



EFRAG TEG **UPDATE** OCTOBER 2007

Summary of the EFRAG TEG meetings in October 2007

On Wednesday 10 and Thursday 11 October EFRAG TEG (EFRAG) held its monthly meeting and discussed:

- The IASB's ED on IAS 39 *Exposures qualifying for Hedge Accounting*
- The need for some form of cost benefit study to be carried out as part of the endorsement process
- IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*
- The IASB's Annual improvements Project
- The PAAinE project on Pensions
- IFRIC 13 *Customer Loyalty Programmes*
- IFRIC D21 *Real Estate Sales*

On Thursday 25 October 2007, EFRAG also held a special meeting (via a public conference call) and discussed:

- IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*
 - IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*
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EFRAG meeting on 10 and 11 October 2007

EFRAG started its normal monthly meeting by discussing **the IASB's ED on IAS 39 *Exposures qualifying for Hedge Accounting***. The ED proposes some amendments to IAS 39 *Financial Instruments: Recognition and Measurement* to clarify what can qualify as hedgeable risks and hedgeable portions.

- Under existing IAS 39 (and subject to certain restrictions), the risk hedged can be either all of the risk inherent in a financial instrument or just one or more of the risks inherent in the instrument. However, it would appear that there is some uncertainty as to what exactly qualifies as a risk, so the ED is proposing that a list of risks should be inserted into IAS 39.
- IAS 39 also permits an entity to designate as a hedged item a portion of the cash flows of a financial instrument. Again, however, there appears to be some uncertainty as to what qualifies as a portion. The proposal is therefore to insert a list of the portions that can be designated as the hedged item.

The IASB's intention in amending IAS 39 in the way proposed is apparently to clarify the standard without causing any significant changes in practice for the vast majority of entities.

EFRAG members generally agreed that the parts of IAS 39 dealing with the hedging of risks and hedging portions need to be clarified. They also generally agreed with the amendments being proposed, although they had some detailed comments. EFRAG members discussed whether the proposals were likely to require entities to make significant changes in practice and tentatively concluded that they generally would not. A draft comment letter will now be developed for approval at the November EFRAG meeting. That draft letter is expected to be issued on EFRAG's website (www.efrag.org) in mid-November.

At the October meeting, the European Commission explained that it has been decided that more extensive work on the costs and benefits of Standards and Interpretations needs to be carried out in future. The IASB has apparently agreed to carry out such work when developing proposals for new Standards and Interpretations, but that commitment will not cover projects already well-advanced and material issued but not yet endorsed. The European Commission is therefore as a result discussing with EFRAG **the need for some form of cost benefit study to be carried out as part of the endorsement process**. Those discussions are ongoing but it is likely that EFRAG will be encouraged to extend the work it carries out in formulating its endorsement advice. This would be the case not only for Standards and Interpretations not yet issued, but also for those Standards and Interpretations on which EFRAG has not yet issued its final endorsement advice; in other words, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* and IAS 1 (Revised) *Presentation of Financial Statements*. It was noted that some further work would also need to be carried out, probably largely by the Commission, on the material on which EFRAG has already issued its endorsement advice: IFRIC 12 *Service Concession Arrangements* and IAS 23 (Revised) *Borrowing Costs*.

As a result, it was now unlikely that IFRICs 12-14, IAS 23 (Revised), and IAS 1 (Revised) will be endorsed before the end of 2007. EFRAG will continue to issue regular updates on the endorsement process on its website (www.efrag.org) in the form of Endorsement Status Reports.

At its October meeting EFRAG also discussed its endorsement advice on **IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction***. EFRAG's draft endorsement advice was that the Interpretation should be endorsed, and all the comment letters received agreed with that draft advice. However, in view of the discussions earlier about the need for some form of cost benefit study to be carried out as part of the endorsement process, EFRAG agreed to consider whether further work would need to be carried out before it would be in a position to finalise its endorsement advice.

Changes to IFRS, however small, are time-consuming and burdensome for all those with an interest in the standard-setting process. With the intention of easing the burden for all concerned, the IASB has developed a process for dealing with non-urgent, minor amendments to IFRS (termed the 'annual improvements process'). This process involves the IASB discussing proposals for non-urgent, minor amendments to standards throughout the year and then, once a year, issuing a combined ED (and eventually a combined IFRS implementing the changes). The first ED in **the IASB's Annual Improvements Project** was issued earlier this month. EFRAG discussed most of the proposals at its July and September meetings so, and at the October meeting, it discussed the remaining proposals and also an initial draft of a possible draft comment letter. EFRAG members generally supported the proposals, although they believe a few either are not appropriate or should not, for various reasons, be dealt with in the Annual Improvements project.

EFRAG's draft comment letter is expected to be issued on EFRAG's website (www.efrag.org) at the end of the month.

The PAAinE (Pro-active Accounting Activities in Europe) initiative was launched several years ago by EFRAG and the European National Standard-Setters. It was agreed that this initiative should initially concentrate on long-term pro-active work; the objective being to stimulate debate within Europe on important items on the IASB agenda at an early stage in the standard-setting process and thereby enable Europe to participate more effectively in the global accounting debate. Four PAAinE papers—on the Framework, Performance Reporting, Stewardship and Revenue Recognition—have already been issued, and several more are expected to be issued over the next few months.

At its October meeting, EFRAG continued discussing a draft of a discussion paper being prepared through the **PAAinE project on Pensions**. This project, which is being led by the UK standard-setter, 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 that the accounting standards around the world on accounting for pensions and other post-employment benefit plans need to be rethought, and Europe has some views on how that should be done. The paper is expected to be issued by the end of the year.

Some entities grant 'points', air miles or other award credits to their customers as part of a sales transaction with those customers. **IFRIC 13 Customer Loyalty Programmes** explains how existing standards should be applied to such transactions. It requires:

- the transactions to be treated as comprising two elements—the basic sale transaction and the sale of rights in respect of a future transaction;
- the fair value of the total consideration received to be allocated between the two elements by reference to their fair value; and
- recognition in the income statement of the consideration allocated to the grant of award credits to be deferred until, usually, the award credits are redeemed.

EFRAG issued its draft endorsement advice letter on IFRIC 13 in September. Although that letter raised some concerns, its tentative conclusion was that IFRIC 13 should be endorsed. At its October meeting EFRAG considered the comment letters it received in response to its draft endorsement advice letter. Although a clear majority of respondents supported EFRAG's draft conclusion; some concerns were raised about the differences between the views expressed in EFRAG's comment letter on the exposure draft of IFRIC 13 and the views expressed in the draft endorsement advice. Whilst noting that there are a number of reasons why those views can differ, EFRAG members decided that it should review the wording used in the Basis for Conclusions attached to its draft endorsement advice letter to ensure that it fully reflects the reasons why the majority of EFRAG members tentatively concluded that IFRIC 13 should be endorsed. It was also agreed that, in view of the discussions earlier about the need for some form of cost benefit study to be carried out as part of the endorsement process, EFRAG should consider carrying out some further work before finalising its endorsement advice on IFRIC 13.

EFRAG also discussed **IFRIC D21 Real Estate Sales**. In existing IFRS there are two revenue standards: IAS 11 *Construction Contracts* and IAS 18 *Revenue*. Transactions fall within IAS 11 if they involve a construction contract (a term that IAS 11 defines); otherwise, they are within IAS 18. D21 clarifies how that definition of a construction contract should be applied to real estate transactions; for example, to a contract to buy an apartment in an apartment block that is entered into before construction of the apartment has been completed.

- D21 proposes that IAS 11 applies when the contract involves providing construction services to the buyer's specification.
- D21 also proposes some features that might indicate that a particular contract is a contract that involves providing construction services to the buyer's specification. One set of features focuses on the extent of the buyer's ability to determine the major structural elements of the real estate involved; and the second set focuses on whether there is continual delivery of the work being carried out under the contract.

EFRAG discussed D21 at great length on several occasions before finalising its draft comment letter. That letter expresses a number of significant concerns about D21. EFRAG will finalise its comment letter in November after considering the letters received in response to the draft letter but, in the meantime, it discussed at its October meeting some views that were not reflected in the draft comment letter. The views relate to whether:

- D21 has the effect of widening the scope of IAS 11 and, if it does, whether that widening is desirable; and
- D21 should be amended so that both features need to be present, or perhaps both need to be absent, in order to draw conclusions about which standard to apply. (D21 currently states that the features *might* indicate, *individually or in combination*, which standard should be applied.)

No decisions were taken and the discussion will continue at the November meeting.

EFRAG meeting on 25 October 2007

EFRAG held a special meeting on 25 October to discuss, inter alia, **IFRIC D22 Hedges of a Net Investment in a Foreign Operation**. D22 clarifies that differences between the functional currency of the foreign operation and the presentation currency of the parent entity do not represent a hedgeable risk. The hedgeable risk, when a net investment in a foreign operation is involved, is the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity (ie the immediate, intermediate or ultimate parent entity of that foreign operation). D22 also clarifies that hedge accounting is

available regardless of which entity or entities within the group hold the hedging instrument (except that the instrument cannot be held by the operation that is being hedged).

EFRAG's draft comment letter on D22 is broadly supportive; it agrees with the main thrust of the proposed interpretation, but raises a number of detailed issues. At the special October meeting EFRAG considered the letters it received in response to that draft comment letter. It was noted that, although a clear majority of letters also supported D22, they too raised a number of concerns, two of which might be potentially significant.

- One such concern was that it is difficult to apply the detailed requirements of D21 whilst at the same time complying with IAS 39. This concern seems to relate where the various gains and losses are required to be recognised—in the income statement or in equity—and the extent to which the gains and losses in the income statement will be offset.
- The other concern relates to the statement in D22 that hedge accounting is available regardless of which entity or entities within the group hold the hedging instrument (except that it cannot be held by the operation that is being hedged). Some commentators suggest that, whilst this statement is correct if the hedging instrument is a derivative, it will not always be correct if the hedging instrument is a cash instrument (such as a loan).

EFRAG discussed all the comments received and agreed that several minor changes should be made to the comment letter. However, no decisions were taken on these two main concerns; instead the staff was asked to carry out further analysis so the issue can be discussed again at the November EFRAG meeting. As a result, it is likely that EFRAG's final comment letter will not be issued until mid-November. When it has been issued, it will be available from EFRAG's website (www.efrag.org).

At the normal monthly meeting earlier in October, the European Commission had explained that it had been decided that there is a need for some form of cost benefit study to be carried out as part of the endorsement process and that, as a result, it was likely that EFRAG would be encouraged to extend the work it carries out in formulating its endorsement advice. Since the meeting, discussions with the European Commission have continued. As a result, the type of additional work that needs to be carried out on several of the projects has become clearer. As it seems that the additional work needed on **IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*** would probably be the most straight-forward, the EFRAG staff prepared an initial draft of a possible report on IFRIC 14 so that the views of EFRAG members could be obtained. The draft was discussed and various comments were made. A revised draft will be discussed at EFRAG's November meeting.

EFRAG's next meeting will be on **Wednesday 7 to Friday 9 November 2007** in Brussels. A special one-day meeting will also be held in Brussels on **Friday 30 November 2007**.

EFRAG has issued, jointly with various European standard-setters, a PAAinE discussion paper entitled *Revenue Recognition: A European Contribution*. Comments on the paper are invited by 10 December 2007. The paper can be downloaded from EFRAG's website (www.efrag.org).

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