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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the activities of the IFRS Foundation, EFRAG and PIOB in 2016

1. PURPOSE AND SCOPE OF THE REPORT

Regulation No 258/2014 of the European Parliament and of the Council, which extended a Union programme to support specific activities in the field of financial reporting and auditing for the period from 1 January 2014 to 31 December 2020, came into force on 9 April 2014 following its publication in the Official Journal[1].

According to Article 9 (3) of the Regulation, from 2015, the Commission shall prepare an annual report on the activity of the beneficiaries of the programme, namely the International Financial Reporting Standards (IFRS) Foundation, the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB). The scope of the report is further defined in Article 9 (4, 5 and 6) of the Regulation.

The report covers the activities of the IFRS Foundation, EFRAG and PIOB in 2016. However, certain events that took place in 2017 were also mentioned where it was deemed useful for the purpose of this report.

2. IFRS FOUNDATION

2.1. General principles against which new Standards have been developed

The general principles against which new standards have been developed including transparency, full and fair consultation and accountability were described in detail in the previous Commission annual report on the activities of the IFRS Foundation.[2]

Following the publication by the IASB of the report of the Effects Analysis Consultative Group[3], its recommendations were implemented for the first time in the effects analysis published with the new standard IFRS 16 *Leases* in January 2016.

In 2016, the Commission initiated a discussion on effects analysis for new IFRS standards with fellow members of the IFRS Foundation. The Monitoring Board concluded this discussion in February 2017 by agreeing that the IASB should accompany important standards with solid effects analysis. The Monitoring Board passed this message to the Trustees who welcomed it. Both parties agreed that conducting effects analysis was important for gathering support for new IFRS.

In May 2017, the IASB issued IFRS 17 *Insurance Contracts*, which was accompanied by a separate effects analysis of the new standard.

[1] OJ L 105/1, 8.04.2014
[2] See the previous Commission report on the activities of the IFRS Foundation, EFRAG and PIOB in 2015 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2016:0559:FIN
[3] The Group had been established to advise the IASB on best practice in the assessment of the likely effects of a new standards and thus to seek to enhance the confidence in, and efficiency of, the processes.

2.2. The IASB's key achievements in 2016

In 2016, two major standards issued earlier by the IASB, namely IFRS 9 *Financial Instruments* and IFRS15 *Revenue from Contracts with Customers,* were endorsed in the EU. In January 2016, the IASB issued another major standard: IFRS 16 *Leases*. In addition, the IASB continued to work on a number of other major projects, in particular the new Insurance Contracts standard IFRS 17 that will replace the existing IFRS 4, Amendments to IFRS 4 to address the misalignment of application dates between IFRS 9 *Financial Instruments* and the new standard on insurance contracts (IFRS 17), the Disclosure Initiative and the Conceptual Framework.

IFRS 16 *Leases*

The Board issued IFRS 16 *Leases*, concluding its decade-long effort to overhaul the accounting for leases. IFRS 16 is a major revision of the way in which companies account for leases and requires all leases to be reported on a lessee's balance sheet as assets and liabilities. The new Standard aims to better reflect the actual consequences of economic transactions and provide much-needed transparency about companies' lease assets and liabilities, meaning that off-balance sheet lease financing no longer goes unrecognised. It is expected to improve comparability between companies that lease and those that borrow to buy.

In its advice submitted in March 2017, EFRAG recommended endorsing IFRS 16 in the EU on the basis of its conclusions that the new standard meets the required qualitative characteristics and is conducive to the European public good.

Other key project achievements

In 2016, the IASB has continued to work intensively to finalise the new standard on insurance contracts, which was finally issued on 18 May 2017. During re-deliberations, the IASB has maintained extensive dialogue with all interested parties. This project will bring much-needed transparency to the plethora of accounting practices currently used throughout the industry. The new standard is expected to result in a more realistic depiction and better comparability of financial performance of the insurance industry in Europe and around the world. The urgency of this project was underlined by a call from the Financial Stability Board for the IASB to finalise the Insurance Standard as soon as possible[4].

In September 2016, the IASB published amendments to the existing insurance contracts Standard, IFRS 4, in order to address the temporary consequences of different effective dates of IFRS 9 *Financial Instruments* (effective date of 1 January 2018) and the new insurance contracts standard (effective date of 1 January 2021). Some of the companies that issue insurance contracts have expressed concerns about the need to implement two significant changes in accounting on different dates. They also highlighted that potential increased accounting volatility could arise in profit or loss if the new requirements for financial

[4] http://www.fsb.org/wp-content/uploads/September-Plenary-press-release.pdf

instruments were to be applied before the new requirements for insurance contracts. These concerns were also voiced by EFRAG in its comment letter on the Exposure Draft of Amendments to IFRS 4. Consequently, the proposals of the IASB in this area aimed to address these concerns and to balance them with the needs of users of financial statements.

Furthermore, the IASB has made significant progress on its Disclosure Initiative, which includes a portfolio of projects undertaken with the aim of improving disclosures in financial reporting, making them more effective and thus less complex and less voluminous without compromising on the primary goal of faithfully reflecting economic reality. In this respect, the IASB published in March 2017 a discussion paper on the Principles of Disclosure, which is the cornerstone of the Disclosure Initiative.

Finally, the IASB continued to take steps to ensure IFRS is applied on a globally consistent basis. In this respect, the IASB set up Transition Resource Groups (TRG) to facilitate the implementation of IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments*.[5] Another TRG is also envisaged with respect to the new standard on insurance contracts (IFRS 17) with an objective to provide a public forum for stakeholders to follow the discussion of questions raised on implementation of the standard and at the same time to help the IASB Board determine if any actions will be needed to address those questions.[6]

2.3. Development of a Revised Conceptual Framework

In 2016, the IASB continued to work on the Conceptual Framework project following the publication of the Exposure Draft proposing changes to the framework and the consultation period. The Board expects to publish the Revised Conceptual Framework around the end of 2017.

The Conceptual Framework describes concepts for general purpose financial reporting. Among other things, the Exposure Draft discussed prudence, faithful representation and an entity's business model[7].

<u>Prudence</u>

In May 2016 the Board tentatively decided to confirm that the revised Conceptual Framework should include a reference to prudence described as the exercise of caution when making judgements under conditions of uncertainty, as proposed in the Exposure Draft. In September 2016, the Board tentatively decided that the main body of the revised Conceptual Framework should acknowledge that, in some cases, income may need to be treated differently from expenses and assets differently from liabilities.

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[5] Revenue Transition Resource Group and Transition Resource Group for Impairment of Financial Instruments

[6] Possible actions could include providing supporting materials such as webinars, case studies and/or referral to the Board/or Interpretations Committee.

[7] Please refer to the previous Commission report on the activities of the IFRS Foundation, EFRAG and PIOB in 2015 for description of these concepts as presented in the Exposure Draft. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2016:0559:FIN

Faithful representation

In May 2016 the Board tentatively decided to confirm that relevance and faithful representation should continue to be identified as the two fundamental qualitative characteristics of useful financial information. Furthermore, the Board tentatively decided to describe measurement uncertainty as a factor affecting faithful representation and to clarify (in the basis for conclusions on the revised framework) that a trade-off can exist between the fundamental qualitative characteristics of relevance and faithful representation.

Business model

In December 2016, the Board tentatively decided to confirm the approach to business activities proposed in the Exposure Draft. Specifically, the revised Conceptual Framework will discuss how the way in which an entity conducts its business activities may affect decisions about the unit of account, measurement, and presentation and disclosure, but will not introduce business activities as an overarching concept that affects all areas of financial reporting.

3. EFRAG

3.1. Consideration of the true and fair view principle and strengthening EFRAG's assessments of impact of new IFRS on the public good

EFRAG provides its input throughout the standard setting process by commenting on IASB proposals and by providing proactive work to stimulate a debate in Europe on important accounting issues. The commenting and proactive activities are essential for ensuring that European views on the development of financial reporting are properly and clearly articulated in the standard setting process with the objective that the resulting standards are fit for Europe.

Following the governance reform implemented in 2014, EFRAG continued to carry out endorsement assessments on whether IFRS were meeting all technical criteria of the IAS Regulation, including the true and fair view principle, and also strengthened its assessment on whether new or proposed financial reporting requirements were conducive to the public good. In 2016, EFRAG, assisted by the Commission staff, has further developed its impact analysis methodology. In this respect, EFRAG's first fully-fledged impact analysis was conducted as part of its endorsement advice on IFRS 16 *Leases,* which will serve as a pilot case to further build EFRAG's capabilities and experience in this area.

In 2016, EFRAG's work was focused on endorsement advice on two major standards: IFRS 16 *Leases* and Amendments to IFRS 4: *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts.* In both cases, EFRAG provided its final endorsement advice in 2017.

The endorsement advice on IFRS 16 *Leases* was supported by a robust impact analysis covering specific issues identified by the Commission in its request for endorsement advice.

In this respect, EFRAG assessed that IFRS 16 would improve financial reporting and would reach an acceptable trade-off between the benefits to the European economy of greater transparency and better information for decision-making and the associated costs. Furthermore, EFRAG does not anticipate that IFRS 16 will have any material effect on entities' access to and the pricing of leasing as a source of finance. EFRAG has assessed that IFRS 16 is likely to have some negative effect on the leasing industry as a result of lessees switching to alternative forms of finance but that the impact should be limited. Overall, EFRAG has assessed that IFRS 16 is not expected to have a material adverse or disproportionate impact on the SME sector in Europe. Based on its own work and the input provided by the European Central Bank, EFRAG has assessed that IFRS 16 is not expected to pose a risk to financial stability in Europe. Finally EFRAG has assessed that EU entities would not be at an overall disadvantage in relation to their competitors that apply US GAAP. Accordingly, EFRAG concluded that endorsing IFRS 16 is conducive to the European public good.

In addition, EFRAG provided the Commission with an endorsement advice on amendments to IFRS 4 *Insurance Contracts* addressing temporary consequences of the different effective dates of IFRS 9 *Financial Instruments* and the upcoming new standard on insurance contracts. While EFRAG concluded that overall these amendments would be conducive to the European public good, it noted that they did not address the cost concerns of many entities which undertake insurance activities but are not predominant insurers. Therefore EFRAG could not exclude that the scope of these amendments could create a competition issue. However, it was not in a position to conclude on whether such an issue could be material from an economic perspective.

On 29 June 2017, Member States in the Accounting Regulatory Committee gave a positive opinion on a Commission Regulation adopting IFRS 16 *Leases*. The Committee also gave a positive opinion on a Commission Regulation adopting the IASB Amendments to IFRS 4 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* together with an EU extension of scope permitting insurance sectors within financial conglomerates to defer the application of IFRS 9 until 1 January 2021 at the latest. This allows insurance companies, whether they are part of a predominant insurance group or part of a financial conglomerate (banque-assurance group), to introduce IFRS 9 at the same time as the new standard on insurance contracts, IFRS 17. By providing equal treatment of insurance companies, irrespective of legal structure, the regulation will ensure that insurers across Europe will be on a level playing field and avoid competitive distortions.

3.2. Consideration of the diversity of accounting and economic models and views in the European Union

EFRAG has put in place a due process, which allows all European constituents to put forward their views for consideration by EFRAG and ensures that the diversity of accounting and economic models and views in Europe are taken into account and that the new IFRS respond to the Union's needs[8]. Following the reform, there has been an increased focus on transparency of meetings of EFRAG Board and EFRAG Technical Expert Group (TEG)[9].

3.3. Implementation of the governance reform following recommendation of the Maystadt report

The governance reform of EFRAG, which was implemented on 31 October 2014, increased the legitimacy and representativeness of the organisation and resulted in a more cohesive process for the participation of the EU in the standard setting process. On 1 July 2016, Jean-Paul Gauzès, former Member of the European Parliament, was appointed as President of the EFRAG Board. His nomination by Commission had been endorsed by the European Parliament and the Council. In 2016, EFRAG reached all its conclusions on a consensus basis without having to resort to voting. The implementation of EFRAG's communication strategy, supported by a team that was put in place under the leadership of the EFRAG Board President, is expected to enhance the visibility and credibility of EFRAG.

With EFRAG Board rotation set to take place in November 2017, EFRAG is currently seeking to broaden its membership among European organisations and National organisations with an interest in financial reporting. Furthermore, with a view to promoting broader representativeness of the EFRAG Board, the General Assembly of EFRAG at its meeting on 12 April 2017 decided to tighten EFRAG Internal Rules so that a maximum of three EFRAG Board members can have the same nationality.

On 13 April 2016 the Commission proposed to Council and Parliament to extend the financing of EFRAG for the period 2017-2020[10]. Following successful negotiations, the extension of financing of EFRAG was finally approved on 17 May 2017[11].

4. PIOB - Developments in the diversification of funding in 2016

The PIOB is responsible primarily for overseeing the IFAC (The International Federation of Accountants) Boards responsible for the development and approval of international standards and the Code of Ethics for auditors. Of particular importance are the International Standards on Auditing (ISAs) which the Commission may adopt to be used all over the EU. The final objective for the PIOB is to ensure that those standards are developed in the public interest.

In order to properly carry out this essential public-interest function it will be important to ensure that the funding of the institution is designed as to preserve its real and perceived independence. To achieve this objective, proper diversification of stable funding sources would help not only to preserve its continuity but also to guarantee that independence. The

[8] See the previous Commission report on the activities of the IFRS Foundation, EFRAG and PIOB in 2015 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2016:0559:FIN

[9] Meetings of the EFRAG Board and EFRAG TEG are held in public. The supporting documents and the summaries of those meetings are made available on EFRAG's website.

[10] https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/1-2016-202-EN-F1-1.PDF

[11] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0827&from=EN

importance of funding diversification was already recognised in the IFAC reform of 2003 which was at the origin of the current international standard setting system, including the PIOB.

Since its creation in 2005 until 2010, when the Community funding programme established by Decision 716/2009/EC became operative, the PIOB, apart from some in-kind contributions by Spain (the PIOB is based in Madrid), was financed exclusively by IFAC.

The funds made available by IFAC in a given year constitute a maximum guaranteed contribution which is made available to the PIOB without any further interference from IFAC. The non-IFAC contributions substitute and thus reduce the IFAC contribution for that specific year. Ideally the IFAC funding portion of the total PIOB annual expenses should be less than half of the total.

The EU contribution in the period 2010-2016 has encouraged other potential donors to make also their own contributions. In year 2016, as shown in page in page 1 of its 2016 financial statements, the PIOB revenues amounted to EUR 1,563,565. IFAC provided EUR 914,758 which represents 58.50% of the total.

The European Commission provided EUR 318,000 (EUR 312,000 in 2015), which represents 20.34% of the total. The Abu Dhabi Accountability Authority provided, as in 2015, EUR 120,000, which represents 7.67% of the total. IOSCO, also as in 2015, provided EUR 100,000, which represents 6.40% of the total. The Bank for International Settlements, kept its contribution of EUR 23,000, which represents 1.48% of the total. The UK Financial Reporting Council provided, as in 2015, EUR 40,000 which represents 2.56% of the total. Finally, the CFA Institute has provided for the first time a contribution which amount to EUR 45,000, representing 2.88% of the total. The balance EUR 2,807 represents interest income.

The IFAC contribution of 58.50% of the total PIOB funding in 2016 is a little lower than that of 2015 (60,67%), and very similar to that of 2014 (58.19%). Something that goes in the right direction.

Article 9.5 of the Regulation stipulates that if funding by IFAC in a given year reaches more than two-thirds of the total annual PIOB funding, the Commission shall propose to limit its annual contribution for that year to a maximum of EUR 300,000. In year 2016 (as in 2014 and 2015), this has not been the case and therefore, as the critical threshold stipulated in the Regulation (66.66%) has not been reached by the IFAC funding, the Commission does not need to review its 2016 contribution to the PIOB.

5. CONCLUSIONS

IFRS Foundation

In January 2016, the IASB issued another major standard: IFRS 16 *Leases* concluding its decade-long effort to overhaul the accounting for leases and in September 2016, the Board published Amendments to IFRS 4 *Insurance Contracts*. In addition, the IASB continued to work on a number of other major projects, in particular the new Insurance Contracts (IFRS 17 finalised in May 2017), the Disclosure Initiative and the Conceptual Framework.

In respect of whether IFRS:

- take due account of different business models: IFRS 9, which was endorsed in the EU in November 2016, explicitly recognises the importance of business models in determining measurement of financial instruments. The Commission is committed to monitoring closely the impact of IFRS 9[12] to ensure that it serves the EU long-term investment strategy[13]. In this respect, the Commission sent to EFRAG in May 2017 a request for technical advice on the accounting treatment of equity instruments under IFRS 9 from a long-term investment perspective. In a first phase, the Commission has requested EFRAG to conduct some fact finding in this area by the end of 2017 in order to evaluate the possible impact of IFRS 9 on long-term investments. In a second phase, the Commission has asked EFRAG by mid-2018 to identify whether and how IFRS 9 could be improved with respect to accounting treatment of equity instruments held as long-term investments. Furthermore, the amendments to IFRS 4 address the issue of misalignment of application dates between IFRS 9 *Financial Instruments* and the new standard on insurance contracts (IFRS 17), which is of particular importance for the insurance industry. Finally, the Conceptual Framework gives business models more emphasis.
- reflect the actual consequences of economic transactions: IFRS 16 seeks to better reflect the actual consequences of economic transactions and provide much-needed transparency about companies' lease assets and liabilities. IFRS 17 *Insurance Contracts* is also expected to provide a realistic depiction and better comparability of financial performance of the insurance industry across different constituencies. This issue will be looked at in detail by EFRAG as part of its work on the endorsement advice on the new standard.
- are not overly complex: IFRS 9 is a complex standard however it has introduced simplifications in the accounting for financial instruments. In EFRAG's view, presented in the endorsement advice, IFRS 9 does not contain any complexity that may impair understandability. Furthermore, it is noted that the Disclosure Initiative is expected to further contribute to the objective of achieving less complex and voluminous financial reporting.
- avoid artificial short-term and volatility biases: As regards IFRS 17 *Insurance Contracts*, the Commission with the help of EFRAG will look at this aspect during the endorsement process following the publication of the standard by the IASB.

[12] See response of the Commission to the European Parliament's resolution on IFRS 9 http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2016/2898(RSP)#tab-0

[13] See Commission Staff Working Document accompanying the Communication of the Commission on the Mid-Term Review of the Capital Markets Union Action Plan
https://ec.europa.eu/info/sites/info/files/staff-working-document-cmu-mid-term-review-june2017_en.pdf

As far as the Conceptual Framework is concerned, the Commission reiterates its support to the re-introduction of the concept of prudence and will closely follow the final phase of this project.

Finally, the Commission welcomes the effects analysis, which accompanied two new major standards IFRS 16 and IFRS 17 and invites the IASB to continue to develop their analysis of impact of new or amended standards.

EFRAG

Following the implementation of its governance reform and the appointment of the President of its Board, EFRAG has strengthened the legitimacy of its positions and significantly contributed to the objective of Europe speaking with one voice.

EFRAG continued to take account in its endorsement assessments of whether IFRS were meeting all technical criteria of the IAS Regulation and strengthened its scope of assessment of whether new or proposed financial reporting requirements are conducive to the European public good.

The Commission has appreciated the comprehensive effects analysis, which supported EFRAG's endorsement advice on IFRS 16 *Leases*, and encourages EFRAG to further develop its capacities in this area.

Thanks to its extensive due process, EFRAG was in a position to provide adequate assessment of whether draft, new or amended IFRS responded to the Union’s needs while taking into account the diversity of accounting and economic models and views in the EU.

PIOB

Regarding the PIOB, the diversification of funding sources has continued with the incorporation of the CFA Institute as a donor. The total portion of revenue sources provided by IFAC in 2016, as shown in page 1 of its 2016 financial statements, is 58.50 % what is lower than in 2015 (60.67%) and well below the two-thirds threshold stipulated in the Regulation.

For the coming years, the Commission will continue monitoring the funding developments and will cooperate with other interested potential donors, in particular with other Monitoring Group members, to ensure that the PIOB benefits from a clear, stable, diversified and adequate funding system so that it can accomplish its public interest mission in an independent, sustainable and efficient manner.