

Beyond the GAAP

N°21 – March 2009

Editorial

Will the current crisis put an end to the convergence project between US GAAP and IFRS? This question may sound weird given the numerous joint projects. Even the G20 called in London for a single international set of accounting standards. Nevertheless, the US are questioning the opportunity to move forward to IFRS. In February, Ms Schapiro, chairwoman of the SEC, presented her concerns to the US Senate. Now, the FASB - the US standard setter - and the Financial Accounting Foundation call for comments as they try to investigate whether the benefits of convergence would outweigh the costs. To be continued.

Happy reading!

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IASCF publications

The IASCF has now published the *International Financial Reporting Standards 2009 Bound Volume*. This edition brings together all the standards and interpretations published at 1 January 2009 and their accompanying documents in a single volume.

The IASCF also published its 2009 edition of the IASCF's *IFRSs – A Briefing for Chief Executives, Audit Committees and Boards of Directors*.

It explains, in non-technical language, all the IFRS standards issued at 1 January 2009. As the title indicates, it is intended for chief executives, audit committee members, directors and to all those who would like a general overview of the standards and their possible implications.

The two publications, priced at £60 and £19 respectively, can be obtained from

http://buy.iasb.org/timssecommerce/timssnet/common/tnt_fr_ontpage.cfm



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European matters

⇒ Consultation on the framework for financial market supervision

March, the European Commission launched consultations on improving financial market supervision.

These consultations aim at identifying proposals for reviewing the framework for European supervision of the financial markets by the end of May 2009. Legislative measures will be proposed in fall for a new European supervisory framework.

At this stage, the Commission is requesting comments on the recommendations of the expert group¹ chaired by Jacques de Larosière (report published on 25 February 2009).

Among the 31 recommendations, one deals specifically with accounting rules. The expert group believes that it is necessary to:

- conduct a wider reflection on the mark-to-market principle;
- find expeditious solutions to the accounting issues concerning complex financial products;
- to prevent accounting standards from biasing business models, promoting pro-cyclical behaviour or discouraging long-term investment;
- reach an agreement among accounting standard setters on a common, transparent methodology for the valuation of assets in illiquid markets where mark-to-market cannot be applied;
- open the IASB standard-setting process to the regulatory, supervisory and business communities in the broad sense;
- strengthen the oversight and governance structure of the IASB.

Comments are expected by 10 April 2009. The de Larosière report can be consulted at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

¹ The High-level Group on Financial Supervision in the EU

⇒ Adoption of IFRIC 12: The European Commission had done it!

Some were doubting that IFRIC 12, *Service Concessions Arrangements*, would be adopted in Europe. The European Commission finally adopted this interpretation in March 2009.

The belated adoption of this interpretation, more than two years after its publication by the IASB, has the effect of delaying its application date.

In Europe, IFRIC 12 will be mandatory for financial years beginning after 29 March 2009. For entities whose financial year coincides with the calendar year, it will be three years after the date of application set by the IASB. The IASB had originally set the application date for this interpretation to annual periods beginning on or after 1 January 2008.

⇒ CESR: 5th extract from the accounting studies database

The CESR (Committee of European Securities Regulators) published the 5th extract from its database of accounting studies in December 2008. In doing so the CESR had made public some of the accounting studies from the various European financial market regulators.

This publication contains seven decisions on subjects as various as the reclassification of financial assets, share-based payments, discontinued operations, control, reverse acquisitions, put options on minority holdings, and preferential shares.

These decisions can be viewed on the CESR web site at <http://www.cesr.eu/index.php?page=groups&mac=0&id=13>

IFRS news

➤ Adoption of IFRS standards by US companies: no clarification!

In January 2009, we reported that Mary L Schapiro, the new chair of the SEC, had told the US Senate that she did not feel bound by the road map for IFRS adoption. This was quite enough to raise concerns about the adoption of IFRS standards by the US by 2014!

These concerns have been intensified by the comment letter issued by the Financial Accounting Foundation (FAF) and the Financial Accounting Standards Board (FASB) on the road map.

The FAF and the FASB are calling for an additional study to identify, understand and assess the strengths, weaknesses, costs, and benefits of possible approaches to achieving the ultimate aim, namely a single set of global accounting standards.

Thus it is no longer a matter of simply adoption the IFRS standards but rather one of studying all the possible ways of achieving the objective of a single standard, including the continuation of the joint standard-setting efforts of FASB and the IASB over a much longer period.

The FAF and the FASB are still considering whether, at this stage, IFRS standards are workable in the US environment.

From there it is only a step to entirely overhauling the IFRS convergence project.

➤ Derecognition of financial instruments

On 31 March 2009 the IASB published an exposure draft entitled *Derecognition* which proposes improvements to IAS 39. In this exposure draft the IASB suggests:

- revising the conditions for the derecognition of financial instruments, and
- improving financial information, in particular where an entity has continuing involvement in a derecognised financial asset.

This exposure draft is part of a wider project on the recognition of off-balance sheet items. It follows the publication of ED 10 in December 2008, which offered a single definition of control and proposed enhanced disclosures on consolidated and non-consolidated entities.

This document can be consulted at http://www.iasb.org/NR/rdonlyres/74354283-FBBE-4B0D-9D45-FFB88BFE313B/0/ED_Derecognition0309.pdf

Comments are invited by 31 July 2009.

➤ Measurement in an illiquid market

The IASB decided to questions on the FASB's proposals for measurement in an illiquid market (published on 18 March). For the IASB, this is a matter of assessing the public reaction to the FASB's proposals. This is all the more important that they conflict with those of the exposure draft.

At this stage, the Board of the IASB has expressed no view of the FASB proposals. Nevertheless, exchanges with the FASB suggest that the IASB does not consider them appropriate.

Similarly, the FASB's unilateral approach is perceived as a knife-thrust to the agreements for cooperation and joint work between the two Boards.

Finally, and in parallel with to the changes to its exposure draft, the IASB called for comments on the FASB proposals within the next thirty days (by 20 April).

➤ Conceptual framework: evaluation

After more than two years, the staff are still trying to identify a conceptual approach which reflects the IASB's repeated assurance that the IFRS standards are not intended to implement 'full fair value'. Quite a challenge...

⇒ Draft standard on income tax

On 31 March, after several years of work and repeated delays, the IASB finally published an exposure draft entitled *Income Tax* proposing a replacement of IAS 12.

This project is part of the work towards convergence with the FASB. Apart from changes to the structure of the standard and certain definitions, the main aim is to strengthen the principle of the immediate recognition of tax on temporary differences.

This would remove or limit most of the exceptions under IAS 12 regarding the recognition of deferred tax assets and liabilities, including the exceptions relating to temporary differences:

- resulting from the initial recognition of assets or liabilities;
- on the securities of subsidiaries, associates, joint ventures and investments in branches.

The IASB also proposes to recognise all deferred tax assets, subject to an immediate devaluation to reduce the net value to the amount 'more likely than not' to be realisable.

Finally the text addresses the question of uncertain tax positions and the classification of tax effects among the different components of financial statements.

Comments on this draft are invited by the IASB until 31 July 2009. Beyond the GAAP will present the main provisions of this exposure draft in the near future.

⇒ Emission rights

The March meeting marked the real start of this project. Board members examined the accountancy model for emission rights.

There is a consensus that the assets should be classified as intangible assets and recognised from the start at fair value. However, members of the Board are divided about the cross-entry: liability or instant gain? A debate between those who uphold dogma and those whose aim is to give priority to relevant information.

⇒ The IASB publishes the IFRS 7 amendment

On 5 March 2009, the IASB published the IFRS 7 amendment entitled *Improving Disclosures about Financial Instruments*. This publication is a part of the IASB's response to the financial crisis and reflects the call for transparency from the G20. It also reflects the discussions of the IASB's Expert Advisory Panel.

This amendment introduces a three-level hierarchy of fair value and requires entities to make additional disclosures about the reliability of their measurements.

This amendment also enhances the existing requirements for the disclosure of liquidity risk. The information disclosed will describe the nature and extent of liquidity risk arising from financial instruments and how the entity manages that risk.

These new obligations will apply to the financial periods open as of 1 January 2009. Entities will not be required to provide comparative information for the first year of application.

⇒ Embedded derivatives and reclassification

On 12 March 2009 the IASB published amendments to IFRIC 9 and IAS 39, *Embedded derivatives*.

This is the final version of the exposure draft issued on 22 December 2008 (see Beyond the GAAP n°18, December 2008).

These amendments state that embedded derivatives must be assessed when financial assets are reclassified on the basis of the existing conditions at the time of acquisition or subscription to the hybrid instrument. The IFRIC 9 and IAS 39 amendments are applicable retrospectively to annual periods ending on or after 30 June 2009.

Dynamic provisioning enters the debate

The financial crisis has highlighted the fact that the interaction between fair value measurement of financial instruments and prudential rules produces procyclical effects, both upwards and downwards. A debate is now under way between standard setters, regulators and political authorities on the advisability of measures for dynamic provisioning. This seems to be the view of Charlie McCreevy who recently suggested that such a mechanism "introduces significant counter-cyclical" ¹.

Different approaches exist for dynamic provisioning: provisions for future losses which are expected to arise over the term of the loan (expected loss model) or, at the opposite, allocation in a non-distributable reserve as a buffer (the amount allocated is determined by the regulatory rules).

This issue was discussed at the G20 summit held in London on 2 April. The Communique issued by the leaders of the Group of 20 statement calls on the accounting standards setters with supervisors and regulators to work this issue on an urgent basis.

The IASB and the FASB have begun to jointly discuss the response they would like to bring to the probable demand for a standard emanating from the Financial Stability

Forum. The views exchanged between members of the two Boards in joint session would so far suggest a preference for the 'expected losses' model.

¹ Speech of 9 February - "The Credit Crisis - Looking ahead".

Launch of review of financial instruments standard

The IASB and the FASB have established the main thrust of the review of the standard on financial instruments, intended to replace IAS 39.

This standard could be based on a mixed assessment model, fair value combined with at least one other aspect of measurement to be determined (amortized cost and/or another form of discounted cash-flows), and will adopt a single method of impairment.

The choice of measurement will be based principally on the cash-flow profile of the instrument, in accordance with whether it is dependent on market movements or contractually defined. In the second case, the measurement will depend on the management model applied to the instrument.

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Leases: A new approach emerges

The subject of the recognition of leases has taken a new turn with the publication on 19 March of a joint Discussion Paper (DP) from the IASB and the FASB entitled *Leases: Preliminary views*.

In the approach adopted by the project, all leases give rise to liabilities for future rental payments in return for the right to use the leased asset.

Beyond the GAAP here outlines the main points in a project which, if it were to come to fruition, would lead to changes in the financial statements of many groups, in particular those which make extensive use of simple leases.

➤ A subject of long-standing concern

The accounting treatment of leases has been under discussion for some considerable time, as the G4+1 publication of two documents demonstrates¹.

In July 2006 the IASB and the FASB added the subject to their agendas as part of the first Memorandum of Understanding.

In July 2008, the IASB and the FASB decided to defer the consideration of lessor accounting which is directly linked to the project on the recognition of income and derecognition. Furthermore, a focus on the lessee would make it possible to resolve the problems associated with lessee accounting as quickly as possible.

The Discussion Paper which has just been published therefore constitutes the first step in the Lease project. The IASB and the FASB plan to issue an exposure draft of a new lease accounting standard in the second quarter of 2010. The current project plan of the IASB envisages that a final Standard will be issued in the second quarter of 2011.

The scope of the future lease accounting standard would be the same as that of the existing standards, i.e.

- IAS 17, IFRIC 4 and SIC 27 for the IASB, and
- SFAS 13 and EITF 01-8 for the FASB.

¹ G4+1 consisted of accounting standard setters in Australia, Canada, New Zealand, the UK and the US, together with members of the IASC (the predecessor of the IASB). The first paper, entitled "Accounting for Leases: A New Approach-Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts" was published in 1996.

➤ A new approach

Rights and obligations under an operating lease

The project analyses a lessee's lease contract as

- the right to use the leased item and
- the obligation to make rental payments.

For the Boards, the right to use the leased item meets the definition of an asset, and the obligation to make rental payments meets that of a liability.

It is not possible to take the view that the right to use the leased item does not constitute an asset on the grounds that it is conditional on rental payments. Such an argument would be equally applicable to any asset acquired on credit.

A lease contract would be reflected in the lessee's financial statements by the recognition of:

- an asset, representing the right to use the leased item, and
- a liability, representing the obligation to make rental payments.

Single asset and liability model

A contract may have a number of components, including renewal options, purchase options, contingent rents or residual value guarantees. The Boards have decided not to require the separate recognition of these different components.

The Boards therefore propose the recognition of

- a single asset, including rights acquired under options,
- a single liability, including contingent rental arrangements and residual value guarantees.

➤ Initial measurement and recognition

The DP proposes that the liability and the asset be initially recognised at the value of the lease payment over the most likely lease term, discounted using the lessee's marginal interest rate².

At the time of the initial recognition the asset and the liability thus have the same value.

The anticipated rental includes not only the payments made under the lease contract but also estimated additional payments (including contingent rents and the residual value guarantee).

At this stage the IASB envisages that contingent rents (or the residual value guarantee) should be determined by a weighted average of the possible outcomes (i.e. probability-weighted contingent rents or residual value guarantees). However, the FASB prefers the "most likely rental payment" approach. We may therefore expect divergent approaches.

The most likely lease term would be determined by reference to contractual and non-contractual factors and to business factors, such as renewal periods, termination options and purchase options. Neither lessee intentions nor past practice are taken into account in this analysis.

²The marginal interest rate is the rate of interest which the lessee would obtain if it were to borrow to acquire the item over the same period and with the same level of guarantee.

➤ Subsequent measurement and recognition

For the subsequent measurement of the asset and the liability, the Boards propose that:

- the liability should be recognised on the basis of the amortised cost model, the rentals being allocated between the repayment of the liability and the financial cost, and
- the assets should be amortised over the most likely lease term or the economic life of the leased item, whichever is the shorter.

Apart from the general model outline above, the DP also tackles a number of subjects associated with measurement which suggest that there are divergences of opinion between the two standard setters.

Changes in the lessee's incremental borrowing rate

The IASB thinks that the liability should be revised to reflect changes in the lessee's incremental borrowing rate, i.e. the current conditions.

As surprising as this may appear, the treatment envisaged by the Board here differs from the approach currently applied to finance leases.

Bear in mind that where the implicit contract rate cannot be determined the existing IAS 17 standard adopts the lessee's incremental borrowing rate and freezes it for amortisation of the loan. The existing IAS 17 standard contains no provisions for the revision of the incremental borrowing rate.

However, the IASB did not decide how frequently reassessment should take place, in particular whether it should take place at each reporting date or only when there is a change in estimated cash flows.

Unlike the IASB, the FASB considers that the lessee's incremental borrowing rate should remain unchanged throughout the term of the lease and should correspond to the rate at the time the contract was concluded.

A reading of the examples provided suggests that the IASB regards the asset as the cross-entry to the revised liability. However, the IASB has not stated this with any clarity.

Reassessment of future cash flows

The two Boards believe that the accounting value of the liability would be adjusted to the present value of the revised cash flows, discounted at the marginal interest rate (the "catch up" approach).

The two Boards diverge as to the interest rate to be applied,

- the FASB preferring to use the original rate
- while the IASB, bearing in mind its position on changes in the incremental borrowing rate (see above), prefers to apply a revised rate rather than the original rate.

Reassessment of the lease term

The lease term should be reassessed at the end of each financial period to reflect any new facts and circumstances.

The results of this reassessment of the liability should be recognised as the counterparty to an adjustment in the accounting value of the asset, rather than an impact on the result.

This approach is consistent with the treatment set out IFRIC 1 in the event of changes in decommissioning liabilities.

Reassessment of contingent rents and residual value guarantees

Though the Boards agree on the principle of annual reassessment, their proposals for the recognition of any resultant changes in liabilities differ significantly:

- the IASB believes that changes to the liability must be recognised as a counterparty to the value of the asset,
- while the FASB prefers to recognise this change (as a profit or loss).

➤ Presentation of financial statements

The two Boards agree that the obligation to pay rentals is a financial liability and should be presented as such, but they do not recommend the same presentation. The FASB proposes to require the separate presentation of rental liabilities on a distinct line on the face of the balance sheet. The IASB does not propose such a presentation.

The two Boards agree that right-of-use should be presented in the statement of financial position on the basis of the nature of the leased item, and separately from owned assets.

Finally, what will be the presentation in the profit and loss account? No decision has yet been reached on this point.

The discussion paper is open for comment until 17 July 2009. We expect this project to arouse a great deal of interest.

The discussion paper can be found at

<http://www.iasb.org/NR/rdonlyres/FF3A33DB-E40D-4125-9ABD-9AF51EB92627/0/DPLleasesPreliminaryViews.pdf>

Events and FAQ

Events/publications

Seminars on "Current developments in IFRS"

Mazars' Technical Department will host a number of seminars throughout 2009 dedicated to current developments in IFRS. These seminars are organised by Francis Lefèbvre Formation. Sessions will be held on 19 June, 25 September and 18 December 2009.

Registration forms can be obtained from Francis Lefèbvre Formation, 13-15 rue Viète, 75017 Paris.

Frequently asked questions

- Allocation of guarantees to purchaser on the deferred price - adjustment of the cost of a business combination.
- Hedging of an inflation protected government bond by recognising it at fair value on the option;
- Determination of the profit on the sale of a subsidiary paid for by the purchaser's bonds redeemable in shares and accompanied by a guaranteed value in the event of an initial public offering or cash reimbursement otherwise;
- Disposal of lease: accounting treatment of the obligation to carry out remedial works with re-invoicing of lessor
- Takeover of an entity previously under joint control;
- Treatment of the exchange rate component in a shared-based payment;
- Accounting treatment of a variable rate v. fixed rate micro-cover operation
- Recognition of cessation of hedge accounting at fair value of a loan recognised at cost.

Upcoming meetings of the IASB, IFRIC and EFRAG

IASB

20 - 24 April 2009
18 - 22 May 2009
15 - 19 June 2009

IFRIC

7 - 8 May 2009
9 - 10 July 2009
3 - 4 September 2009

EFRAG

28 - 30 April 2009
4 - 5 June 2009
8 - 10 July 2009

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