

Beyond the GAAP

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Editorial

The financial crisis, one year on... Against this background, the G20 meeting held in Pittsburgh in late September culminated in a wish to see the accounting principles of members countries converge by June 2011. Shortly after, Sir David Tweedie appeared before the European Union's Economic and Financial Affairs Committee, ECOFIN, to provide an update on the IASB's responses to the issues raised by the financial crisis. In particular, the redrafting of IAS 39 is still in full swing. Beyond the GAAP introduces the proposals set out in the exposure draft Classification and Measurement, about which the IASB has now received more than 200 comment letters!

Enjoy your reading!

Michel Barbet-Massin

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News

Redrafting the standards on financial instruments: FSB recriminations

In a formal declaration addressed to G20 leaders meeting in Pittsburgh at the end of September, the FSB¹ (Financial Stability Board) highlighted the significant differences between the projects for the reformulation of standards on financial instruments conducted by the IASB and the FASB respectively.

The FSB notes, for example, that the FASB is focusing on a fair value measurement model for the majority of financial instruments, whereas the IASB is likely to opt for a mixed model (amortised cost / fair value). The FSB also noted that the IASB is inclining towards the provisioning of financial instruments on the basis of expected losses, a route which is not being explored by the FASB.

The FSB therefore urged the FASB and the IASB to redouble their efforts to converge the texts on the recognition of financial instruments while reducing the complexity of the underlying principles, increasing transparency and reducing the pro-cyclicality.

¹ The FSB drafts and implements regulatory and supervisory policies in the interests of financial stability. It consists of senior representatives of national financial authorities and international financial institutions.

European matters

➤ CESR: 6th extract from the accounting studies database

The CESR (Committee of European Securities Regulators) published the 6th extract from its accounting studies database on 26 August.

This publication contains 8 decisions on subjects as various as:

- the impairment of equity instruments classified as available for sale (AFS);
- cashflow statements;
- the remuneration of principal administrators as related parties;
- put options on minority holdings, contingent liabilities; and
- preferential shares.

The CESR's position on the impairment of AFS financial assets is in line with that of the IFRIC (see Beyond the GAAP July-August 2009) in that assets must be considered as impaired when there is a significant OR prolonged decline in value (and not significant AND prolonged).

These decisions can be accessed on the CESR web site at: <http://www.cesr.eu/popup2.php?id=5936>

➤ Adoption of the IAS 39 amendment, "Reclassification of Financial Instruments - Effective date and transition"

On 13 October 2008, against the background of financial turmoil, the IASB published Amendments to the standards IAS 39 and IFRS 7 allowing the reclassification of certain financial assets. Many questions as to the effective date and transitional arrangements followed publication.

In response, the IASB published a supplementary amendment on 27 November 2008 clarifying these points.

Though the European Commission was particularly prompt to adopt the Amendments to IAS 39 and IFRS 7 on the

reclassification of financial instruments *Regulation (EC) No 1004/2008 of 15 October 2008* it has only just adopted the "Effective Date and Transition" amendments (*Regulation (EC) No 824/2009 of 9 September 2009*).

This belated adoption has led the European Commission to indicate that companies which have already presented their financial statements (i.e.: including the reclassification of financial instruments) do not have to re-present them (i.e.: if the transitional arrangements used do not comply with the amendment to IAS 39).

➤ Adoption of the IAS 39 amendment "Eligible Hedged Items"

The European Commission has just adopted the IAS 39 amendment "Eligible Hedged Items" (*Regulation (EC) No 839/2009 of 15 September 2009*).

This amendment provides clarifications on the time value of options in a hedging relationship and on the possibility of hedging the inflation risk.

In practice, this means that:

- the time value of options is excluded in a hedging relationship (the change impacts profit or loss) ;
- hedging the inflation risk is only authorised where inflation is separately identified in the contract, for example in an asset's price formula.

This amendment is applicable for annual periods beginning on or after 1 July 2009. Early application is permitted.

IFRS News

➤ Practical difficulties in the application of the revised IAS 23: IASB clarifications on the calculation of the capitalisation rate for general borrowing costs

In July 2009 the IFRIC was asked about the concept of 'general' borrowing in the standard IAS 23R on borrowing costs. This standard distinguishes general borrowings from borrowings that are made specifically for the purpose of obtaining a qualifying asset. For general borrowings, IAS 23R states that the interest recorded is calculated on the basis of a capitalisation rate equal to the weighted average of the entity's borrowing costs (other than those relating to specific borrowings) over the period under consideration, applied to the expenditures incurred.

The question in practice is whether borrowings made specifically to fund the acquisition of a non-qualifying asset must nevertheless be considered as specific under IAS 23R; it would then be excluded from general borrowings for the purposes of determining the capitalisation rate. This is the case, for example, when borrowing is undertaken to fund investment in an associate company.

The IFRIC considered that this is rather a matter of 'application guidance' than interpretation and referred the issue to the IASB.

In July the Board decided not to amend IAS 23R as part of the 'annual improvement' process. It considered that IAS 23R clearly states that the capitalisation rate must be calculated on the basis of borrowings other than those incurred specifically for the acquisition of qualifying assets, i.e. including borrowings incurred for the acquisition of non-qualifying assets.

The IASB thus did not want to study further the contradiction in IAS 23R between this rule and the principle of only capitalising borrowing costs which would have been avoided in the absence of the construction or acquisition of a qualifying asset.

➤ IFRS improvements, 2009 project

On 26 August 2009, the IASB published its 3rd annual draft update of IFRS standards. Parties concerned have until 24 November 2009 to submit their comments.

The proposed amendments, 15 in all, relate to the following standards and interpretations:

- IFRS 1 *First-time Adoption of International Financial Reporting Standards*;
- IFRS 3, *Business combinations*;
- IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*;
- IFRS 7, *Financial Instruments: Disclosures*;
- IAS 1, *Presentation of financial statements*;
- IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*;
- IAS 27, *Consolidated and Separate Financial Statements*;
- IAS 28, *Investments in Associates*;
- IAS 34, *Interim Financial Reporting*;
- IAS 40, *Investment Property*;
- IFRIC 13, *Customer Loyalty Programmes*.

The most significant amendments are those regarding business combinations and consolidation.

Beyond the GAAP will return in more detail to the proposed amendments in the next edition.

Highlights

Presentation of financial statements

THE IASB has taken its first decisions with a view to preparing an exposure draft setting out a new presentation of financial statements.

The Board has opted for a very restrictive definition of the "Financing" section (the financial debts incurred for funding purposes, derivatives and associated costs only). The "Investing" category has been removed and the Board has opted for the publication in the notes of a variation of net debt (debts presented under "Financing" less the disposable assets servicing these debts).

➤ Revenue recognition

In the course of discussions on the "Revenue recognition" project, the IASB has adopted a definition of the transfer of control of an asset between supplier and customer. This is to make it possible to recognise revenue in accordance with a single principle for both industrial and commercial activities. Transfer of control will be assessed from the point of view of the customer. A series of indicators will make it possible to determine whether or not the transfer has taken place.

It remains to test the relevance of this proposal, in particular to construction contracts and other long-term contracts.

➤ Second phase of the IASCF constitution review: Trustees' proposals

The IASCF has a duty to review its Constitution every five years to ensure that its operational procedures remain appropriate to its objectives and the constraints of its context.

Since its creation, the total independence of the institution, whose trustees are co opted by each other, has posed a

problem to many political bodies, and primarily to the Commission and the European Parliament.

In 2008, an early review of the IASCF's constitution was conducted in order to establish a Monitoring Board¹ intended to meet the institution's new requirements for governance and its supervisory conditions. The new provisions came into effect on 1 February 2009.

Following an initial call for comments in the first half of 2009, the IASCF published a second series of review proposals on 9 September, which fall within the normal timeframe. The same day were held roundtables on this subject in the presence of Geritt Zalm, Chairman of the Trustees. Mazars was attended this meeting.

These proposals are aimed at:

- clarifying the IASCF's objectives;
- reaffirming the role of the Monitoring Board in the institution's governance structure;
- strengthening the process for setting the IASB agenda, with the involvement of the Trustees and the SAC²;
- developing discussions with bodies other than accounting standard setters, including regulators;
- establishing a procedure for accelerating due process in exceptional circumstances;
- broadening the geographical distribution of the Trustees, not least through the mandatory representation of Africa and South America.

Comments should be submitted by 30 November 2009.

¹ The Monitoring Board is the IASCF's supervisory committee and is composed of representatives of the US (SEC), Japanese (FSA) and international (OICV) regulatory bodies and the European Commission.

² The SAC (Standards Advisory Council) is a consultative standards committee whose aim is to advise the IASB on its working programme and to inform it of users' opinions on the main standards projects.

Highlights

⇒ New definition of a discontinued operation: the Board decides

The content of the future amendments to IFRS 5 was partly decided during the IASB meeting last July. The Board has finally reached a decision on what should be described as discontinued operations for the purposes of the revised standard.

The Board has also confirmed that discontinued operations should continue to be presented separately from continuing activities in the statement of comprehensive income (at the profit or loss level). This is a joint project undertaken with the FASB which is due to amend FAS 144.

The new definition of discontinued operations would thus draw on the concept of "reportable segment" as defined in IFRS 8, Operating segments. This involves a difference of scale as compared with the definition proposed in the exposure draft published in September 2008. That text proposed that a discontinued operation should be defined as a component of an entity that is an "operating segment" in accordance with IFRS 8, which the entity has either disposed of or which is classified as held for sale.

Henceforth, the Board will thus analyse after the aggregation of operating segments, rather than before. The "net result from discontinued operations" heading on the statement of comprehensive income should therefore almost disappear. It is quite unusual for an entity to decide to dispose of a "reportable segment".

This definition will at least have the merit of avoiding the current difficulties of apply the notion of a "separate major line of business or geographical area of operations".

The amendments are expected to be published during the last quarter of 2009. Given the transitional arrangements set out in the exposure draft, the new definition of a discontinued operation will be applied retrospectively. Reclassification could therefore be carried out in the statement of comprehensive income to present all the amounts relating to discontinued operations on the basis of the revised definition for all comparative periods presented.

⇒ Employee benefits discount rate

On 20 August 2009 the IASB published an exposure draft proposing to amend IAS 19 provisions on the discount rates to be used in measuring employee benefits in an illiquid market.

Currently, this standard states that in discounting post-employment benefit obligations the entity should use a rate determined with reference to an active market rate applied to high-quality corporate bonds. In the absence of an active market for high-quality corporate bonds the entity should apply the State bonds rate.

In the current financial crisis, which has widened the gap between State bond rates and the rate of corporate bonds, the IASB proposes to remove the reference to State bonds.

Whether or not the market is active, the discount rate would thus be measured by reference to the yields of high-quality corporate bonds in the same currency and for which the duration corresponds to that estimated for the post-employment benefits. For this, entities should consult IAS 39, in particular the comments relating to the application of the principles of fair value measurement in an illiquid market.

The IASB is aware that this proposal will increase entities' scope for judgement. This is regarded as the lesser evil, given the problems of comparability with have arisen from the rates used at 31 December 2008.

In view of the urgency of the issue, the IASB set a shortened period for comments on the exposure draft. If adopted, the amendments that arise from this exposure draft could be applied in December 2009 financial statements.

➤ Review of IAS 39 – Financial Instruments

This month the IASB considered the various reactions to its proposals and suggestions published before the summer:

- proposals for the amendment of IAS 39 as regards the classification and measurement of financial instruments (see the special report on page 12 of this edition),
- discussions regarding the interactions between the issuer's credit risk and the pricing of debts,
- consultation on the impact of the introduction of the anticipated losses model for the impairment of financial instruments.

In the light of the comments received, the Board has already taken some decisions.

An exposure draft proposing the anticipated losses model will be prepared, in which the standard setter will aim to define a basic principle which leaves no room for interpretation. The Board will be assisted throughout the autumn by a group of practitioners chosen from the heads of risk units in financial establishments in order to determine the practical arrangements which ought to accompany the definitive standard.

The Board has also started its deliberations on the review of hedge accounting. As the basis of the future provisions, the Board has adopted the cash flow hedge accounting model in order to preserve a standard means of pricing similar financial instruments, whether hedged or not. Portfolio hedge accounting will be the subject of a second series of proposals. The provisions as regards hedge accounting for net investments in a foreign operation should remain unchanged.

➤ IFRIC Draft Interpretation D25 Extinguishing Financial Liabilities with Equity Instruments

In the current environment, some entities are renegotiating the terms of financial liabilities with their creditors.

In some circumstances, the creditor agrees to accept an entity's shares or other equity instruments to settle the financial liability fully or partially. These transactions are sometimes referred to as "debt for equity swaps".

The Draft Interpretation addresses the accounting of these transactions in the financial statements of the entity that issues equity instruments.

According to the Draft Interpretation, an entity shall initially measure equity instruments issued to a creditor to extinguish all or part of a financial liability at the fair value of the equity instruments issued or the fair value of the liability extinguished, whichever is more reliably determinable. The difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued is recognised in profit or loss.

Comments on this project were to be submitted to the IASB before 5 October 2009.

➤ Provisions

After months of discussion, the IASB has finally reached a majority decision on establishing a method of measuring provisions, although six of the fifteen Board members have announced their intention of voting against the definitive standard.

Unlike the existing IAS 37, the future standard will require that a provision – and any other non-financial liability covered by its scope – should be measured on the basis of the expenditure required to settle it with a third party. This expenditure will thus include a margin.

When an entity employs its own resources to meet its obligations, it should also make provision, in addition to the estimated costs, for the margin which any external player – or the entity itself if it provides the service for a third party – would demand.

This measurement will be adjusted, as normal, to take account of uncertainty and time value.

The Board will decide at a future session whether its decisions should be the subject of a fresh call for comments before the final standard is published.

➤ The new US GAAP Codification

The Codification is basically a restructuring of the existing codes (eg FAS 133 *Accounting for Derivative Instruments and Hedging Activities*) in order to simplify user access to all authoritative US GAAPs (thousands of texts). A new codification structure was implemented that classifies guidance by topics (eg Leases), subtopics (eg Operating leases), etc. It drops any reference to the issuing body (FASB, AICPA, etc.).

Last but not least, it also changed the text's hierarchy. All guidance now included within the Codification will be equally authoritative, compared to the four authoritative levels (A to D) that previously existed.

US GAAP new Codification is effective for interim and annual periods ending after 15 September 2009.

Groups reporting under IFRSs and whose securities are traded on the US market need no longer reconcile their

financial data to US GAAPs.

However, it is a fact that US GAAPs remain an interesting source of information, especially for specific industry guidance.

This Codification is the result of a five-year project involving more than 200 people.

The FASB website provides access to the Codification to subscribers only (<http://asc.fasb.org/>).

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Rate-regulated Activities: at last an exposure draft that does not deal with Financial Instruments!

The IASB Rate-regulated Activities project deals with the recognition and measurement of regulatory assets and liabilities as a result of rate regulation¹.

A specific standard on accounting for the effects of rate regulation currently exists in US Generally Accepted Accounting Principles (GAAP) – FAS 71, but it had no counterpart in IFRSs up to now.

Though not a convergence project or a high priority project such as Financial Instruments, the Rate-regulated Activities project has been progressing rapidly since the IASB decided to deal with the issue in December 2008. An exposure draft was issued on 23 July 2009 and is now open for public comments until 20 November 2009.

➔ A long story

In 2005, the IFRIC received a first submission to consider whether FAS 71 could be a reference when using the hierarchy set out in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. At the time, the IFRIC rejected the issue and stated that to be assets or liabilities under IFRSs, items had to meet the related definitions in the *Framework* to IFRSs. However, the wording for rejection did not intend to preclude entities to recognise regulatory assets or liabilities.

A second request received early 2008 asked specifically whether assets or liabilities could be recognised as a result of regulatory actions under IFRSs. The IFRIC decided again not to add the issue to its agenda, but asked the IASB Board members to take the subject into consideration, which eventually the IASB agreed on last December.

➔ Why it became urgent to issue a standard

Rate regulation is widespread and significantly affects the economic environment of rate-regulated entities. In jurisdictions that refer to US GAAP, the amount of 'regulatory' assets and liabilities currently recognised under FAS 71 is said to represent billions of dollars. The concern is that many jurisdictions currently applying FAS 71, or referring to this standard, will adopt IFRSs in the short term. The issue also arises for European groups with the growth of regulated activities resulting from the liberalization of certain markets (e.g.: energy, gas ...).

The IASB thus decided that clarifying the IFRS treatment of assets and liabilities arising from rate regulation was significant enough to be addressed quickly.

¹ Rate regulation is a restriction in the setting of prices that can be charged to customers for services or products. Generally, it is imposed by regulatory bodies or governments when an entity has a monopoly or a dominant market position that gives it excessive market power.

➤ Main features of the standard

A three fold standard: Scope, measurement and disclosures

The scope

Two criteria need to be met in order to apply the proposed accounting treatment to an entity's rate-regulated activities:

- The regulatory environment is such that prices are set by an authorised body and they bind customers,
- The regulation takes the form of a so-called 'cost-of-service' regulation.

The first criterion focuses on the fact that prices are not negotiable on a customer by customer basis; indeed, the regulator acts on behalf of the customer base as a whole.

The cost-of-service type of regulation referred to in the exposure draft is defined as 'a process for setting an entity's prices in which there is a **cause-and-effect relationship between the entity's specific costs and its revenue**'. A key feature is to recognise as an asset (liability) an amount that would otherwise be recognised in that period in the statement of comprehensive income as an expense (revenue), thereby reducing accounting mismatches.

An outstanding feature compared to other IFRSs is that the exposure draft does not set a recognition threshold. Consequently, regulatory assets and liabilities have to be recognised whenever they arise from activities that fall in the scope.

Therefore, the scope appears to be critical when applying the standard, which means that preparers need strong documentation to support the accounting treatment.

The probability of recovery (refund) shows through the measurement of regulatory assets (liabilities) via the estimation of the probability of each outcome occurring.

Measurement

Once an entity's activities have been assessed to fall under the scope, the entity recognises a regulatory asset or a regulatory liability. These items are measured at their **expected present value** both on initial recognition and at the end of each subsequent reporting period.

The determination of the expected present value is based on the future cash flows generated by the regulatory assets or liabilities weighted by the probabilities of each possible outcome (e.g. allowance of recovery from the regulator). A discount rate is then applied in order to account for the time value of money.

Beyond the individual measurement of regulatory assets at their expected present value, the exposure draft explicitly states that rates to be charged to customers integrating the regulatory assets should be taken into account while performing impairment tests at the level of the cash-generating unit (CGU) corresponding to the regulated activity.

However, there may be cases where prices are set at a level that may affect future demand, hence impact overall recoverability. In such situations, the exposure draft states that the cash-generating unit that includes the regulatory assets may have to be impaired. The resulting impairment loss, if any, shall be allocated to the assets of the cash generating unit, including the regulatory assets. To stay consistent with the proposed measurement the exposure draft suggests that impairment loss be reflected in the estimation of future cash flows generated by the regulatory assets.

Presentation and disclosures

As far as financial statements presentation is concerned, regulatory assets and liabilities should **not be offset** and should be presented using the **current/non-current classification**.

The cost of self-constructed property, plant and equipment or internally generated intangible assets should include all the amounts the regulator permits to be included in their cost, as an exception to the requirements in IAS 16 *Property, Plant and Equipment*, IAS 23 *Borrowing Costs* and IAS 38 *Intangible Assets*.

In the notes to the accounts, an entity presenting rate-regulated activities could use a tabular format to comply with the requirement to provide a reconciliation of the carrying amount of the various categories of regulatory items in the statement of financial position from one period end to the next. Such reconciliation would also show the movements in the accounts as a result of amounts recognised in the statement of comprehensive income.

➤ What's new compared to FAS 71?

Scope

Under FAS 71, the scope is determined by a third criterion assessing the probability of recovery of the entity's costs in view of the demand for the regulated services or products and the level of competition. This third criterion is indeed a threshold for recognition and the IASB decided in the exposure draft to address it as part of measurement rather than recognition. This may lead to more regulatory items being recognised under IFRS.

Measurement

Under the exposure draft, regulatory assets and liabilities are measured at their present expected value whereas FAS 71 proposes a cost model. This is likely to create differences unless the expected cash flows include remuneration in respect of the recovery period.

Such differences bring about the issue of first-time adoption for entities that previously referred to US GAAP.

➤ Transition and first-time application exemption

Transition

The Board decided that an entity should apply the IFRS to regulatory assets and liabilities existing at the beginning of the first comparative period presented in the annual financial statements in which the entity first applies the IFRS. Any adjustments arising on transition should be recognised in the opening balance of retained earnings.

First-time application exemption

If amounts determined using the entity's previous GAAP would otherwise be recognised separately as regulatory assets in accordance with IFRSs, first-time adopters of IFRSs could elect to include them in the carrying amount of property, plant and equipment or intangible assets.

➤ Conclusion

Given the pace of the project and the fact that North American entities are really interested that the outcome to be as close as possible as FAS 71, it is of critical importance that rate-regulated entities in other parts of the world express their views during the comment period ending 20 November 2009.

Exposure Draft on Classification and Measurement: major principles and first reactions!

As part of its work in response to the financial crisis, the IASB has launched a thorough accelerated review of IAS 39. The progress of this four-stage project is summarised in the table below.

Project	Exposure draft	Definitive standard	Date of application
Derecognition	Published in March 2009	Anticipated for early 2010	A priori : - No mandatory application before 2012, but several years of comparative statement may be required. - Early application is permitted
Classification and Measurement	Published in July 2009	Anticipated for late 2009	
Impairment	Anticipated for October 2009	During 2010	
Hedging	Anticipated for December 2009	During 2010	

Beyond the GAAP discussed the exposure draft on Derecognition in its June 2009 edition. We now propose to set out the main principles of the exposure draft on Classification and Measurement published on 14 July (*ED Financial instruments: Classification and Measurement*) along with the initial lessons learned from the comment letters received by the Board (the closing date on this exposure draft was 14 September 2009).

➤ The general principles of the exposure draft

A new two category approach

The new approach developed by the IAS is based around two categories of instruments:

- those measured at fair value;
- those measured at amortised cost.

The Board has finally opted to maintain a mixed measurement model. Beyond the GAAP will first review the treatment of equity instruments (securities), then moving on to discuss debt instruments (loans, receivables, obligations, financial liabilities etc.).

A "full fair value" approach to equity instruments

The exposure draft proposes that all equity instruments should be measured at fair value. The current exemption which allows measurement at cost where fair value cannot be reliably determined would thus be withdrawn. Once this principle of fair value measurement has been established, the question arises of how the performance of these instruments should be recognised.

The default position is that the entirety of the investment's performance should be recognised in profit or loss:

- latent or realised profits and losses;
- dividends.

This treatment is similar to the current provisions for the Trading category.

However, in order to take into account an entity's strategic investments, the Board has chosen to provide an option to recognise the totality of the investment performance in equity (other comprehensive income). In this case, the performance will never affect the profit and loss account. Dividends received and profits and losses will remain in equity even when the investment is disposed of.

The choice of this presentation option would apply instrument by instrument. It would thus be possible to hold two securities in the same entity and to classify each in one or other of the two categories: fair value through profit or loss, and fair value offset against equity.

However this choice of presentation must be made at the time the instrument is first recognised and no later changes will be authorised. In other words, no reclassification between these two methods of presentation would be allowed.

It should also be stressed that the option to present the performance in equity may not be used if the investment is made during the course of a trading activity. In this instance, the default measurement (fair value with recognition of the performance in profit or loss) would be of mandatory application.

The Board believes that this presentation option has two major advantages:

- it makes it possible to recognise all the performance of the investment on a single line of the overall result (other comprehensive income or net income).
- it provides a simple solution to the issue of the impairment of investments in equity instruments. In the first case, all reductions in value would be automatically recognised in net income; in the second case, the total absence of recognition of performance in net income would make the question of impairment irrelevant.

Main stages in the analysis of a debt instrument

It should first be stressed that the steps described below are intended to apply to any debt instrument, whether held (asset side) or issued (liability side) by the entity.

Under the approach set out in the exposure draft, debt instruments would be measured:

- either at fair value with recognition of changes in value through profit or loss;
- or at amortised cost.

The first category (fair value through profit or loss) would continue to be the default category. To benefit from measurement on an amortised cost basis, the entity should conduct a four-step analysis:

Step 1: was the instrument concluded in the course of trading? If so, classification in the fair value category is mandatory. If not, move on to step 2.

Step 2: does the instrument only have basic loan features? If not, the instrument as a whole is transferred to the fair value category. If so, the analysis continues with step 3.

Step 3: is the instrument managed on a contractual yield basis? If not, the instrument should be classified in the fair value category. If so, continue the analysis.

Step 4: has the entity optionally chosen to classify the instrument in the fair value category to resolve an 'accounting mismatch'? If so, the entity can classify the instrument in the fair value category. If not, the instrument should be classified in the amortised cost category.

Two further points should be made:

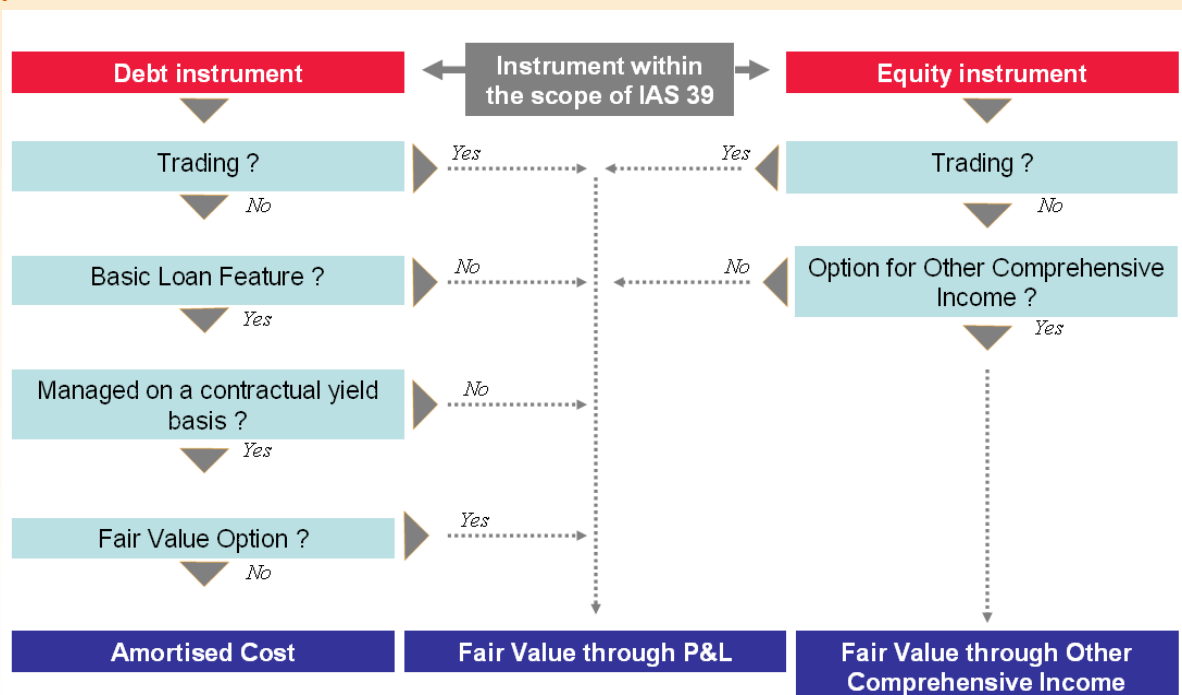
- the analysis carried out at the time of the first recognition of the instrument is final. The exposure draft consequently prohibits any subsequent reclassification;
- the 'basic loan' concept replaces the embedded derivative notion, which will be removed. The separate recognition of a host contract and an embedded leveraged component would thus no longer apply. If some feature of the instrument (clause, indexation, etc.) does not qualify as 'basic', it will be classified in its entirety (i.e. host contract AND structured component) in the fair value category. This is a major change in the approach to the measurement of financial liabilities.

What about derivative instruments?

Under the approach proposed by the exposure draft, all independent derivative instruments would be mandatorily classified in the fair value category, and revalued through profit or loss¹. Such instruments do not meet the definition of a 'basic loan'.

The exemption in the existing standard for derivatives of securities whose fair value cannot be reliably determined would thus be withdrawn.

Summary decision tree



¹ Hedge accounting will be addressed at a later stage in the project. An exposure draft is expected to be published during December 2009.

➤ Taking the analysis further...

Two new concepts in the exposure draft deserve further consideration.

The 'basic loan' concept

This concept is intended to replace the current concept of the 'embedded derivative'. The aim of this rule is to ensure that debt instruments, whether held or issued, containing a significant structured component cannot benefit from measurement at amortised cost.

A number of provisions are explicitly cited in the exposure draft as normal clause, or clauses unlikely to create a significant leverage effect. These include:

- the use of embedded options to limit the variability of interest flows (cap and floor);
- prepayment provisions that are not contingent on future events (other than covenant violations).

However, the exposure draft takes up no clear position on a number of instruments which are nevertheless common and well known to the Board, such as inflation-indexed bonds.

Similarly, the exposure draft considers that in some cases subordination ranking leads to increased credit risk on an instrument, to the benefit of senior instruments with a lower risk. This type of mechanism, known as tranching, is common in securitisation operations. In such a case, the exposure draft considers that, of the liabilities issued by the entity, only the least risky debt instrument (i.e. the senior tranche) meets the definition of a basic loan since it is the only one which does not provide credit protection to the other liabilities issued.

Management on a contractual yield basis

According to the exposure draft, a debt instrument is managed on a contractual yield basis when the entity's *business model* is to pay (receive) the contractual cash flows that are generated when held or issued

It should be stressed that this condition must not be evaluated instrument by instrument. Nevertheless, a single enterprise can apply several business models. For example, a bank can simultaneously act as a retail bank within which it will carry its loans over the long term, and trade in loans within another segment or subsidiary. It is important to note that determining the business model is not an option at the discretion of management. It is rather a matter of observing how the instrument is managed by the entity in actual practice.

Trade receivables are an important issue for industrial and service groups, and here the exposure draft explicitly states that they are deemed to be managed on a contractual yield basis.

Conversely, the exposure draft considers that a financial asset that is acquired at a discount that reflects incurred credit losses does not meet the definition of management on a contractual yield basis. Thus, an entity which specialises in the acquisition of instruments which have already incurred credit losses would have to measure its investments at fair value and record variations in fair value in profit or loss.

➤ First lessons from the comment letters

This exposure draft has attracted considerable attention, and more than 200 comment letters have been received by the IASB. Beyond the GAAP presents the early indications in the letters sent to the Board.

The principal points regarded as positive

The IASB's decision to retain a mixed measurement method including both fair value and amortised cost has been welcomed by a large majority of commentators, who believe that these two complementary methods are necessary in the measurement of financial instruments.

The appearance of a condition reflecting an entity's business model has also been favourably received. A number of commentators have also requested that this criterion should be given more prominence in the approach ultimately adopted by the IASB.

The model proposed by the IASB was very frequently preferred to the preliminary proposals presented by the US regulator (the FASB's approach is explained below).

The principal points which attracted criticism

The absence of an option to recognise performance of an equity instrument through profit or loss, in the event that the entity has chosen to recognise its value changes in equity, attracted lively criticism. Very many commentators consider that the dividends received on these instruments must always be recognised through profit or loss in order to offset the charges recognised on the liabilities associated with these investments. Though many commentators acknowledge the merits of this approach in simplifying the impairment rules for equity instruments, some appear to believe that a fresh discussion of this matter would nevertheless be preferable to the adoption of the solution proposed by the IASB.

The default classification of debt instruments issued (liability side) at fair value, with the recognition of fair value changes through profit or loss, has also attracted criticism on two grounds:

- the suppression of the concept of the embedded derivative could lead to a significant increase in the number of liabilities measured at fair value...
- ... which reopens the debate about taking account of credit risk changes in the fair value measurement of liabilities ².

Other points

In the light of the comment letters received, the IASB has also undertaken to reconsider the following topics:

- should the fair value measurement exemption be withdrawn for equity instruments the value of which cannot be reliably determined?
- should the exposure draft's proposals on subordination mechanisms be retained? A number of commentators have suggested that this rule has no conceptual basis and is likely to open up substantial opportunities for structuring;
- should the exposure draft's proposals on debt instruments acquired at a significant discount be retained? Some commentators have asked the Board to explain the reasons justifying different treatment of a loan in default, based on whether it had been granted directly by the entity or acquired in the secondary market;
- should some types of classification be authorised, for example where the entity changes its business model?

² Taking account of the entity's own credit risk in the measurement of its liabilities has the following impact: the more an entity is financially weakened, the higher its credit costs and the more the market value its previously issued debt falls. Therefore, if the liability is measured at its market value, this fall in value automatically leads the entity to recognise a gain.

➤ The next steps

The IASB programme will be exceptionally crowded at the end of the year. On financial instruments alone, the Board aims to publish a definitive standard on this first aspect, Classification and Measurement, and two exposure drafts on Impairment and Hedging over the next three months.

To meet these deadlines, the Board has decided to increase the frequency of its meetings and has added a weekly Tuesday meeting to its programme of monthly meetings.

As we write, the IASB has already started discussions on the points most criticised by commentators. Beyond the GAAP will naturally keep you up to date with the outcome of these discussions.

Current FASB position:

The points below summarise the FASB's current position (i.e.: before public commentaries process):

- the FASB proposes to recognise all financial instruments (assets and liabilities) at fair value;
- by default, changes in fair value will be recognised through profit and loss;
- an entity should be authorised to recognise changes in fair value of a financial instrument in equity subject to two conditions:
 - the financial instrument is held in a portfolio managed with a view to generating cashflows and the entity is unlikely to be in a position in which it has to sell or settle the instrument before maturity;
 - the instrument presents no variability risk in its cashflows. More particularly, the instrument:
 - has a fixed date of maturity;
 - cannot fall in value such that the investor does not recover his initial investment;
 - is neither a derivative, nor an instrument containing an embedded derivative which should be separated under the existing rules, nor an equity instrument.
- the sole exception to the principle of fair value measurement would concern certain long-term financial liabilities which meet the following two conditions:
 - they meet the criteria for recognising changes in fair value in equity;
 - the recognition of these liabilities at fair value would create an accounting mismatch because of their association with non-financial assets measured at cost.
- the separation of embedded derivatives would no longer be required, as the identification of an embedded derivative to be recognised separately would be replaced by the classification of the instrument in its entirety in the default category;
- classification would occur at the time of first recognition, and no future reclassification would be authorised.

The exposure draft, which will include classification, measurement and impairment of financial instruments, along with hedging matters, is expected for the end of the year, or the beginning of 2010.

Events and FAQ

Events/publications

Special issue

The Mazars Doctrine department has published a special issue entitled "Impact of the application of new standards on quoted companies at 30 June 2009".

"IFRS News" Seminar

The next session organised by Francis Lefèbvre Formation focusing on IFRS news will take place in Paris on 18 December 2009.

Registration forms can be obtained from Francis Lefèbvre Formation, 13-15 rue Viète, 75017 Paris
– www.flf.fr +33 (0)1 44 01 39 99.

Closing of 2009 financial statements

The Doctrine team at Mazars will conduct a seminar related to the closing of 2009 financial statements under IFRS. It will be held in Paris on 21 October.

Registration applications should be sent to Francis Lefèbvre Formation – www.flf.fr +33 (0)1 44 01 39 99.

Frequently asked questions

IAS / IFRS

- How should you treat acquisition costs incurred in 2009 on account of a business combination which will take place in 2010 (under IFRS 3R)?
- Allocation of goodwill to CGUs and groups of CGUs as a result of the first application of IFRS 8.
- Accounting treatment of an additional holding in an associate company with transfer to joint control.
- Consequence of a "hardship clause" on the recognition of a "take or pay" gas contract.
- Fair value hedging of a structured rate loan.

Upcoming meetings of the IASB, IFRIC and EFRAG

IASB

19 - 23 October 2009

16 - 20 November 2009

14 - 18 December 2009

IFRIC

5 - 6 November 2009

7 - 8 January 2010

4 - 5 March 2010

EFRAG

8 - 9 October 2009

11 - 13 November 2009

10 - 11 December 2009

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