EFRAG's Draft Letter to the European Commission Regarding Endorsement of Disclosure Initiative - Amendments to IAS 7

Olivier Guersent
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

[dd May] 2016

Dear Mr Guersent

Adoption of *Disclosure Initiative - Amendments to IAS 7*

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, EFRAG is pleased to provide its opinion on the *Disclosure Initiative - Amendments to IAS 7* ('the Amendments'), which was issued by the IASB on 29 January 2016. An Exposure Draft of the Amendments was issued on 18 December 2014. EFRAG provided its comment letter on that Exposure Draft on 11 May 2015.

The objective of the Amendments is to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. The Amendments become effective for annual periods beginning on or after 1 January 2017, with earlier application permitted. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, i.e. whether the Amendments would provide relevant, reliable, comparable and understandable information, lead to prudent accounting and not be contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship; and raise no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS and that all necessary disclosures are required. Therefore EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that adopting the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

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

Yours sincerely,

Roger Marshall
Acting President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 *Disclosure Initiative - Amendments to IAS 7* (the 'Amendments') were issued in January 2016.

The issue and how it has been addressed

2 The Amendments were issued to address comments from users highlighting that understanding an entity's cash flows was critical to their analysis and that there was a need for improved disclosures about an entity's debt, including changes in debt during the reporting period.

3 The Amendments introduce a disclosure objective that requires entities to provide disclosures that enable users of financial statement to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.

What has changed?

4 The Amendments state that the disclosure objective enunciated in paragraph 3 above can be satisfied in various ways and, in considering this objective, an entity should take into consideration:

(a) the extent to which information about changes in liabilities arising from financing activities provides relevant information to its users; and

(b) whether the entity is already satisfying the disclosure requirement through other disclosures included in the financial statements.

5 The Amendments specify that one way to fulfil the disclosure requirement is by providing a tabular reconciliation between the opening and closing balances in the statement of financial position for liabilities arising from financing activities. However, this is not a mandatory format.

6 If a tabular reconciliation is provided, an entity shall disclose the following changes in financial assets and liabilities where the cash flows are or will be included in cash flows from financing activities:

(a) changes from financing cash flows;

(b) changes arising from obtaining or losing control of subsidiaries or other businesses;

(c) the effect of changes in foreign exchange rates;

(d) changes in fair values; and

(e) other changes.

7 The Amendments also require that if an entity provides the disclosures required by the Amendments in combination with disclosures of changes in other assets and liabilities, it shall disclose the changes in liabilities arising from financing activities separately from changes in those other assets and liabilities.

When do the Amendments become effective?

8 The Amendments apply for annual periods beginning on or after 1 January 2017 with early application permitted.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606/2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments lead to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

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 technical criteria for European endorsement, 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 IFRS or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (the IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (the Accounting Directive); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that '*to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic*

requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive' (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessment of the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether they meet all other technical criteria including whether the Amendments lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 7 - 13;

(b) reliability: paragraphs 14 - 17;

(c) comparability: paragraphs 18 - 21;

(d) understandability: paragraphs 22 - 27;

(e) whether overall they lead to prudent accounting: paragraphs 28 - 29; and

(f) whether they would not be contrary to the true and fair view principle: paragraphs 30 - 35.

Relevance

7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

8 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

9 EFRAG first observes that the Amendments are intended to meet the request made by users for a net debt reconciliation. In their feedback to EFRAG, users supported the Amendments as this would result in useful information. They pointed out that many entities already provide more information on a voluntary basis and they welcomed the fact that the Amendments will not preclude entities from continuing to do so. Therefore, in EFRAG's view, the Amendments will generally result in the provision of relevant information to users.

10 EFRAG also considered the feedback from some respondents to its consultation that the relevance of the Statement of Cash Flows, taken as whole, may be limited for certain industries (such as financial institutions) and therefore any benefits arising from the Amendments may also be limited. For these industries, only some of the sources of finance are generally classified as 'financing activities' and other disclosure requirements (for example, regulatory disclosure requirements) may already result in sufficient disclosure.

11 EFRAG has however assessed that these concerns have been addressed by including an objective for the disclosure requirements and inviting entities to exercise judgement to determine the most appropriate and commensurate way to meet that disclosure objective and to provide additional information, if deemed relevant for their users.

12 In that respect, EFRAG observes that the Amendments permit the disclosure requirements to be addressed in various ways (i.e. not only by providing a reconciliation) and that an entity should take into consideration both the extent to which information about changes in liabilities arising from financing activities provide relevant information to users; and whether the entity is satisfying the disclosure requirement through other disclosures included in the financial statements

13 EFRAG's overall assessment is that the Amendments would result in the provision of relevant information and therefore satisfy the relevance criterion.

Reliability

14 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and 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.

15 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

16 EFRAG observes that the Amendments would raise no concerns about freedom from material error and bias, faithful representation, and completeness, as they introduce an additional disclosure requirement that provides useful information about changes in liabilities arising from financing activities. Furthermore, EFRAG notes that the Amendments are designed to improve the users' understanding of the changes in liabilities arising from financing activities, including changes arising from cash flows as well as non-cash changes. The Amendments are therefore expected to improve the completeness of the information provided in the financial statements in those cases where this information was not disclosed in the past.

17 EFRAG's overall assessment is that the Amendments would result in the provision of reliable information and therefore satisfy the reliability criterion.

Comparability

18 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.

19 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

20 EFRAG observes that, although the Amendments do not affect the way transactions are accounted for, they are intended to bring more consistency in the disclosures on movements in liabilities arising from financing activities by stating an objective for the disclosure. EFRAG acknowledges that, as the Amendments do not specify a unique format for the disclosure but rather invite entities to exercise their judgement to determine the most appropriate and commensurate way to meet the disclosure requirements, this may not lead to standardised disclosure. However, EFRAG considers that comparability does not mean uniformity and less uniformity in

disclosures between entities does not necessarily lead to a loss of comparability if entities apply judgement appropriately in the provision of information that is relevant, based on the specific nature of their operations.

21 EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

22 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.

23 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

24 As a result, in EFRAG's opinion, the main additional issue it needs to consider when assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

25 EFRAG first observes that the Amendments rely on the existing guidance in IAS 7 for the classification of cash flows and do not introduce new requirements that may create complexity.

26 EFRAG considers that the disclosures resulting from the application of the Amendments are likely to help users improving their understanding of the entity's sources of finance and how those sources have been used over time, and their confidence in forecasting the entity's future cash flows by better relating the information contained in the Statement of Financial Position and that in the Statement of Cash Flows.

27 In EFRAG's view, the Amendments do not introduce any new complexity that may impair understandability. Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

28 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

29 EFRAG has concluded that the Amendments do not raise any issues in relation to prudence as defined above.

True and Fair View Principle

30 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

31 EFRAG first observes that the Amendments do not affect the accounting for transactions as they relate solely to disclosures.

32 EFRAG has assessed that, on a stand-alone basis, the Amendments provide relevant, reliable, comparable and understandable information and do not affect prudence.

33 EFRAG has also assessed that the Amendments do not create any negative interactions with other IFRS. In particular, the Amendments set an objective for the disclosure about changes in liabilities arising from financing activities and invite entities to take into consideration other existing disclosure requirements in IFRS, in determining whether they have satisfied that objective. Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore they do not impede financial statements from providing a true and fair view.

34 EFRAG has concluded that the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.

35 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

36 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to adopt the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw an intermediate conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes to a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation, i.e. improve the transparency and comparability of financial reporting.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments are intended to help users understand changes in liabilities that are classified as financing activities. In their feedback to EFRAG, users supported the Amendments as this would result in useful information. They pointed out that many entities already provided more information on a voluntary basis and they welcomed the fact that the Amendments will not preclude entities from continuing to doing so.

4 EFRAG also observes that entities will be able to exercise judgement to determine the most appropriate way to meet the disclosure objective included in the Amendments. Entities will also have the possibility to include additional components of debt that are not captured by current disclosure requirements and, for instance, to provide the reconciliation on a net basis.

5 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of the Amendments

6 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some 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 Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

Cost for preparers

7 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

8 EFRAG has also assessed that entities that do not currently provide a reconciliation of debt (or provide it in a different format) may incur one-off and ongoing cost to enable changes in liabilities arising from financing activities to be tracked and collated.

9 However, EFRAG foresees that additional costs are not likely to be significant insofar as the Amendments:

(a) do not change the recognition or measurement for liabilities arising from financing activities and instead require to track changes in those items and, in a lot of instances, that information would already be available;

(b) do not explicitly require a specific format for the reconciliation and, instead, establish a disclosure objective and invite entities to exercise judgement to determine the most appropriate and commensurate way to meet that objective;

(c) allow entities that already provide a reconciliation under a different format to continue to do so by clarifying that the disclosures can be extended to include changes in other assets and liabilities (for instance to present the reconciliation on a net basis); and

(d) exempt entities from providing comparative information upon first application.

10 Overall, EFRAG's assessment is that the Amendments will not result in a significant increase in costs to preparers.

Costs for users

11 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

12 As mentioned above, the Amendments do not affect the accounting for transactions as they relate solely to disclosures. Therefore, EFRAG's assessment is that no one-off costs are expected to be incurred by users as a result of the initial application of the Amendments.

13 EFRAG also considers that the Amendments will not result in increased ongoing costs for users. The disclosures provided are likely to reduce costs for analysis for those users that prepare their own analysis and tracking of changes in financial liabilities.

14 Overall, EFRAG's assessment is that implementation of the Amendments will not result in a significant increase in costs to users.

Benefits for users and preparers

15 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

16 EFRAG's assessment is that the Amendments are likely to result in relevant and understandable information about changes in financial liabilities and help better relate the information contained in the Statement of Financial Position and in the Statement of Cash Flows.

17 EFRAG observes that the Amendments address a request made by users for improved disclosures about changes in debt during the reporting period that help them better understand an entity's cash flows and of the entity's sources of finance and how those sources have been used over time; and therefore enhance their analysis.

18 Finally, as mentioned above, the provision of this information may reduce the cost incurred by some users in preparing their own reconciliations.

19 As mentioned in its assessment of the 'relevance' criterion, EFRAG acknowledges that the benefits resulting from the Amendments may be limited for some preparers, such as financial institutions, for which the relevance of the Statement of Cash Flows taken as a whole is limited. However, EFRAG has assessed that, in such circumstances, the Amendments allow entities to exercise their judgment to determine the most appropriate way to meet that disclosure objective considering the actual needs of users and the other disclosures already provided in the financial statements.

Conclusion about the benefits for users and preparers

20 Overall, EFRAG's assessment is that both preparers and users are likely to benefit from the Amendments, which result in relevant and understandable information.

Conclusion on the costs and benefits of the Amendments

21 EFRAG's overall assessment is that the overall benefits of relevant and understandable information on changes in liabilities arising from financing activities are likely to outweigh costs associated with implementing the requirements and the ongoing costs of complying with the Amendments.

Conclusion

22 EFRAG considers that the Amendments will generally bring improved financial reporting when compared to current guidance. As such, their adoption is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

23 EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

24 Furthermore, EFRAG has considered whether there are any other factors that could mean that adoption is not conducive to the public good and has not identified any such factors.

25 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that adopting the Amendments is conducive to the European public good.