AGENDA PAPER

IFRS Foundation Trustees meeting

Washington DC   12 July 2012   **Agenda ref 2**

Memorandum

To: IFRS Foundation Trustees

From: Hans Hoogervorst

Date: 21 June 2012

Re: Report of the IASB Chair

Overview

Until the middle of June 2013, the IASB will be primarily occupied with completing the projects in the current agenda. This includes the four major projects being undertaken jointly with the FASB: Financial Instruments, Revenue Recognition, Leases and Insurance Contracts.

In response to the comments received on the agenda consultation, we will begin work on a Conceptual Framework project, and we will start 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. We will also initiate a broader research programme focusing on up to ten financial reporting issues.

Since the Trustees last met in April 2012, the IASB has:

- issued *Annual Improvements 2009–2011 Cycle*, in response to issues addressed during the 2009–2011 cycle;
- continued discussions of feedback received on its first formal public agenda consultation and begun discussions of feedback received on its first post-implementation review; and
- received recommendations from the Trustees on the efficiency and effectiveness of the IFRS Interpretations Committee.

In addition:

- The IFRS Interpretations Committee published proposed guidance on the accounting for put options written on non-controlling interests and on levies charged by public authorities on entities that operate in a specific market.
- The Trustees have proposed enhancements to its due process handbook.

Accompanying this report you will find a copy of the work plan as at 14 June 2012 and a more detailed analysis of the work that we have been undertaking since April.

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 and the FASB (the boards) are aiming to finalise deliberations on their joint 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 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 need 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

As I discussed in the April meeting, 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 certain issues raised by stakeholders. However, the Board 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 Board 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. Owing to the different stages of development, the boards propose that any exposure drafts should be separate but achieve as converged an outcome as possible. (For example, the IASB exposure draft would focus on changes to IFRS 9.)

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 of 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.

As I mentioned in the April 2012 meeting, 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 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 Board 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. The review draft will be made available on the IASB website for about 90 days. We expect this document to be published in the middle of 2012. This will provide the Board with the opportunity to undertake an extended fatal flaw process. The Board also wishes to give the FASB the opportunity to consider the planned requirements. The Board plans to finalise the general hedge accounting requirements once this review is complete. However, the Board has not yet completed its formal review of its due process steps. It will do so following the 90-day review period, after which the Board will review its due process steps and will assess 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 that 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 Board continues its public discussion of accounting for portfolio hedges. In May 2012 the Board 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. As I have previously reported, the boards re-exposed their revised proposals in November 2011, and 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 was 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 comments 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

As I mentioned in April 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 cost to fulfil the obligation, the boards have reached different decisions on several aspects of the model, including the recognition of changes in estimate, 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.

Transition guidance – proposed amendments to IFRS 10[1]

As I mentioned in April, in December 2011 the IASB published a very short exposure draft to clarify the transition requirements for IFRS 10 *Consolidated Financial Statements*. The comment period ended in March 2012. In May 2012 the IASB discussed the feedback received from that exposure draft. Many preparers implementing IFRS 10, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities* have raised concerns regarding the burden of restating comparative information. In response to this, the IASB agreed to restrict the requirement to restate comparatives in IFRS 10, IFRS 11 and IFRS 12 to

[1] On 1 June 2012 the European ARC (Accounting Regulatory Committee) endorsed IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities* with a mandatory date of 1 January 2014. Early application will be permitted. The actual IFRSs have a mandatory application date of 1 January 2013.

one year on initial application. In addition, the IASB agreed to provide relief from the requirement to provide comparative information about the risks arising from involvement with unconsolidated structured entities on initial application of IFRS 12.

The IASB agreed to finalise these proposals expeditiously because of the mandatory effective date of IFRS 10 (1 January 2013).

Investment Entities

In 2011 the boards published proposals that would require investment entities (as defined) to measure investments in controlled entities at fair value through profit or loss (rather than consolidating such investments). In April 2012 boards discussed the feedback received on such proposals. In May 2012 the boards discussed the issues that stakeholders had raised about the proposed investment entity and investment company criteria and the general approach that the guidance should take. The boards tentatively decided that they would provide a general definition of an investment entity together with additional factors to consider. At the June 2012 meeting the IASB decided that a non-investment entity parent of an investment entity should not retain its subsidiary's fair value accounting for controlled investees (the so-called 'roll up') in its consolidated financial statements. The FASB reached the opposite conclusion[2]. 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). The boards plan to issue final standards by the end of 2012.

IAS 8 - Effective date and transition methods

In October 2010 the IASB published a *Request for Views* on when new financial reporting standards should become effective and related transition methods. Issues were raised in the feedback received and from the outreach performed relating to the disclosures required in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when there is a change in accounting policy.

In May 2012 the IASB made tentative decisions in relation to that feedback.

The IASB will further discuss this in the July 2012 meeting. An exposure draft proposing amendments to IAS 8 is expected to be published in the second half of 2012.

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

[2] This difference was also reflected in the proposals in the exposure drafts issued by the boards.

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 commencing 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 will commence in late 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 will be 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 Board 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 its 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

As I previously mentioned, in March 2012 the IASB discussed the planned approach for the post-implementation review of IFRS 8 *Operating Segments*. The Board 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 published by the Board.

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

- the structure of the investigation and reporting phases should reflect the main decisions that were made when the Board 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 Board expects to issue in July 2012. As part of that discussion, the Board 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 Board 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.