on how revenue is affected by economic factors. That member noted that all entities are affected by economic factors, and that those factors can change from period to period. Consequently, to meet that disaggregation principle, that member was concerned that the categories used to disaggregate revenue could be different from reporting period to reporting period, which would reduce comparability. Mr Brady explained that the boards did not intend that entities should disaggregate revenue differently each reporting period, and he indicated that this would be clarified in the final standard.

33. On the proposed disclosure of a reconciliation of contract balances, Mr Brady mentioned the concerns from preparers that they do not prepare a similar reconciliation for internal management purposes and that therefore some of the information may not be available in their accounting systems. One CMAC member suggested that, at least for long-term contracts, preparers should have that information on a contract-by-contract basis. Mr Brady answered that although preparers might be able to get this information, it will most probably be outside the accounting system (eg in project management reports within the business units). Another CMAC member suggested that the boards should consider proposing alternative disclosures that explain the relationship between revenue and contract balance if the entity does not prepare a reconciliation for internal management purposes. It was noted that preparing this kind of information could be good for management too and could enhance management reporting. CMAC members indicated that any alternative disclosure proposal should not produce boilerplate narrative information, and some members suggested that this information should be presented in tabular format.
Post-implementation Review of IFRS 8

34. IASB staff member April Pitman discussed the post-implementation review of IFRS 8 Operating Segments. The aim of such a review is to determine whether the standard achieved its stated objectives and whether it has improved financial reporting. To do that, the analysis would compare what companies disclose under IFRS 8 with the information that was disclosed under IAS 14 Segment Reporting.

35. CMAC members expressed general dissatisfaction with the segment disclosures provided under IFRS 8, because in their view, such information is often different from the needs of users of financial statements. Ms Pitman described the concerns of other users about the reduced comparability and usefulness of information after the adoption of IFRS 8.

36. CMAC members agreed that the post-implementation review should have a narrow focus on unexpected issues or costs. They also said that the IASB should evaluate the effects earlier, when drafting the standard, and not at the post-implementation review stage, to prevent the danger of having to re-expose standards. Ms Pitman responded that the IASB intends to create effect analysis for more recent standards and to assess whether the older standards meet their objectives.

37. CMAC members asked how the IASB intends to measure improvements. Ms Pitman responded that there will be two components: an academic review and a matrix of prioritisation factors that involve judgement; for example, investors and analysts will assess whether the standard is an improvement from their perspective. The group noted that it would be difficult for users to make such an assessment. Some suggested the use of best practice and worst case examples for assessing whether the promised benefits were obtained. One CMAC member said such an assessment should be done without explicitly asking users to compare IFRS 8 with IAS 14. The staff agreed.

38. Ms Pitman stated that the IASB would be conducting a survey for investors and analysts and a few CMAC members volunteered to help develop the survey.
IFRSs 10-12 Effective Date

39. Patrina Buchanan, IASB staff member, provided an update on the endorsement of IFRSs 10-12 in Europe. She explained that although EFRAG was planning to issue positive endorsement advice to the European Commission on these standards, it had indicated that it would recommend a one-year delay to the effective date. She noted that in January 2012 the IASB had discussed a request to defer the effective date of those standards but had decided not to do so. There were a number of reasons for that decision, the main one being because of the important improvements to financial reporting that would result from the implementation of those standards, including the disclosures about interests in unconsolidated structured entities in IFRS 12 Disclosure of Interests in Other Entities.

40. Patrina explained that the request for the delay arose because some entities were concerned that they might incur costs in consolidating some entities under IFR 10 Consolidated Financial Statements which, if the IASB finalised its investment entities proposals, would not be consolidated. One of the IASB members said that this could be mitigated by early application of the investment entity amendments, which is what those affected companies are likely to do.

41. One of the CMAC members said that from the IASB’s perspective, due process had been followed and that all its steps had been completed. What remains now is an EFRAG process that is separate from the IASB, as with any other jurisdiction.

42. The general view seemed to be that, while CMAC members agree that the standards are an improvement to financial reporting, it would not be significantly detrimental to wait for one additional year for those improvements to be implemented by European entities.