IFRS Advisory Council

London
18-19 June 2012

Agenda paper 1

Memorandum

To: IFRS Foundation Advisory Council

From: Hans Hoogervorst

Date: June 2012

Re: Chairman's Report

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.

In response to the comments received on the Agenda Consultation, we will begin work on a Conceptual Framework project, and 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 Advisory Council last met in February 2012 the IASB has:

- issued amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* to provide relief related to loans received from governments at a below-market rate of interest for first-time adopters;
- 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 of the IFRS Foundation have proposed enhancements to its due process handbook.

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

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 at finalising deliberations on their joint proposals on impairment accounting and classification and measurement in the first half of 2012. To date these deliberations have resulted in substantially converged outcomes.

The joint deliberations on lease accounting are substantially complete[1].

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 needed 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

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

[1] At the time of writing this report the boards had yet to discuss the appropriate profit and loss profile for the lessee accounting model. An oral update on that discussion will be provided at the Advisory Council meeting.

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 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.

IFRS 9–Classification and measurement

Limited modifications to IFRS 9

As I discussed in the February meeting, in late 2011 the IASB agreed to consider modifying IFRS 9 *Financial Instruments*, particularly in view of certain issues raised by stakeholders, as well as in the light of the need for convergence and the insurance contracts project. 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.

The joint discussion on classification and measurement is now substantially complete. The circumstances in which an entity can elect to measure items at fair value (the fair value option) are still outstanding, along with several minor issues and the finalisation of transition and disclosure requirements. 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.)

Hedge accounting

The general model

In September 2011 the Board completed its deliberations on general hedge accounting and asked the staff to prepare a draft of the final requirements, including application guidance and a Basis for Conclusions. That 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 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 macro hedge accounting model

The Board continues its public discussion of portfolio hedge accounting. In May 2012 the Board decided that, based on the different approach to macro hedge accounting 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

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.

At the June 2012 meeting the boards will discuss the appropriate profit and loss profile for lessees. The boards are targeting completing deliberations and issuing exposure drafts in the second half of 2012. During the comment period, the boards plan to conduct additional outreach with users of financial statements and entities that undertake lease activities. Depending on the nature and extent of issues raised, we expect a final standard in mid-2013.

Revenue recognition

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 February the boards 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 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.

We continue to estimate that we will conclude the major technical discussions in the second half of 2012. The IASB is yet to determine whether it should publish another exposure draft or proceed to a final IFRS.

Consolidation[2]

In May 2012 the IASB discussed the feedback from their short exposure draft clarifying the transition requirements for IFRS 10 *Consolidated Financial Statements.* 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 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 April 2012 the boards discussed the feedback received on the related investment entity/investment company 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 will provide a general definition of an investment entity with additional factors to consider. The important issue of whether a non-investment entity parent of an investment entity should retain its subsidiary's fair value accounting for controlled investees (the so-called 'roll up') will be discussed at the June 2012 meeting. The boards plan to issue final standards by the end of 2012.

Effective dates and transition

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.

[2] 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.

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

- to remove the requirement to disclose the current period effect of a new accounting policy when the change is a result of changes in IFRSs; and
- to retain the requirement to disclose the possible impact of forthcoming IFRSs that are not yet effective. However, the Board tentatively decided to modify IAS 8 to require this disclosure only for IFRSs that were issued by the end of the reporting period.

An exposure draft proposing these amendments to IAS 8 is expected to be published in the second half of 2012.

Beyond the MOU

Agenda consultation

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.

These proposals will be discussed in more detail later on during this Advisory Council meeting.

Post-implementation review

The goal of improving financial reporting underlies any new IFRS. The IASB carries out a post-implementation review (PIR) of each new IFRS or major amendment. This is normally carried out two years after the new requirements have become mandatory and been implemented. The Board's *Due Process Handbook* indicates that a PIR is an opportunity to assess the effect of the new requirements on investors, preparers and auditors. The review must consider the issues that were important or contentious during the development of the publication (which should be identifiable from the Basis for Conclusions, Project Summary, Feedback Statement and Effect Analysis of the relevant IFRS), as well as issues that have come to the attention of the IASB after the document was published. The IASB and its staff also consult the wider IFRS community to help the IASB identify areas in which possible unexpected costs or implementation problems were encountered.

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 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.

The Board plans to further discuss the PIR of IFRS 8 at its June 2012 meeting, when it will consider the preliminary findings of the review of academic literature. In June 2012 the staff will also request permission from the Board to issue the RFI.