# AGENDA PAPER

IFRS Foundation Trustees meeting with the Monitoring Board

Washington DC 12 July 2012 **Agenda ref MB 3**

**Memorandum**

**To:** IFRS Monitoring Board

**From:** Hans Hoogervorst

**Date:** 3 July 2012

**Re:** Report of the IASB Chairman

## Overview

When I first joined the IASB in July 2011, I gave a speech in China in which I outlined what I saw as the IASB's priorities in the near future: completing our convergence programme, consulting on the post-convergence agenda, delivering global standards and strengthening institutional relationships. I believe that now, nearly a year later, while these priorities have not changed, I am proud to say that we have made significant progress on each.

***Completing our convergence programme***

Last year the we agreed that the IASB must first complete the remaining convergence projects with the FASB to the highest possible standard, and do so in a way that benefits from the input that we receive from the entire global financial reporting community. These remaining convergence projects address some of the most difficult and important areas of financial reporting.

Nearly twelve months on, we have made significant progress on the four main projects and we are at an important point in the process. We are close to finalising the Revenue Recognition project and then issuing a final Standard. We are nearing the next due process steps on our other main projects and expect to issue Exposure Drafts or near final documents before the end of this year. I have set out a more detailed analysis of the status of these projects later in this report.

The IASB's approach to completing these projects has been to seek a balance between the needs of our current stakeholders, convergence with the FASB, and timeliness. We are addressing this by adjusting our speed when necessary, allowing sufficient time to consult thoroughly with interested parties while respecting the importance of our due process, and aiming to converge with the FASB as far as possible. Sometimes jurisdictional differences and different starting positions have prevented us from addressing issues at the same time as the FASB and made it more difficult for the two boards to reach identical conclusions. We have still, however, tried to address differences wherever possible. For example, in the Financial Instruments: Classification and Measurement project we have each reached conclusions that will significantly reduce the differences between our standards.

***Consulting on the post-convergence work programme***

In July 2011 we initiated the first of what will become a three-yearly public review of the IASB's programme. This first review is particularly important because it will help to shape the post-convergence work programme. Our consultations have included a public request for views, public round-table meetings, focused investor surveys and consultation and participation in many IFRS-related events.

The IASB believes that the future agenda should reflect the commitment that many jurisdictions have already made to IFRSs. Countries using IFRSs, or considering adopting them, have identified aspects of IFRSs where they believe that improvements should be made. We have been told that the focus on convergence projects has created a perception that the IASB has given less priority to other improvements that are particularly important to some jurisdictions, such as accounting for agriculture, business combinations under common control and rate-regulated activities. During the agenda consultation, we received consistent messages that priority should be given to completing the four main projects, resuming work on the Conceptual Framework project and starting to address matters that have been brought to us by those already applying IFRSs.

When discussing the feedback received on the agenda consultation, the IASB also agreed that it would initiate a broader research programme focusing on up to ten financial reporting issues. We have also started our first Post-Implementation Review (PIR) (reviewing our Standard on segment reporting IFRS 8 *Operating Segments*) and will continue to work on the post-implementation reviews as an important due process step.

***Delivering global standards***

The IASB is committed to doing all it can to complete the G20-endorsed transition towards global financial reporting standards. There was an enormous amount of support from the G20 leaders down, and there still is, for a single set of global financial reporting standards. For the IASB to harness and retain this incredible support and goodwill at the highest levels we must continue to produce standards that meet the needs of a global economy. The IASB is not equipped to complete this undertaking alone, and nor should we develop standards in isolation. We will continue to reach out to others for their help and support.

In addition, the G20 and the Financial Stability Board (FSB) continue to request convergence and support the IASB's progress in working with the FASB. An important piece of the IFRS jigsaw is encouraging the United States to come on board. IFRSs are already permitted for use by non-US companies listed on US markets. The SEC has indicated that it is in the process of making a decision about incorporating IFRSs into the US financial reporting regime for US companies.

However, regardless of the timing of the SEC's decision, there will soon come a time when the IASB will complete these convergence projects and move on to new agenda items. The expectation of both the G20 and the FSB is that our current projects will be finalised by mid-2013, including the four major projects being undertaken jointly with the FASB. It remains important that we complete these projects and are as converged as possible with US GAAP before beginning with our new agenda.

The IASB has spent the last ten years on a convergence programme. We have managed to eliminate many of the differences between IFRSs and US GAAP while at the same time improving both sets of standards. However, on a long-term basis, a dual decision-making process is less stable than having a strong and responsive single global standard-setter. It has not always been successful in eliminating divergence. In some cases, reaching a common solution has only been possible by the IASB and FASB allowing inconsistencies with their other requirements, which is suboptimal.

Convergence therefore may not always result in the highest-quality outcome. And while both boards have agreed that convergence has served its purpose, it is time to move on with our respective work plans.

When the four big projects are completed, the formal convergence programme will also come to an end. The IASB should concentrate on further improving the quality of its standards and continuing to encourage the countries with which it has been working on convergence programmes to adopt IFRSs.

***Strengthening institutional relationships***

The IASB will continue to strengthen its institutional relationships in a way that respects and enhances the independence of the standard-setting process. We remain aware of the importance of other G20 countries' decisions in this process, for example, China, Japan, India, and Russia. The IASB is working to enhance its governance in line with the results of the Trustees' and Monitoring Board's reviews. The IASB is also establishing a way to work more closely and to structure its work with National Standard-Setters: rather than having bilateral discussions with the FASB, the Accounting Standards Board of Japan (ASBJ), etc. We would like to formalise our consultations and establish an Accounting Standards Forum, which would meet with the IASB on a regular basis and replace our current purely bilateral relationships. We also intend to help securities regulators in working to improve the consistency of application of IFRSs. The Chairman of the IFRS Foundation Trustees will discuss this in more detail in his report at paper MB 2A.

Finally, I would like to reiterate the extreme importance the IASB places in our due process procedures and our work to continually enhance this process. We continuously strive to go above and beyond our due process requirements to protect the integrity of the standard-setting process and to ensure adequate stakeholder participation and transparency in our standard-setting process.

For example:

- Revenue Recognition re-exposure: while the IASB unanimously agreed there was no formal due process requirement to re-expose the Revenue Recognition proposals, the IASB also decided 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. As a result, we re-exposed our Revenue Recognition proposals in November 2011 to give stakeholders an opportunity to comment on revisions that the IASB and the FASB had undertaken since the publication of the original Exposure Draft in June 2010.

- Due Process Handbook: as detailed in David Sidwell's report at paper MB 4, in May 2012 the Trustees issued an updated version of the *IFRS Foundation Due Process Handbook* (the Handbook) for public comment. The revised Handbook fully incorporates the necessary due process enhancements recommended by the recent Monitoring Board Governance Review and the Trustees' Strategy Review, as well as recommendations from the Trustees' Review of the Efficiency and Effectiveness of the IFRS Interpretations Committee. The revised *Due Process Procedures Handbook* will include more formal acknowledgement of the responsibility that the IASB has to communicate with securities and prudential regulators. This gives formal recognition to the regular meetings that are already taking place.

- The IASB provides regular status reports to the G20 and the Financial Stability Board on enhancements to our governance process.

- The IASB will chair a working group from the international community to develop an agreed methodology for field work and effect analyses.

- The IASB will develop a strategy by the end of 2012 for the Trustees to consider on how to develop a research capability that is consistent with more evidence-based standard-setting and that will provide leadership in thinking in the field of financial reporting.

## Completed projects

Since the Monitoring Board's last meeting with the IASB in July 2011, the IASB has published the following documents:

- IAS 32 *Offsetting Financial Assets and Financial Liabilities* (Amendments to IAS 32) to clarify the application of the offsetting requirements (issued December 2011);
- Disclosures—*Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7), jointly with the FASB, to enable users of financial statements to better compare financial statements prepared in accordance with IFRSs and US GAAP (issued December 2011);
- *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) to defer the mandatory effective date of IFRS 9 *Financial Instruments* to 1 January 2015. The amendments also provide relief from restating comparative information and require disclosures (in IFRS 7 *Financial Instruments: Disclosures*) to enable users of financial statements to understand the effect of beginning to apply IFRS 9 (issued in December 2011);
- *Annual Improvements 2009–2011 Cycle*, in response to issues addressed during the 2009–2011 cycle (issued May 2012);
- Amendments to IFRS 1 *First Time Adoption of International Financial Reporting Standards* to address accounting for government loans (issued March 2012); and
- IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*. The Interpretation clarifies when production stripping should lead to the recognition of an asset and how that asset should be measured, both initially and in subsequent periods (issued October 2011).

Accompanying this report you will find a copy of the work plan as at 14 June 2012. The remainder of the report includes a detailed analysis of the status of our current projects.

## Completing the MoU and convergence projects

By the end of 2012 we expect to issue due process publications in relation to three of the four main projects on the current agenda and to complete the substantive redeliberations on the fourth project, Revenue Recognition.

The IASB is aiming to finalise deliberations on their proposals on Impairment accounting and Classification and Measurement in July 2012. To date these deliberations have resulted in substantially converged outcomes.

The joint deliberations on Leases are substantially complete. At the June 2012 meeting the FASB and the IASB (the boards) were able to agree on a common approach to lessee accounting. This was an important outcome for convergence.

The boards have reached different decisions on some important aspects of insurance contracts accounting. These discussions have been complicated by the very different starting points for insurance accounting faced by the two boards, because the IASB urgently needs to establish an insurance contracts accounting model.

In the next sections I provide more detail on the developments in these and other projects.

## *Financial instruments*

### IFRS 9—Classification and Measurement

#### *Limited modifications to IFRS 9*

In late 2011 the IASB agreed to consider modifying IFRS 9 *Financial Instruments*, particularly in the light of the need for convergence, the Insurance Contracts project and some particular issues raised by stakeholders. However, the IASB also agreed 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.

Consequently, the IASB decided to only reconsider:

- the contractual cash flow characteristics criteria;
- whether bifurcation for financial assets should be reconsidered; and
- whether an OCI (other comprehensive income) remeasurement should be used for some debt investments.

The IASB and FASB have made tentative decisions with respect to these areas. These decisions further align the classification models under IFRS 9 with the FASB's tentative approach and address some of the insurance community's concerns. The majority of these decisions did not change the current IFRS 9 model, but instead reaffirmed it, while agreeing to additional application guidance. The IASB did, however, tentatively agree to include a third measurement category in IFRS 9–Fair Value through Other Comprehensive Income (FVOCI) for simple debt investments. This category would result in a fair value balance sheet and an amortised cost profit or loss statement, with one impairment model being used for all financial assets not at fair value through profit and loss.

Other than the clarification of several minor issues and the finalisation of transition and disclosure requirements, the joint discussion on classification and measurement is now substantially complete. The boards plan to complete these discussions by mid-2012 and to issue Exposure Drafts in the fourth quarter of 2012.

### 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, primarily by reflecting the general pattern of deterioration and improvement in their credit quality. The main focus is the estimation and reporting of expected losses in a timely manner. This project is being developed jointly with the FASB.

The IASB and the FASB have developed an approach that places financial assets into three categories (or ‘buckets’) for the purpose of assessing expected losses, making use of credit risk management systems. The impairment allowance recognised would vary depending on which category an asset is allocated to.

On origination (or purchase) of non-credit-impaired assets, financial assets would be placed into the first category, which would have an allowance balance recorded equal to **12 months** of expected losses.

If the credit quality of a financial asset deteriorates *and* it is reasonably possible that the contractual cash flows will not be collected (the transfer criteria), the asset would be ‘transferred’ into another category and the entity would recognise an impairment allowance equal to the **lifetime** expected losses for those assets. The model is symmetrical in that if an asset’s credit quality subsequently improves in such a way that it no longer meets the transfer criteria, the asset would be moved back into the first category, reinstating a 12-month impairment allowance.

As I mentioned earlier, we have nearly finished the impairment discussions, with the treatment of off balance sheet items, disclosures and transition requirements still open. The current plan is to complete joint deliberations and issue largely aligned Exposure Drafts in the second half of 2012, most probably in the fourth quarter. On the basis of the timetable, we would plan to finalise the new impairment requirements in the first half of 2013.

We are aware of the importance of finalising the Impairment project expeditiously, because impairment accounting has been a primary area of concern during the financial crisis. However, impairment accounting has major implications for costs and systems, particularly for financial institutions, so we need to balance the need for timely completion against the importance of obtaining robust input from our constituents.

## Hedge Accounting

### *The general model*

In September 2011 the IASB completed its deliberations on general hedge accounting and asked the staff to prepare a review draft of the final requirements, including application guidance and a Basis for Conclusions. We expect this document to be published in the middle of 2012. The review draft will be made available on the IASB website for about 90 days. This will provide the IASB with the opportunity to undertake an extended fatal flaw process. The IASB also wishes to give the FASB the opportunity to consider the planned requirements. The IASB plans to finalise the general hedge accounting requirements once this review is complete. However, the IASB has not yet completed its formal review of its due process steps. It will do so following the 90-day review period, including assessing whether re-exposure is necessary.

The hedge accounting phase of the financial instruments project is not a joint project. However, the FASB sought comments from its constituents on the IASB's hedge accounting Exposure Draft, which it will consider in conjunction with feedback on its own proposals when it recommences its hedge accounting deliberations.

***The accounting model for macro hedges***

The IASB continues its public discussion of accounting for portfolio hedges. In May 2012 the IASB decided that, because of the different approach to accounting for macro hedges and the complexity of the subject, it will first publish a Discussion Paper before moving on to an Exposure Draft. In the interim, the portfolio hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* would be retained, enabling entities using those requirements to do so until any new model is put in place.

## *Leases*

This is a joint project with the FASB. Lease obligations are widely considered to be a significant source of off balance sheet financing. The objective of the Leases project is to improve financial reporting by lessors and lessees particularly by recognising leases on the balance sheet.

In May 2012 the boards discussed the feedback received during the leases outreach meetings held in April and May 2012. The feedback related mainly to lessee accounting, and the related profit and loss profile. There was also some feedback on the lessor accounting proposals. The feedback confirmed strong user support for lessees to recognise leases on the balance sheet and mixed views on the related profit and loss profile.

As a result of this feedback, at the June 2012 meeting the boards discussed the appropriate profit and loss profile for lessees. The boards tentatively agreed that there should be two different expense recognition patterns for leases that would depend on the consumption of the underlying asset. (For example, for leases of real estate the income statement would typically reflect a straight-line expense, whereas for most equipment leases the income statement would be akin to a debt-financed purchase of a right-of-use asset.)

The lease accounting deliberations are now substantially complete. The boards are targeting completing deliberations and issuing Exposure Drafts in the fourth quarter of 2012. During the comment period, the boards plan to conduct additional outreach with users of financial statements and with entities that undertake lease activities. Depending on the nature and extent of what issues are raised, we expect a final Standard in mid-2013.

### Revenue Recognition

This is also a joint project with the FASB. In November 2011, the boards re-exposed their revised proposals. The comment period ended in March 2012. In addition, the staff and both boards engaged in extensive outreach activities between September 2011 and May 2012. Those outreach activities followed on from the targeted outreach that had been performed throughout the redeliberations phase that led to the development and publication of the revised Exposure Draft.

In the May 2012 meeting the joint staff provided a summary of the outreach activities performed, including the round-table meetings and discussion forums that had been held. The staff also summarised the feedback received from the comment letters and the outreach activities.

Substantive redeliberations are expected to be completed in 2012 with a final Standard expected to be issued in early 2013.

## Other projects

### Insurance Contracts

The boards are working together on the Insurance Contracts project but have reached different decisions on several basic matters. While both boards have agreed to measure the insurance liability using a current measure of the estimated costs to fulfil the obligation, the boards have reached different decisions on several aspects of the model, including the recognition of changes in estimates, the inclusion of a risk margin in the measurement of the liability and the treatment of acquisition costs.

In addition, the IASB has already published an Exposure Draft, whereas the FASB has only published a Discussion Paper. The IASB also urgently needs to complete this project in order to establish an insurance contracts accounting model in IFRS.

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 a result, in May 2012 the boards made tentative decisions to require the use of other comprehensive income (OCI) to present some changes in the measurement of the insurance contract liability. The staff and the boards understand that this decision, combined with the introduction of the FVOCI category for classification and measurement of simple debt investments, should address many of the concerns raised by various stakeholders about whether the insurance business model is properly reflected in the financial statements.

In June 2012 the boards decided on the accounting for the unbundling of components in insurance contracts. The boards are continuing to discuss the treatment of acquisition costs.

The IASB is yet to determine whether it should publish another Exposure Draft or proceed to a final IFRS.

### *Investment Entities*

In 2011 the boards published proposals that would require investment entities (as defined by the boards) to measure investments in controlled entities at fair value through profit or loss (rather than consolidating such investments. The IASB has consistently noted that it is important to finalise deliberations on this project expeditiously to confirm the scope of consolidation for those applying IFRS 10 (mandatorily effective 1 January 2013).

### *IFRS for SMEs—Comprehensive Review 2012-2014*

When the IASB issued the *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs) in July 2009, it stated that it would undertake an initial comprehensive review of the Standard to enable the IASB to assess the first two years' experience in implementing the Standard and consider whether there is a need for any amendments. Because companies have now been using the IFRS for SMEs for two years (2010 and 2011), we are beginning the initial comprehensive review. We have also said that, after the initial review, we expect to consider amendments to the IFRS for SMEs approximately once every three years.

The SME Implementation Group (SMEIG), an advisory body to the IASB, is providing recommendations to the IASB throughout the comprehensive review of the IFRS for SMEs, including recommendations about possible amendments to the Standard. Specifically, the SMEIG and the IASB will consider whether to amend the IFRS for SMEs:

- to incorporate issues that were addressed in the Q&As;
- for new and amended IFRSs issued since the IFRS for SMEs was published; and
- to reflect any other issues, eg implementation issues identified by constituents that may necessitate a change in the Standard.

The review began in June 2012 with the IASB issuing a Request for Information seeking public views on whether there is a need to make any amendments to the IFRS for SMEs. The deadline for responses is 30 November 2012. The IASB targets publishing an Exposure Draft of the proposals in mid-2013, depending on the comments received and the possible amendments to the Standard.

## Beyond the MoU

### *Agenda consultation*

As discussed in our previous meeting, in July 2011 the IASB launched its first formal public agenda consultation on its future work plan. Through the agenda consultation, the IASB is seeking input from all interested parties on its strategic direction and on the broad overall balance of the work plan. The agenda consultation will provide the IASB with important input when considering possible agenda items.

In May 2012 the IASB discussed the proposed responses to the key messages received from the agenda consultation and the IASB staff presented their recommendations on the future agenda. The IASB tentatively agreed to the following steps to move forward with the future agenda:

(a) the IASB will host a public forum to assess strategies for improving the quality of financial reporting disclosures, within the existing disclosure requirements;

(b) the IASB will give priority to work on the Conceptual Framework project with a focus on elements, measurement, presentation, disclosure and reporting entity;

(c) the IASB staff should give priority to:

  i. developing standards-level proposals for potential amendments to IAS 41 *Agriculture* (in relation to bearer crops); rate-regulated activities; and the equity method in separate financial statements; and

  ii. recommencing research on emissions trading schemes and business combinations under common control;

(d) the IASB staff should initiate the research programme, focusing initially on discount rates; the equity method of accounting; extractive activities/intangible assets/R&D; financial instruments with the characteristics of equity; foreign currency translation; non-financial liabilities; and financial reporting in high-inflation and hyperinflationary economies; and

(e) the establishment of a consultative group to assist the IASB with matters related to Shariah law.

### *Post-implementation reviews*

In March 2012 the IASB discussed the planned approach for the post-implementation review of IFRS 8 *Operating Segments*. The IASB agreed that:

- the review of IFRS 8 should also include investigating whether IFRS 8 has been effective at achieving its objectives of convergence with US GAAP and improving financial reporting; and
- that the transparency of the review process should be increased through soliciting comment letters in response to a Request for Information that will be published by the IASB.

In May 2012 the IASB further discussed the planned approach for the PIR of IFRS 8. The IASB agreed the following:

- the structure of the investigation and reporting phases should reflect the main decisions that were made when the IASB developed IFRS 8. These decisions were:

  (a) to identify segments on the basis of the management approach;

  (b) to measure disclosed line items on the basis used for internal reporting; and

  (c) to disclose only those line items that are regularly reviewed by the chief operating decision maker.

- the proposed structure of a Request for Information (RFI) on the effect of implementing IFRS 8 that the IASB expects to issue in July 2012. As part of that discussion, the IASB discussed a list of preliminary issues identified for investigation and considered what other investigation tools, in addition to the RFI, could be employed in the PIR process.

In June 2012 the IASB discussed the preliminary findings of the review of academic literature related to IFRS 8, and agreed that the staff should issue the Request for Information in June 2012. The RFI will have a 120-day comment period.