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IASB® *Investor Update*

Our newsletter for the investment community

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The IASB's Investor Update *highlights market-relevant accounting topics that could impact the companies that investors follow. It also shares with investors information on the IASB's standard-setting activities and insights from our ongoing dialogue with the investment community. We invite investors seeking further detail on accounting proposals and current requirements to contact us.*

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Editors' welcome

We'd like to welcome you back from the summer holidays (in the Northern Hemisphere at least!) with the second issue of the International Accounting Standards Board's (IASB) *Investor Update*.

For those of you who are reading this for the first time, this newsletter aims to make it easy (or easier) for investors to 'keep up to speed' on changes in the world of International Financial Reporting Standards (IFRS) and how those changes may affect an investor's day job.

We have had positive feedback from our first newsletter, which was published in June (access the newsletter by clicking here). As a result of the June *Investor Update* we were contacted by a number of senior analysts in the investment community who wanted to know more about some of the changes to accounting that are in the pipeline—including revenue recognition, pensions and financial instruments.

From talking to them, it appears that few investors and analysts realise that we don't just ask questions about accounting—we can answer them too! Whether attending a team meeting or supporting you during a client event, we are more than happy to explain new accounting changes and how they might impact your work.

We continue to welcome your views and suggestions on the newsletter as well as on our outreach activities—we want to make sure that they are as useful to you as possible.

Barbara and Fred

In this issue:

IFRS®

We need your views

The IASB sets Standards for you, the investor. But we can't do this in isolation. We need your help in understanding whether potential changes to the Standards will provide you with the information that you analyse and that ultimately drives your investment decisions.

You do not have to be an accountant to speak to us. It is the insight that you offer as one who uses financial information to make investment decisions that is important to us. Below we provide you with a calendar of anticipated timing for topics on which we expect to be asking investor views in the coming year and an overview of those topics.[1]

Outreach planner

		Anticipated outreach timing		
Topic	Next step	Q4 2014	Q1 2015	Q2 2015
Changes in debt	Exposure Draft[2] → Q4 2014	✓	✓	
Rate-regulated activities	Discussion Paper[3] → Q3 2014	✓	✓	
Conceptual Framework	Exposure Draft → Q1 2015		✓	✓
Segment reporting—follow up	Exposure Draft[4] → 1H 2015		✓	✓
Dynamic risk management	Discussion Paper closes 17 Oct 2014		✓	✓

Click here to keep up to date on outreach activities and here for the IASB's complete work plan.

[1] This does not include any forthcoming research or other projects for which we may request your input.

[2] An Exposure Draft is a mandatory step in our due process. It sets out a specific proposal in the form of a proposed Standard, or amendment to an existing Standard.

[3] A Discussion Paper is not mandatory, but the IASB normally publishes one on any major new topic to explain the issue and solicit early comment from stakeholders.

[4] Publication of an Exposure Draft for this item (ie because it was a Post-implementation Review) will depend on feedback received during the review process.

Overview of topics

Changes in debt

This is part of the overall Disclosure Initiative project. Its objective is to improve investors' understanding of changes in a company's liabilities by providing a reconciliation of these items. This will help investors understand any non-cash movements in liabilities.

Rate-regulated activities

In many countries, governments regulate pricing and supply in key industries (ie gas, water or electricity supply). We refer to this as 'rate regulation'. Rate regulation can have a significant impact on the timing and amount of a company's revenue, and on the certainty of related cash flows. IFRS does not provide any specific accounting guidance for these industries. We would like to understand if there is a need for specific accounting for these types of activities.

Conceptual Framework

The *Conceptual Framework for Financial Reporting* sets out the concepts that the IASB uses to set Standards. We are continuing to seek feedback from investors on a number of areas, including: the use of information in other comprehensive income; what information is useful for different types of financial instruments (for example, equity versus liabilities); and our decision to reintroduce a reference to prudence.

Segment reporting—follow up

In 2013 we completed a review of our segment reporting requirements. We have now followed up on the comments received and have tested possible solutions with preparers, standard-setters and investors. The staff recommendation of any proposed amendments to the current requirements will be discussed in Q4 of 2014.

Dynamic risk management

For companies with revenues and profits that are exposed to market price movements, risk management activities can be quite complex, often involving the risk management of portfolios of exposures that continuously change. Our Discussion Paper explores how to better reflect these activities in a company's financial statements.

Spotlight: financial instruments

The IASB recently finalised its project to improve the accounting for financial instruments with the publication of IFRS 9 *Financial Instruments*. IFRS 9, which is effective from 1 January 2018, will replace the current accounting requirements for classifying and measuring financial instruments, the impairment of financial assets and hedge accounting.[5]

IFRS 9 aims to make financial reporting for financial instruments more relevant and understandable for investors. Many financial instruments are complex, so accounting for them will still require companies to make judgements and estimates. The IASB has therefore put great emphasis on improving the quality of disclosures accompanying IFRS 9.

We will discuss IFRS 9 over several issues of the newsletter. In this issue we highlight what investors can expect to be the source of the biggest change: the introduction of an expected credit loss impairment model.

Who will be most affected?

Although IFRS 9 applies to all companies, investors can expect the financial services sectors (for example, banking and insurance) to be the most affected by the new impairment requirements, because they have significant financial instrument exposures. The banking sector in particular has significant exposure to loans, other financial assets and off-balance sheet commitments to provide credit.[6]

How will impairment requirements change?

The biggest change is that provisions for impairment will now be calculated based on expected credit losses even if a loss event has not occurred. Management will have to take into account all available information, including forward-looking estimates. This is a significant difference from the previous model, which was based on evidence of losses being incurred. This change aims to address a key criticism of the impairment model during the financial crisis—that delayed recognition of credit losses on loans was a weakness in accounting.

Don't be surprised by a decline in shareholders' equity on initial application

A key implication of the new impairment model for many companies (for example, banks) is that, to the extent that moving from the incurred loss model to an expected loss model results in a higher loan loss provision, there will be a reduction in shareholders' equity. This has already been highlighted in a banking industry survey (Deloitte's *Fourth Global IFRS Banking Survey—Ready to Land*) as well as in our fieldwork on the 2013 Exposure Draft.[7] This probably doesn't come as a surprise for banks analysts since they will have already seen how changing banking regulations (ie Basel III) incorporate an expected loss concept for provisions and associated effects on capital.

Earnings will reflect expectations

Accounting changes are not just about dealing with the changes resulting from initial application of the new model. They are also about getting a handle on making accurate earnings forecasts. For this task, investors can expect provisions to be more responsive to changes in expected credit losses from period to period, as opposed to being a lag indicator that is labelled as 'too little too late'.

Don't confuse a higher provision for weakened loan underwriting standards

Investors should remember that larger impairment provisions under IFRS 9 should not be interpreted as a weakening of loan underwriting standards. While the new model requires impairment to be recognised earlier than the incurred loss model, it still ultimately results in the same amount of cumulative cash losses (again, all else being equal). In that sense, the new model attempts to more faithfully represent the economics and timing of expected credit losses. It does not attempt to build 'cookie-jar' reserves nor to incorporate allowances for unexpected credit losses.

How can I stay in the loop?

The IASB hosts conferences during which companies share their thoughts on transition, providing investors with insights ahead of the change. We have publications that discuss IFRS 9 in greater detail, including an IFRS 9 Investor Perspectives article and an IFRS 9 Project Summary. We have also announced an Impairment Transition Resource Group to support companies on implementation issues that may arise as a result of the new impairment requirements of IFRS 9.

[5] IAS 39 *Financial Instruments: Recognition and Measurement*.

[6] The impairment model also applies to all instruments not measured at fair value through profit or loss, off-balance sheet commitments to provide credit, lease receivables and trade receivables.

[7] Exposure Draft *Financial Instruments: Expected Credit Losses*.

Investor FAQs about changes to revenue recognition

In the June issue of the *Investor Update* we introduced the new Standard for revenue recognition (IFRS 15 *Revenue from Contracts with Customers*), and explained that companies can apply one of two different methods to transition to the new Standard.[8]

In this issue we share some FAQs that we have heard from investors as they begin to consider the potential impact of this new Standard.

Q: If companies apply IFRS 15 before the mandatory effective date, will that impact the comparability of their reported financial information?

Under IFRS, companies are allowed to early apply the new Standard, while under US GAAP they are not. The IASB allows early application because it believes that if a better Standard is available, companies should be permitted to apply it as early as possible in order to improve financial reporting.

Based on our conversations with IFRS preparers we do not expect those for which IFRS 15 would have a major impact to apply the new requirements early. This difference in the ability to early apply could reduce the comparability of the data reported by US GAAP versus that of IFRS filers. In a similar vein, if some but not all IFRS filers within a given industry early apply, then comparability could be affected. We suggest investors engage with management about their plans for moving to IFRS 15.

Q: Will the application of IFRS 15 bring forward or delay the recognition of revenue?

For many contracts, in particular many straightforward retail transactions, we believe it is unlikely that the timing of revenue recognition will change. The new accounting requirements should instead improve the usefulness of the note disclosures about revenue. For example, companies will be required to provide greater transparency into the terms of their long-term contracts. We will profile improvements to these disclosure requirements in more depth in a future issue.

However, there are some sectors (for example, telecommunications and software) in which the timing of revenue recognition may be affected. IFRS 15 will require companies that bundle together products and services and deliver them over time to identify and separately account for each 'performance obligation' in a contract. This could result in a change to the timing of revenue recognition as compared with current practice.

Q: What type of impact might investors expect to see in sectors such as telecommunications?

Telcos often sell bundled products and services such as subsidised handsets with a wireless service contract. The requirement of IFRS 15 to separately account for each performance obligation could lead to revenue being recognised earlier (ie when the customer takes possession of the mobile device), as compared with current practice. Under IFRS 15, more of the contract's revenue will be proportionally allocated to the subsidised handset on the basis of stand-alone selling prices. Understanding this potential change can help investors interpret the effect on key financial metrics.

But investors should also bear in mind that industry practice can change before new accounting requirements are implemented. There is already evidence of some telcos beginning to sell wireless plans bundled with a non-subsidised handset instead of plans bundled with a subsidised handset. In such cases, investors may not see much change once IFRS 15 is applied.

Q: What implications will IFRS 15 have on a metric such as 'free cash flow'?

It depends. If the timing of a company's revenue recognition is unaffected then we would expect measures such as free cash flow (often defined as operating cash flows less capital expenditures) to be unaffected as well.

However, if the timing of revenue is affected by the implementation of IFRS 15, then the relationship between what is reported as net profit and what is calculated as free cash flow could change. Investors will want to consider this when forecasting results beyond the year of first-time application.

How can I stay in the loop?

The IASB has a programme to help stakeholders through the transition to IFRS 15. This includes a webcast with the CFA Institute on the new Standard, the development of a Revenue Transition Resource Group and hosting conferences during which companies share their thoughts on transition, providing investors with insights ahead of the change.

[8] IFRS 15 *Revenue from Contracts with Customers* was issued in May 2014 and is effective from 1 January 2017. The requirements are fully converged with the equivalent Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which was introduced into US GAAP.

In profile

Every issue we will be featuring IFRS events and/or interviews with key stakeholders or IASB members. For this issue we interviewed two new members of the IASB's Capital Market Advisory Committee (CMAC)[9]: Tanya Branwhite and Paulo Cezar Aragão.

***IASB investor team*: Australia adopted IFRS some time ago. For Brazil, IFRS has only recently come into effect. What benefits, if any, have you both seen from adoption?**

Tanya: There's no doubt that you see benefits from having a common set of accounting standards. Property is an interesting example. We have global investors who are looking at property around the world, and so to have our companies comparable to those in Europe or the UK is certainly very helpful.

Paulo: Because IFRS offers comparability with companies in other countries, all of a sudden we could tell international investors that our accounting standards are very similar. This is really fantastic in terms of attracting investors and in terms of cost of capital.

***IASB investor team*: And what have been the challenges, if any, of adoption?**

Paulo: Moving to IFRS was frankly quite a challenge. Moving from a rules- and tax-based system to a principle-based system is quite a change, because people now have to make judgements. It is very simple to look at rule X or Y and say that means I have to do that. All of a sudden people are faced with the idea that they have to exercise judgement, and that's difficult.

Tanya: I think the criticism that users have of accounting standards at the moment is about its complexity and the use of judgement. For me, having to use judgement is not the issue. Instead, understanding on what basis that judgement has been made has been an issue. I do think there is increasing recognition of this as well as recognition that providing the information needed to understand the judgement and how the information has been put together is what's really important.

***IASB investor team*: As a member of the CMAC, what would be your advice to the IASB as it thinks about future changes to IFRS?**

Tanya: Fair value has increased the degree of volatility in profit or loss. The IASB should be enabling those who are using profit or loss to have a clearer understanding of the financial performance of the entity in the period.

Paulo: Investors rely more and more on non-accounting measures—a cause for debate in Brazil. The Brazilian SEC has even issued regulation with the aim of trying to improve the comparability of these numbers. This use of non-accounting measures—both in Brazil and elsewhere—is driving investors away from profit or loss to cash flows.

***IASB investor team*: Why do you think investors should be talking to the IASB as a standard-setter? And along those lines, why did you join the CMAC?**

Paulo: You cannot generate useful information without the benefit of talking to the users to find out what kind of information they want or need. The CMAC is a bridge to allow investors to tell the IASB what information to make available. In a way, it is also a bridge to the preparers. I am really very excited to be taking part in this.

Tanya: We have a responsibility to engage with the standard-setters. I think it's disingenuous of users to be critical of accounting standards if we don't engage with them when given the opportunity. If we want to have high quality financial information to make good quality investment decisions, then the only way that we can expect to do that is by working together.

Tanya is Head of Macquarie Securities Group's Australian Equity Strategy & Economics teams and is an Executive Director of Research for the Securities division of Macquarie Group Ltd.

Paulo is a Partner at Barbosa, Mussnich & Aragão Advogados. Previously, Paulo was General Counsel of the Brazilian Securities and Exchange Commission, and a Partner and Managing Director of GP Investimentos, one of the largest private equity firms in Brazil.

[9] The CMAC is an independent advisory group that provides the IASB with regular input from the international community of users of financial statements. Click here for more information about the CMAC and its members.

Stay up to date

Recent events and announcements

In his speech 'The dangers of ignoring unrealised income', Hans Hoogervorst, Chairman of the IASB, discussed the IASB's project to update its *Conceptual Framework*. Mr Hoogervorst argued that excluding all unrealised gains and losses from profit or loss would not result in a faithful representation of a company's financial performance and would be detrimental from a stewardship perspective.

Ian Mackintosh, Vice-Chairman of the IASB, delivered the speech 'Are truly global standards achievable?'. Mr Mackintosh argued that the highly interconnected nature of national capital markets presents a compelling case for a global language of financial reporting.

The European Commission has launched a public consultation on IFRS in the European Union, with a particular interest in to what extent the adoption of IFRS has improved the efficiency of EU capital markets by increasing the transparency and comparability of financial statements.

IASB staff published updated information on the Leases project. The document provides an update on the most important tentative decisions reached during the first half of 2014, the reasons for the decisions made and the work that remains.

The IFRS Foundation hosted the Tommaso Padoa-Schioppa Memorial Lecture, with a keynote speech delivered by Mario Draghi, President of the European Central Bank. Mr Draghi recognised the significant progress made in the last 10 years towards IFRS becoming global standards.

The IFRS Foundation published IFRS as global standards: a pocket guide. The guide summarises the use of IFRS in the 130 countries and other jurisdictions around the world that have been surveyed to date.

IASB member Philippe Danjou contributed to a high level round-table discussion entitled 'Revisiting the accounting of long-term investment by institutional investors', co-hosted by the OECD and the Ministry of Finance of Singapore.

The Japanese government unveiled its 'growth strategy', which includes steps to accelerate the already significant adoption of IFRS by Japanese companies, providing enhanced transparency and in turn promoting inward investment.

New Standards and amendments

Standard	Effective date	Key changes
IAS 19 Employee Benefits	01/01/13	Removes the 'corridor method' for employee benefit accounting.
IFRS 7 Financial Instruments: Disclosures	01/01/13	Adds better disclosure information for investors about offsetting activities.
IFRS 10 Consolidated Financial Statements	01/01/13	Sets out a single consolidation model that identifies control as the basis for consolidation for all types of entities.
IFRS 11 Joint Arrangements	01/01/13	Introduces a principle for classifying joint arrangements based on rights and obligations. This results in accounting for these arrangements as either joint operations (ie recognition of assets and liabilities) or joint ventures (ie the equity method).
IFRS 12 Disclosures of Interests in Other Entities	01/01/13	Sets out a new disclosure package for IFRS 10 and IFRS 11, including disclosures for unconsolidated structured entities.
IFRS 13 Fair Value Measurement	01/01/13	Sets out a new definition of fair value, a framework for measuring fair value and additional disclosures.
IFRS 14 Regulatory Deferral Accounts	01/01/16	Sets out short-term guidance for first-time IFRS adopters until the research project is final.
IFRS 15 Revenue from Contracts with Customers	01/01/17	Results in a more robust revenue framework, improved comparability and enhanced disclosures.
IFRS 9 Financial Instruments	01/01/18	Sets out a forward-looking 'expected loss' model, a new classification and measurement model and substantial changes to the hedge accounting. requirements.

Click here to register for investor email alerts to stay up to date about accounting changes, investor-focused activities and other IFRS Foundation events.