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International Accounting Standards Board

This document is provided as a convenience to observers at Standards Advisory Council meetings, to assist them in following the Council's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting:	**November 2006, London**
Project:	**Chairman's Report to SAC November 2006 (Agenda Paper 3)**

As members of the SAC will be aware the Board has three main strategic objectives at the present time:

- Completion of a standard for SMEs.
- Encouraging more countries to switch to IFRS rather than use national standards.
- Convergence of IFRS and US GAAP.

This report highlights the significant events in the past 4 months.

Progress towards the SME standard

The Board has continued its discussions over recent months of the draft Exposure Draft of an IFRS for SMEs. We expect to publish the exposure draft by the end of the year.

Publication of the exposure draft is a milestone in a detailed process. But the exposure draft is by no means the first public consultation in the process. We have:

- Issued a Discussion paper on the approach to developing a standard for SMEs. 120 comment letters were received.
- Published a questionnaire on recognition and measurement, and received 101 responses. We subsequently held roundtable discussions with 45 of the respondents.
- Held three meetings of the Working Group assisting us with this project.

- Discussed the project at five meetings of the Standards Advisory Council, and three annual meetings with world standard-setters.

The proposed SME standard deals all the subjects on which there are IFRSs. Accordingly it has taken considerable time at board meetings to debate its contents. The SME project has been discussed at 27 board meetings since 2003.

Encouraging the adoption of IFRS

In July, following consultation with the Trustees of the IASC Foundation, the Standards Advisory Council, and a wide range of interested parties, the IASB announced a number of initiatives to encourage adoption of IFRSs. The IASB concluded that by addressing issues related to the timing of effective dates and consultation, it would continue both to encourage consistent and rigorous application of IFRSs and to facilitate broad input into the IASB's work programme.

Those initiatives are:

- <u>Increased lead time to prepare for new standards</u>:

  The IASB recognises that many countries require time for translations and implementation of new standards into practice and, where IFRSs are legally binding, into law. To accommodate the time required, the IASB intends to allow a minimum of one year between the date of the publication of wholly new IFRSs or major amendments to existing IFRSs and the date when implementation is required.

- <u>Increased opportunity for input on conceptual and measurement issues</u>:

  The IASB and the FASB have agreed to publish discussion papers, rather than moving directly to exposure drafts, on the individual sections of their Conceptual Framework project.

  The IASB announced at its meeting in June that it will also publish a discussion paper, rather than an exposure draft, as the next step of its Fair Value Measurement project, which is aimed at providing consistency in the application of existing fair value requirements. The document being released as a discussion paper is the recently published FASB standard, accompanied by a series of questions to enable the IASB to determine whether amendments are necessary to the standard for use in the international environment.

  The decision to use discussion papers as part of these projects means that there will be at least two opportunities for public comment.

- <u>Public round-tables on key topics:</u>

  The IASB will hold public round-table discussions in the near future on two key topics on which constituents have expressed particular interest. The first is the proposed amendments to the recognition and measurement principles in IAS 37 Provisions, Contingent Liabilities and Contingent Assets. These round-tables will be held in November and December of this year. The second is the measurement phase of the Conceptual Framework project. Discussions will focus on the range of possible measurement attributes, including cost and fair value, that could be used both at initial recognition and subsequently. The round-tables will be held in the first quarter of 2007.

- <u>No new major standards to be effective before 2009</u>:

  Consistently with the steps described above, the IASB will not require the application of new IFRSs under development or major amendments to existing standards before 1 January 2009. The establishment of 2009 as the first date of required implementation of new standards will also provide countries yet to adopt IFRSs with a clear target date for adoption.

By refraining from requiring new standards to be applied before 2009, the IASB will also be providing four years of stability in the IFRS platform of standards for those companies that adopted IFRSs in 2005. The establishment of this approach does not preclude the publication of new standards before that date, and companies would be permitted to adopt a new standard on a voluntary basis before its effective date. Interpretations and minor amendments to deal with potential issues identified during implementation would not be subject to this approach.

The IASB believes that providing additional clarity about its plans for effective dates for ongoing projects will benefit the marketplace, without affecting the IASB's ability to pursue the objectives described in the FASB-IASB Memorandum of Understanding of February 2006. This approach to effective dates will apply to all major IASB projects, including those described in the Memorandum of Understanding.

In developing the Memorandum of Understanding the FASB and the IASB anticipated that, whilst some of their joint projects would be completed by the end of 2007, it would be impractical, when factoring in the need for research, deliberation, consultation and due process, to complete many of their joint projects by 2008. The adoption of the approach regarding effective dates does not change these projections. These joint efforts of the FASB and the IASB in addressing priority issues would contribute to the elimination of the need for the reconciliation requirement for non-US companies that use IFRSs and are registered in the United States, as outlined in the roadmap.

For those involved with International Financial Reporting Standards, the past few years have been a time of great activity. The initiatives announced in July are designed to assist those involved with implementation of IFRSs throughout the world, while enabling us to make progress on our contribution toward the elimination of the need for reconciliation requirements by 2009. The IASB has listened to the needs of many interested parties and recognises the benefits that will derive from stability until 2009. At the same time, we welcome the desire of many of those who follow the standard-setting process to make a fuller contribution to our work programme.

One concern raised about the proposals was that in 2009 there might be another 'big bang' similar to that experienced by many companies in 2005. This will not be the case.

Of the short-term convergence projects, only borrowing costs and segmental reporting are expected to be finished before 2008, and both involve changes that will be widely welcomed The change on borrowing costs simply removes the option to recognise them as expense, leaving instead the more popular policy of capitalising them. The segmental reporting standard will be replaced by that used in North America, which requires companies to use the data reported to their senior executives – a change that will reduce much of the systems required at present. The other short-term projects will not be completed until 2008.

Three other standards should be completed in 2007. Of the other major MoU convergence projects, only Business Combinations is expected to be completed – the rest are unlikely to be completed until 2009–2011. A first stage of another of these MoU projects will also be completed – an amendment to IAS 1 requiring items previously taken to equity to be presented in a statement of recognised income and expenses similar to the North American statement of 'other comprehensive income' ie a statement showing profit and then all the other gains and losses relating to the company's assets and liabilities (apart from transactions with shareholders).

The third new standard is the revision to IAS 37 *Liabilities* which involves amendments designed mainly to converge with a FASB standard, to clarify aspects of business combinations, and to address other issues in IAS 37.

In short, we expect only five major standards to become effective in 2009 – two of which involve relatively small changes, the third being a development of the Business Combinations standard, the fourth, *Operating Segments*, involving a change that proved to be very popular during the exposure process and the fifth the revision to IAS 37. Thereafter, in the years after 2009 we expect to issue two or at most three standards a year.

While we also expect that the IFRS for SMEs will be issued and be effective in 2009, it applies to a different group of companies from those affected by the standards mentioned above.

Convergence programmes

Our convergence work with major economies other than the United States goes on apace.

India

In July we were advised by SAC member Shailesh Haribhakti that the Prime Minister of India, Dr. Manmohan Singh, had made the following statement: "We will expedite the adoption of accounting standards in alignment with the International Accounting Standards."

The Institute of Chartered Accountants of India has started its work towards implementation of IFRS. Many of the current Indian Accounting Standards are 'based on' International Accounting Standards (IASs) but they have not been updated for changes made to IASs or for the issue of IFRSs in recent years. We have suggested that India take advantage of the current period of stability, with no new standards effective until 2009, to adopt IFRSs in full, rather than rewrite them as Indian Accounting Standards. We are sending a team to India in February to commence discussions about convergence.

Accounting Standards Board of Japan (ASBJ)

In late September, representatives of the ASBJ and the IASB held their fourth joint meeting towards the goal of achieving convergence between Japanese GAAP and IFRSs. Both boards believe that these discussions are useful in promoting mutual understanding that will contribute to subsequent deliberations at the respective boards. In addition, the boards confirmed their plans to continue their joint work and reviewed their respective project plans. We suggested to the ASBJ that they speed up their convergence work to take advantage of the current period of stability, with no new standards effective until 2009.

The next meeting with the ASBJ will be held in Tokyo in March 2007. The boards agreed that the technical sessions of their future convergence meetings should be open to public observation.

China

The IASB staff continues its active engagement with China's Ministry of Finance (MoF). During August and September, the IASB staff commented on over 30 interpretations of China's Accounting Standards for Business Enterprises. The objective of that review was to identify any areas in which the interpretations might create differences from IFRS. In late September, the IASB Director of Research spoke to a conference sponsored by the International Valuations Standards Committee and the Chinese Valuations Standards Committee in Kunming, China. We continue to profit from the contributions made by members of the MoF staff who have been seconded to the IASB. The person currently on secondment will return to China at the end of this year, and we have begun discussions to have another member of the MoF staff spend time with us in London.

Convergence of IFRS and US GAAP

The convergence work we are undertaking fulfils our commitment as a standard-setter towards:

- the removal of the need for overseas registrants to reconcile their financial statements to US GAAP; and
- the eventual existence of only one set of high-quality accounting standards.

The removal of the reconciliation requirement depends upon the efforts and actions of many parties – including companies, auditors, investors, standard-setters and regulators. The joint work with the FASB is designed to ensure that the answers produced by IFRS and US GAAP will be substantially the same once the programme set out in the Memorandum of Understanding (MoU) between the IASB and the FASB is completed.

Accordingly a significant part of the Board's work is centred on the requirements set out in its MoU with the FASB. The IASB Work Plan and Due Process Summaries for each project accompany this report.

New projects added to the agenda

As the SAC will be aware, the IASB has added three new projects to its agenda, two of which help to meet our obligations under the MoU. The third arose from our convergence discussions with China and Japan.

The first two will be comprehensive reviews of the standards on leases and employee benefits. Our discussions with a broad range of interested parties indicate that these are two areas where accounting could benefit from a re-examination of the current standards in order to provide additional transparency for investors. Adding these projects to our agenda is the first step in meeting the goals set out in the MoU.

The third project is to amend the standard on related party disclosures. The IASB's work with regulators and other standard-setters has highlighted the need to reconsider our standard on related party disclosures, and this short-term project will examine options for doing so.

Leases

Leasing is a major international industry and an important source of finance for a wide range of entities. The current accounting requirements, set out in IAS 17 *Leases*, were developed some 25 years ago and have been criticised for allowing similar transactions to be accounted for in very different ways. At the same time, while the world leasing volume amounted to US$579 billion in 2004[1], leasing transactions remain largely off balance sheets, raising questions about the usefulness of the financial statements. The project will reconsider all aspects of lease accounting and is expected to lead to a fundamental revision of the way that lease contracts are treated in the financial statements both of lessees and of lessors. This project will be conducted jointly with the FASB and is expected to result in the publication of a joint discussion paper in 2008.

The IASB and FASB are currently establishing an international working group to advise on lease accounting issues. The closing date for nominations to the working group was 30 September 2006. The first meeting of the group is expected to take place in February.

Employee benefits, including pensions

The accounting for employee benefits and, in particular, defined benefit pension plans has received much media attention. The heightened public interest underlines the need for high quality and well-understood financial reporting of pension plans and other employee benefits. The project, to be conducted in two phases, will be a comprehensive reconsideration of the accounting required by IAS 19 Employee Benefits. The first phase will consider revisions that would achieve significant improvements in the short term, with a view to an interim standard in the next three to four years. Other aspects of accounting for employee benefits will be considered in the second phase. The FASB is also undertaking a two-phase post-retirement benefits

[1] Source: World Leasing Yearbook 2006

project. Although the timing and scope of the first phases may differ, the two boards are committed to arriving at a common approach at the end of the second phase.

Related parties

The disclosures required by IAS 24 *Related Party Disclosures* are intended to ensure that users of financial statements receive information about the existence of related party relationships and the effects of those relationships on an entity's profit or loss and financial position. In the course of its work with the Chinese Ministry of Finance (MOF) towards the convergence of Chinese accounting standards and IFRSs, the IASB has become aware of the difficulties that state-controlled entities face when applying IAS 24. As mentioned earlier, the IASB has been working with the Accounting Standards Board of Japan (ASBJ) with the aim of achieving convergence of Japanese standards and IFRSs. The work with the ASBJ highlighted concerns about aspects of the definition of a related party in IAS 24. Similar issues have also been raised by other jurisdictions and contacts around the world. The IASB has, therefore, decided to review IAS 24 in the light of the issues raised by the ASBJ and the Chinese MOF, and by interested parties in other jurisdictions.

Publication of consultation documents

Conceptual Framework project

The IASB added this project to its agenda in October 2004. The project is being conducted jointly with the FASB. The objective of the project is to develop a common conceptual framework, ie a single framework that brings together and improves upon the existing frameworks of both boards. At present, the boards are each guided by their own individual framework. These differ from each other in various respects, are incomplete, and are not up to date. The boards believe that a common conceptual framework will improve the foundation and concepts that underlie global financial reporting and serve as a more effective guide in developing global financial reporting standards.

In July the IASB and the FASB published for public comment the first two chapters of the proposed common conceptual framework, in the form of a discussion paper setting out preliminary views. The draft chapters define the objective of financial reporting, and the qualitative characteristics of decision-useful financial information.

In addition to the two draft chapters already published, the boards envisage further chapters including such matters as the definitions of assets, liabilities, revenues and expenses, how they are measured and recognised in financial statements, and the presentation of disclosure of information in financial statements.

The discussion paper restates the existing frameworks' definition of the objective of general purpose external financial reporting as providing information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions. The document also identifies relevance, faithful representation, comparability (including consistency) and understandability among the characteristics of financial information that make it decision-useful.

The discussion paper is open for comment until 3 November 2006. When they have considered the responses received, the boards plan to publish an exposure draft of these chapters in 2007.

An important question that arises on the boards' progress towards a common conceptual framework is the sequence and timing of the boards' joint and separate decisions on the project. Given the magnitude of the project the boards are discussing the draft new framework by individual chapters, and expect to publish draft chapters as individual discussion papers for public comment as and when they are completed. However, this process leaves unanswered the question of how the individual chapters will be issued when finalised – should they be issued as instalments or held back for publication as a complete framework? This question raises issues such as the purpose and status of the framework within the context of each board's body of pronouncements, and how the boards (and their constituents) are to deal with inconsistencies that may arise between the new framework and the old and between the new framework and existing standards. A further practical matter, which arises whether the framework is issued as a part work or as a single document, is the implications of turnover in the membership of the boards.

These issues are being discussed by the IASB in October and at its subsequent joint meeting with the FASB.

Classification of certain puttable financial instruments as equity

In June the IASB published for public comment proposals to improve the financial reporting of particular types of financial instruments that have characteristics similar to ordinary shares but are at present classified as financial liabilities. The proposals respond to requests from entities around the world.

IAS 32 *Financial Instruments: Presentation* requires an instrument to be classified as a liability if the holder of that instrument can require the issuer to redeem it for cash. That straightforward principle works well in most situations. However, many instruments that would usually be considered equity, including some ordinary shares and partnership interests, include provisions that allow the holder to 'put' the instrument (to require the issuer to redeem it) for cash. The instruments are therefore considered liabilities, rather than equity, under the existing provisions of IAS 32.

The IASB and the US national standard-setter, the Financial Accounting Standards Board, are working together on a comprehensive project on distinguishing debt from equity. However, that project will take several years to complete. There are many legitimate reasons for put features, and the IASB concluded that its constituents should not be forced to await the outcome of the long-term project. It decided to propose amendments to IAS 32 so that some instruments would be classified as equity rather than as liabilities.

Under the proposed amendments, the following types of financial instruments would be classified as equity, provided that specified criteria are met:

- ordinary shares that are puttable to (ie redeemable from) the issuer at fair value;
- ordinary shares of limited life entities; and
- partners' interests in a partnership that must liquidate upon exit of a partner (eg on retirement or death).

The amendments also propose disclosures about the instruments affected by the proposals. The Exposure Draft is open for comment until 23 October 2006.

Short-term convergence – borrowing costs

In May the IASB published for public comment proposals to improve the accounting treatment for borrowing costs. The proposals mark another step towards convergence with US generally accepted accounting principles (GAAP).

The proposed amendments to IAS 23 *Borrowing Costs* would remove a major difference between the accounting treatments for borrowing costs under IFRS and US GAAP. The Exposure Draft proposes to require an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. The option of immediately recognising those borrowing costs as an expense would be removed.

The IASB believes that the elimination of one of the two options in accounting for borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset would improve financial reporting and would result in information that is more comparable between entities.

The Exposure Draft was open for comment until 29 September 2006.

Meetings with representatives of standard setters

World Standard Setters

The IASB held its annual two day conference with world standard-setters in September. The conference was addressed by two Trustees, Sam DiPiazza and Cornelius Herkströter, and an analyst, Christian Dreyer from Tertium Datur AG.

In addition to presentations on the IASB Work Plan and the work of the IFRIC, the standard setters heard presentations from project staff on the conceptual framework project, the proposed IFRS for SMEs, and the fair value measurement guidance project. We received valuable input from discussions in breakout group sessions. Tom Seidenstein and Michael Wells discussed access to IASB publications and educational activities being undertaken by the IASCF. We took the opportunity to raise the IFRS brand issue with the standard setters.

European Financial Reporting Advisory Group (EFRAG)

We have arranged a regular meeting with representatives of EFRAG. The first meeting took place in April. The second meeting was held on 17 October.

The meetings will take place shortly before the joint meetings of the IASB and the FASB held each April and October. The subjects discussed at the recent meeting were:

- The Memorandum of Understanding between the IASB and the FASB
- Progress on joint IASB/FASB projects – mainly equity/liability classification, financial statement presentation, business combinations and the conceptual framework.

These meetings are held in public.

The impact of 2005

We have been asked whether the Trustees or the IASB should take some time to review the transition to IFRS in Europe and Australia in 2005, and determine whether there are lessons to be learned or future risks to be managed as regulators assess the effectiveness of compliance with IFRSs in coming months.

That simple request for a review is not straightforward to fulfill. Searching Google for "IFRS implementation" produces 682,000 results; for "IFRS compliance" 887,000 results; and even restricting the search by adding "Europe 2005" only reduces those results to 304,000 and 280,000 respectively.

We note that the firms are undertaking some surveys.

A PricewaterhouseCoopers / Ipsos MORI survey of 187 fund managers across Europe reports that 79% of European fund managers believe the adoption of IFRS is a significant development for financial reporting. In some countries the figure was over 95%. 76% agreed that the IFRS information companies reported during 2005 was very clear (11%) or fairly clear (65%), although the proportion of 'fairly clear' answers indicated that there was room for improvement in IFRS communications.

Ernst & Young[2] reviewed the 2005 financial statements of some of the largest companies in the world to see how they have applied IFRS – mainly for the first time – in their financial statements, to assess the degree of consistency and comparability among companies that has resulted from IFRS adoption, and to ascertain how performance measures based on IFRS have been used in market communications.

[2] Ernst & Young's *Observations on the Implementation of IFRS*

Among the themes and trends they observed were:

- The 2005 implementation of IFRS has been a resounding success overall.
- IFRS financial statements retain a strong national identity.
- IFRS implementation has required extensive judgment to be applied in the selection and application of IFRS accounting treatments and this restricts consistency and comparability.
- Companies do not seem confident that IFRS financial information is sufficient for the purpose of communicating their performance to the markets.
- IFRS financial statements are significantly more complex than financial statements based on national accounting standards.

KPMG[3] asked a number of leaders in the fields impacted by the widespread introduction of IFRS — standard-setters, preparers, users, regulators and auditors — for their experience so far, and for their hopes and fears for the challenges that remain. It notes:

> Late in 2005 critics of the implementation process were at their most furiously vocal at the height of the practical difficulties of introducing the new system.
> Now it looks as though those views have been reversed just a few months later.
> Probably most relieved at the soft landing post-IFRS implementations are the standard-setters and regulators.

The Foreword to the KPMG publication notes:

> Consistency of application has also been identified as an important factor in the elimination of the reconciliation requirement. Expectations of consistency must be realistic. Principles-based standards need to be applied by preparers and auditors with integrity and judgment. Regulators will need to avoid second-guessing such judgment, placing emphasis on an acceptable interpretation in every case; not the same interpretation.
> However, the complexity of a number of the existing standards is a significant barrier to developing consistency of application. Balancing continued convergence with sufficient stability to allow consistency to develop is a major challenge for the IASB and regulators.
> As the IASB continues to develop new standards, constituents are debating fundamental issues concerning the future direction of financial reporting, for example the wider use of fair value for the measurement of assets and liabilities.
> It is essential that constituents, particularly users and preparers, play a full and active part in the future development of IFRS.

[3] KPMG's *International Financial Reporting Standards –Views on a Financial Reporting Revolution*

In his speech to the recent World Standard Setters conference, Sam DiPiazza of PwC summarized the situation as follows:

> Although it is still too early to conclude on 2005, most seem to agree that, all things considered, the transition went reasonably well.
>
> But a few key questions remain:
>
> - “Will we remain disciplined in developing principled based standards that reflect economic reality, not just accounting theory?”
> - "Will companies and other market participants live up to an environment with broad principles but fewer detailed rules?"
> - “Will the regulators accept judgments that might vary based on circumstances and backgrounds?”

The Board is actively involved with the FASB and the major accounting firms in attempting to ensure that the answers to those questions are positive. Once agreement with the major firms is reached on how principle-based standards can be implemented, we intend to make a joint approach with the FASB to the regulators and the auditing oversight boards to seek their support. We shall keep the SAC informed on progress.