IFRS

Due Process Oversight Committee

IFRS Foundation Trustees

13 October 2011 **Agenda paper 3F**

Memorandum

To: David Sidwell, Chairman - Due Process Oversight Committee

From: Alan Teixeira

Date: 30th September 2011

Re: Due Process Update

Overview

The update covers four areas

(a) Effect analyses

(b) Recently published exposure drafts

(c) Forthcoming IFRSs and exposure drafts

(d) Other projects

Highlights

Since the DPOC last met in July, the IASB has completed the effect analyses for the Joint Arrangements and Consolidated Financial Statements projects. The IASB has also published two exposure drafts—an ED relating to Investment Entities and an ED proposing the deferral of the effective date of IFRS 9 *Financial Instruments*. The latter has a comment period shorter than the normal 120 days.

The IASB has completed its deliberations on the financial asset and liability offsetting project and expects to publish related amendments in December.

The IASB ratified an Interpretation referred to it by the IFRS Interpretations Committee in September, which the IASB expects to publish in October.

The IASB decided to correct an oversight by amending IFRS 1, which focuses on first-time adoption of IFRSs. The planned exposure period is shorter than the normal 120 days. The IASB expects to publish that exposure draft in October.

Attached to this update is the most recent version of the IASB work plan, with a risk assessment overlay—see Agenda Paper 3F(i).

That paper analysis highlights increased risk for two projects:

- the classification and measurement chapters of IFRS 9, as a result of a proposal to delay its mandatory effective date; and
- investment entities, as a result of a recently created difference in scope between the IASB and FASB proposals.

The paper also notes reduced risk for two projects:

- Leases, as a consequence of the decision by the Boards to re-expose the proposals; and
- Asset and liability offsetting, as a result of a decision not to address the difference between IFRSs and US GAAP.

Effect analyses

We have completed and issued the effect analysis for both IFRS *Consolidated Financial Statements* and IFRS 11 *Joint Arrangements*, and their related disclosures (which are included in IFRS 12 *Disclosure of Interests in Other Entities*).

These documents took longer to develop than we expected, or hoped, partly because we needed time to incorporate additional information to help meet the needs of EFRAG. The effect analysis for IFRS 11 was distributed at the July meeting of the DPOC and for IFRS 10 by email on 7 September.

We have not prepared a full effect analysis for IFRS 13 *Fair Value Measurement*, although we have included a small section on costs and benefits in the IFRS 13 Feedback Statement.

Internal developments

The effect analyses have been discussed more widely among staff and some Board members. We are making a concerted effort to have more staff involved in the development of the processes that feed into these analyses.

Developing the two most recent documents has highlighted areas where the staff can improve their development of examples, their management of data about outreach activities and the way by which information is disseminated to the Board and publicly (such as on our website).

We are also continuing to monitor, and intend to work with, EFRAG in its project on effect analyses. The letter to EFRAG in this regard is included as Agenda Paper 3G.

Exposure drafts

Investment Entities

In July the Board published an exposure draft proposing to create an exception to consolidation for *Investment Entities*. Some jurisdictions, including Canada and the United States, have special reporting requirements for entities that only invest in other entities and do not participate in the operation or management of any of the businesses in which they invest.

The project objective is to define an investment entity and to require that an investment entity should not consolidate investments in entities that it controls, but to measure those investments at fair value, with changes in fair value recognised in profit or loss.

This exposure draft has been developed with the FASB. In my last report I noted that the FASB would not be ready to release its version until about 22 July, because it is linking the release to a separate exposure draft on investment property companies. The IASB completed all of its formal voting requirements in June 2011 and held back the publication date so that the two boards could release the proposals together.

However, the FASB experienced further delays with the related proposals on investment property companies. We therefore decided to publish the IASB version of the exposure draft rather than wait for the FASB. The FASB planned to have a shorter comment period, which would realign the project timeline.

Accordingly, the IASB exposure draft was published on 25 August with a 120-day comment period.

The IASB exposure draft was supported by 12 Board members, with 3 Board members dissenting from the proposals. I also noted in July that the Board has not published a discussion paper or established a working group for this project. The project focuses on a narrow set of entities and the accounting issues are well understood.

Despite its narrow scope, the exposure draft is likely to generate significant debate. There are strongly held views about whether this exception is appropriate. Many jurisdictions considered but rejected this exception in their reporting requirements before they adopted IFRSs. Before publishing this exposure draft, the IASB had considered and rejected this exception.

A podcast and Snapshot were released at the same time as the ED. The Board will hold round tables after the comment period ends. The topic has been included in presentations at the World Standard Setters meeting in September and is on the agenda at the AOSSG meeting in November.

Adding to the debate will be one difference between the IASB and FASB decisions. The FASB proposals have a much broader scope than those of the IASB, allowing a much wider range of entities to use the exception. At the date of this report the FASB had still not published its version of the ED.

IFRS 9—deferral of the mandatory date

In July I reported that the staff were going to recommend that the IASB should move the mandatory effective date for IFRS 9 *Financial instruments* from 1 January 2013 to 1 January 2015. The remaining chapters were expected to be finished by now, which is one of the factors that the Board considered when it set the original date of 1 January 2013.

On 22 July the Board decided to expose that change.

Due process considerations

The staff requested that the Board should set a comment period shorter than the normal 120 days. The project staff originally requested a 45-day comment period.

The Due Process handbook states:

> The IASB normally allows a period of 120 days for comment on its consultation documents. For exposure drafts, if the matter is exceptionally urgent, the document is short, and the IASB believes that there is likely to be a broad consensus on the topic, the IASB may consider a comment period of no less than 30 days, but it will set such a short period only after formally requesting and obtaining prior approval from 75 per cent of the Trustees. For major projects, the IASB will normally allow a period of more than 120 days for comments. The comment period on draft IFRIC Interpretations is usually 60 days, but may be less in urgent cases.

The exposure draft is very short, and is very narrow in scope—it focuses only on changing the mandatory effective date from 1 January 2013 to 1 January 2015. It should therefore not create a significant burden for potential respondents.

However, there are two matters that I think you should be aware of. The first is that, even though the main factor motivating this change is the fact that the remaining chapters of IFRS 9 have not been completed, the proposed change could generate significant comments. One of the secondary factors motivating the proposal is that because the EU has not yet endorsed IFRS 9, European entities that are also US registrants would soon need to run dual systems to avoid the SEC reconciliation requirements. We expect the proposal to be well supported because of this.

Board members and staff have been approached on an individual basis by representatives from large banks in Europe urging them to defer the mandatory date, as a matter of urgency, to address this issue. However, it is possible that some respondents will use the exposure draft as an opportunity to comment on the lack of EU endorsement. In that sense, the exposure may generate some attention for other than technical reasons.

The other factor is that the exposure draft was published at the beginning of August, which is traditionally a holiday period in Europe. The Board was conscious of avoiding criticism for having a large portion of the comment period fall in August.

The staff recommendation was that the comment period should be approximately 75 days, giving the staff sufficient time to analyse comments, undertake any additional consultation and still finalise the proposal, if appropriate, by the end of 2011.

The Board decided to have a comment period of a minimum of 75 days. The exposure draft was published on 4 August with comments due by 21 October 2011. This is a 78-day comment period.

Forthcoming

IFRIC 20 Stripping Costs in the Production Phase of a Surface Mine

Background

In August 2010 the IFRS Interpretations Committee published for public comment proposed guidance on the accounting for stripping costs in the production phase of a surface mine. The Interpretations Committee was asked to consider how to account for stripping costs (the process of removing waste from a surface mine in order to gain access to mineral ore deposits) given the divergence in practice that exists.

The Interpretations Committee received 50 comment letters. Having considered the responses received, the Interpretations Committee developed and approved IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*. One IFRS Interpretations Committee member voted against publication of the IFRIC.

At its meeting in September the Board ratified IFRIC 20.

Due process considerations

Before ratifying IFRIC 20, the Board considered and agreed with the conclusion of the Interpretation Committee that the Interpretation does not need to be re-exposed. The Interpretations Committee and the Board followed all due process steps relevant to issuing an Interpretation.

The IASB expects to publish the new Interpretation in mid-October with an effective date of 1 January 2013, with earlier application permitted. The Board also approved a related amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* as a consequence of its approval of IFRIC 20.

Proposed amendment to IFRS 1 First-time Adoption of IFRSs

Background

In September 2011 the Board considered a request to amend IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

The proposed amendment to IFRS 1 would provide relief to a first-time adopter from full retrospective application of IFRSs in circumstances in which the first-time adopter is in receipt of a loan from a government at an interest rate that is below the market rate of interest. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* was amended in 2008 to require the use of fair value in such cases, but only for loans received after the effective date of the amendment. No equivalent relief from retrospective application was provided for first-time adopters. This was brought to the attention of the Board this year and the Board accepts that this was an oversight.

The organisation requesting the proposed change has suggested that if the amendment is made quickly, it could be used by entities adopting IFRSs in 2011. The Board is sympathetic to this suggestion.

Due process considerations

The document is very short (two pages, including Basis for Conclusions) and it is expected to be non-contentious. We are therefore proposing a short comment period of [60] days. If the Board publishes the exposure draft in mid-October a [60]-day comment period would end in mid-[December]. We think that the very short length of the exposure draft will mean that there will be the time needed for translation and consultation by constituents.

Financial instruments—Offsetting of financial assets and financial liabilities

Background

The IASB and FASB developed a proposal that would align the offsetting requirements for financial assets and liabilities. The proposal focused on netting on the basis of the ability and intention to offset payments on a day-to-day basis. This is closer to the requirements in IFRSs than to US GAAP, which focuses on rights in bankruptcy. The current IASB requirements, and the proposals exposed, have been described as a gross approach. This is an unfortunate mischaracterisation of the model. The current IASB requirements, US GAAP and the proposals are all offsetting models, but they use different risk factors as the basis for offsetting. The effect of the proposals would be that entities applying US GAAP would, generally, not be able to offset as many financial assets and liabilities as they do now.

In June the IASB and FASB reached different conclusions—the IASB voted 15-0 to confirm the proposals whereas the FASB voted 4-3 not to proceed as proposed.

Completion of project

The IASB and FASB are completing the disclosure proposals exposed to help users reconcile between US GAAP and IFRSs. In addition, the Board decided to provide additional application guidance in IAS 32 *Financial Instruments: Presentation*, to address current practice issues identified during the redeliberations. The Board completed its deliberations in September 2011 and expects to issue the amendments to IAS 32 and *IFRS 7 Financial Instruments: Disclosures* in December 2011.

The Board concluded that the offsetting criteria and amendments to the offsetting application guidance should remain in IAS 32, and that the disclosures should be placed in IFRS 7.

The Board decided that the amendments should be effective for annual and interim reporting periods beginning on or after 1 January 2013.

Due process considerations

The Board noted that it was satisfied that all mandatory due process steps for the offsetting project and that sufficient non-mandatory due process steps had been performed. A copy of the due process paper is included at Agenda Paper 3F(ii).

All Board members supported these decisions.

The Board decided that neither the amendments to the IAS 32 application guidance nor the converged disclosure requirements required re-exposure. Fourteen Board members supported this decision. One Board member thought that a more cautious approach was warranted because any change, or addition, to the wording in IAS 32 could change practice. However, that Board member is not actually dissenting from the amendments.

Hedge accounting (the general model)

Background

The Board has continued to consider the comments received from comment letters and outreach on the general hedge accounting model.

In September 2011 the Board completed its deliberations and asked the staff to prepare a draft of the final requirements, including application guidance and a Basis for Conclusions. That draft would be made available on the IASB website for about 90 days. This will provide the Board with the opportunity to undertake an extended fatal flaw process and to undertake additional outreach. The Board also wishes to give the FASB the opportunity to consider the planned requirements. The Board plans to finalise the requirements once this review has been completed.

Due process considerations

The Board has not yet completed its formal review of its due process steps. It will do so once the staff have completed the drafting review and reported back to the Board as to whether any matters raised during that review need to be considered as sweep issues.

After that process has been completed the Board will review its due process steps and will assess whether re-exposure is necessary.

The Board resumed its public discussion of portfolio hedges in April and expects to develop further its proposals related to portfolio hedging before it finalises the more general hedging requirements. We therefore expect to publish an exposure draft for portfolio hedging in the first half of 2012.

Leasing

Background

Lease obligations are widely considered to be a significant source of off balance sheet financing. The objective is to improve financial reporting by lessors and lessees.

The boards published a joint exposure draft in August 2010. During 2011 the IASB and FASB have been considering the comments received.

In July 2011 the boards decided that, although they had not completed all of their deliberations, they had sufficient information to be able to conclude that they would re-expose the proposals,

The boards expect to complete their deliberations in October. They will then prepare the revised exposure draft.

Due process considerations

The Board has not yet formally decided on the comment period, but the staff are recommending that it should have a 120-day comment period and, like any ED, that it will have a full Basis for Conclusions and any related application guidance and illustrative examples.

The exposure draft is expected to be issued in February 2012.

The staff and boards will undertake targeted outreach during the exposure period. However, because the revised exposure draft will not be published for some months, outreach plans for the re-exposure phase of the project are only at a preliminary stage of development.

Revenue recognition

Background

This is a joint project with the FASB. The boards have issued two due process documents: a discussion paper in December 2008 and an exposure draft in June 2010. As I reported in July, the boards decided to re-expose their revised proposals. It was the unanimous view of the boards that while there was no formal due process requirement to re-expose the proposals it was appropriate to go beyond established due process, given the importance of the revenue number to all companies and the need to take all possible steps to avoid unintended consequences.

A revised exposure draft is treated no differently to any other exposure draft. It will include a full Basis for Conclusions and any related Application Guidance (which is an integral part of the proposed IFRS and would therefore be incorporated into laws and regulations in adopting countries) and illustrative examples (which are educational in nature and accompany the IFRS to be helpful to those applying the standard, but are not incorporated into laws and regulations in adopting countries).

So far in the re-exposure process the staff have received comments from the boards on two pre-ballot drafts. There is a single sweep issue to be taken to the joint board meeting on 19 October. This relates to the disclosure in interim reporting. This topic will not affect the

substance of the boards' proposals. The staff expect to publish the revised exposure draft in November 2011. On that timetable, and with a comment letter period of 120 days, the comment deadline is expected to be in March 2012.

In the revised exposure draft, the boards have limited their request for responses to five questions.

Outreach

The staff plan to conduct the full range of publication outreach within a few days of publication, eg press release, snapshot, webcast, and stakeholder letter. In addition, the staff have planned outreach specifically targeted towards investors, including an Investor Perspective and Investor Spotlight at publication. An investor-specific webcast and analysts' briefing will take place shortly after publication.

Before publication, and throughout the comment letter period, a diverse range of outreach is currently planned to raise awareness of the boards' proposals and to educate interested parties. The project will be presented at the IFRS conferences in Brazil and Melbourne; at the AAOSSG meeting in November; and at the FEI Conference in the US. The staff and board members will attend industry-specific outreach such as the European software group, the US Engineering and Construction conference and the EFRAG-organised industry workshops in Europe.

Known areas of change will also be addressed. In particular, the staff will prepare their outreach initiatives to real estate developers in Asia and Brazil to ensure that the proposed standard adequately addresses the issues raised locally in relation to IFRIC 15 *Agreements for the Construction of Real Estate*.

The boards also intend to hold public discussions on their proposals in May 2012 in London, Norwalk and Tokyo. The staff will post updates on the project outreach page throughout the re-deliberations to ensure that the outreach process is transparent.

Impairment

Background

The objective is to increase the usefulness of financial statements by improving the transparency of information about the credit quality of financial assets. The main focus is the estimation and reporting of expected losses in a timely manner. This phase of the project has been developed jointly with the FASB.

In November 2009 the IASB published for public comment an exposure draft on provisions. The proposals followed an initial *Request for Information*, published in June 2009, on the practicalities of moving to an expected loss model. Recognising the significant practical challenges of moving to an expected loss model, the IASB established an Expert Advisory Panel (EAP) in December 2009 that was made up of experts in credit risk management.

In January 2011 the IASB published, jointly with the FASB, a supplement to the December 2009 exposure draft. The supplement presented an impairment model that the boards believed would enable them to satisfy at least part of their individual objectives for impairment accounting, while still achieving a common solution to impairment. Feedback was mixed, with many respondents preferring the IASB's simplified proposals and others preferring aspect of the FASB's original model.

Recent developments

At the last meeting I reported that the boards were continuing to develop an impairment model building on the previously exposed proposals, taking into account the feedback from the boards' original EDs and the SD. That approach places financial assets into three categories (or 'buckets') for the purpose of assessing expected losses, making the maximum use of credit risk management systems.

The boards have been discussing how to determine the category into which a financial asset should be placed on initial recognition and the factors that should determine when a financial asset is transferred into a different category. The boards have agreed that the principle should reflect the point in time when the credit risk associated with the financial assets increases to the point at which there is current significant uncertainty about the ability to collect contractual cash flows and the entity begins to manage the financial assets more actively because of the heightened credit risk.

The next step in the process is likely to be an exposure draft, to be published jointly with the FASB.

Insurance contracts

In June the boards were planning to publish the next due process documents for insurance by the end of 2011. This is now not expected to happen until at least the first half of 2012.

The boards have reached different decisions on several basic matters. In addition, the IASB has already published an exposure draft, whereas the FASB has only published a Discussion Paper.

The boards are assessing how best to address these differences and how to align the timetables so that the outcome is identical final standards. If the IASB re-exposes the insurance contract proposals it will align the project timetables.

The other challenge is the relationship between the insurance contracts project and the financial instruments project. We have also made it clear that the IASB will need to ensure that the insurance contract IFRS and the financial instruments requirements (IFRS 9) work together.