

# **Developments and Key Issues - Accounting Standards**

**Vincent Papa, CFA**  
**Director, Financial Reporting Policy (EMEA)**  
**CFA Institute**



# Introduction



# Introduction

- **Brief Overview of SFMI Financial Reporting Engagement**
- **State of Play of IFRS Convergence and Standard Setting**
  - **Objectives**
  - **Progress**
  - **Sources of Uncertainty**
  - **Effectiveness and Efficiency of Process**
- **Selected Issues on Key Projects**
  - **Financial Instruments-Hedging**
  - **Revenue Recognition**
- **Q and A**

# Outreach and Engagement

## ➤ **Financial Reporting Standard Setting Engagement**

- IASB and FASB engagement (comment letter responses, liaison meetings, involvement with working groups)
- Dialogue with EC, EFRAG and SEC

## ➤ **Audit Related Standard Setting Engagement**

- Engage with various audit regulators IAASB, PCAOB, IFIAR and EC

## ➤ **Pro-active Research and Thought Leadership**

- Widely cited Comprehensive Business Reporting Model (CBRM)-(IASB – Progress scorecard referenced CBRM)
- IASB Investor website: Paul Pacter: *Developing accounting standards consistent with the CFA Institute's vision*
- Risk disclosure- Work in progress

# Outreach and Engagement

## ➤ **Member Engagement**

- Webcasts ( One due shortly on convergence, have held this on financial instruments)
- CFA Magazine articles
- Society engagement
- Corporate Disclosure Policy Council
- Surveys to all members and to Financial reporting survey pool
- Arranging for direct access to members

## ➤ **Media Engagement**

- **Dialogue with Interested Parties** (CRUF, CII, ABI, IMA)

# Objectives, Progress, and Sources of Convergence Uncertainty



# IFRS Convergence and Standard Setting-Objectives

- **IFRS applied in 120+ countries**
  
- **IASB and FASB Convergence Objectives**
  - Inception was in 2002 with Memorandum of Understanding. Updated in 2006 (11 projects).
  - Given impetus by G20 support during the market crisis
  - Convergence progress is a key yardstick for the SEC evaluation of IFRS for purposes of potential US adoption
  - Espoused goals of convergence are to both a) improve quality of key accounting standards and b) create globally comparable financial statements
  - April 2008 IASB and FASB staff categorised projects into
    - Those with significant deficiencies and needed prioritisation for completion by mid-2011 (i.e. Revenue recognition, fair value measurement, consolidation policy and de-recognition)
    - Worthwhile improvements where IFRS and US standards are similar (i.e. Financial statement presentation, post-retirement benefits, leasing, financial instruments and liabilities/equity)
  - Target completion of current convergence initiative was June 30th 2011. This has been extended by a few months

# Notable Differences- IFRS versus US GAAP

- **Some areas of difference not addressed under current convergence. These result in visible differences under 20-F reconciliation**
  - Revaluation of Property, plant and equipment
  - Goodwill impairment
  - Deferred tax
  - Share based payment
  
- **Differences in Net Earnings- Study of 100 Foreign Filers (Plumlee and Plumlee, 2008)**
  - 75% IFRS Filers report IFRS net income that is higher than US GAAP net income
  - More than half US GAAP net income falls within +/- 15% of IFRS net income
  - Significant dispersion in difference of net income ( -206% to 253% IFRS net income versus US GAAP net income)
  - 43% firms report IFRS values exceeding stockholder's equity under US GAAP

# Notable Differences- IFRS versus US GAAP

## ➤ Earnings Management

- More managerial discretion, judgement under IFRS principles based approach
- Fragmentary and inconclusive empirical evidence on whether or not IFRS results in more earnings management. Recent observations showed that
  - De-recognition/consolidation more of an issue under US GAAP ( structuring around bright lines)- Enron, QSPE abuse during the crisis
  - Revenue recognition more subjective and potentially less conservative under IFRS
- Convergence will reduce revenue recognition differences
- However, accounting standards only partially contribute to earnings management
- Earnings management and financial reporting practices also influenced by:
  - Institutional environment (legal, regulatory enforcement, forms of ownership)
  - Managerial incentives (compensation, covenants, capital market pressures)
  - Prevailing audit practices
- **No clear cut empirical evidence, nevertheless, increasing subjectivity of standards can threaten overall comparability of financial reports**

# IFRS Convergence and Standard Setting-Progress

## ➤ **IFRS completed projects**

- Business Combinations (IFRS 3)
- Segment Reporting (IFRS 8) – Undertaking a post implementation review
- Joint: Fair value disclosures (IFRS 13)
- IASB-Consolidations (IFRS 11)
- De-recognition disclosures (IFRS 7)
- Financial Instruments-Classification and Measurement (IFRS 9)
- Post-retirement benefits (IAS 19)
- Joint project: Presentation of OCI

# IFRS Convergence and Standard Setting-Progress

- **During last few months Boards have prioritised 5 areas**
  - Revenue recognition, (Discussion paper, exposure draft issued, due for re-exposure)
  - Financial Instruments-Impairment (Exposure draft, Intended re-exposure),
  - Financial Instruments-Hedging, (Discussion paper on financial instruments in 2008, Exposure Draft)
  - Insurance,
  - Leases (Discussion paper, exposure draft, undergoing re-deliberation)
  
- **Other areas of coverage-Not completed, but likely to be considered after the current phase of convergence**
  - Liabilities and Equity (Discussion paper in 2008)
  - Financial statement presentation (Discussion paper in 2009, staff draft)

# Convergence- Sources of Uncertainty

## ➤ **IFRS Adoption Questions**

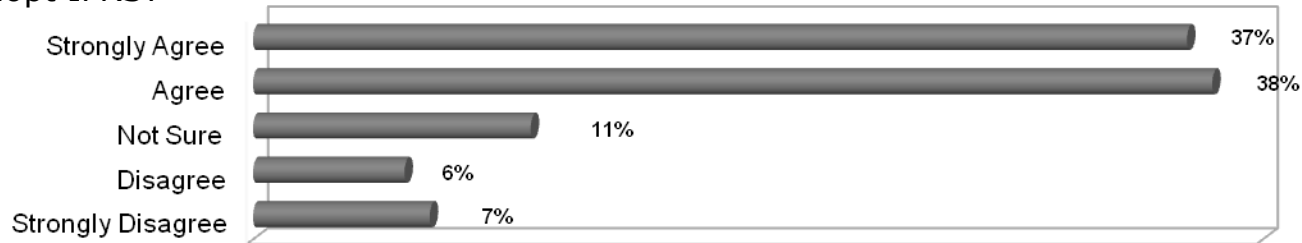
- SEC Decision on US IFRS adoption is expected in 2011. Will the US adopt IFRS and if so when?
  
- What form of adoption will occur in the US? SEC communication and consultation
  - November 2008- SEC Roadmap
  - February 2010- SEC Work-plan (Evaluation criteria and possible staggered adoption)
  - October 2010- SEC Work Plan (Progress Report)
  - May 2011-SEC Work Plan (Exploring the 'Condonement' option i.e. Ongoing convergence, with FASB's primary focus being to endorse IFRS)
  
- What are the risks associated with the failure of the US to fully adopt IFRS?
  - What will it mean for current adopters? Will they abandon IFRS?
  - What will it mean for prospective adopters (e.g. Japan, China)? Will it be as enticing?
  
- Will the EU endorse the Financial Instruments Standard (IFRS 9)?
  
- Will comparable IFRS versions be adopted globally with national endorsement option?

# Convergence- Sources of Uncertainty

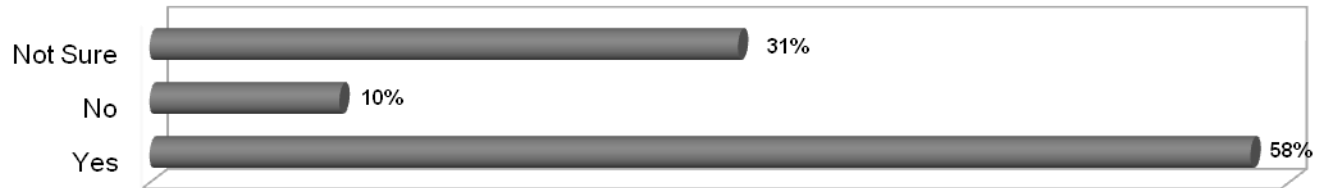
- **IFRS Governance-Key Questions on Institutional Independence and Accountability**
  - Is there an overlap between trustee and monitoring board roles in IFRS governance?
  - Will expanded responsibilities for the monitoring board impact on the IASB's independence?
  - Funding stability: Diversity of funding

# Investor Perspectives– U.S. Adoption of IFRS (Expected Outcomes)

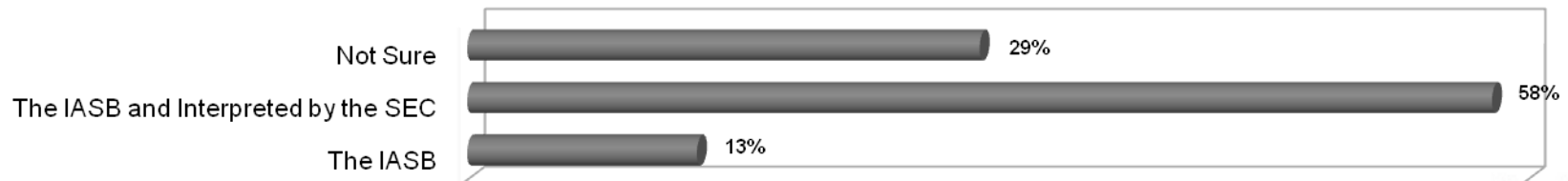
**Should U.S. Adopt IFRS?** – Given the perceived benefits, costs, risks, and potential outcomes associated with promulgation and adoption of IFRS standards, to what extent do you agree or disagree that the United States should adopt IFRS?



**Will SEC Decide to Require IFRS?** – Do you believe the U.S. SEC will ultimately decide to require IFRS for reporting by U.S. public companies?



**Will U.S. Adoption Result in IFRS Promulgated by IASB?** – Do you believe U.S. adoption of IFRS will result in adoption of IFRS as promulgated by:

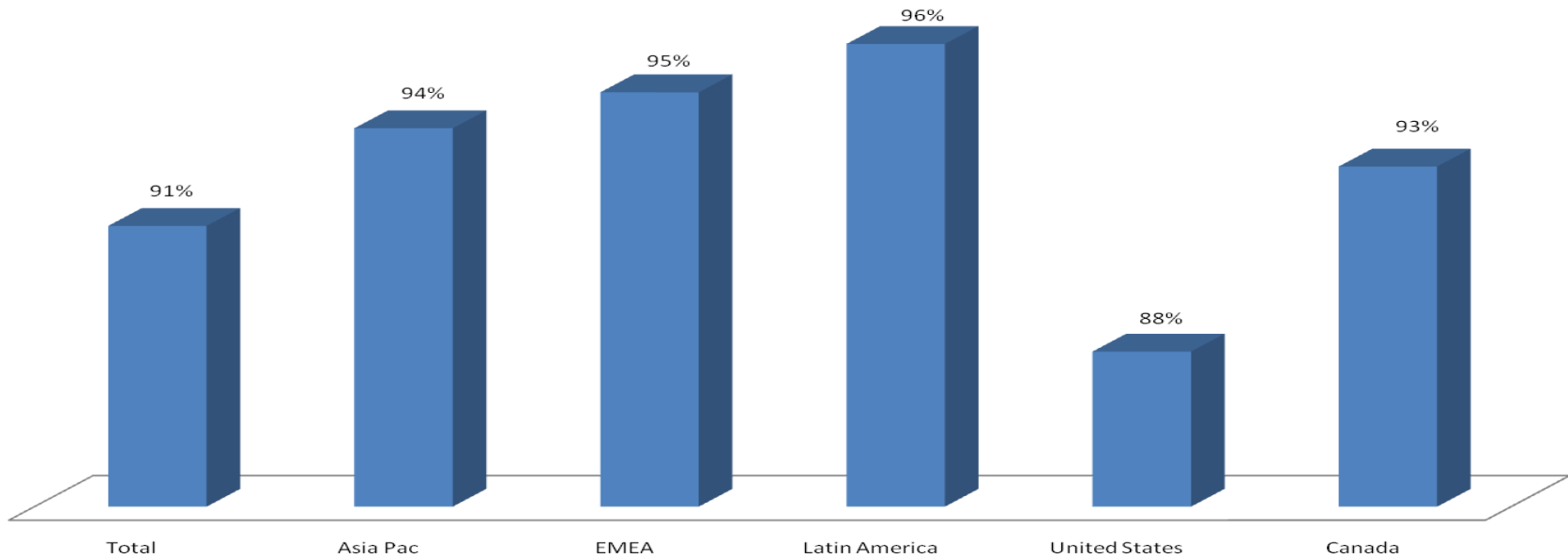


# Investor Perspectives – IFRS Convergence

## Support for Single Set of High-Quality Global Accounting Standards:

Do you support or oppose having all companies throughout the world using a single set of accounting standards to prepare general purpose financial statements?  
(N=1542)

■ % Support



# Investor Perspectives – IFRS Convergence (Support Premise? Objective Achievable?)

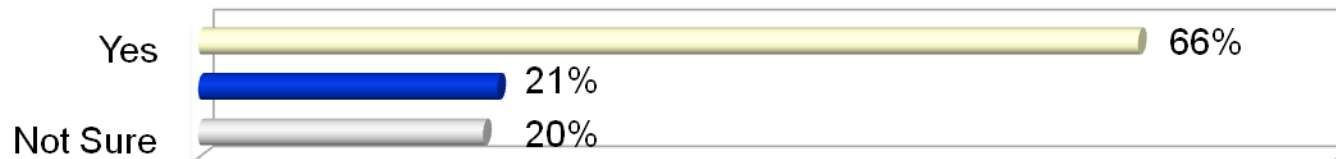
**Support Convergence Premise?** – Do you support the goal of a single-set of global, high quality, understandable and enforceable accounting standards?



**Is Convergence an Achievable Goal?** – Do you believe it is feasible to achieve the goal of a single-set of global, high-quality, understandable and enforceable accounting standards?



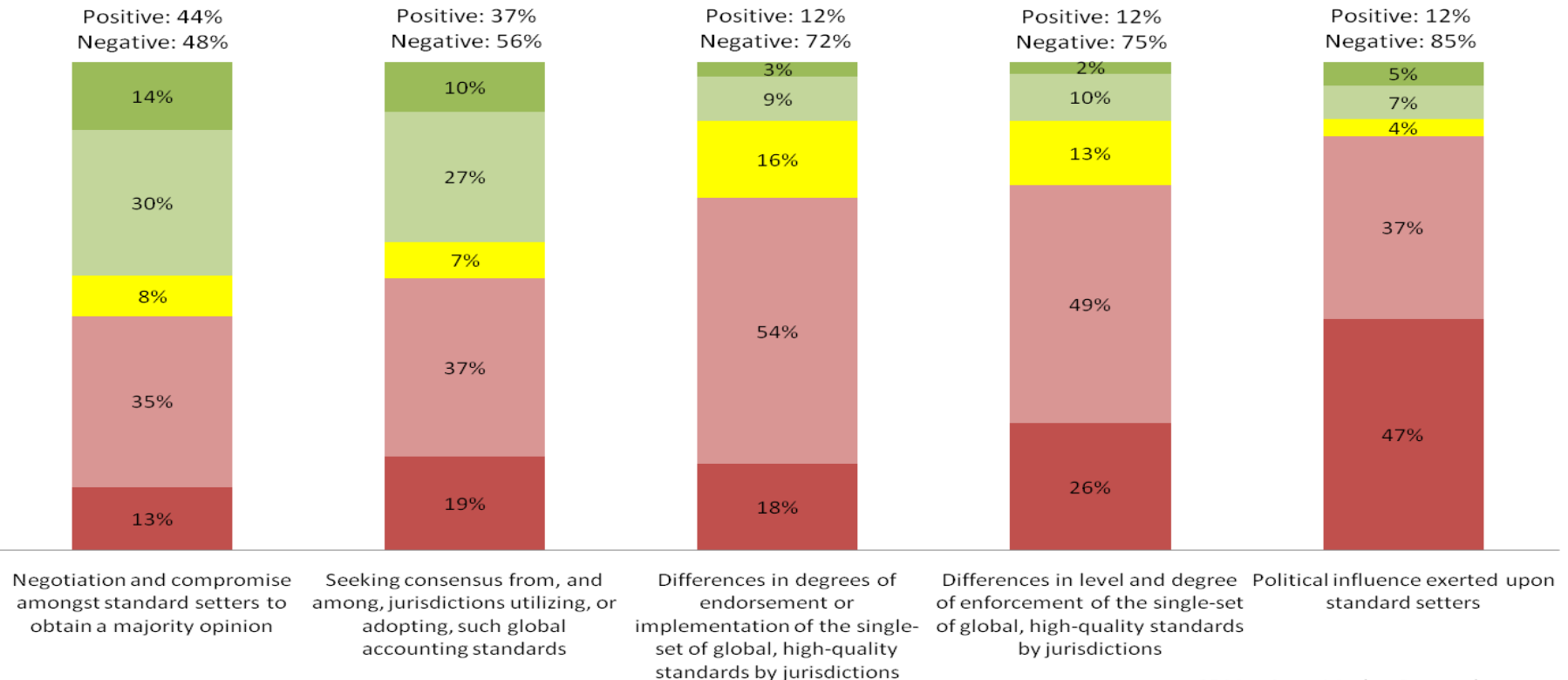
**Will Different Purposes For Financial Statements Limit Achievability of Convergence?** – Do you believe differing views regarding the primary purpose of financial statements across countries will impact the realizability of the goal of a single-set of global, high-quality accounting standards?



# Investor Perspectives – IFRS Convergence (Impacts)

To what extent do you believe the following factors have, or will, negatively or positively impact the ability to achieve the goal of convergence to a single-set of accounting standards?

■ Significant negative impact   ■ Slight negative impact   ■ No impact   ■ Slight positive impact   ■ Significant positive impact

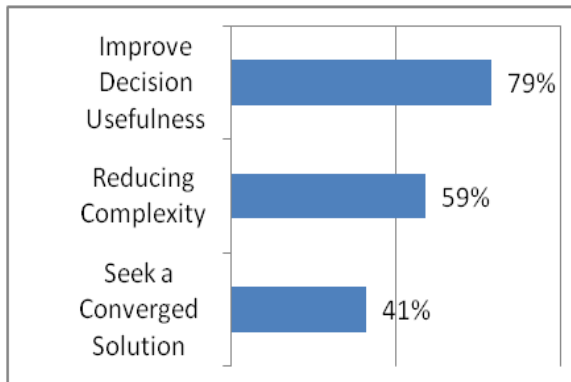


CFA Institute Market Research

# Investor Perspectives – IFRS Convergence

## Most Important Objective of Financial Reporting Reform:

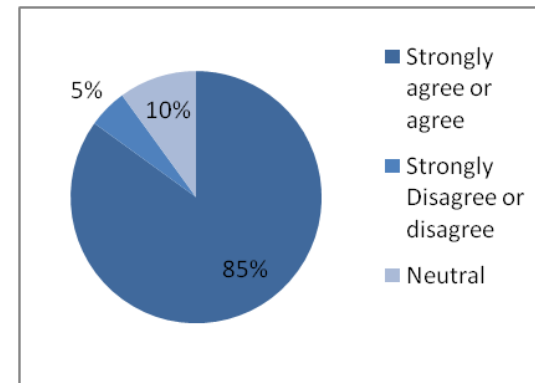
The financial reporting objective considered to be at least as important or more important than any other:



**Key Message:** Improving decision-usefulness is the most important objective.

## Convergence as an Objective of Financial Reporting Reform:

Based on experience thus far, to what extent do you agree that IASB & FASB convergence should remain one of the objectives of financial reporting reform?



**Key Message:** Convergence should remain an objective of financial reporting reform.

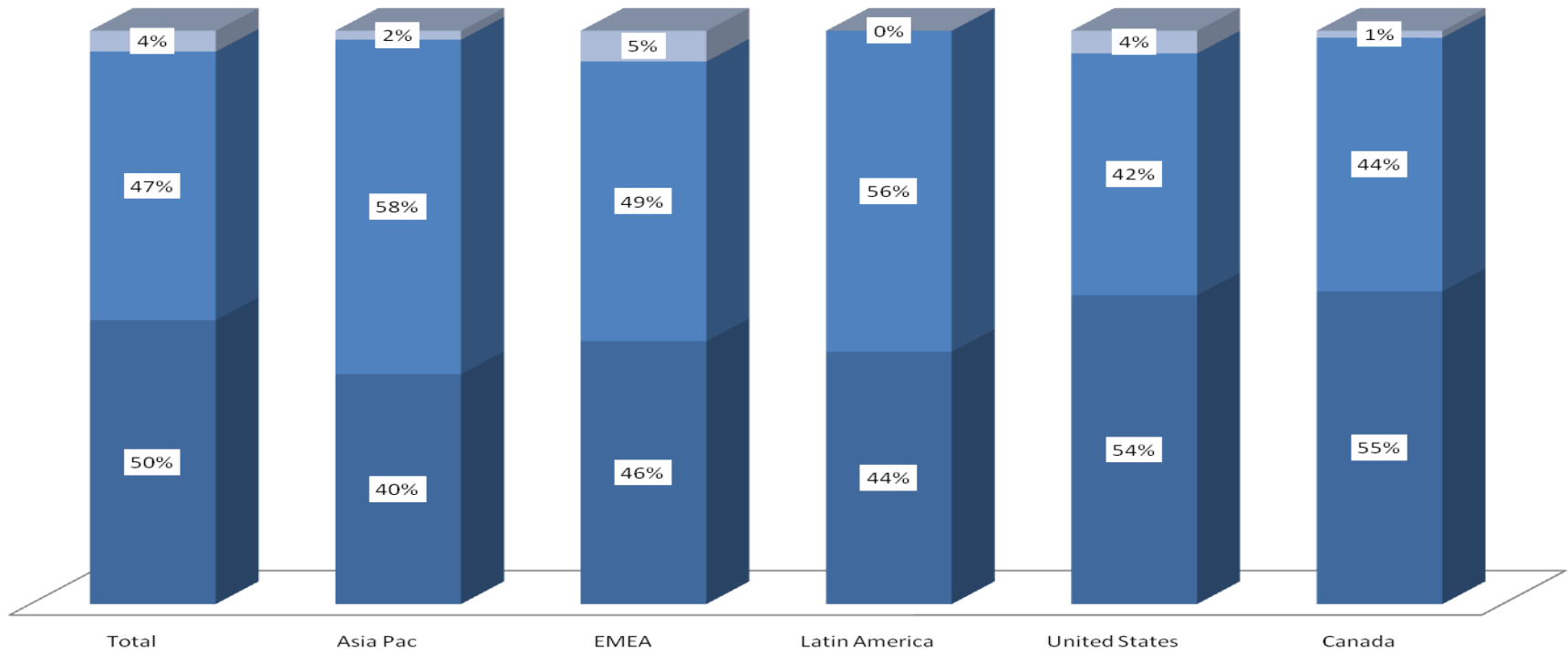
# Investor Perspectives – IFRS Convergence (Who Should Enforce IFRS?)

## Enforcement Responsibilities

If companies were permitted or required to use a single set of standards, who should be responsible for ensuring consistent enforcement across countries?

(N=1,432)

- A single body is necessary to ensure consistent enforcement across countries.
- Enforcement should be determined at the country level.
- Other



# Effectiveness and Efficiency of Standard Setting



# Current State of Standard Setting- Threats to Quality

- **Fixation with Reducing Earnings Volatility- Compromises relevance of information**
  - Emphasis on mitigating portrayal of true economic volatility through recognition and measurement decisions and use of other comprehensive income.
    - Impairment model with smoothing pattern and use of foreseeable future;
    - Business strategy (i.e. intent) based classification & measurement;
    - Hedging proposal expanded use of OCI
  
- **Regulatory vs. Investor Interests – Double Edged Sword**
  - Basle Pillar 3 disclosures have improved comprehensiveness of risk reporting for financial institutions (i.e. Market risk, liquidity risk, credit risk and structured finance/de-recognition disclosures)- Mutually reinforcing with IFRS 7 disclosures
  
  - However, regulatory considerations appear to unduly influence decision-making. Examples include:
    - Offsetting proposals may be overturned due to U.S. regulatory leverage concerns;
    - Impairment model for open portfolios results in smoothing of expected losses;
    - Classification & measurement of investments not being at fair value is heavily influenced by regulatory requirements/concerns.

# Current State of Standard Setting-Limited Impact Assessment

- ***Several questions for investors remain on key projects due to there being no demonstrable evidence of likely effects***
  - How will expanded hedge accounting result in transparency of both hedged risk exposures and un-hedged risk exposures.
  - Financial Instruments Impairment: Does new impairment model solve the 'too little too late' recognition of losses? Has the model been back-tested? Will it result in comparable information across reporting entities?
  - Revenue Recognition : Will the patterns of revenue , across different industries, be
    - more or less lumpy?
    - front loaded or delayed,?
    - closer to cash flow patterns?
  - Are there sufficient safeguards and disclosures to ensure comparability and objective depiction of revenue by all types of reporting entities
- ***Overall, there is a significant risk of unintended consequences on some of these key projects***

# Current State of Standard Setting- Due Process

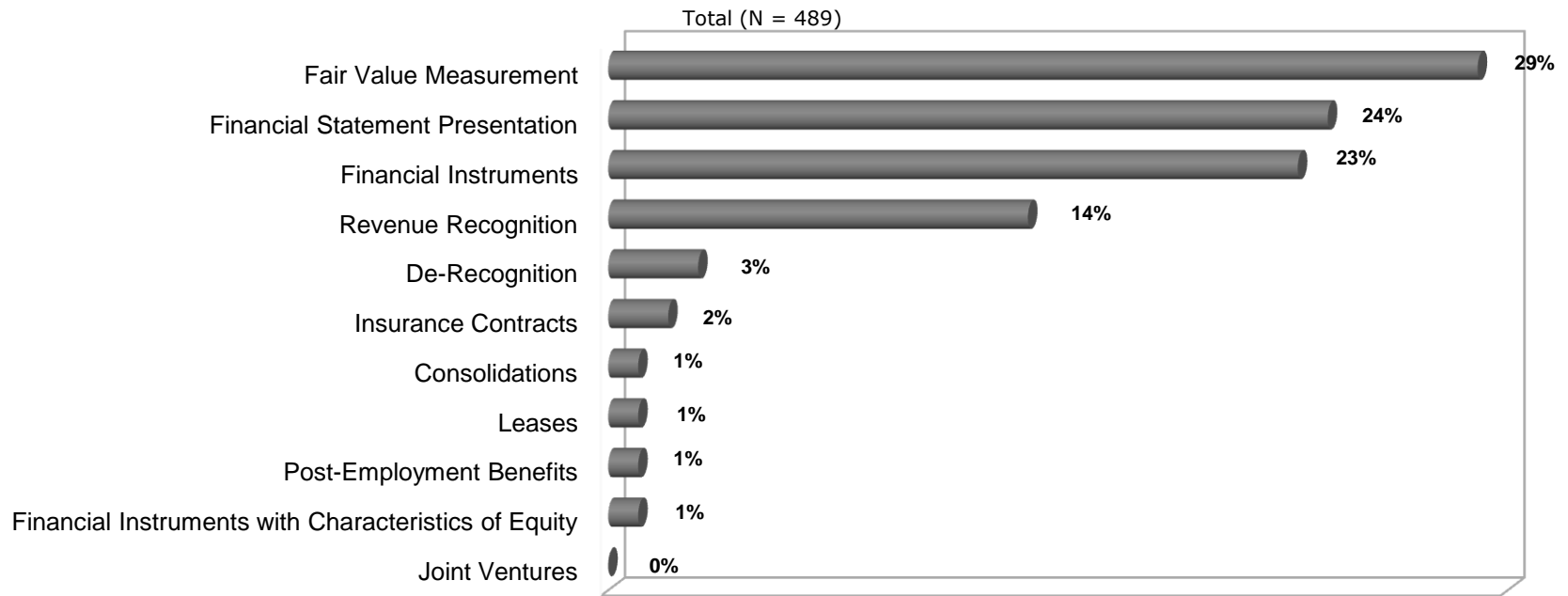
- **Consultative due process** comprised of **Discussion Paper, Exposure Draft, Staff Draft, Re-exposure draft, private outreach by IASB and FASB, outreach by national standard setters and EFRAG.**
  
- **Key consultative issues are:**
  - Often consultative process suffers from lack of coherent linkage
  - Burdensome for investors and other stakeholders- hard to keep up with multiple iterations, moving parts, especially when the consequences of standards are not readily apparent
  - Standards being re-exposed- Revenue recognition (August 2011), Impairment (September 2011), Leases (??)
  
- **Prioritisation and Resource Allocation**
  - Belated prioritisation is inefficient
  - Rush to completion-symptomatic of allocative inefficiencies
  - Need to align agenda with investor interests- see survey results

# Indicator of Investor Priorities

## ➤ Importance of the Financial Statement Presentation Project

### Investor Priorities Related to 2006 MoU Projects:

- What do you find to be the most important 2006 MoU projects?
- Rank 2006 MoU Projects from 1 (most important) to 11 (least important)



Source: June 2010 Convergence / SEC Work Plan Survey

# Cross Cutting Issues – Unresolved Similar Issues

- **Key areas of inconsistencies across projects include:**
  - Transfer of Control Notion (Revenue recognition, leases, de-recognition)
  - Inconsistent Measurement Methods (Entry, Exit, Hybrid)
  - Discount Rates Are Highly Inconsistent
  - Inconsistent Definition or Articulation of When & How to Use
  - Probability Weighted, Expected Loss, or Expected Value
  - Differences in Accounting for Costs
  - Most Complex to Measure Liabilities are Those Closest to Current Value (e.g. Insurance & IAS 37)
  - Unbundling Method – Specified in Revenue Recognition, Not in Insurance
  - Variable Consideration – Revenue recognition, Leases)
  
- **Boards Should Resolve Key Conceptual Issues**
  - **OCI Purpose:** Other Comprehensive Income purpose needs to be defined
  - **Conceptual Framework-** Will it only be dealt with at tail end of process? Issues to settle include:
    - What is the most relevant measurement basis?
    - What are performance reporting objectives?
  
- ***Resolving issues across projects rather than within project silos would increase the aggregate efficiency***

# Confessions of a standard setter – Ex FASB Board Member

- *The development of standards is typically characterised by the below steps:*
  - *The process starts with fuzzy objectives, which lead to*
  - *Choices among recognition, measurement, and display methods, which in turn lead to*
  - *Debate within and among standard setters, reporting entities, financial analysts, educators, and others about which choice to make, and*
  - *If the choice that most threatens the status quo of manageable earnings appears to be winning the debate, that threat leads to*
  - *Lobbying of government overseers by corporate reporting entities, often leading to;*
  - *Government interference, which, along with all of the foregoing infirmities, leads to;*
  - *Compromised accounting standards with deficiencies that cause;*
  - *Recycling of many issues into future standard-setting projects, and thus we have*
  - *A process without end for any complex accounting issue; and*
  - *A process overall with an insatiable appetite for consuming time and thereby failing to address myriad problems that fester until they become too rancid to ignore.*
  
- **Source: Mosso, David, 2010, *Transparency Unveiled: Financial Crisis Prevention through Accounting Reform*, Accounting Horizon, Vol.24, No.1, pp 95-107**

# Review of Selected Issues on Proposed Standards



# Selected Issues: Financial Instruments – Hedge Accounting

## ➤ **Questionable Benefit to Users Due to the Following:**

- Inappropriate Expansion of Hedge Accounting
  - Overreliance Upon Management Intent & Inadequately-Defined Risk Management Terminology
  - That is not to say users are not interested in risk management but hedge accounting should not be seen as sole means of depicting risk management
  - Users also interested in un-hedged exposures
  - Lack of Robust Method For Assessing Effectiveness (unbiased and 'other than accidental offsetting)
- Disclosures are not sufficient given increased complexity & management intent Bias
  - Disclosures do not sufficiently inform synthetic exposures created through aggregation, netting allowed for hedge accounting
- Limited Ability for Investors to Assess Economic Hedge Effectiveness
  - Ineffectiveness May Not Be Appropriately Reflected in Profit & Loss
- Free Choice in Classification & Measurement
  - Can by-pass IFRS 9 classification and measurement for cash financial instruments

★ **Overall proposal increases user interpretation complexity, likelihood of misapplication of hedge accounting and decreases comparability of risk management practices**

# Revenue Recognition – Components

Transfer	Core principle of model
	Determining when a good or service is transferred
	Measuring progress
Separation	Segmenting a contract
	Identifying distinct goods or services
	Perfunctory performance obligations & promotional/marketing deals
Contract Issues	Definition & existence of a contract
	Constructive performance obligations
	Contract modifications
	Combination of contracts
Transaction price	Measuring uncertain consideration
	Constraining estimates of uncertain consideration
	When is uncertainty a recognition event versus a measurement event (royalties etc.)
	Collectibility
	Time value of money
	Consideration payable to a customer (Co-op dividends)
Allocation	Allocating the transaction price (initially & subsequently)
Scope	Financial instrument fees
	Boundary of revenue recognition model & receivables accounting
	Risk-sharing (collaborative) arrangements
Disclosure	Revenue disclosures
Onerous Test	Level at which onerous test should apply
	Which costs should be included in onerous liability
Costs	Acquisition costs
	Assets arising from fulfillment costs
	Impairment of assets arising from fulfillment costs
	Disclosures
Transition and Effective Date	Transition methodology
	Effective date & early adoption
Implementation Guidance	Analysis of industry issues (from letters and ED guides)
	Warranties
	Gift cards & breakage
	Rate-regulated activities
	Nature of a PO in a license/right to use
	Repurchase agreements
Other	Cost benefit considerations and other sweep issues
	Telecommunication entities (additional industry considerations)
	Retail real estate (Asia/Brazil)
	Private sector considerations

# Selected Issues: Revenue Recognition

- **High Quality Revenue Recognition Standard =**
  - Show how the firm generates revenue and operating earnings.
  - Assist investors in forecasting future revenues, cash flows and operating earnings.
  - Assist investors in making comparisons among companies and over time.
  
- **Areas of difficulty:**
  - **Transfer of control:** Application in service industry.
  - **Separating distinct performance obligations**– Needs robust principles to avoid earnings management opportunities (e.g. Using distinct profit margin as a basis of separation could be manipulated)
  - **Uncertain consideration:** How should it be measured? Should there be constraints?
  - **Multiple element contracts:** Increased likelihood of subjectivity in transaction price allocation and front loading of revenues (would have liked to see a hierarchy with primacy accorded to observable market prices)
  - **Industry Impacts = Unclear to Investors**
    - There is need to further delineate economic/financial statement consequences across industries so as to enhance user understanding.
    - Investor have only glimpses of impact on certain industries (e.g. telecommunication, software and construction industries).
    - Transition disclosures comparing old standards and new standards is key to communicating impact of changes.

# Selected Issues: Revenue Recognition

- **Observations on Proposed Standard (Continued)**
  - **Disclosures = Crucial**
    - **Prioritisation of Disclosures is Important** – If Board fails to prioritise disclosures, there is a high likelihood that preparers will simply provide inadequate/boilerplate disclosures
  - **Investors Will not be Overburdened with Informative Disclosures**
  - **Preparers' Argument That Disclosures Are Costly = Overblown**

# Selected Issues: Revenue Recognition Further Disclosures

- **Disclosure of Basis for Judgements Should be Required** –
  - How contracts were defined and aggregated
  - Separate performance obligations identification criteria
  - How transfer of control criteria were identified and evaluated.
  - How variable consideration was measured.
  - Initial and subsequent changes in credit risk expectations.
  - The basis of the discount rate determination for the time value of money.
  - When and how changes in transaction price occur and how they are allocated.
  - How estimated selling price was determined and what level of estimation was required.
- **Roll-forward by Product Category** – Rollforward by product category should be required in tabular format.
- **Costs** – Presently no disclosures regarding costs incurred or capitalized or deferred.
- **Contracts Approaching Onerous** – Contracts that are on the verge of being characterised as onerous (i.e. a watch list)
- **Backlog of Orders & Unsigned Contracts** – No present disclosure of backlogs or unsigned contracts.

# Selected Issues: Revenue Recognition

## ➤ **Presentation Requirements Are Important to Investors**

- **Greater Disaggregation** – On face of statement of comprehensive income by nature and function given the postponement of the FSP Project (e.g. Goods, services, leases)
- **Support Gross Presentation** – We are opposed to net presentation of contract assets and contract liabilities.
- **Linked Presentation of Revenue Adjustments** – Separate presentation of warranties, refunds and credit risk adjustments.
- **Performance Obligations vs. Contract Balances** – There is need for greater clarity on presentation differences between performance obligation and contract balances.

# Questions



# Contact

Vincent Papa, CFA  
[vincent.papa@cfainstitute.org](mailto:vincent.papa@cfainstitute.org)  
+ 44 (0) 207 330 9521

