BUSINESSEUROPE

EFRAG
35 Square de Meeûs
B-1000 Brussels

1 June 2018

Dear Sir or Madam,

Re: EFRAG Research Agenda Consultation

BusinessEurope appreciates the opportunity to provide comments on the EFRAG Research Agenda Consultation.

We believe that research projects initiated by EFRAG should be focused on financial reporting issues of significant practical relevance for preparers and users. It is important that EFRAG's resources are used in an effective way and that research performed by financial reporting standard-setters are not duplicated by EFRAG without any additional benefits for European stakeholders. We encourage EFRAG to actively coordinate with European standard-setters and contribute resources/support to projects that are pursued by them.

Our general comments and our comments on the projects proposed by EFRAG are set out in the Appendix to this letter. In addition, we make some proposals of our own for new projects. If you require any more information, please do not hesitate to contact us.

Yours sincerely,

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APPENDIX

General comments

BusinssEurope believes that research projects initiated by EFRAG should be focused on financial reporting issues of significant practical relevance for preparers and users. It is important that EFRAGs´ resources are used in an effective way and that research performed by financial reporting standard-setters are not duplicated by EFRAG without any additional benefits for European stakeholders. We encourage EFRAG to actively co-ordinate with European standard-setters and contribute resources/support to projects that are pursued by them.

BusinessEurope acknowledges that there might be different reasons for starting an EFRAG research project regarding IFRS. There might be new types of transactions or business models that warrants research of how to account for those phenomena, since current IFRS might be incomplete or not providing necessary guidance. Another reason might be that current IFRS is inconsistent in its approach to similar or identical issues. A third reason might be to try to solve fundamental financial reporting issues that are deemed not to have a satisfactory solution in IFRS today.

We note that the IASB after having finished the major standards projects (IFRS 9, IFRS 15, IFRS 16 and IFRS 17) has adopted a piece-meal approach. Many small amendments are proposed over time and reviews of a specific standard, e.g. IAS 8, are staggered. This approach has a number of drawbacks. Constituents have difficulties following all details and it is also difficult to understand what the total effect might be.

EFRAG is responding to all proposals from the IASB but EFRAG has not taken a holistic approach in reviewing the whole IFRS-package. One might wonder if EFRAG should indeed not challenge the conventional wisdom that the IASB followed in the past and see if the conceptual approach pursued by the IASB is still relevant. The goodwill impairment test or what to do with fair value movements are good examples of this.

Further, EFRAG has not undertaken a systematic review of the work plan of the IASB. While some would consider that this is an issue to address to the IASB when the IASB performs its agenda consultations, we believe that EFRAG should take on a more European pro-active role regarding issues that are at the level of standard-setting. We also consider that the delimitation between the standard-setting level and the research level is not very clear neither at the IASB nor at EFRAG.

We therefore encourage EFRAG to perform a strategic analysis of the work plan of the IASB and consider what pro-active initiatives that might be appropriate. We also call on EFRAG to ask constituents from time to time if there are any urgent financial reporting issues that should be addressed at standard-setting level. We note that much of the pro-activity at EFRAG in the last years has been focused on banking and insurance. We believe that it is important that EFRAG also takes an active role related to financial reporting issues for non-financial companies. BusinessEurope makes some suggestions about such projects hereunder.

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<u>**Comments on projects proposed by EFRAG**</u>

BusinessEurope believes that the projects proposed by EFRAG are motivated by all the reasons mentioned above. Better information on intangible assets seems to be a long-standing fundamental issue, while cryptocurrencies can be classified as a new emerging issue. The other three possible projects proposed (derecognition, transaction-related costs and variable and contingent payments) seem to be based on differences in accounting for similar or identical items across standards in IFRS.

We appreciate that EFRAG has given its view of what it believes can be achieved through an EFRAG research project. This certainly helps stakeholders in their assessment of the proposed projects and priorities. We here present our view on the proposed projects.

Better information regarding intangible assets
We believe that better information regarding intangible assets contrary to what EFRAG thinks is not a new question. Instead, this is part of a fundamental issue regarding the difference in recognition in financial reporting between internally created economic resources and assets acquired through an external transaction. Many stakeholders are interested in understanding more of the how the gap between the market value of the entity and net equity in the financial reports can be explained. However, that is not a task for financial reporting to fix. EFRAG is correctly stating that the project is not to trying to solve this issue, to which we agree.

Instead EFRAG is focusing the project on describing different elements of internally generated intangibles and investigate how to take into consideration uncertainties related to those elements. Further, EFRAG states that another objective could be to develop metrics expressing earnings potential and value. These metrics may not, according to EFRAG, be fit as a measurement basis, but could be used to disclose information in the notes to the financial statements.

We note that other interested parties already have done some work on this topic and therefore we question how much incremental value that can be added by EFRAG. We also question whether this project really is an IFRS project or not. EFRAG seems to think that more disclosures could or should be given in the notes. We think that this kind of information is more related to a directors´ report/management commentary. If EFRAG decides to perform research on this issue we therefore think that the project boundary needs to be more clearly defined that it is in the research agenda consultation.

If EFRAG is going to take on a project on intangible assets, we suggest that it is focused on a) to solve the complexities created by IFRS 3 and b) to reconsider the guidance on R&D, where significant parts of internally generated value is expensed immediately not allowing a good view on "where does the company put the money into and with what return".

Cryptocurrencies
Regarding cryptocurrencies, we believe that this issue is new and emerging and should be addressed. However, we are not sure if this is an issue suited for research or if it is

more of an "IFRIC-issue". Care should be taken so that EFRAG will not do similar or identical research performed by standard-setters or other interested parties. Co-operation is key here.

Derecognition
We consider that this project is not high on our list of priorities.

Transaction costs
We consider that this project is not high on our list of priorities.

Variable and contingent payments
We support the proposal regarding variable and contingent payments. We encourage EFRAG to broaden the topic to also look into the treatment of rights associated with contingent payments.

Please consider the following example. In a business combination a parent acquires 60 % of the shares in its new subsidiary. At the same time, the parent enters into a forward contract to purchase all outstanding shares. Under specific circumstances, current IFRS literature suggests the application of the "anticipated acquisition method" implying the presentation of a 100% business combination. At the same time, this seems not possible for acquisitions of interests in associates or joint ventures.

Proposals by BUSINESSEUROPE for new projects

BusinessEurope would also like to propose that EFRAG takes up the following projects.

Equity method
We believe that it is obvious after the discussion regarding the IASB ED on IAS 28 that there is an urgent need to address the equity method and related issues in IFRS. We therefore urge EFRAG to give this project high priority.

Improvement of IFRSs regarding discount rates
Different discount rates in IFRSs
The diversity in guidance across IFRSs makes it difficult for preparers to explain and for users to understand the use of different discount rates for different items on the balance sheet.

Even preparers' management often asks for clarifications on how the discount rate is used and determined (1) for impairment test purposes, (2) for pension plans or (3) for any other provisions. For instance, for nuclear provisions: how to explain internally to management that the provision is discounted at a rate which is close to the risk-free rate while the funding of these provisions is legally covered by a portfolio of assets that globally has a significantly different return rate?

Formulating a consistent set of principles for discounting in IFRS would be helpful to mitigate this problem. We suggest that a way forward may be to address discounting issues in a separate standard in order to achieve greater consistency.

Discount rates used for provisions with a long time horizon (IAS 37)
The current standard is based on the use of a single discount rate that is applied to all cash flows expected throughout the entire time horizon. The standard deals with accounting for the effect of changes in interest rates on the discount rate applied. Our understanding is that this concerns changes in the level of interest rates. Or said otherwise: changes due to moving interest rate curves.

The standard does not however specify how to deal with the effect that, as time passes and the maturity becomes shorter, shorter term interest rates become more relevant than the long term interest rate initially retained. Or said otherwise: differences in interest rates that correspond to different time horizons within an unchanged interest rate curve.

Analysis of consistency and interaction between IFRS 15 and IFRS 16
We encourage EFRAG to take on topics that analyze the consistency and interaction within the existing IFRS. One example is the interaction between IFRS 15 and IFRS 16.

Contracts with customers including different components, i.e. performance obligations, e.g. lease component and service component
The analysis whether a contract with a customer according to IFRS 15 exists is based on IFRS 15.9. If a contract with a customer includes more than one performance obligation and one of those performance obligations is not classified as an IFRS 15 element, e.g. since the criteria for the accounting of the component according to IFRS 16 are fulfilled, the guidance in IFRS 15 regarding the existence of a contract with a customer do not apply (IFRS 15.9: "An entity shall account for a contract with a customer that is within the scope of this Standard only when all of the following criteria are met [...]"). However, IFRS 16 does not clarify when a lease contract with a customer exists but only states that at contract inception it needs to be assessed whether a contract is or contains a lease (IFRS 16.9). Accordingly, it is not clear whether the definition of a contract with a customer included in IFRS 15 may also be applied to lease components and lease contracts. For other topics like the allocation of consideration IFRS 16 clearly refers to IFRS 15, see e.g. IFRS 16.17.

In case the guidance regarding the existence of a contract set out in IFRS 15.9 also may be applied to lease contracts/performance obligations, the following questions may arise: (1) evaluation of the collectability of a contract and (2) recognition of order backlog for lease contracts.

Evaluation of the collectability of a contract
According to IFRS 15.9 (e) it would have to be analyzed amongst other things whether the collectability of the consideration to which an entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable. Assuming the entity is the lessor in case of an operating lease contract/performance obligation, risks and rewards of the asset stays with the entity. Does it then make sense in case of an operating lease to analyze the rating/customer's ability to pay, when risks and rewards out from the leased asset are still with the company? In case of a low credit rating of the customer the lessor would not be allowed to recognize revenue until substantially all of the consideration is received and no obligations remain, although the risks and rewards of the leased asset still remain at the lessor.

Recognition of order backlog for lease contracts
In case a lease performance obligation needs to be accounted for according to IFRS 15 then IFRS 15.9 regarding the point in time of the initial recognition of order backlog and IFRS 15.47 et seq. regarding the amount of order backlog recognized need to be applied. Regarding the point in time of the first recognition of order backlog there may be a gap between IFRS 15 and IFRS 16 performance obligations depending on the considerations mentioned before. Regarding the amount of order backlog recognized, the inconsistency between IFRS 15 and IFRS 16 mentioned in EFRAG's Research agenda consultation in chapter "Enhancing current financial reporting – Variable and contingent payments" exists.

The project should analyze and discuss existing lack of guidance as well as consistency and interaction between IFRS 15 and IFRS 16.

Control vs. risks and rewards approach
There has been a change when developing new IFRSs focusing on assessment of control instead of an assessment of risks and rewards. Some examples are:

- IFRS 10.5: Determination of whether an entity is a parent company is dependent on the existence of control over an investee.
- IFRS 15.31: An entity shall recognize revenue when a performance obligation is satisfied by transferring an asset to a customer which is when (or as) the customer obtains control of that asset.

Within those standards risks and rewards still exist as indicators for the notion of control but not as a stand-alone approach, i.e. in contrast to the preceding reporting standards (SIC 12 and IAS 18/IAS 11) which were solely based on the risks and rewards-approach.

Nevertheless, in other new IFRSs, the notion of risk and rewards is still used, e.g.:

- IFRS 16.62: A lease is classified as finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.
- IFRS 9.3.2.6: When an entity transfers a financial asset, it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset.

This may cause challenges to consistently apply IFRS. We believe that a project should analyze those differences as well as the consistency and interaction between IFRSs.

Addressing issues regarding decision usefulness and relevance
In the light of the amended Conceptual Framework, we also encourage EFRAG to look into areas regarding decision usefulness and relevance in financial reporting. Two examples where our impression is that users have a low degree of understanding of IFRS are Income Taxes and Pensions.

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