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EFRAG Research activities – new Agenda topics
Issues Paper

Objective

1 It is expected that some of the active EFRAG Research projects will be completed during 2018 (see Paper 10-03 for more details). The EFRAG Secretariat considers that there is capacity to add two new Research projects to the agenda.

2 The EFRAG Secretariat has conducted some initial research on possible areas in IFRS Standards that would benefit from improvement and/or clarification and collected some preliminary input from EFRAG working groups and has short-listed a number of possible Research projects.

3 In January, the Secretariat has submitted a list of six potential topics to EFRAG TEG. EFRAG TEG considered that five of them had merit and should be included in an Agenda consultation.

4 When identifying the topics, the EFRAG Secretariat has assessed a number of factors:

   (a) Where the topic currently sits on the IASB work plan;

   (b) EFRAG publications in recent years;

   (c) How the EFRAG Research could be used to influence the IASB work;

   (d) Current and future activities from other Standard Setters;

   (e) How evidence could be collected.

5 This paper identifies the following topics and presents a case-plan for each of them:

   (a) Transaction-related costs;

   (b) Better information on intangible assets;

   (c) Derecognition;

   (d) Disclosure of interests in subsidiaries;

   (e) Variable and contingent payments

Transaction related costs

What is the issue?

6 When an entity acquires an asset, a business, a contract, a liability or an equity instrument it generally incurs costs associated with the acquisition. IFRS Standards use different terms to refer to these costs, such as directly attributable costs, acquisition-related costs, incremental costs and transaction costs. This paper refers to this type of costs as acquisition-related costs. Depending on the applicable IFRS Standard, acquisition-related will either be capitalised (generally added to or deducted from the amount initially recognised as an asset or a liability), expensed or recognised in equity.

7 From a conceptual perspective, it is not always clear why IFRS Standards require different accounting for acquisition-related costs. A second issue is which costs qualify for capitalisation when an IFRS Standard requires capitalisation. As already mentioned above, a third issue is one of terminology, as IFRS Standards use different terms to describe similar type of costs. Examples of IFRS Standards that refer to acquisition-related costs and similar costs include:

(a) IAS 16 *Property, Plant and Equipment* (PPE) require that **directly attributable costs** required to bring the asset to its location and condition necessary for its intended use, are capitalised as part of the cost of an item of PPE. Although IAS 16 provides examples of directly attributable costs, in practice questions still arise about which costs qualify for capitalisation.

(b) IFRS 3 *Business Combinations* requires an entity to account for **acquisition-related costs** as expenses in the periods in which the costs are incurred and the services are received. The reasoning is that acquisition-related costs are not part of the exchange transaction between the acquirer and the acquiree (or its former owners), they are not considered part of the business combination. In contrast, IFRS 3 (as issued in 2004) required the acquisition-related costs to be included in the cost of a business combination.

(c) IFRS 9 *Financial Instruments* requires **transaction costs** to be included in the initial measurement of financial assets and liabilities unless they are carried at fair value through profit or loss, in which case the transaction costs are expensed immediately in profit or loss. Transaction costs include only those costs that are directly attributable to the acquisition or origination of a financial asset or issue of a financial liability.

(d) IAS 32 *Financial Instruments: Presentation* requires that **incremental costs** which are directly attributable to equity transactions (such as issuing new shares or buying back own shares) are recognised in equity. Costs which are not considered as ‘incremental’ should be expensed as they are incurred.

(e) IFRS 15 *Revenue from Contracts with Customers* requires an entity to recognise as an asset the **incremental costs** of obtaining a contract with a customer if the entity expects to recover those costs. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission). Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are recognised as an expense.

(f) IFRS 16 *Leases* requires any **initial direct costs** incurred by a lessee to be included in the initial measurement of the right-of use asset. For a lessor, initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. Initial direct costs are defined as incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease. For an operating lease, a lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

8 There are a number of different aspects about acquisition-related costs. One aspect is that the accounting for acquisition-related costs is a key difference[1] between the accounting for asset acquisitions and business combinations for which there is no clear conceptual basis.

9 Another aspect is that some argue that there is a tension between recognising share issuance costs in equity and including them in the initial measurement of a financial asset and financial liability that is measured at amortised cost. Furthermore, it is not always clear which costs quality for recognition in equity and which ones should be included in the measurement of a financial asset or financial liability.

Objective of a Research project

10 A Research project would start with an analysis of how transaction-related costs are treated in different IFRS Standards and which costs are considered ‘qualifying costs’.

11 A Research project would examine whether transaction-related costs should be accounted for similarly, and if so, seek to develop a common principle to account for acquisition-related costs under IFRS. This would enhance consistency in IFRS reporting and help to reduce (or justify) the tensions in existing IFRS Standards caused by the different accounting treatments, such as making the distinction between an asset acquisition and a business combination and accounting for share issuance costs versus costs to issue a financial liability or acquire a financial asset.

12 The Research project would seek to develop a common definition for all types of transaction-related costs and a common principle to help determine which costs quality for capitalisation or recognition in equity. A common practice issue is deciding whether internal costs quality for this treatment. The project could also address this issue.

EFRAG TEG input

13 EFRAG TEG was highly supportive of this topic and recommended that the scope should be expanded from acquisition-related costs to transaction-related cost. Disposal costs are part of the measurement basis in a few Standards (such as IFRS 5 *Non-current Assets held for Sale and Discontinued Operations).*

14 However, EFRAG TEG recommended that an attempt is made to assess the size of the issue.

[1] The main differences are the treatment of acquisition-related costs, contingent consideration and deferred taxation.

Better information on intangible assets

What is the issue?

15 There has been a lot of debate lately about how financial reporting does not fully 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 reflected in the financial statements.

16 However, there are a number of challenges around recognition and measurement of these intangibles. Assessment of control is judgmental, 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 input, since there is little or no active market for intangibles (most intangibles) and they may be not tradeable separately.

17 EFRAG could start a Research project to develop alternatives to provide more relevant information on intangibles. 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. However, both EFRAG TEG and the Board have already indicated that the project should not aim at proposing accounting requirements with the view to align the accounting equity to market valuations.

Objective of a Research project

18 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 reporting. It should also be considered which intangibles could be subject to separate description or disclosure.

19 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.

20 A third aspect could be about developing metrics to express earnings potential and value. These metrics may not be fit as measurement basis, but could be used to provide information in the footnotes.

21 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.

EFRAG TEG input

22 EFRAG TEG was supportive of the project. However, the discussion showed that the topic is multi-layered and can be addressed under multiple perspectives. It would be essential to define the scope rigorously to avoid expectation gaps and ensure the project can be efficiently managed. Also, depending on the scope definition, specific expertise not available in EFRAG may be required.

Derecognition

What is the issue?

23 The Conceptual Framework includes a lengthy discussion on recognition criteria for assets and liabilities. Many Standards, such as IFRS 15 *Revenues from Contracts with Customers* and IFRS 16 *Leases* have added guidance to assess the conditions to recognise an item.

24 Less attention has been given on derecognition. Only IFRS 9 *Financial Instruments* includes detailed guidance to assess when an entity can achieve derecognition of financial assets (and to less extent, financial liabilities).

25 Derecognition brings along significant financial impacts. In many cases, it triggers recognition of gains, and less frequently losses. Certain items can or must be recycled out of OCI through profit or loss and others may be transferred within equity.

26 It may be argued that there is no need for specific guidance because recognition criteria can be used in a mirroring approach. However, this may not be the case in some IFRS Standards. In IFRS 16, the IASB maintained the distinction between finance and operating leases in lessor accounting: operating leases result in the lessee recognising a right to use, but the lessor does not derecognise any portion of the underlying asset.

27 In IFRS 9, transfer of substantially all risks and rewards results in derecognition of financial assets, while control acts as a fallback test. This is different from the approach in IFRS 15, where control is the condition to assess performance completion and transfer of risks and rewards is used as an indicator.

28 There are a number of different aspects around derecognition. The first aspect would be to discuss if and under what circumstances recognition and derecognition may not be specular.

29 The second could be to how to distinguish between termination and modification of a transaction. Modification is generally treated differently, but in certain conditions issues were raised about the distinction.

30 A third aspect concerns features such as put and call options, repurchase agreements or guarantees, and how they should impact derecognition of an asset/liability or of a gain.

31 A fourth aspect concerns the use of a full or partial derecognition approach for transactions like a sale-and-leaseback or a partial settlement. The use of either method may be more appropriate based no specific characteristics and has an impact of the amounts recognised in profit or loss.

Objective of a Research project

32 The project would start with a comparative analysis of how derecognition is assessed in different IFRS Standards and what are the accounting implications. It could then develop a common definition and conceptual approach for derecognition. This would be relevant also to assess when a gain/loss is considered to be ‘realised’.

33 The project would not necessarily lead to recommending changes in IFRSs but it would be useful to assess the degree of coherence across Standard and whether different treatment are justified.

EFRAG TEG input

34 EFRAG TEG was supportive but less so than the project on transaction-related costs. Some member noted that it may not be a significant issue outside financial instruments. Another member noted that the project should also address the accounting for step-acquisition, which in substance requires de-recognition of previously held interests.

Disclosure of interests in subsidiaries and joint arrangements

What is the issue?

35 IFRS 12 *Disclosure of Interests in Other Entities* combines the disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and structured entities into one disclosure IFRS Standard. IFRS 12 was developed as part of the revised IFRS 10 *Consolidated Financial Statements* and the new IFRS 11 *Joint Arrangements*.

36 At the ASAF meeting in December 2017, the DSRC presented a paper titled 'Information deficiencies of todays' group financial statements and the specific of consolidation regarding these'.

37 The DSRC paper noted that while it is widely acknowledged that transactions with and between members of the same (consolidated) group should not influence the outside appearance of that group and therefore be eliminated, such eliminations do result in a loss of information which is definitely and finally lost for outside users of financial statements. Furthermore, much of today's complexity in the environment is not captured in the consolidated financial statements although it could highly influence the position, performance and cash flows of the group (e.g. strategic alliances, negative synergies).

38 ASAF members generally agreed that consolidation led to loss of information through aggregation and the question then became how to provide lost information through disaggregation or disclosure, and there were different ways to disaggregate. A number of suggestions were made on how to address this. For example one suggestion was to have a summary in the disclosures on the impact of legal structures on the control of assets and liabilities to ensure people understood that the structure was of consequence to the understanding of the financial information, and the underlying tax assumptions. Separate financial statements were also viewed by some as playing an important role to fill the information gap.

39 In past discussions, users of financial statements have also reported concerns that consolidated financial statements were sometimes lacking information on key areas such as restrictions on cash and profits due to exchange regulations. Dividend policy at subsidiary level was also important but this information was not available at consolidation level. User often had to consult separate financial statements to obtain a comprehensive overview of dividend distribution but the problem was that the single accounts were often prepared in the national language.

40 The introduction of IFRS 11 in 2013 presented a significant change to the accounting for some types of joint venture arrangements; from proportionate consolidation to the equity method.

Research project

41 A Research project would examine whether the disclosure requirements in IFRS 12 are sufficiently robust to address the concerns of missing information in the consolidated financial statements. The project could undertake a review of the information being reported in a selection of consolidated financial statements of large listed European companies and gather feedback from users of financial statements on the reported information.

42 The loss of proportionate consolidation for joint ventures has raised some concerns about the loss of information. The Research project could examine this area and assess which information investors consider to be missing.

43 The findings of the project could also serve as input to the IASB's forthcoming PIR of IFRS 10, IFRS 11 and IFRS 12.

EFRAG TEG input

44 There were mixed views. Some members noted that measurement causes issues around investments in associates. Others suggested that there would be an interaction with IFRS 8 *Operating Segments.* It was also noted that the outcome of the IASB Principle of Disclosure may have a general impact on all disclosure requirements.

Variable and contingent payments

What is the issue?

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

46 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.

47 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.

48 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.

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

50 A fourth aspect is whether all variable and contingent payments 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.

Objective of a Research project

51 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.

52 Also, it may be useful to define a scope in 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.

53 The objective of the Research would be to:

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

(b) Outline what are the information needs for users of financial statements in regards to V&CP;

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

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

(e) Develop a number of accounting alternatives and illustrate the relevant strengths and limitations; and

(f) Consider improvements in presentation.

EFRAG TEG input

54 EFRAG TEG was supportive of the issue, and it was noted that the project is sufficiently narrow to be manageable. However, one member noted that IFRS 16 had achieved a practical solution which could be extended to other situations.

Questions for EFRAG Board

55 Do you support the topics identified above for inclusion in an EFRAG Research agenda consultation?

56 Do you have suggestions for other Research topics and why do you think these other projects would be relevant for European constituents?