

## EFRAG STAFF PAPER FOR PUBLIC MEETING

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## EFRAG TEG CHAIRMAN'S REPORT TO THE EFRAG BOARD

**Françoise Flores**  
15 November 2014

### 1- Preamble

The last report provided to the EFRAG SB in September was written in the form of a state of play at the time of handing the organisation over. It is reproduced as an appendix to this report and is helpful to understand the context of this report that covers EFRAG TEG's activities for the last two months.

### 2- Endorsement of IFRS

#### *IFRS 15 Revenue Recognition*

EFRAG TEG has approved the EFRAG draft endorsement advice on IFRS 15 in its October meeting.

Contrary to what was initially envisaged, no explicit assessment of prudence has been carried out. In the ARC meeting on 23<sup>rd</sup> September, Germany and the UK specifically called on EFRAG not to modify in any way endorsement criteria used in its assessment of IFRS. As the EC's request for the explicit assessment of prudence was informal and could not be formalized at that stage, EFRAG abstained from any explicit assessment.

The ARC had requested that EFRAG assesses specifically whether entities would have enough time to properly implement IFRS 15 before its mandatory effective date of 1<sup>st</sup> January 2017. A specific question has been asked in the draft endorsement advice issued for public consultation. It is worth noting that the FASB is undertaking in parallel a specific outreach in the US to make similar assessment. Proper follow up of those developments need to be made.

#### *IFRS 9 Financial Instruments*

EFRAG TEG considered in its October meeting a first analysis of IFRS 9 against the technical endorsement criteria in the IAS Regulation. This first draft attracted a lot of comments and input from EFRAG TEG members and a redraft will be considered at the December meeting.

In November EFRAG TEG considered a staff's follow up analysis of the results of field tests conducted in 2013 on IFRS 9 classification and measurement, and impairment, proposed requirements. EFRAG TEG recommended that previous participants in the

field tests and potentially other participants stimulated by the European banking organisations be consulted on whether they would share these preliminary assessments. A questionnaire has been prepared that will be submitted shortly to the Chairs of the NSS of France, Germany, Italy and the UK who partnered with EFRAG in the organisation of the field tests.

A meeting was held between the EC, the EFRAG Acting President, the EFRAG TEG Chairman and the EFRAG Technical Director to consider a first draft request for advice that is to be submitted to the ARC on 27 November. The EC has indicated interest in the results of the follow up recommended by EFRAG TEG, including another attempt at getting quantitative indications, where possible.

#### *Other IFRS publications*

EFRAG has issued also draft endorsement advices for:

- Amendment of IAS 27 *Separate Financial Statements* allowing the equity method in separate financial statements for interests in subsidiaries, joint ventures and associates;
- Annual Improvements to IFRSs - 2012-2014 cycle

### **3- Participation in the IASB standard setting process**

#### *Leases*

In the last ASAF meeting held after the EFRAG SB meeting in September, EFRAG reported on the results of the supplementary outreach organised in the course of the summer. The definition of a lease was further discussed on the basis of a paper prepared by EFRAG staff. One of the proposals made by EFRAG staff was to align the future standard on leases with the guidance in IFRS 15 on whether goods and services are distinct within a contract with a customer. This proposal received good support from other ASAF members, however was later dismissed in the IASB's staff recommendations that the IASB decided to follow. EFRAG staff had also highlighted that where payments for the asset component were subject to the performance of service obligations included in the arrangement, the contract should be considered as a whole as service contract. This aspect did not receive support from the other ASAF members, however would have deserved to be pursued further in order to be better understood.

In its November meeting EFRAG TEG discussed leases again, concluding that the limited changes that the IASB was ready to make to the definition of a lease were not sufficient to dismiss EFRAG TEG's concerns that the definition was too broad. EFRAG TEG concluded also that all possible efforts seemed to have been made and recommended no further action.

#### *Insurance*

In its October and November meetings, EFRAG TEG received updates from EFRAG staff on IASB's latest deliberations/educational sessions. In November more particularly EFRAG TEG underwent a specific educational session so as to understand and debate the various possibilities under discussion of interest rates to be used to measure the interest expense born on participating contracts' liabilities in the income statement, so as to minimize accounting mismatches. EFRAG TEG affirmed further its support to the book yield approach promoted in the Alternative Proposal of the Insurance Industry; it noted however that further insight into reinvestment and returns assumptions would be necessary.

#### *Conceptual framework*

In its meeting in November, EFRAG TEG has started giving input to EFRAG staff for the draft comment letter that EFRAG will send to the IASB in response to the exposure draft of which publication is expected early 2015.

In addition to remarks already included in our September report to the EFRAG SB, additional points should be of concern in Europe: the IASB is no longer intending to consider recognition criteria, whereas EFRAG had been supportive of the DP proposals to have relevance and faithful representation retained as recognition criteria; EFRAG had insisted however that those criteria should be effective. The IASB is moving to mere indicators, making the presumption that all assets and liabilities should be recognized even more difficult to rebut. Furthermore the IASB will propose to eliminate the recognition exemption for executory contracts and not include any measurement filter as was once envisaged.

#### *Rate Regulated Activities (RRA)*

EFRAG TEG has approved the issuance of EFRAG draft comment letter on the DP Regulated Activities in October. EFRAG, EFFAS and IASB organise a public event with the objective of seeking the views of users further on 18 December. EFRAG will at the ASAF meeting in December present the results of its former outreach activities with users and the preliminary views expressed in its draft comment letter.

#### *Accounting for dynamic risk management activities.*

EFRAG TEG has finalized its comment letter in a series of conference calls end of October. Comments received from constituents showed a lot of consensus in Europe on the main aspects explored in the DP. However controversy arose on whether forecast transactions and the equity model book should be accepted in a fair value based model. Proponents of their inclusion gave priority to avoiding restrictions in how hedging activities would be reported (and hence to maximizing the elimination of accounting mismatches) whereas others considered that these were stretching the limits of accounting too far.

Constituents' comments reflect that next step by the IASB is expected to be another discussion paper, because, based on the comments sent to the IASB, significant further development and consultation is necessary before an exposure draft could be issued.

*Amendment to IAS 12 – Recognition of Deferred tax losses for unrealized losses:* the EFRAG draft comment letter is out for comment.

#### **4- Early stage proactive activities**

EFRAG has currently three items in work in progress:

- A bulletin in the conceptual framework series is under preparation on the unit of account; EFRAG staff has presented to EFRAG TEG an outline of the bulletin and a series of examples that can illustrate the unit of account issue applicable to recognition and measurement (including getting insight into whether the unit of account should be the same or could differ whether recognition or measurement is considered);

- Researching why the cash flow statement is not considered relevant for financial institutions and what information should be substituted that would be more useful for investors;
- The academic research sponsored jointly with ICAS to prolong earlier work on a better understanding of how capital providers use financial statements; this research will focus on what information best supports the assessment of stewardship; the objective is to obtain interviews of up to 120 users, the area in the project where EFRAG brings the benefits of its 3 years of efforts in developing its user outreach.

Appendix

**EFRAG CHAIRMAN'S REPORT TO THE SUPERVISORY BOARD**

**Françoise Flores**  
12 September 2014

**5- Preamble**

With the new governance of EFRAG about to become effective as of 31<sup>st</sup> October, I have written this report in a different style from what we are used to, assigning to this report the role of describing where the current organisation has come to, i.e. the state of play at the time of handing the organisation over, rather than focusing on the accomplishments of the past few months.

**6- Endorsement of IFRS**

The IASB has published IFRS 15 *Revenue Recognition* end of May and IFRS 9 *Accounting for Financial Instruments* end of July. Time has therefore come for Europe to consider endorsement of these two major standards.

*IFRS 15 Revenue Recognition*

In line with the recommendations of the Maystadt report to improve the interaction between the ARC and EFRAG, the European Commission has consulted with ARC on the Revenue Recognition standard before sending to EFRAG its request for endorsement advice. At the ARC meeting in June, EFRAG presented the results of the various field tests it had undertaken in 2011 and followed up on subsequently and provided an overview of what recommendations had been made throughout the standard setting process and how and to what extent those recommendations had been followed. The ARC complimented EFRAG for all the work done and concluded that no supplementary field test was necessary, a follow up of the latest findings would suffice, and EFRAG should seek input from constituents as to whether an effective date as of 1<sup>st</sup> January 2017 would provide sufficient time for implementation of the standard. EFRAG shortly thereafter received the EC request for endorsement advice and it was agreed that EFRAG should start its public consultation on its draft endorsement advice without waiting for the entry into force of the new organisation. EFRAG TEG had gone through various preparatory steps early in the year in anticipation of IFRS 15 publication and is now expected to issue a draft endorsement advice before the end of October.

It was agreed with the European Commission that:

- EFRAG would include an open question to constituents as to whether they had reasons to believe that IFRS 15 would not be conducive to the European public good, so that the new Board be in a position to deal with the necessary input for finalising an endorsement advice that would consider all criteria in the IAS regulation;
- EFRAG draft endorsement advice would include an explicit assessment of whether the standard has the quality of prudent accounting, in compliance with the Accounting Directive. EFRAG TEG has therefore included this explicit assessment in the scope of its work.

### *IFRS 9 Accounting for Financial Instruments*

The European Commission has indicated that they would follow the same process for IFRS 9 as for IFRS 15, i.e. consult first with the ARC before issuing a request for endorsement to EFRAG. IFRS 9 having more economic policy implications than IFRS 15, the EC intends to prepare with the ARC a detailed request for endorsement advice, so that EFRAG is asked to provide specific assessment in areas of interest and/or concern of Member States.

EFRAG has therefore undertaken the following efforts:

- To prepare for a presentation to ARC similar to what was done on IFRS 15, i.e. highlighting the main changes from IAS 39, reporting the extent to which EFRAG's recommendations/European expectations have been met in the finalization of the standard, and on results of the field tests conducted throughout the standard setting process;
- To run in EFRAG TEG educational sessions so as to be ready to issue an advice to the EFRAG new Board, assessing the final standard on the basis of qualitative characteristics, including whether the standard can be assessed as requiring prudent accounting.

It is expected that the request for endorsement advice may be received by EFRAG either at the time or shortly after the new organisation has entered into force. Working on IFRS 9 draft endorsement advice will therefore be one of the first items on the new Board agenda, with the objective of starting public consultation in December 2015 or January 2016.

### *Other IFRS publications*

Some narrow scope amendments are about to be finalized or have been finalized. EFRAG TEG has proceeded with the preparation of endorsement advice without delay. None of the items in this work in process should cause concern or heavy work by the EFRAG Board when it starts its work.

## **7- Participation in the IASB standard setting process**

EFRAG has continued monitoring the deliberations of the IASB, leading to final standards in the Lease and Insurance projects, leading to an exposure draft in the Revision of the Conceptual Framework project and to a Discussion Paper in the Rate Regulated Activities project. It has also issued its draft comment letter on the IASB DP *Dynamic Risk Management* and finalized its contributions to the post-implementation review of the Business Combinations package.

### *Leases*

As reported back in May, the IASB and FASB have diverged in their pre-final decisions on lessee accounting. Furthermore the latest deliberations of the two Boards on the definition of a lease, i.e. the scope of asset and liability recognition in lease arrangements, do not satisfy the call received from EFRAG/Europe throughout the project that a better boundary should be drawn between leases and services, so as to be consistent with the objective of the project, i.e. account for leases which are akin to financing arrangements as is done for other borrowings of the entity.

EFRAG and the National Standard Setters of France, Germany, Italy and the UK have therefore undertaken a supplementary round of public consultation during the summer, in order to collect further input on those arrangements that would be scoped

in although they are considered by constituents as service contracts, and to indicate whether there was more support for the IASB or the FASB model, taking into account both aspects of relevance and cost. The results of this supplementary consultation that is due to culminate in a round-table event in Brussels on 15 September will be released so as to support European participation in the September ASAF meeting. Furthermore the EFRAG staff has developed a paper to serve as a basis for discussion of the boundary between leases and services at the next ASAF meeting. The paper builds on former discussions either with individual EFRAG TEG members or with NSS staff/board members. EFRAG staff had in the past brought to EFRAG TEG numerous papers to support EFRAG being proactive on the issue; however those efforts have never been fruitful as the EFRAG TEG deliberations failed to take as a starting point the stage reached by the IASB in its redeliberations.

#### *Insurance*

The IASB re-deliberations have also been closely monitored with many interactions between EFRAG and the IASB, including notably participation of IASB Board and staff members in the EFRAG Insurance Working Group, in addition to their participation in EFRAG TEG meetings.

Progress in defining the general insurance contract model has been satisfactory and most of EFRAG's recommendations have been followed. Specifics applicable to insurance contracts with participating features, a very significant part of the business of insurance companies, are still under intense discussions.

In its comment letter on the last ED, EFRAG expressed support for the principles on which the so-called "Industry proposal" was based. Subsequently, in June and September, EFRAG TEG has considered and approved a fuller description of the approach that is fully consistent with the general model. It should be noted that this approach has the support of both auditors and preparers in the Insurance Working Group.

EFRAG has also liaised with the CFO Forum who has expressed serious concerns after discussions and exchange of views with the IASB, as the IASB seems to want to isolate the insurance company share in investment returns from the underwriting income, although from a business perspective it would be artificial to isolate them as if they were arising from a distinct business activity.

Insurance contracts with participating features will be discussed at the September ASAF meeting also, and the IASB has postponed to after that meeting any decision making in this area.

Finally the CFO Forum has expressed the strong view that IFRS 9 should not be endorsed in Europe before IFRS 4 has been fully sorted out.

#### *Conceptual framework*

In the past few months, EFRAG has been primarily busy monitoring the IASB progress in its deliberations towards an Exposure Draft.

As we know the revision of the conceptual framework has raised high expectations in Europe, in particular because it is expected to provide guidelines on when to report changes in assets and liabilities in P/L or other comprehensive income. Distinctly from the majority view so far expressed in Europe, the IASB has decided to propose that all changes in assets and liabilities should be presumed to be reported in profit or loss. In the past, the IASB had triggered strong rejection in Europe in its attempts at eliminating profit or loss. When the IASB today insists on P/L being the primary

measure of performance and sets as principle that all changes in assets and liabilities should be reported in P/L, it is doubtful that this position would satisfy the majority view in Europe, even though the first statement (P/L maintained as primary measure of performance) seems to be fully satisfactory. The IASB has also decided to give more prominence to the objective of assessing stewardship and to reinstate the qualitative characteristic of prudence, albeit without meeting the full extent of our recommendations.

Thanks to the proactive work performed on the conceptual framework by EFRAG so far, and all work that has been done monitoring, and interacting with, the work of the IASB in the project, the EFRAG Board should not encounter big difficulties in bringing EFRAG's views on the exposure draft to be published by the end of 2014.

#### *Rate Regulated Activities (RRA)*

Since the beginning of this project, EFRAG has benefited from the invaluable input brought by its Working Group and from the excellent interaction between its staff and the IASB staff (this is the case in every project, however the IASB staff on RRA is more particularly open to EFRAG's work).

To support an educational session on all issues that are likely to be dealt with in the Discussion Paper, the EFRAG staff has run a survey with Working Group members during the summer. This has been the basis for a very productive session in the September EFRAG TEG meeting.

It is now expected that the Discussion Paper will be issued mid-September; a first draft of a draft comment letter will be discussed in a conference call with members of the Working Group in the second part of September. It is therefore likely that EFRAG TEG will be in a position to release a draft comment letter after its October meeting.

It is worth noting that there is a strong convergence in views among the RRA Working Group and with and within EFRAG TEG so far.

#### *Accounting for dynamic risk management activities.*

EFRAG has issued its draft comment letter on the discussion paper in June, two months after the DP was issued. A strong consensus has arisen that the model applied to all portfolios that are dynamically managed should be rejected, and the IASB's efforts be guided into hedge accounting again. EFRAG has acknowledged that the IASB had conducted a very thorough analysis of how interest rate risk was managed in large banks and that it has entered boldly and positively into new territory with its proposals.

In the course of the summer EFRAG staff has run a proactive outreach program to various stakeholders to get an understanding of whether the analysis of interest rate risk management would be relevant for the management of other risks; to evaluate the operational implications of the model limited to risk mitigation; to explore whether some alternatives to the IASB's proposals were worth investigating further.

EFRAG is expected to finalise its comment letter on the DP before the end of October.

Except for narrow scope amendments, there is no other work in progress at the moment. EFRAG has since May completed its work on the post implementation of the Business Combinations package. This has led EFRAG to summarise findings in its outreach activities with preparers on the one hand, with users on the other. It is worth noting that more users than preparers have participated in EFRAG's outreach



initiatives. This very positive effort is due to EFRAG coordinating its efforts with EFFAS, it is worth mentioning the heavy involvement of Serge Pattyn, EFRAG TEG member and member of EFFAS Accounting Working Group (and of course of the EFRAG staff team in charge of the project). This should be noted as one of the very positive outcomes of our special outreach effort to users that has been developed in the last three years.

## **8- Early stage proactive activities**

EFRAG has conducted its proactive activities with the aim of leaving to the new Board as clean a plate as feasible, so that the new EFRAG Board can make its own agenda decisions and provide directions for the organisation of proactive work in the future.

As a result since May:

- EFRAG, the FRC and the ANC have published a feedback statement reflecting comments received on their Research Paper investigating what role the business model should play in financial reporting;
- EFRAG, ICAC, RJ and OIC have published their Discussion Paper on *IFRS Separate Financial Statements*;
- EFRAG has issued an educational paper on *Classification of claims* to help frame the debate in Europe and beyond on the distinction between liabilities and equity;
- EFRAG has issued two supplementary papers in its Short Discussion Series:
  - ✓ A review of what changes in IFRS are needed to avoid the outcome of the interpretation on Levies: the paper was prompted by some ARC members requesting that the revision of IAS 37 “Provisions” be considered as a priority by the IASB;
  - ✓ A paper discussing possible accounting treatment of step ups in business combinations: the paper was initiated as a response to one of the main issues raised in the post-implementation of IFRS 3, i.e. that performance of the group after a significant business combination may be difficult to analyse.
- Work has been stopped on two other initiatives, one summarizing what had been learned from the discussion on the presentation of financial statements and the other illustrating how the IFRS IC and IASB could adopt a more principle based approach to narrow scope amendments.
- EFRAG has published together with the ASBJ (Japanese NSS) and the OIC a paper produced by a joint Research team on the Accounting for goodwill.

The only work in progress that remains is the development of bulletins as part of EFRAG and NSS proactive effort in the conceptual framework dealing with the unit of account and the cash flow statement.

The EFRAG PRC is also to discuss and finalise a “legacy” document that has been prepared in the course of the summer.