



EFRAG TEG **UPDATE** JANUARY 2008

Summary of the EFRAG meetings in December 2007 and January 2008

On Monday 17 December 2007 EFRAG TEG (EFRAG) met with the European National Standard-Setters in EFRAG's Consultative Forum of Standard-Setters (CFSS) to discuss:

- The IASB/FASB's Business Combinations project
- The PAAinE project on Pensions

On Tuesday 18 and Wednesday 19 December 2007 EFRAG held its monthly meeting and discussed:

- The PAAinE project on Pensions
- The ED of proposed amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*.
- The IFRIC project on Distributions of Non-cash Assets to Owners
- The IASB Discussion Paper on Insurance Contracts
- IAS 23 *Borrowing Costs* Effects Study
- IFRIC 12 *Service Concession Arrangements* Effects Study
- The IASB/FASB Framework project's on the Objectives of Financial Reporting

Finally, on Wednesday 16 to Friday 18 January 2008 EFRAG met again and discussed:

- The ED of proposed amendments to IFRS 2: Group and Treasury Share Transactions
- IAS 23 *Borrowing Costs* Effects Study
- IFRIC project on Customer Contributions
- The IASB's Annual Improvements project
- The IASB Discussion Paper on Insurance Contracts
- ED 9 *Joint Arrangements*
- The IFRIC project on Distributions of Non-cash Assets to Owners
- IFRIC 14 *The Limit of a Defined Benefit Asset, Minimum Funding requirements and their Interaction* Effects Study
- IAS 1 (Revised) *Financial Statement Presentation* Effects Study

EFRAG meeting with the National Standard-Setters on 17 December

At EFRAG's meeting with the European National Standard-Setters in late December, participants received a presentation from Alan Teixeira, the Senior Project Manager at the IASB responsible for **the IASB/FASB's Business Combinations project**. The presentation, and subsequent discussion, focused on key aspects of the revised IAS 3 *Business Combinations* and IAS 27 *Consolidated and Separate Financial Statements*, how the new requirements compare to previous standards and to the equivalent new requirements under US GAAP, some key aspects of the IASB's consultation and the feedback the IASB received from constituents during that process.

It is currently expected that EFRAG will start evaluating the revised standards and supporting material at its February meeting.

The National Standard-Setters and EFRAG decided a few years ago to launch an initiative (subsequently named the Pro-active Accounting Activities in Europe or PAAinE) that, it was hoped, would enhance Europe's ability to participate actively and on a timely basis in the global accounting debate on accounting. To date, papers on the Framework, Performance Reporting, Stewardship and Revenue Recognition have been issued. At the December meeting participants received a presentation on **the PAAinE project on Pensions** from the project leaders, the staff of the UK Accounting Standards Board. The presentation focused on the main issues addressed in a discussion paper that was subsequently issued in final form at the end of January 2008.

EFRAG meeting on 18 and 19 December

For some months now EFRAG has been discussing aspects of the draft paper being prepared by the UK standard-setter in **the PAAinE project on Pensions**. The paper is looking at all aspects of accounting for pensions and other post-employment benefit plans. This is being done because there is a widely-held view that the accounting standards around the world on accounting for post-employment benefit plans need to be rethought, and Europe has some views on how the accounting for pensions can be improved. At its December meeting EFRAG took its final look at the paper and agreed that EFRAG should issue the paper.

The paper has now been issued and is available from EFRAG's website (www.efrag.org).

EFRAG also discussed **the IASB ED of proposed amendments to IFRS 1 and IAS 27 Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate**. The IASB originally issued an exposure draft on this subject back in January 2007, when it explained that it was proposing to grant some relief to first-time adopters from the requirements in IFRS 1 and IAS 27 that parent entities in their individual financial statements should measure their investments in subsidiaries at cost or fair value and should, for the purposes of applying the cost method, distinguish between the subsidiary's accumulated pre-acquisition profits and post-acquisition profits. EFRAG, in its comment letter, had supported what the IASB was trying to do, but had expressed concern about how it was proposing to do it. The IASB, having considered the comments received, has revised its proposals.

EFRAG considered the IASB's new proposals and tentatively concluded that they met the concerns it had raised previously. It therefore asked staff to prepare a draft comment letter supporting the proposals in the ED. It was also agreed that the draft letter should ask constituents for views on one aspect of the ED's proposals concerning a mandatory impairment test for all entities receiving dividends from an investment in subsidiaries, jointly controlled entities and associates.

EFRAG's draft comment letter has been issued for comment and is available from EFRAG's website (www.efrag.org).

At its December meeting EFRAG also discussed **the IFRIC project on Distributions of Non-cash Assets to Owners**. The purpose of the discussion was for EFRAG heard to start developing some thoughts on the tentative IFRIC conclusions that were subsequently issued as IFRIC D23.

The first issue D23 addresses is which standard should apply to the obligation that arises when an entity agrees to make a non-cash distribution to some or all of its owners. EFRAG members agreed with IFRIC's tentative view that it should be IAS 37, although they did not all agree with the IFRIC's reasoning. The second issue addressed is how should that IAS 37 liability be measured, particularly if the non-cash asset to be distributed changes in value. IFRIC's tentative view is that the entity should "consider" the fair value of the assets to be distributed to measure the related liability. EFRAG members had different views on this proposal, not least because of the potential accounting mismatch that would arise were the liability to be measured at the fair value of the asset whilst the asset is measured at a cost-based amount.

EFRAG's consideration of D23 continued at the January meeting.

EFRAG also discussed **the IASB Discussion Paper on Insurance Contracts** and, in particular, the comments EFRAG had received on its draft comment letter on the discussion paper. The focus of EFRAG's discussion was on the measurement of insurance liabilities, and the tentative decisions taken were that EFRAG's final letter should contain the following main messages:

- EFRAG agrees that the insurance liabilities should be measured at the present value of an explicit unbiased probability weighted estimate of future cash flows, plus an explicit margin of some kind. EFRAG also agrees that the explicit margin should as a minimum represent the cost of capital, but is undecided as to whether it should include other elements (ie it is undecided as to exactly what the explicit margin should represent) and how the explicit margin should be released into profit and loss.
- There is a strong link between a number of the key issues raised in Discussion Paper and other major IASB projects (such as performance reporting, revenue recognition, IAS 37, fair value measurement, equity/liability, etc). EFRAG's inability to reach a conclusion as to what the explicit margin should represent (ie what the measurement objective should be) illustrates why it is so important for the IASB to accelerate its consultations on parts of those linked projects so that a comprehensive debate can take place in a proper context, and a broadly-based decision can then be taken and then used as the basis for the Insurance IFRS and a number of other important or revised new standards.
- The Discussion Paper's proposals as to the cash flows an insurer should take into account in arriving at an explicit unbiased probability weighted estimate of future cash flows are problematic in that they do not appear to capture fully the economics of insurance activity as regards beneficial policyholder behaviour. EFRAG encourages the IASB to continue to identify and explore other possible approaches. If accounting theory results in an unsatisfactory accounting result, the accounting theory might need to evolve.
- Broadly speaking, EFRAG supports the application of an expected cash flows approach in respect of contracts with discretionary participating features, but also believes it is important to provide additional disclosures about the expectations used and how they have changed.
- EFRAG believes that the unit of account should be the entire insurance contract rather than each of the rights and obligations arising from the insurance contract.

EFRAG discussed the other issues raised by respondents at its January meeting.

In October the European Commission and EFRAG decided that in future, prior to taking endorsement decisions, more extensive work on the costs and benefits of Standards and Interpretations needs to be carried out. The IASB has apparently agreed to carry out such work when developing proposals for major new Standards and Interpretations, but that commitment will not cover projects already well-advanced and material issued but not yet endorsed. It has therefore been decided that, for the projects on which EFRAG has already finalised its endorsement advice (ie IFRIC 12 *Service Concession Arrangements* and IAS 23 (Revised) *Borrowing Costs*), the European Commission will be responsible for carrying out the additional work; and for the other projects EFRAG will extend the scope of its endorsement advice work in order to incorporate such studies. On the projects that are the European Commission's responsibility, the Commission has asked EFRAG, as its technical adviser on accounting matters, to prepare certain technical material for it. At its December meeting EFRAG considered drafts of two of those pieces of material.

- The first piece concerned **the IAS 23 Borrowing Costs Effects Study**. The Commission has asked EFRAG to prepare an analysis, in non-technical language, of the arguments for and against capitalising borrowing costs and for and against expensing borrowing costs.
- The second piece concerned **the IFRIC 12 Service Concession Arrangements Effects Study**. As it has been suggested that IFRIC 12's interpretation of existing IFRS is not the only interpretation possible, the Commission has asked EFRAG to provide it with an analysis of the other interpretations suggested. EFRAG is not an interpretations body, so it intends to limit its analysis to gathering together relevant material available from existing sources.

EFRAG discussed a first draft of both analyses and provided the staff with comments and advice on how to improve them.

EFRAG also discussed the work being carried out in **the IASB/FASB project on the Framework on the Objectives of Financial Reporting**. In July 2006, the two Boards issued a discussion paper *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*. The current expectation is that an exposure draft on the subject will be issued in Q1 2008, and the purpose of EFRAG's discussion was to consider how the Boards had responded to EFRAG's comments on the discussion paper and to have an initial discussion of the issues EFRAG might want to raise on the exposure draft.

EFRAG members noted that one of the main changes that had been made was that the objective of financial reporting had been broadened. EFRAG had been concerned about the previously proposed objective because EFRAG believed it did not fully encompass the stewardship objective that EFRAG believes at least some financial reports have. EFRAG members broadly supported the change, although some thought it would be preferable to have a separate and explicit stewardship objective. EFRAG will continue to monitor this project closely.

EFRAG meeting on 16 to 18 January

In December, the IASB issued an **ED of proposed amendments to IFRS 2: Group and Treasury Share Transactions**. EFRAG started the New Year by discussing the ED and gathering its thoughts for inclusion in a draft comment letter. IFRS 2 applies to all share-based payment transactions as defined and also to certain equity-settled arrangements that would be share-based payment transactions did they not involve the equity instruments of one entity in a group being used to pay for the goods or services received by another entity in the same group. The ED proposes to bring within the scope of IFRS 2—and to set out how to account for—cash-settled arrangements that would be share-based payment transactions did they not involve one entity in a group paying in cash for the goods or services received by another entity in the same group. EFRAG members broadly agreed with the ED's main proposals with some reservations. The main proposals are that:

- such arrangements should be accounted for under IFRS 2;
- such arrangements should be accounted for as cash-settled transactions; and
- the entity receiving the goods and services (but not directly paying for them) should account for the credit side of the entry as a capital contribution.

A draft comment letter will now be prepared and, in due course, issued for public comment.

As explained above, the European Commission has asked EFRAG to prepare on its behalf an analysis of the arguments for and against capitalising borrowing costs and for and against expensing borrowing costs for inclusion in **the IAS 23 Borrowing Costs Effects Study** work the Commission is carrying out. An initial draft of a possible analysis was discussed at the December meeting, and a revised draft was discussed at the January meeting. EFRAG provided the staff with further comments and advice on how to improve the analysis. It is expected that this analysis will be finalised and submitted to the Commission by early March.

Last November EFRAG had an initial discussion of some of the tentative conclusions being reached in **the IFRIC project on Customer Contributions**. At its January meeting it considered the draft Interpretation on the subject, IFRIC D24 *Customer Contributions*. When building a new house, the housebuilder will attach to the house water pipes and electricity cables that are in due course connected to the networks of a water access provider and an electricity access provider respectively. That water pipe and electricity cable are what D24 calls 'customer contributions'. D24 notes that, sometimes cash is contributed to the access provider, which is then obliged to acquire or construct an item of plant, property and equipment (PP&E) that it must use to provide access to a supply of goods or services to one or more customers. The main issues D24 addresses are:

- when there has been a non-cash customer contribution, should the access provider recognise the contributed asset as an asset or not? And, if it does, at what amount should it be recognised and what should the double-entry be? D24 suggests that the material in existing IFRS should be used to determine whether an asset has been received and should be

recognised. D24 then goes on to propose that, when the customer contribution does involve the access provider receiving a non-cash asset (and the access provider is not deemed to have finance leased that asset to anyone), the access provider should recognise the asset at its fair value and should recognise a liability (to provide access to a supply of goods or services). That liability should be 'released' into profit and loss over the shorter of the period for which the access provider has agreed to provide access in return for the asset or the useful life of the asset. EFRAG members raised a number of concerns about these proposals.

- when there has been a non-cash customer contribution that involves the access provider receiving an asset and then finance leasing the asset to someone, the access provider recognises neither an asset nor a liability. EFRAG members generally thought proposal was inconsistent with the existing material in IAS 17 on sale-and-finance leasebacks, which would require the access provider to recognise a lease receivable.
- when the customer contribution involves the access provider receiving cash, the access provider should determine whether it has in effect sold the item of PP&E that it is required to acquire or construct and use to provide access to a supply of goods or services to one or more customers. If it is not deemed to have sold the PP&E, the access provider should recognise a liability to use the asset to provide access. That liability should again be 'released' into profit and loss over the shorter of the period for which the access provider has agreed to provide access in return for the PP&E or the useful life of the PP&E. Again EFRAG members had some concerns about these proposals.

A draft comment letter will now be prepared and, in due course, issued for public comment.

EFRAG also discussed at its January meeting the comments it received in response to its draft comment letter on the first exposure draft issue under **the IASB's Annual Improvements project**. Although the letters received were generally in agreement with most of what EFRAG's draft letter said, EFRAG re-debated in detail many of the comments it had made in the draft. The main changes agreed to the draft were as follows.

- EFRAG decided to amend its comment on the treatment in the cash flow statement of assets held for rental (Issue 10). The final letter would now support the IASB's proposal, which is that both the cash outflow (when the asset is acquired) and the cash inflow (when it is sold) should be treated as investing. However, the letter would also continue to argue that the proposals deal with just one example of a much wider issue and it was that wider issue that needed to be addressed, probably outside of the Annual Improvements project.
- EFRAG decided to revise its position on the IASB proposal to replace "fall due", in IAS 19's definitions of 'short-term employee benefits' and 'other long-term employee benefits', with "employee becomes wholly entitled" (Issue 16). EFRAG had supported the proposal in its draft comment letter, as did most of EFRAG's respondents. However, following further discussion EFRAG concluded that the proposal was problematic because the "entitled to" terminology would result in uncertainties in relation to vesting and also could have unintended measurement consequences. EFRAG's letter will therefore suggest that the IASB reconsider the proposal.
- The IASB proposed to clarify the meaning of "as incurred" in the IAS 38 requirement that expenditure on advertising or promotional activities, training activities and start-up activities, and on relocating or reorganising part or all of an entity should be recognised as an expense as incurred (Issue 28). In its draft comment letter EFRAG agreed with the IASB's analysis and conclusions, but questioned whether the proposed amendment might change practice significantly and was therefore too big an issue to be dealt with in the Annual Improvements project. Having considered the comments received, EFRAG concluded it was not a minor amendment and should not therefore be dealt with in the Annual improvements project.

EFRAG has now issued its comment letter. It is available from EFRAG's website (www.efrag.org).

In December EFRAG started to discuss the letters it received in response to its draft comment letter on **the IASB Discussion Paper on Insurance Contracts**, and reached some tentative decisions on what its final comment letter should say about measuring insurance liabilities. At its January meeting it continued to discuss the letters received and to agree changes to its draft letter. The main changes it tentatively decided to make are as follows:

- In the draft letter, EFRAG disagreed with the Discussion Paper's proposal that an insurer would recognise rights and obligations created by an insurance contract when it becomes a party to the contract; EFRAG argued that the rights and obligations arising from an insurance contract should be recognised when coverage commences. In its final letter EFRAG will argue that the issues involved are much more complex than the discussion in the paper indicates, and that the IASB needs to carry out further analysis of the issue. EFRAG's tentative view however remains that it is the date on which coverage commences that is important.
- On the issue of whether diversification benefits should be taken into account in measuring insurance liabilities, EFRAG's letter should explain that EFRAG is not convinced that the proposals in the paper—which are that the diversification effects within a portfolio should be taken into account, but not those between portfolios—reflect sufficiently well the economics of insurance activity and aspects that are integral to an insurer's business model. The matter should therefore be investigated further before a conclusion is reached.

It is expected that EFRAG will finalise its comment letter in early February, at which point it will be available from EFRAG's website (www.efrag.org).

EFRAG also discussed the comments it received in response to its draft comment letter on **ED 9 Joint Arrangements**. The main proposal in the ED is that entities should no longer be permitted to use proportionate consolidation to account for their joint ventures; henceforth equity accounting should always be applied. EFRAG criticised this proposal in its draft comment letter, as had most of those responding to the draft letter. EFRAG has decided to maintain this position in its final letter. It decided also to continue to argue that the changes to the definitions and descriptions of the various types of joint arrangement that the ED is proposing should be made were unnecessary. In addition, EFRAG decided that it would continue to suggest in its letter that:

- rather than eliminate the choice entities currently have as to how to account for joint ventures, the standard should be amended to restrict that choice so that entities will apply proportionate consolidation in certain circumstances and equity accounting in certain other circumstances.
- the disclosure requirements of existing IFRS (and IFRS as amended by ED 9) do not (and would not) provide sufficient information to enable users to understand the nature and extent of the reporting entity's activities that are carried out in joint ventures.

It is expected that EFRAG will finalise its comment letter in February, at which point it will be available from EFRAG's website (www.efrag.org).

As explained above, EFRAG started to discuss **the IFRIC project on Distributions of Non-cash Assets to Owners** at its December meeting. At that meeting EFRAG tentatively agreed with the suggestion in IFRIC D23 *Distributions of Non-cash Assets to Owners* that, if an entity agrees to make a non-cash distribution to some or all of its owners, the resulting obligation should be accounted for in accordance with IAS 37. EFRAG continued its discussion of D23 at its January meeting.

- EFRAG discussed how the liability recognised should be measured under IAS 37, but again the discussion was inconclusive—primarily because EFRAG members were concerned about the accounting mismatch that would arise were the liability to be remeasured at the fair value of the asset whilst the asset is measured at a cost-based amount.
- If the carrying amount of the asset is different from its fair value, and the liability is being measured at the fair value of the asset as D23 proposes, there will be a difference to recognise when the liability is settled. D23 assumes that this difference will not be recognised until the liability is settled, and it proposes that it will then be recognised in profit and loss. An alternative view in D23 argues that it should be recognised directly in equity. EFRAG members were similarly divided over the issue.

A draft comment letter will now be prepared and, in due course, issued for public comment.

As explained above, it has been decided that more extensive work on the costs and benefits of Standards and Interpretations needs to be carried out in future. For the projects on which EFRAG has already finalised its endorsement advice (IFRIC 12 and IAS 23 (Revised)), the European Commission will be responsible for carrying out the additional work; and for the other projects EFRAG will extend the scope of its endorsement advice work in order to incorporate such studies. EFRAG discussed certain of the work being carried on two of those 'other projects', namely:

- the **IFRIC 14 *The Limit of a Defined Benefit Asset, Minimum Funding requirements and their Interaction Effects Study***; and
- the **IAS 1 (Revised) *Financial Statement Presentation Effects Study***.

In both cases EFRAG had, before it was decided that it would be necessary to extend the work EFRAG performs before giving its endorsement advice, already issued its draft endorsement advice and the comment period for the draft advice had ended. Therefore, on these projects EFRAG would need to issue a second consultative paper on endorsement; this one focusing primarily on costs and benefits. EFRAG members have previously discussed the form this second consultative paper might take and, at the January meeting, near-final drafts of both papers were discussed. EFRAG members provided the staff with comments and advice on how to improve the drafts.

It is expected that final versions of both papers will be issued in early February for public comment. As soon as they are issued, they will be available from EFRAG's website (www.efrag.org).

EFRAG will hold its next monthly meeting from **27 to 29 February** in Brussels. In addition, it is likely that in early February EFRAG will hold one or more meetings by conference call. Arrangements will be made to enable members of the public to listen to those calls, and those arrangements will be announced on EFRAG's website (www.efrag.org).

EFRAG will also be holding a meeting by conference call on 6 March 2008. Arrangements to enable members of the public to listen to those calls will be announced on EFRAG's website (www.efrag.org) towards the end of February.

EFRAG and various European National Standard-Setters have recently issued two European Discussion Papers, both of which are available from EFRAG's website (www.efrag.org).

- *Distinguishing Liabilities from Equity*, which was developed by the German standard-setter, discusses ways of distinguishing liabilities from equities. It highlights the problems with the existing approach and sets out for discussion a possible new approach: the so-called loss absorption approach. In the next few weeks the IASB will issue a discussion paper setting out for discussion three other possible approaches developed by the FASB
- *The Financial Reporting of Pensions*, which was developed by the UK standard-setter, takes a fresh look at the principles that might be reflected in future accounting standards on pensions and other post-employment benefits. The purpose of the paper is to encourage debate on an area of accounting that has recently been the subject of significant controversy.

Comments are invited by July 2008.

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