

AGENDA PAPER

IFRS Foundation Trustees meeting – Due Process Oversight Committee

LONDON 8 JULY 2014

Agenda ref 3G

PRESENTERS MICHELLE SANSOM/DAVID LOWETH

Correspondence: update

Introduction

1. The purpose of this paper is to provide an update on whether any correspondence has been received on due process issues since the DPOC's meeting held on 8 April 2014 in Sydney.
2. At the time of writing (27 June), no new correspondence requiring the DPOC's attention has been received.

EFRAG Draft letter

3. Having said that, we wish to bring one potential item to the DPOC's attention. The European Financial Reporting Advisory Group (EFRAG) has issued on its website a draft letter *EFRAG Invites comments on proposal to enhance IFRS quality control*. A copy of this draft letter is at Appendix A. The draft letter calls for a change to the final stage of the IASB standard setting process. It proposes that if the IASB does not introduce a fatal flaw public exposure draft then a specific "implementation stage" should be inserted into the standard setting process. The implementation stage would start after publication of the Standard and be conducted for a defined period of time. The draft letter is open for comment until 15 August 2014.
4. In summary the draft letter states:
 - a. Recent experience shows that despite efforts, final requirements can be difficult to understand and implement by the public at large. This is evidence that the IASB should improve its standard setting process at the stage of finalising a standard.
 - b. Difficulties in understanding the standard increase implementation costs, feeds the views of those that consider IFRS to be complex and encourages the questioning of the quality of IFRS.
 - c. Those currently involved in the private fatal flaw review have a prior understanding of the intended outcomes and therefore the review is likely to miss shortcomings in the drafting.

- d. EFRAG, in its response of 20 September 2012 to a public invitation to comment on revisions to the *Due Process Handbook*, called for the due process in relation to the review drafts to be further developed.
 - e. If the IASB does not implement a fatal flaw public exposure draft it “could” consider inserting a new “implementation stage”. This stage would be after the publication of the Standard and would require the IASB to set up a dedicated team to be responsive to difficulties encountered in practice. The team would have sufficient authority to handle understandability and implementation issues similar to the issuance of agenda decisions by the IFRS Interpretations Committee. Before the end of the implementation stage, an amended version of the final standard would be approved by the IASB and published without supplementary due process, to reflect all tentative drafting changes decided and published throughout the implementation stage.
5. Formal adoption procedures would be after the implementation stage. However, in the EFRAG’s view, jurisdictions would have the comfort that the final standard is ready to be applied without major difficulty.

Staff comment

6. As noted above, EFRAG raised the issue of a public fatal flaw review in its response to the IFRS Foundation’s 2012 review of the *Due Process Handbook*. The DPOC considered this at its meeting in October 2012, as part of its consideration of the issues raised by responses to the proposals to revise the *Handbook*. The report of that meeting¹ noted that:

“The DPOC considered the suggestions made by some respondents that review drafts should in effect become a systematic step in the due process and be published on the website for public fatal flaw reviews and field testing. It was noted that the purpose of a review draft was unclear. The IASB saw review drafts as a final ‘housekeeping check’ to ensure that the draft document was clear and reflected accurately the technical decisions made by the Board. It was not a document used to consider the appropriateness of the Board’s decisions. The DPOC accepted that having a review draft for external review should not become a mandatory due process step, but thought that the DPH should clarify the purpose of a review draft and what a review draft was not”.

7. This view was reflected in the *Due Process Handbook: Feedback Statement* that accompanied the issue of the revised Handbook in February 2013:

“We do not think that a review draft should become a mandatory due process step. The *Due Process Handbook* clarifies what the purpose is of such a draft and what it is not, noting that it does not constitute a formal step in the due process, and it is not a substitution for a formal due process step. It has a limited purpose, representing an

¹ Available at: <http://www.ifrs.org/DPOC/meetings/Documents/DPOCmeetingreportOct12.pdf>.

editorial ‘fatal flaw’ review in which reviewers are asked whether the draft is clear and reflects the technical decisions made by the IASB. To reflect this, the *Due Process Handbook* uses the term ‘draft for editorial review’².

8. The *Due Process Handbook* (paragraph 3.31) does give the IASB flexibility as to whether it makes available a draft for editorial review available on the website, together with the discretion as to the nature of the external review. But the Handbook (paragraph 3.32) does go on to specify the limited purpose of the draft for editorial review and the fact that it does not constitute, nor is it a substitute for, a formal step in the due process. EFRAG’s draft proposal would imply the introduction of another formal step.
9. We see some further difficulties with EFRAG’s proposal. For example, in a number of jurisdictions, final Standards are adopted automatically (ie without any further endorsement process). The implication is that these jurisdictions would have to wait until the end of the implementation stage, in order to avoid the possibility of the adoption of a final Standard being superseded very shortly after release due to drafting amendments to the Standard. This reinforces the view that EFRAG’s proposal would constitute another formal due process step. Consequently, some preparers might not proceed with implementation as they would conclude that they do not have the final standard. Another potential difficulty is that what the ‘dedicated team’ and the IASB view as drafting changes may be seen as something more substantive by some stakeholders, which – if introduced without supplementary due process as proposed – could lay the Board open to criticism that it has introduced changes without due process.
10. Further, we do not consider that EFRAG’s proposal to introduce an implementation stage would be practical or cost effective for preparers. The suggested stage appears to be more akin to a “field-testing stage”. Where appropriate, field-testing is carried out in developing the Standard, often in partnership with national and regional standard setters. Field-testing is time consuming and therefore costly for preparers. From our perspective, requesting a second round of field-testing does not appear feasible and would further extend the time to complete a standard.
11. As at the date of writing there are no responses to the draft letter posted on the EFRAG website.

Action

12. At this stage, we would simply welcome the views of DPOC members on the EFRAG draft and whether Committee members agree with the staff comments set out above. It may be that, subject to responses to EFRAG, the EFRAG draft will be amended or even not submitted. If the EFRAG draft letter is finalised and submitted, then we will revert to

² The Feedback Statement can be accessed at: <http://www.ifrs.org/DPOC/Documents/2013/Feedback-Statement-Due-Process-HB-February-2013.pdf>.

the Committee with a proposed response to EFRAG which, subject to comments, will make the points above.

DRAFT LETTER TO THE IASB

Comments expected to be received by 15 August 2014

EFRAG invites comments on proposal to enhance IFRS quality control

As numerous stakeholders, EFRAG praises the IASB's standard-setting process and dedication of the IFRS Foundation teams to deliver high quality financial reporting standards.

Despite those efforts, difficulties of interpretation and implementation may arise once an IFRS has been released. With the implementation of the Transition Resource Group on Revenue Recognition, the IASB is showing a strong willingness to best assist implementation efforts by practitioners. However, EFRAG believes that amendments and clarifications that may appear necessary when implementation efforts begin should benefit from a lighter due process than that imposed for any amendment to IFRS, so as to allow for the appropriate level of responsiveness by the IASB in lifting uncertainties or undetected operational difficulties in applying the new standard.

We invite you to respond to the following questions:

- 1- Do you agree with EFRAG that some specific standard setting process step involving the public at large is necessary to further enhance quality control of IFRS? Please explain your views.
- 2- Do you support the proposal made by EFRAG? Please explain your views?
- 3- Would you favour alternative proposals? If so, what are they?

The draft letter is available below.

DRAFT LETTER TO THE IASB

Hans Hoogervorst
IASB
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Hans,

Re: IASB's quality control procedures prior to or post issuance of a final standard or major amendment to a standard

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing this letter to make recommendations for enhancing the IASB quality control procedures prior to final amendments or standards becoming effective.

In EFRAG's view, appropriate IASB quality control is necessary to facilitate and reduce the cost of implementation of new requirements and support our common objective of consistent application of IFRS. There is no doubt that the IASB and its staff are dedicated to delivering the best possible product and already make all possible efforts within the IASB's current due process. Recent experience shows that, despite all these efforts, final requirements – or intended final requirements – can be difficult to understand and implement by the public at large. If we consider recent projects, we note that at the time the IASB and the FASB issued the second exposure draft on Revenue Recognition, they genuinely thought that a final standard was nearly ready for issue. The consultation period showed, however, that constituents had considerable difficulties in understanding some of the proposed requirements. An example of a recent standard that is causing numerous and significant implementation problems is IFRS 11 *Joint Arrangements*.

In EFRAG's view this situation shows that the IASB's standard setting process at the stage of finalising a standard can be improved. The IASB is striving to have its new standards improve financial reporting at as low a cost as feasible. Difficulties in understanding a standard increase the implementation costs, feed the views of those who feel that IFRS are too complex and encourage the questioning of the quality of IFRS. It also creates divergence in practice and tends to transfer to the auditors the responsibility for interpreting IFRS. In several cases in the recent past, narrow-scope amendments to recent standards have been needed, with the supplementary cost to IFRS standard setting, adoption and implementation of the frequent changes in financial reporting.

In the past EFRAG has recommended that the IASB undertakes public fatal flaw reviews prior to finalising any major amendment or new standard. All those who participate in the IASB's private fatal flaw reviews, including ourselves, have had involvement and interaction with the IASB in the development of the standard. As a result, the draft requirements are read with prior understanding of the intended outcomes and the review is likely to miss shortcomings in the drafting. These shortcomings appear only after standards are published and exposed to the fresh eyes of preparers, auditors, and enforcers who have had no direct involvement in setting the standard.

Hence in our response to the revision of the IASB *Due Process Handbook*, we noted that the IASB's due process in relation to review drafts needed to be further developed. More particularly, EFRAG:

- (a) Welcomed and underlined the need for the use of public review drafts for systematic public "fatal flaw" reviews and identification of potential implementation difficulties or undue costs.
- (b) Recommended to the IASB that results of public fatal flaw reviews should be assessed, in a public meeting, before the IASB makes its final decision on a new or amended standard.
- (c) Recommended to the IASB that final balloting should only take place on the final draft after including the results of the public 'fatal flaw' review and when appropriate of field tests.

We believe that the experience of the public fatal flaw review of IFRS 9 phase 3 "General Hedge Accounting Model" was successful. In its comments EFRAG did not re-open issues already fully deliberated – we recommended particular care in the final drafting of the basis for conclusions. Comments received were helpful in adjusting the final wording and this supplementary due process step has been helpful in reducing misunderstandings. One of the advantages of this process was that the IASB was encouraged to proceed to some helpful late amendments without undertaking a separate public consultation. Another advantage was that the fatal flaw review could be coupled with a final effect analysis of the upcoming standard.

Despite this successful experience, we understand that the IASB sees more impediments than benefits in public fatal flaw reviews, and our recommendations have not been reflected in the final version of the IASB *Due Process Handbook*.

We believe however that some form of change to the final stage of the IASB standard setting process should be considered to meet the objective of enhanced quality control.

The decision of the IASB and the FASB to establish a Transition Resource Group to support the implementation of the Revenue Recognition standard has been the opportunity to discuss other ways in which the IASB could further assist the implementation of a new standard. We note that wide support for such efforts has been expressed by the IFRS Advisory Council. Whilst the Transition Resource Group has just been populated and is ready to start work, the IASB has indicated that no change would be made to the standard without the usual due process steps. We are not aware of any other proposals that are being considered that would, more generally, eliminate to the extent feasible the difficulties encountered in the implementation phase of new IFRS.

If the IASB maintains the decision that fatal flaw public exposure of final drafts cannot be conducted before publication of final requirements, the IASB could consider inserting a specific "implementation stage" that would start after publication and be conducted for a defined period.

Final publication of a standard would give the signal that implementation efforts could be started on a large scale. During the implementation phase, the IASB would set up a dedicated team to be responsive to difficulties encountered in practice. It could work in close coordination with Regional Groups and National Standard Setters. The team should have sufficient authority to handle all understandability and implementation issues in the following manner, similar to agenda decisions of the IFRS IC:

- Either the drafting of the final standard is deemed appropriate and the group would issue a statement similar to current IFRS IC rejection notices;
- Or the drafting of the final standard would be deemed in need of improvement and tentative changes in the drafting of the standard would be published on the IASB website, together with explanations of the clarifications they provide.

In either case, constituents would have the opportunity to comment on the group's tentative decisions.

Before the end of the implementation stage, an amended version of the final standard would be approved by the IASB and published without supplementary due process, to reflect all tentative drafting changes decided and published throughout the implementation stage.

Major flaws would not be expected to be identified in this process, as it would come after publication of the standard, i.e. after proper field testing of the IASB new requirements has been performed and concluded. However, in the rare case that some material change were to be needed to the Standard, the usual due process should be followed.

Whilst the assessment for endorsement of the final standard could be carried out from the outset of the implementation phase, formal adoption processes would be expected to be completed only after the implementation phase has ended, and the text of the standard reflects all changes that have been deemed necessary. Jurisdictions would have the comfort that the final standard is ready to be applied without major difficulty. Further, we would expect that the number of requests to the IFRS IC for interpretations would be significantly reduced.

We believe that the above recommendations will enhance the IASB's quality control and result in new IFRS requirements that are of higher quality.

If you would like to discuss our comments further, or if we can assist in any other way, please do not hesitate to contact Françoise Flores or me.

Yours sincerely,

Hans van Damme
Acting Chairman
EFRAG Supervisory Board

Cc: Michel Prada, Chairman, IFRS Foundation
Scott Evans, Chairman, IFRS Foundation DPOC