IFRS Advisory Council

London
20-21st February 2012

Agenda paper 1

Memorandum

To: IFRS Advisory Council

From: Hans Hoogervorst

Date: February 2012

Re: Chairman's Report

Overview

Since the Advisory Council last met in October2011 the IASB has:

- Published three exposure drafts—an ED proposing an amendment to the accounting for government loans, a revised ED for revenue from contracts with customers and a short ED clarifying the transition requirements for the new consolidation standard (IFRS 10).
- Published three final amendments to IFRSs – common offsetting disclosure requirements with the FASB, clarifications of our application guidance for offsetting financial assets and financial liabilities and the change in the mandatory effective date of IFRS 9.
- Published an Interpretation referred to it by the IFRS Interpretations Committee ratifying the requirements for accounting for stripping costs in the production phase of a surface mine.
- Commenced discussions of feedback received on its first formal public agenda consultation.

Accompanying this report you will find a copy of the work plan and a more detailed analysis of the work we have been undertaking this year.

Completing the MoU projects

Through much of 2010 and the first half of 2011 the focus of the IASB was on the successful completion of four projects by the end of 2011—the three remaining projects on the IASB-FASB MoU (financial instruments, leasing, and revenue recognition) and insurance contracts.

However, by July 2011 it became clear that the projects would not be completed until 2012. We re-exposed revenue recognition in November 2011 and plan to re-expose the leases proposals.

We have also had difficulties reaching converged solutions with the FASB on financial instruments and insurance. We hope to finalise deliberations on joint proposals on impairment accounting in the first half of 2012. In January 2012 we decided to jointly redeliberate selected aspects of our financial instruments classification and measurement models to seek to reduce key differences. We have also decided to publish a staff draft on hedge accounting for a 90 day period. This has the benefit of providing the FASB with more time to decide how they want to proceed with their hedge accounting project.

Delays in completing these much needed improvements to financial reporting for those using IFRSs and US GAAP are unfortunate, but they should not be seen as a failure. They reflect the IASB being cautious, responsive and responsible. It is incumbent on the Board to ensure that changes made to our accounting requirements are appropriate and that our stakeholders have had the opportunity to fully participate in the process. Re-exposure, in this case, is part of that process.

In the next sections I provide a brief summary of the developments in these projects.

Financial Instruments

Financial instruments—offsetting financial assets and financial liabilities

In January 2011 the IASB and FASB developed a proposal that would align the requirements for offsetting 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 as well as in circumstances of default and bankruptcy. This is closer to the requirements in IFRSs than to US GAAP, which, for derivatives, gives primacy to bankruptcy. The effect of the proposals would have been that entities applying US GAAP would, generally, not have been able to offset as many financial assets and liabilities as they do now.

In June 2011 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.

In December 2011 the IASB and the FASB completed common disclosure requirements to help users compare between US GAAP and IFRS financial statements in relation to offsetting. This was important given that the boards were unable to reach a common approach to offsetting on the face of the balance sheet. In addition, the IASB decided to provide additional application guidance in IAS 32 *Financial Instruments: Presentation* to address current practice issues identified during the redeliberations. These changes were also completed in December 2011. The disclosure requirements will be effective for annual reporting periods beginning on or after 1 January 2013 whereas the clarifications of IAS 32 will be effective for annual reporting periods beginning from 1 January 2014. In both cases the new requirements will apply retrospectively.

Hedge accounting

The general 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 will be made available on the IASB website for about 90 days. We expect this document to be published in the first quarter of 2012. This will provide the Board with the opportunity to undertake an extended fatal flaw process and 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 is complete.

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; after which the Board will review its due process steps and will assess whether re-exposure is necessary.

The macro hedge accounting model

The Board resumed its public discussion of portfolio hedges in April 2011 and expects to develop further its proposals related to portfolio hedging before it finalises the more general hedging requirements.

Impairment

The objective of the impairment project 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 is being developed jointly with the FASB.

In November 2009 the IASB published for public comment an exposure draft on impairment accounting. 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 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 aspects of the FASB's original model.

Since then, the IASB and the FASB have focused on an approach that 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 impairment allowance recognised would vary depending on which category an asset is allocated to. On initial recognition, financial assets would be placed into the first category, which would have an allowance that is less than the lifetime expected losses.

At the December 2011 meeting the boards tentatively agreed to recognise 12 months of expected losses for these loans. If the credit quality of a financial asset deteriorates, it would be transferred to a lower quality category and the entity would recognise an impairment allowance equal to the lifetime expected losses.

The next step in the process is likely to be an exposure draft, to be published jointly with the FASB. We are aware of the importance of finalising the impairment project expeditiously as impairment accounting has been a primary area of concern during the financial crisis. However, impairment accounting has major cost and systems implications, particularly for financial institutions so we need to balance the need for timely completion against the importance of obtaining robust input from our constituents.

IFRS 9 – Classification and Measurement

Deferral of the mandatory date

In December 2011 the Board issued *Mandatory Effective Date of IFRS 9 and Transition Disclosures*, which defers the mandatory effective date of IFRS 9 from 1 January 2013 to 1 January 2015. This change was unanimously supported by respondents to the exposure draft and enables the board to maintain its objective of requiring all phases of the project to replace IAS 39 to become mandatory at the same time. The Board also responded to requests from constituents to provide relief from the requirement to restate comparative information when first applying IFRS 9, instead requiring disclosures to assist users of financial statements understand the impact of moving to IFRS 9.

Limited modifications to IFRS 9

The classification and measurement chapters of the new financial instruments standard, IFRS 9, were completed in 2009 (financial assets) and 2010 (liabilities). While the FASB has now also tentatively decided on a mixed measurement model for financial instruments, they have reached different answers from the IASB model on matters such as the number of classification categories, which assets should be measured and reported at fair value, where fair value changes should be recognised and the bifurcation of embedded derivatives. In addition there are important legacy differences, such as whether items measured through OCI should be recycled to net income when they are sold.

The two boards cannot avoid facing these differences. International markets and the G20 would find significant differences between IFRSs and US GAAP unacceptable. Early on we committed to exposing the FASB proposals for comment. The FASB has yet to decide formally whether they would need to re-expose their model. However, they have made many changes from their original proposals and it is most likely that they will re-expose.

In addition, many insurance companies have requested that we consider changes to the accounting for financial assets to assist them in properly reflecting their business models.

However some entities are already applying IFRS 9 and others have made a considerable investment in anticipation of moving to IFRS 9. We are aware of the tensions between considering changes to IFRS 9, giving users of IFRSs stability and certainty and the need to ensure that the accounting for financial instruments is of the highest quality.

In November 2011 the board agreed to consider modifying IFRS 9 particularly in view of convergence and the insurance contracts project. However the Board noted that any changes should be made in a manner that minimises disruption for those who have already started to apply or were close to applying IFRS 9. The Board also noted that IFRS 9 is fundamentally sound and that the project should be completed expeditiously.

In December 2011 the Board tentatively decided to limit the items to be reconsidered to the contractual cash flow characteristics criteria, whether bifurcation for financial assets should be reconsidered and whether an OCI remeasurement should be used for some debt instruments.

In January 2012 the IASB and the FASB decided to jointly redeliberate these items and any knock-on effects (for example, disclosures or the model for financial liabilities in the light of the financial asset decisions). The boards plan to discuss each issue jointly and what changes, if any, they would propose to make to their separate models and incorporate in their respective exposure drafts.

Leases

Lease obligations are widely considered to be a significant source of off balance sheet financing. The objective of the leasing project 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 considered 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.

Although the boards have addressed many of the issues raised by respondents to the exposure draft we are aware of some remaining concerns about whether all leases should be accounted for in the same way. For example, to achieve a straight line P&L expense some have questioned whether, for example, the lessee accounting for real estate leases should be different to the proposed model. While the redeliberations are substantially complete, the boards are likely to reconsider this issue in light of feedback already received prior to publishing the new exposure draft.

In January 2012 the leases working group discussed various aspects of lessee accounting and the definition of an investment property. Using input received from the working group meeting the boards will further discuss lessee accounting in the February 2012 joint board meeting.

The Board has not yet formally decided on the comment period, but the staff recommend a 120-day comment period. Like any ED, it will have a full Basis for Conclusions and any related application guidance and illustrative examples. The exposure draft is expected to be issued late in the second quarter of 2012 although the timing will be affected by the extent to which the boards decide to further consider lessee accounting prior to re-exposing.

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

This is a joint project with the FASB. As I reported in October 2011, 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. Therefore, the boards have now issued three due process documents: a discussion paper in December 2008, an exposure draft in June 2010 and a revised exposure draft in November 2011.

The revised exposure draft is like any other exposure draft—it includes a full Basis for Conclusions, related application guidance and illustrative examples.

The revised exposure draft was published on 14 November 2011, and with a comment letter period of 120 days, the comment deadline is 13 March 2012.

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

Before publication, a diverse range of outreach was conducted to raise awareness of the boards' proposals and to discuss their implications with interested parties. This outreach has continued to be conducted throughout the comment letter period.

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

Other Projects

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 second half of 2012. It has not been formally decided if there will be an exposure draft or a review draft.

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 to best ensure that the outcome is as converged as possible.

The other challenge is the relationship between the insurance contracts project and the financial instruments project. We have always made it clear that the IASB will need to ensure that the insurance contract standard and the financial instruments requirements (IFRS 9) work together. As such, at the November 2011 Board meeting, all IASB members voted in favour of making limited modifications to IFRS 9, in particular to consider the interaction with the insurance contracts project. In January 2012 the boards specified certain aspects of the boards' classification and measurement models that they will redeliberate. This will also aim to address specific concerns that have arisen from stakeholders in the insurance project.

Consolidation

In December 2011 the Board published a short exposure draft to clarify the transition requirements for IFRS10 *Consolidated Financial Statements*. This is expected to allay fears by confirming the extent of relief intended to be provided on transition which some had misunderstood as being more narrow than the Board intended. Given its length, the fact that the clarifications benefit preparers and thus should be well received and the fact that the mandatory effective date of IFRS 10 is 1 January 2013 a 90 day comment period has been provided. This was previously advised to the DPOC. The Board expects to start its deliberations based on the feedback received in April 2012.

The Board received a request from EFRAG for deferral of the effective date of IFRS 10, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*. The Board discussed this request and noted that IFRS 12 in particular was an important financial crisis related project and that others (including some European constituents) did not feel deferral was appropriate given the resources committed to timely application. On balance the Board decided not to defer the mandatory effective date.

Agenda Consultation

On 26 July 2011 the IASB launched its first formal public agenda consultation on its future work plan. Comments were requested by 30 November 2011. Through the agenda consultation the IASB is seeking input from all interested parties on the strategic direction and the broad overall balance of the work plan. The agenda consultation will provide the Board with important input when considering possible agenda items.

In January 2012 the Board discussed the staff's summary of feedback received on the agenda consultation. The feedback reported to the Board was developed on the basis of the 245 comment letters received, the results of an on-line survey of investors and feedback received from outreach activities undertaken by Board members and staff members. These papers will also be presented to the Advisory Council in this meeting.

The staff did not make any recommendations and the Board was not asked to make any technical decisions. The Board requested that the staff should do further research to clarify some matters raised in the comment letters and suggested further ways in which the priorities for standards-level projects could be assessed. The Board expects to discuss a development plan in March 2012