Summary of the EFRAG TEG meeting in May 2006

On Wednesday 17th to Friday 19th May 2006, the Technical Expert Group of EFRAG (EFRAG) held its monthly meeting and discussed the following topics:

- Potential matters of interpretation relating to the issues addressed in IFRIC 9
- IASB's proposals on financial instruments puttable at fair value
- Discussion Paper *Measurement Bases for Financial Reporting—Measurement on Initial Recognition*
- IASB's proposals on borrowing costs
- Insurance
- Business Combinations and IAS 37
- The PAAinE project on pensions
- The PAAinE project on the conceptual framework
- IASB Exposure Draft of Proposed Amendments to IFRS 2 *Vesting conditions and cancellations*
- IASB Exposure Draft 8 *Operating Segments*
- Revenue Recognition

When EFRAG finalised its endorsement advice on IFRIC 9 *Reassessment of Embedded Derivatives*, it identified a number of additional **potential matters of interpretation relating to the issues addressed in IFRIC 9**. At its May meeting it discussed an analysis of those issues and considered whether any of the issues should be discussed further with the IASB or IFRIC.
EFRAG noted that the standards and interpretations issued by the IASB and IFRIC together represent a principles-based, relatively high-level financial reporting framework and it is important that all stakeholders—preparers, auditors, users, standard-setters and enforcement agencies—behave in a way that is consistent with such a framework. This means, inter alia, that the IASB's standards need to be based on good clear principles and IFRIC should not be asked to supplement those principles with too many detailed interpretations.
EFRAG concluded that one of the issues discussed indicated the need for a clear principle. That issue was whether, on a business combination, a fresh view could be taken in the consolidated financial statements on issues such as the need to separate embedded derivatives, whether to apply the fair value option, the way in which financial assets and financial liabilities should be categorised under IAS 39, etc. EFRAG will discuss the matter further with relevant parties.

It is currently expected that the **IASB's proposals on financial instruments puttable at fair value** will be issued as an exposure draft (ED) before the end of July. EFRAG therefore had a preliminary discussion of the proposals likely to be made. It noted that, in the absence of the full ED, it could be difficult to understand the reasoning behind some of the proposals. However, on the basis of the reasoning as it understood it, EFRAG's initial view was that the proposals were rules-based and, although designed to address a very narrow issue, could have wider, unintended, consequences.
When the ED is issued, EFRAG will discuss the proposals in greater detail and issue a draft comment letter for public comment.

In October the IASB issued a **Discussion Paper *Measurement Bases for Financial Reporting—Measurement on Initial Recognition***, which had been prepared by staff of the Canadian standard-setter. EFRAG issued a draft comment letter on the paper in February and, at its May meeting, it considered the comments received on the draft in order to finalise the letter.
EFRAG's draft letter criticised the main conclusions reached in the paper about the superior relevance of fair value information, arguing that the reasoning underlying those conclusions was neither persuasive nor complete. It suggested a number of additional factors that needed to be taken into account in any discussion of measurement.
Of the comments received in response to the draft letter, all were critical of the Discussion paper and all but two were also very supportive of the comments in EFRAG's draft letter. Having considered the comments received in detail, EFRAG decided to retain the main messages in its draft letter but make some detailed changes to the text.
It is expected that a final letter will be issued before the end of the month and published on EFRAG's website (www.efrag.org).

The IASB will be issuing an ED containing **proposals on borrowing costs** later in May. The ED is part of the IASB's short-term convergence project and the proposal will be that the option in the existing standard (IAS 23) to expense borrowing costs will be eliminated if those costs are directly attributable to the acquisition, construction or production of a qualifying asset. US GAAP also requires interest cost to be capitalised.
In order to prepare its draft comment letter, EFRAG considered the proposals.

- Although EFRAG is supporting the IASB's efforts to achieve greater convergence of accounting practice, it was not convinced the proposals represent a significant step towards convergence because, although the proposals would mean that IFRS and US GAAP would both require capitalisation, the limited scope of the project means that the amount capitalised would differ, sometimes significantly.
- EFRAG took the view that, as the proposals do not represent a significant step towards convergence, they needed to be judged just on their technical merits (ie whether they result in an improvement in the information that is provided to users). It noted that the IASB is not arguing that capitalising the actual borrowing costs incurred is a better approach than expensing those costs, and concluded that further work is needed to determine which approach would improve the information provided.
- Although EFRAG is not generally in favour of standards that contain options, it noted that the existing IAS 23 has the advantage of allowing those companies that wished to adopt the US approach (capitalisation) to do so while not forcing other companies to adopt an approach that might be inferior to immediate expensing.

EFRAG therefore decided to suggest in its draft letter that the proposed changes should not be made; instead, work should be carried out to determine the best way of accounting for borrowing costs and the IASB (and if necessary FASB) should then encourage convergence around that approach. EFRAG's draft comment letter will be issued on EFRAG's website (www.efrag.org) soon after the ED is issued.

Towards the end of the year it is expected that the IASB will issue a discussion paper on **insurance**. To prepare itself for the paper, EFRAG will be having a series of insurance educational sessions. The first of those sessions—which was attended by members of EFRAG's Insurance Accounting Working Group and Peter Clark, the IASB Senior Project Manager responsible for its insurance project—took place at the May meeting. The session focused on the background to the IASB project, the key issues that needed to be addressed, and the links between the insurance project and other projects.

EFRAG received an update on the decisions taken recently by the IASB and FASB in their joint projects on **Business Combinations and IAS 37**. EFRAG will continue to follow the debates closely.

Last year EFRAG and the National Standard Setters (NSS) agreed to co-ordinate some of their work on the IASB's agenda so as to enable Europe as a whole to participate more fully in the development of global standards. (We refer to the activities by the acronym 'PAAinE', which stands for 'Proactive Accounting Activities in Europe'.) At its May meeting, EFRAG discussed the PAAinE projects on pensions and conceptual framework.

(a) On **the PAAinE project on pensions**, which is being led by staff of the UK standard-setter (the ASB), EFRAG discussed some of the issues being addressed in the project. Those issues included the treatment of unvested benefits, the use of corridors and similar techniques, and the circumstances in which the employing entity will have a large pension-related asset and a large pension-related liability and the circumstances in which it will have a smaller pension-related asset or liability.
The current intention is that a lengthier discussion of the issues being addressed will take place at the meeting in June between EFRAG and the European national standard-setters.

(b) On **the PAAinE project on the conceptual framework**, which is being led by staff of the French standard-setter (the CNC), EFRAG discussed an early draft of a paper that might be published as part of the project work. The paper focuses on five issues that CNC's staff had identified as worthy of discussion at this stage:
- the purpose and status of the IASB Conceptual Framework,
- whether the Framework should focus on all types of financial reporting or, for example, just on financial statements,
- whether the information needs of creditors, long-term existing investors, short-term existing investors, and potential investors are really alike,
- whether aspects of financial theory should be included in the Framework and, if so, which aspects (for example, the concept of capital maintenance), and
- issues concerning the reporting entity.

Various suggestions were made as to how the paper might be developed further. The current intention is that a revised draft of the paper will be discussed at the meeting in June between EFRAG and the European national standard-setters.

In March EFRAG issued its draft comment letter on the **IASB Exposure Draft of Proposed Amendments to IFRS 2 *Vesting conditions and cancellations***. The main proposal in the ED is that cancellations by employees of their participation in a share-based payment arrangement should be accounted for in the same way as cancellations by employers (by immediately expensing the cost that would otherwise have been recognised for that employee over the remainder of the arrangement). In its draft letter EFRAG disagreed with this proposal, arguing that an employee cancellation was more like a decision not to exercise and should be accounted for by recognising the expense over the remaining period of the arrangement. The draft supported the other proposals on the definition of vesting conditions and the transitional arrangements. At its May meeting EFRAG considered the responses it received to its draft and discussed what if any changes should be made to the letter.
- On the main proposal, views were mixed. The main argument used by those disagreeing with EFRAG's conclusion was that it might sometimes be difficult to differentiate between an employer cancellation and an employee cancellation. EFRAG accepted that employers might sometimes encourage employees to cancel if that led to a more advantageous accounting effect, but believed that the approach chosen should be the most appropriate and not simply the approach that involves the least engineering opportunities. EFRAG therefore decided to continue to express concerns about the proposal.
- On the other proposals, respondents generally agreed with EFRAG's letter. In response to those comments, EFRAG decided to suggest in its letter that additional guidance was needed on what is and is not a performance condition. That apart, no significant amendments were to be made to the comments made in the draft.

It is expected that EFRAG's final comment letter will be issued in the next few days, at which time it will be published on EFRAG's website (www.efrag.org).

The **IASB Exposure Draft 8 *Operating Segments*** was issued in January. ED 8 proposes to eliminate the current differences between IFRS and US GAAP on segment reporting by in effect issuing the US standard as an IFRS. The main implications of this are that companies would:

- split their activities into segments by reference to the segments used internally to manage their business; and
- report on the segments identified using measures used internally (and not IFRS measures, if the internal measures are not IFRS measures).

EFRAG issued a draft comment letter on ED 8 in February. In that draft, EFRAG agreed that the segments identified should be those used internally, but argued that IFRS measures rather than internal measures should be used. Some concerns were also expressed about the proposed scope of the revised standard.

At its May meeting EFRAG considered the comments received in response to its draft letter. Those responses were divided on whether internal measures or IFRS measures should be used. EFRAG discussed this issue again at length and concluded that it should argue in its final comment letter for entities to be allowed a choice as to whether to use IFRS measures or internal measures. The responses were broadly supportive of the other comments made, and EFRAG decided to leave those parts of its letter largely unchanged.

EFRAG's final letter is expected to be issued in the next few days, at which time it will be published on EFRAG's website (www.efrag.org).

The IASB and FASB have for some time now been developing jointly a discussion paper on **Revenue Recognition**. In order to enhance the awareness within Europe of the issues involved and to develop some European ideas on the subject, EFRAG and the German standard-setter are developing their own discussion paper and have been regularly discussing draft sections of the paper. At its May meeting EFRAG considered sections of the paper that discussed the Framework's asset/liability approach to accounting, the critical event and continuous approaches to revenue recognition, and the extent to which it might be appropriate to disaggregate whole contracts into part-contracts for the purposes of revenue recognition. EFRAG provided the staff working on the paper with advice and suggestions. Work on the paper will continue, and the intention is to discuss further issues with EFRAG at its June meeting.

The next EFRAG meeting will be from **13 to 15 June 2006** in Brussels. On the first day, EFRAG will mean with the European Standard Setters in the Consultative Forum of Standard Setters.

Finally, at its May meeting EFRAG members bade farewell to **Reinhard Biebel**, its Assistant Technical Director, who will be joining the staff of the European Commission later in the month. Reinhard is a founder member of the EFRAG staff team, and many of the improvements in our work and in the way we organise ourselves are down to him. It has been a pleasure to work with him and we will all miss him greatly.

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