Research agenda consultation
Recommendation for new topics

Objective

1 The objective of this paper is to provide a high-level presentation and analysis of possible topics to be added to the EFRAG Research agenda. It would be useful to identify and rank those projects that EFRAG would recommend to add to the EFRAG future activities. EFRAG TEG should also take into consideration how these projects could fit into EFRAG future work, including also any additional activities arising out of the European Financial Reporting Lab.

Information for EFRAG TEG

2 Based on the input from constituents and internal discussion, EFRAG Secretariat has identified six possible candidates. The first three topics were included in the EFRAG consultation document:

(a) *Better information on intangible assets.*

(b) *Cryptocurrencies.*

(c) *Variable and contingent payments.*

(d) *Equity-liability distinction.*

(e) *Equity method of accounting.*

(f) *Accounting in a circular economic environment.*

3 For the first three projects, the paper reproduces the description from the consultation document and the main comments from constituents. The replies have not suggested substantial modifications.

Better information on intangible assets

<u>What is the issue?</u>

4 There has been a lot of debate lately about how financial reporting does not provide a full picture of the value drivers of businesses. Internally-generated intangibles such as know-how, market share, assembled workforce, research and so on play an ever-increasing role in the performance of entities, but are not recognised in the IFRS financial statements.

5 However, there are a number of challenges around recognition and measurement of these intangibles. Assessment of control is judgemental, especially at an early development stage, and future benefits are highly variable. Historical cost may have little relevance and current value would be mostly based on unobservable inputs, since there is little or no active market for intangibles (most intangibles) and they may be not tradeable separately.

6 EFRAG could start a Research project to develop alternatives to provide more relevant information on intangibles. The EFRAG Secretariat considers that a preliminary analysis of the gap between market valuations and accounting equity would provide good insights for the project - for instance, by providing evidence of whether this gap is more commonly found in specific industries.

7 However, both EFRAG TEG and the EFRAG Board have already indicated that the project should not aim at proposing accounting requirements with the view to align the carrying amount of equity to market prices.

What would EFRAG try to achieve

8 The project could address a number of aspects in relation to internally-generated intangibles. First, it could consider and describe the different categories (marketing, technological, social and reputational) and how their different features are relevant in terms of financial reporting.

9 A second aspect could be to investigate how to take into consideration uncertainties in relation to these elements, especially when they cannot be protected legally or they can be duplicated by competitors. Uncertainties can exist both in relation to the entity's ability to access future benefits, and their amount/timing.

10 A third aspect could be about developing metrics to express earnings potential and value. These metrics may not be fit as a measurement basis but could be used to disclose information in the notes to the financial statements.

11 A number of initiatives (Integrated Reporting, the World Intellectual Capital/Asset initiative….) have already taken steps to improve the reporting in this area. An important part of the Research project would be to investigate and leverage from these other initiatives for financial reporting.

Comments and analysis

12 This project is considered to be highly relevant and draws interest among respondents. However, it would be quite important to identify the scope with clarity and precision, as there is risk that the project may quickly become too large and unfocused.

13 The Academic Panel had a first discussion and advised not to proceed with the project, with members pointing out that the topic has been very widely investigated in the last decades and noting that it would be difficult for EFRAG to provide significant contribution.

14 In terms of format of the output, the EFRAG Secretariat considers that the topic is not suited for a short discussion series. It would however be possible to split the project in different phases, with each being the subject of a separate publication (like EFRAG did with the bulletins on the Conceptual Framework).

Cryptocurrencies

What is the issue?

15 A cryptocurrency is a virtual or digital currency and refers to a form of exchange that does not exist in physical form. It is not linked to any physical currency, does not have a central repository nor is it typically backed by any government or central bank. It is generally held for capital appreciation or in limited cases (and in some jurisdictions) as a means for exchange.

16 The accounting treatment of cryptocurrencies under IFRS Standards is unclear. They may not qualify as financial assets, as they neither represent a right to receive cash or other financial instruments, nor a contract to exchange assets. They may qualify as intangible assets, but they are not legally protected and have no useful life. It is also debatable that the measurement requirements in IAS 38 would provide relevant information - and the impairment issue would need to be addressed.

17 Cryptocurrencies make it easier to transfer funds between two parties in a transaction and are typically based on the blockchain technology. They are initially 'mined' but could subsequently be bought, exchanged, awarded, or granted. Mining cryptocurrencies is a specialised activity and the accounting for such activities warrant further research. There are a number of potential options to account for them and diversity has already emerged in practice under different GAAP's and potentially under IFRS.

18 Cryptocurrencies including initial coin offerings (ICO's) are undergoing rapid growth and developments, although they are also subject to extreme price volatility. ICO's are gaining increasing attention from investors, businesses and regulators, and are popular because of the ease with which they can be used to obtain public funding with less complexity and greater speed than traditional methods.

19 In December 2017, the Accounting Standards Board of Japan issued for public comment an exposure draft on the accounting for virtual currencies under local Japanese GAAP. A final Standard is expected to be issued in the first half of 2018. The Canadian Securities Exchange (CSE) announced in February 2018 the launch of a securities clearing and settlement platform based on the Ethereum Blockchain that allows companies to raise capital with security tokens. Some established exchanges have launched bitcoin futures.

20 Some European countries have discussed initiatives to facilitate the blockchain technology. However, there is also a view that global cryptocurrency regulation is necessary. Some claim that cryptocurrencies appear as a threat to the long-term financial stability. This topic is scheduled to be discussed at the forthcoming G20 meeting.

What would EFRAG try to achieve

21 The objective of the project would be to assess whether the current IFRS Standards could be used to account for digital assets or whether a new accounting model should be developed to cater for the specific characteristics of this type of virtual currency.

22 Another aspect could be to assess whether the measurement basis should be the same for all digital assets held or whether different bases may be justified based on the business model or purpose and based whether an active market exists,

23 A third aspect could be to investigate the accounting implications, including disclosure, of specific activities linked to digital assets such as held by an entity on its own behalf versus on behalf of others, mining and Initial Coin Offerings.

Comments and analysis

24 Those who expressed support noted that the issue was both conceptually relevant and important. Others instead expressed doubts on whether the issue was really widespread among European entities and also noted that the topic was already being addressed by other organisations.

25 In terms of format of the output, the EFRAG Secretariat considers that the topic is suited for a short discussion series.

Variable and contingent payments

<u>*What is the issue?*</u>

26 The issue of variable and contingent payments has been raised in different IFRS Standards recently. Both IFRS 15 and IFRS 16 include guidance on recognition and measurement. However, the guidance is not fully consistent.

27 The IFRS Interpretations Committee (IFRS IC) had a long-standing project on variable payments for tangible and intangible assets, with the objective being to address initial recognition and subsequent measurement. The project was put on hold pending completion of IFRS 16, which was expected to provide relevant guidance; however, the IFRS IC eventually did not agree to extend similar requirements to tangible and intangible assets and dropped the project.

28 There are a number of different aspects about variable and contingent payments (V&CP). The first is the moment of initial recognition. This could occur when the underlying transaction is initially recognised; when their likelihood exceeds a defined recognition threshold; or when they become due under the terms of the underlying transaction.

29 The second is the measurement basis. If these payments are recognised before they become due, then they need to be measured at an estimated amount. The basis for measurement could be fair value, expected outcome, or a single outcome (such as most likely outcome). If a probability threshold is included in the recognition criteria, the implications for the measurement basis should be assessed.

30 The third aspect is how the re-assessment should be accounted for. When these payments are related to the purchase of assets, the question arises if changes in subsequent measurement should affect the carrying amount of the asset or be charged to profit or loss.

31 A fourth aspect is whether all variable and contingent payments should be accounted for similarly. Payments could vary or be conditional on different factors: performance or output of the asset, changes in market prices and other events. Some of these factors are under the control of the management and others are not.

<u>*What would EFRAG try to achieve*</u>

32 One important aspect would be the scope definition. A fixed selling price per unit results in a total amount variable upon the number of units sold. This would not qualify for the scope of the project, however the distinction may not always be clear.

33 Also, it may be useful to define a scope with reference to only certain classes of transactions. For instance, variable and contingent employee benefits (long-term bonus, post-retirement benefits, share-based payments with vesting conditions) pose specific issues.

34 The objective of the Research would be to:

(a) Identify the accounting issues around V&CP;

(b) Assess to the extent possible the frequency, magnitude and nature of V&CP used in practice;

(c) Summarise and compare the guidance across different IFRS Standards and assess the rationale (or lack thereof) for difference in the requirements;

(d) Develop accounting alternatives and illustrate the relevant strengths and limitations for each alternative; and

(e) Consider improvements in presentation and disclosure.

Comments and analysis

35 There was less support for this topic compared to the previous two. Supporters confirmed that there are diverging practices in the treatment of variable payments. Others questioned that the topic was really urgent or a priority for European constituents.

36 In terms of format of the output, the EFRAG Secretariat considers that the topic could be suited both for a full discussion paper or a short discussion series, with the latter being preferable if the focus is mostly on practical solutions.

Equity-liability distinction

What is the issue?

37 The distinction between liabilities and equity is of great importance because it affects, for example, gearing (leverage) and solvency ratios, which may result in a breach of debt covenants and may be important if the company is required by law to maintain a certain level of equity

38 Currently, the key challenges of IAS 32 *Financial Instruments: Presentation* can in general be classified as:

(a) conceptual issues: IAS 32 includes complex exceptions that override the definition of a liability in the Conceptual Framework, which make it inconsistent within itself and with other standards; and

(b) application issues: the lack of clarity in the existing guidance and the absence of guidance on some issues leads to divergence in practice, for example the application of the fixed-for-fixed condition to derivatives on own equity and the accounting for instruments for which the form and/or amount of the settlement depends on events beyond the control of the entity and the counterparty.

39 To address these issues, the IASB is considering potential improvements to the classification, presentation and disclosure requirements of financial instruments under the scope of IAS 32, including the possibility of making amendments to the definitions of liabilities and equity in the Conceptual Framework.

What would EFRAG try to achieve

40 In theory EFRAG could investigate alternative accounting approaches to the distinction between equity and liability. However, the EFRAG Secretariat notes that the publication of the IASB Discussion Paper on FICE is imminent. The investigation and development of alternative accounting approaches would require a significant amount of time and does not seem compatible with the current timetable of the IASB project. Moreover, it is likely that the feedback from constituents on any EFRAG proposals would duplicate their feedback on the IASB paper.

41 EFRAG is planning to conduct an early impact analysis of the IASB proposals, including investigating how this would affect existing instruments and the size of the potential accounting impact. Given the lack of information publicly available, this will need to be achieved by some form of consultation also to assess possible behavioural changes.

Comments and analysis

42 In 2014 EFRAG published a paper *Classification of Claims* to contribute to the conceptual debate. The paper did not aim to identify how the distinction should be made, but discussed the process and the objectives of the classification of claims and how different approaches measured to the objectives.

43 EFRAG received 11 replies to the consultation, mostly from national Standard Setters. Respondents generally supported the identified framework and choices to be taken, but in a number of cases disagreed with how the identified objectives were described and derived and/or the relative priority assigned to them.

44 Most respondents also called for a binary classification model, with a positive definition of a liability and a negative definition of equity

45 The respondents to the Agenda consultation that proposed this topic expressed a concern that the IASB may develop an approach designed to prevent abuse and regulate specific types of instruments, rather than a principles-based approach.

Equity method of accounting

What is the issue?

46 In recent years, when IASB has addressed issues involving the use of the equity method, there has been considerable debate. The IASB published and then deferred indefinitely the amendments to IAS 28 on sale or contribution of assets between an investor and its associate. More recently, the amendment on the application of IFRS 9 to long-term interests that form part of the net investment in an associate to which the equity method is not applied raised controversy.

What would EFRAG try to achieve

47 A project on the equity method of accounting could investigate different aspects. A first aspect would be a comprehensive reflection on how to best reflect the economics of the relationship between an investor and an associate/ joint venture. IAS 28 describes how to apply the equity method, but does not explain clearly what its objective really is.

48 A second aspect would concern the scope of application of the method, both in relation to the consolidated and individual accounts of the investor. That would include a reflection on whether the same method is appropriate for both associates and joint ventures (or all types of joint ventures) and what components should be considered as part of the investor's interest.

49 A third aspect would be to consider the application issues, in relation for instance to transfers and contributions from and to an associate, accounting for step acquisitions and the application of impairment.

Comments and analysis

50 In January 2014, EFRAG issued the paper *The equity method: a measurement basis or a one-line consolidation?* with the objective to assist the IASB to develop a clear set of principles for the basis of the equity method, before they address inconsistencies through narrow-scope amendments to IAS 28

51 The paper did not intend to reach a conclusion on the conceptual nature of the equity method and did not discuss its scope of application.

52 EFRAG received replies from nine constituents, mostly Standard Setters. Replies confirmed the need to clarify the objective of the equity method and the existence of application issues but highlighted the lack of a shared view. Some respondents expressed doubts that the discussion on the conceptual nature of the equity method would assist in addressing the issues.

53 It would be of key importance to clearly define the project approach. A focus on the application issues may result in identifying practical solutions, but with the risk of creating conceptual inconsistencies. However, the feedback on the 2014 paper highlights the risk that a conceptual debate may fail to identify a shared solution.

Accounting in a circular economy

What is the issue?

54 Circular economy refers to measures that are directed to maintain the value of products and materials as long as possible. The objective of a circular economy is to replace a 'take-make-dispose' model with a model where goods are re-used and reparability, durability and recyclability are encouraged.

55 From an accounting perspective, the issues that are raised are about the shared use of an asset over its useful life and entitlement to different economic benefits.

56 There may also be impacts in terms of new ways to finance projects, share economic benefits or end-of-life obligations, such as decommissioning costs, and distribute goods or services (pay-per-use versus legal sales).

What would EFRAG try to achieve

57 The project could consider how traditional notions such as control, property and use may need a new articulation in the context of a circular economy.

58 While EFRAG Secretariat does not think that one objective of accounting standards is to promote specific business models or practices, the project could also consider the broader impact of alternative accounting approaches.

Comments and analysis

59 The EFRAG Secretariat considers that this topic has the potential to be innovative and original. While the circular economy is part of the broader debate on sustainability, and as such is likely to draw attention from constituents, its narrower focus may make the project more manageable. A research project on the accounting implication of the circular economy has also potential synergies with future Reporting Lab initiatives.

60 The topic has been proposed by a single respondent. At this stage, it would require a preliminary work to understand what type of transactions and accounting issues it could encompass, and whether there could be a common model to address them. The risk is that the project ends up as a series of narrow-scope accounting issues unrelated to each other.

61 In terms of format of the output, the EFRAG Secretariat considers that the topic is not suited for a short discussion series.

EFRAG Secretariat recommendation

62 The EFRAG Secretariat has considered the projects both under the profile of relevance and feasibility. A premise should be made that for each candidate, some preliminary work would be required to fine tune the scope and plan. That being said, the EFRAG Secretariat would recommend to select the projects on *Better information on intangible assets, Cryptocurrencies* and *Variable and contingent payments.* The EFRAG Secretariat considers that the activities already planned by EFRAG on the IASB FICE projects will allow to address satisfactorily the topic.

Questions for EFRAG TEG

63 Do you agree to recommend three new Research topics to be added to the EFRAG Research agenda?

64 Do you agree that EFRAG does not need to add an independent Research project on the equity-liability distinction because its already planned activities are already sufficient to address the topic?

65 Do you agree with the EFRAG Secretariat analysis and recommendation?