IFRS™

AGENDA PAPER

IFRS Foundation Trustees meeting

Singapore 11-12 January 2012 **Agenda ref 2**

Memorandum

To: IFRS Foundation Trustees

From: Hans Hoogervorst

Date: December 2011

Re: Report of the IASB Chair

Overview

Since the Trustees last met in October, 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 IFRS – common offsetting disclosures with the FASB, clarifications of our application guidance for offsetting 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.

Accompanying this report you will find a copy of the work plan, as at 20 December 2011, 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 have re-exposed revenue recognition and plan to re-expose the leasing proposals.

We have also had difficulties reaching converged solutions with the FASB on financial instruments and insurance. We hope to issue joint proposals on impairment accounting in the first half of 2012 and are investigating ways to reconcile differences in the classification and measurement of financial instruments. We have decided to place a staff draft of the hedge accounting proposal on the IASB website as part of an extended, 90 day, fatal flaw review and to give 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 of financial assets and financial liabilities

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. 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 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 the IASB and the FASB completed disclosure requirements to help users reconcile between US GAAP and IFRSs 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. 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 from January 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 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 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 (macro) hedging in 2012.

Impairment

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 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 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 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. 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. When assets are clearly non-performing or distressed they would be transferred to the lowest quality category, which also has an impairment allowance based on lifetime expected losses but that would be expected to be calculated on the basis of more detailed information about the credit quality.

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 November the Board agreed to move the mandatory effective date for IFRS 9 *Financial Instruments* 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. 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, 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 changes in the fair value for some debt instruments should be presented in OCI (other comprehensive income).

Leasing

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 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.

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. The staff are considering whether this needs to be addressed further.

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 in the second quarter of 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

This is a joint project with the FASB. As I reported in October, 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.

During the process of preparing the exposure draft the staff received comments from the boards on two pre-ballot drafts. An issue relating to the disclosure in interim reporting was taken to the joint board meeting on 19 October. This topic did not affect the substance of the boards' proposals. 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 will continue to be conducted throughout the comment letter period. The project has been presented at the IFRS conferences in Brazil and Melbourne; at the AOSSG (Asian-Oceanian Standard-Setters Group) meeting; and at the FEI (Financial Executives International) 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 (European Financial Reporting Advisory Group)-organised industry workshops in Europe.

Known areas of change will also be addressed during outreach. 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.

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 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 to best ensure 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 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 Board meeting, all IASB members voted to review IFRS 9 and consider making limited modifications in the light of the tentative decisions reached in the insurance contracts project.

Consolidation

In December the Board published a very 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 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. The DPOC was consulted before the exposure period was set.

Beyond the MoU

Although we now know that the decision by the US SEC about the incorporation of IFRS will not be made in 2011, we do expect it in the coming months. This is an important decision for the US, as well as other parts of the world that have yet to formally commit to IFRS. In November 2011 the SEC published an analysis of IFRS in practice, as well as a comparison of US GAAP and IFRSs. The quality of the analysis in the updates by the SEC to its IFRS work plan is evidence that the SEC is taking a deep and thoughtful approach to the decision.

The IASB is an international standard-setter and we are ready to be a global standard-setter. When the IASB was established in 2001 its standard-setting process was largely modelled on that of the FASB. Since then both organisations have continued to enhance our respective due processes. For the IASB, this has resulted in enhancements to the depth and transparency

of its standard-setting and consultation activities. We have also developed an outstanding approach to outreach which I believe is second to none. I have never worked in an organisation that is so transparent in its activities, and that consults so widely.

Having said that, we know we can do better. Every country has some form of safety valve in its endorsement process. That is not surprising given that they are delegating a very important process to an independent organisation. We understand the importance of demonstrating to each jurisdiction that we are acting in the best interests of investors with an independent mind-set. Quite simply, we need to justify our work. We are now completing effect analyses and post-implementation reviews for major standards and are committed to the enhanced due process oversight the Trustees have implemented.

One area of concern is that inconsistent application of the standards makes international comparison more difficult. One set of accounting standards is a necessary condition for comparability of financial reporting, but it is not a sufficient condition. We have our part to play, by making sure that the standards are clear and enforceable. We are working more actively with groups of securities regulators such as ESMA. We were very pleased to see ESMA take the step of providing guidance on impairment accounting for sovereign debt in anticipation of December year-end financial statements. Their publication of that document reflects the benefit of our organisations working more closely together.

As more countries apply IFRS the call for greater assistance in implementation has increased. We have been discussing this with our Interpretations Committee. In addition by appointing Wayne Upton as Chair of this committee and by further improving the link between our educational and technical activities we are modifying the organisation to enable us to provide greater implementation support where appropriate.

The way we develop our new work plan will also be critical. It gives us a chance to demonstrate that we are able to develop a strong and coherent work plan that strengthens financial reporting without putting our constituents under stress.

The first triennial public agenda consultation is the catalyst for this change. We have already strengthened our structures internally, by giving greater focus to the forward looking aspects of our work. This includes building a stronger research base, drawing, where appropriate, on the network of national standard-setters and others.

We await with interest the decision of the SEC. But whatever they decide, I believe the IASB has positioned itself to deliver what the markets and its participants want and need—high quality international financial reporting standards.