

Beyond the GAAP

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Editorial

The end of the financial reporting period is drawing near! Though the previous year has seen an IASB focus on financial instruments, European preparers will not be able to apply the first phase of the revised IAS 39 as from 31 December. The European Union has indeed decided to postpone the adoption of IFRS 9.

Beyond the GAAP considers the pros and cons most commonly presented in the discussions as regards IFRS 9.

Enjoy your reading!

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News

The IASB continues its project for the amendment of IAS 39

Having completed its revision of the classification and measurement of financial assets, the IASB will now continue its work on replacing the standard on financial instruments. On 5 November it published an exposure-draft entitled "*Financial Instruments: Amortised Cost and Impairment*".

This exposure-draft will enable the Board to receive the comments of interested parties on its proposals to replace the current incurred loss impairment model with one based on expected loss.

The call for comments on this text is open until 30 June 2010. The definitive standard should be published before the end of 2010. Application should be mandatory after three years, with early application authorised.

Beyond the GAAP will present the IASB proposals in details in a future edition.

➤ The IASB and FASB sketch the outlines of a model for the recognition of emission allowances

The development of a standard devoted to the treatment of greenhouse gas emission allowances has been resumed in conjunction with the FASB. As a basis, the two Boards have chosen an approach which should avoid any distortion of the result, in contrast to the proposal in the IFRIC Interpretation 3 withdrawn in June 2005. Provision would be established on the basis of gas emission forecasts when recognising the emission allowances received. Future developments - which are likely to be slow - will address the interactions arising from this approach.

➤ Publication of the revised IAS 24

On 4 November the IASB published IAS 24R on related party disclosures. This new revision (following that carried out in 2003) mainly aims to simplify disclosures where a state has control, joint control or significant influence over the reporting entity¹. It also aims to clarify the definition of a related party. On the first point, the amendment resolves the significant practical difficulties of applying the existing standard in environments in which the state is very active.

This publication is the result of two years of deliberations. The negative response to the publication of an initial exposure-draft in February 2007 led the IASB to review its proposals. A second exposure-draft was then published in December 2008.

The changes in the definition of a related party brought about by IAS 24R remain limited. They aim to resolve the inconsistencies in the existing definition, to precise the Board's intention and to clarify the text by reorganising it. For instance, IAS 24R makes it clear that two entities are not related parties of each other if they are both significantly influenced by the same investor.

The changes are much more substantial in the case of entities in which the state has control, joint control or significant influence.

The 2009 revision introduces a partial exemption for disclosures requirements regarding transactions carried out

by these entities with the state, or with other entities which are themselves under the control, joint control or significant influence of the same state.

This partial exemption means that the disclosures required for these transactions will be limited to:

- the type and the amount of each individually significant transaction with a state or an entity under the control, joint control or significant influence of the same state;
- a qualitative or quantitative indication of the extent of other transactions which are collectively rather than individually significant.

The purpose of these disclosures is to enable users of financial statements to understand the impact of transactions between parties related through the state.

It should be noted that if two entities are related parties for a reason other than the mere fact of their relationship with the same state, the partial exemption will nevertheless be applicable. In practice, this means that if entity A and entity B are controlled by the same state, and A also has, for example, a significant influence over B because they have directors in common, A will benefit from the partial exemption on disclosures under IAS 24R in respect of its relationship with B.

IAS 24R will be of mandatory application for annual periods beginning on or after 1 January 2011. Early application is authorised.

Given that the partial exemption on disclosures regarding relations between entities controlled by the state is in contradiction with the provisions of the current version of IAS 24, European entities would not be able to apply IAS 24R early if the European Union has not endorsed this standard before the end of the 2009 reporting period. In fact IAS 24R is very unlikely to be endorsed by Europe before this date.

¹ The term used in the standard is "government". This is defined in IAS 24R under paragraph 9: "Government refers to government, government agencies and similar bodies whether local, national or international."

European matters

Actuarial gains and losses could be recognised in other comprehensive income

In January 2009, the IASB took the decision to end any differed recognition of provision for pensions and other post-employment benefits, thus eliminating the 'corridor approach' to the treatment of actuarial gains and losses. Additionally, the Board decided that all actuarial gains and losses should be presented as components in profit or loss, removing the option of presenting these gains and losses in other comprehensive income. This decision also involved the removal of any reference to the expected return on assets.

The Board had little chance of pushing through a decision which, as well as being hugely unpopular, would also have introduced divergence with US GAAP (the corridor approach has been retained in US GAAP in the determination of profit or loss). The IASB has therefore opted to take a step back, preserving the option to present actuarial gains and losses in other comprehensive income. But the corridor approach should indeed be removed.

However, the Board would like to retain the removal of any notion of expected return on assets, and adopt a presentation which reflects, in the accounts, the impact of the extent of financing on the different plans. The staff will present the various options at a future session.

Europe will not endorse IFRS 9 in 2009

After preparing for a very rapid endorsement of the new standard on the classification and measurement of financial assets published by the IASB on 2 November 2009, the European Commission has decided to postpone this process due to the objections received. There is currently no way of knowing when a new endorsement process will be launched (for more details, see the special study on IFRS 9 page 4).

Europe endorses IFRIC 17

On 26 November the European Commission endorsed the IFRIC 17 interpretation - *Distributions of Non-cash Assets to Owners* (see *Beyond the GAAP No17*, November 2008).

This interpretation is for mandatory application no later than annual periods beginning on or after 31 October 2009 (a delay of four months in the date of first application proposed by the IASB). Early application is permitted.

Regulation EC 1142/2009 is available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:312:0008:0013:EN:PDF>

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IFRS 9: the main pros and cons

On 11 November, the ARC¹ met to discuss the endorsement of IFRS 9 in the European Union. Following a discussion with the interested parties, the ARC decided not to submit the endorsement of IFRS 9 to the vote and to delay any decision to an unspecified later date.

What were the main reasons for this delay? What are the main observations (positive and negative) formulated on this standard which cause controversy? What are the next steps for the European entities in view of the revision of IAS 39?

Our October issue set out the main provisions of IFRS 9. Beyond the GAAP now provides an update on the main pros and cons behind the positions adopted 'for' or 'against' IFRS 9.

➤ A standard which does not lack arguments!

Among the aspects frequently cited by supporters of IFRS 9, the three main points are as follows:

Retention of a mixed measurement method

IFRS 9 retains two methods of measurement for financial instruments on the balance sheet: fair value and amortised cost. This decision is significant for two reasons:

- the IASB has long wanted to adopt an "all fair value" approach to financial instruments. This thus represents a change of direction on its part which takes into account the many criticisms expressed by commentators;
- the FASB, the US standard setter, is conducting its own project on a standard for financial instruments. It would currently appear that the FASB is proposing to measure all financial assets at fair value, the counterparty being recorded either in other comprehensive income or in profit or loss, depending on the situation.

Against this background, the IASB's decision to retain its mixed measurement method has been welcomed by a majority of commentators.

Taking into account an entity's business model

Taking into account an entity's business model in determining the accounting classification of a financial asset is one of the aspects of IFRS 9 almost widely approved. The interested parties have thus welcomed the introduction of this criterion alongside the criterion based on the characteristics of the instrument.

Nevertheless, detractors of the standard believe that the IASB had not gone far enough on this point (see below).

Attempts at simplification

Since the publication of the discussion paper entitled "*Reducing Complexity in reporting financial instruments*", the IASB has made clear its intention of simplifying the existing IAS 39. A number of commentators have welcomed the removal of some provisions which regularly cause problems of interpretation and/or practical difficulties. This includes the elimination of the embedded derivative concept, and the removal of the impairment of equity instruments.

However, simplifying the treatment of subjects which are by their nature complex is rarely straightforward, as the negative comments received demonstrates. Beyond the GAAP provides an overall view of the main arguments advanced against the standard.

¹ The ARC, the Accounting Regulatory Committee, is responsible for recommending the endorsement of standards on the advice of the EFRAG and the SARG.

➤ The IASB has not gone far enough

Use of the business model could be improved

Though taking account of an entity's business model represents undeniable and uncontested progress, many of the interested parties believe that this criterion has not been given sufficient weight.

IFRS 9 sets this criterion as a necessary but not sufficient condition for the classification of a financial instrument in the amortised cost category. On the other hand, the measurement of financial assets at fair value, with changes in fair value reflected in the statement of comprehensive income, is not subject to any 'business model' criterion¹. Consequently, the business model criterion as defined in IFRS 9 means that the fair value through profit or loss category is regarded as the default category.

Commentators with an activity of medium to long-term management horizon are very critical of this fact. Actually, they fear that fair value measurement through profit or loss, which was formerly reserved essentially for speculative activities, ever get in future to be applied to a much wider range of operations.

Unsatisfactory treatment of equity instruments

Under IFRS 9, equity instruments (e.g. non-consolidated shareholdings) are mandatorily measured at fair value. Changes in fair value can be recognised:

- either in profit or loss (trading operations) ;
- or in other comprehensive income, but in this case, gains and losses will never be recognised in profit or loss, even in the event of disposal. In practice the IASB is here imposing the recognition of performance in the other comprehensive income, and no longer in profit or loss.

Commentators which manage their investments over the medium to long term have emphasized that none of these treatments make it possible to reflect their performance correctly. They believe IFRS 9 would not allow them to differentiate themselves from trading operations while presenting the entirety of actual (as opposed to latent) performance in profit or loss.

¹ Let us remember that in the existing IAS 39, the 'trading' category is strictly circumscribed by business model conditions and that among the conditions that enable the fair value option through profit or loss, there also exists a condition linked to the business model.

The consequences of the elimination of embedded derivatives

As we have mentioned, the elimination of embedded derivatives is a measure aimed at simplification. The instrument will be measured in its entirety, and no longer in accordance with an approach which separates the components - the host contract and the embedded derivative.

In practice, this measure may result in the measurement of a large number of contracts at fair value, whereas they were previously measured at amortised cost, at least for the host contract component.

Commentators have emphasized that this change of measurement method will pose significant problems in application, not least in determining the fair value of certain loans, unlisted by their nature, for which credit spreads are not observable.

Reclassification prohibited, with rare exceptions

Reclassification between the different measurement categories is forbidden under the new IFRS 9. There is a single exception: an entity may take account of a change in business model when classifying its debt instruments. However the standard notes that such changes in business model are rare by definition.

Thus a provisional disappearance of liquidity on a market which leads an entity to amend its model in the expectation of a return to normal conditions does not meet the definition of a 'change of business model'.

This prohibition on reclassification (to or from the fair value category in particular) was questioned by commentators. They consider that this principle contrasts with the decision taken by the IASB in autumn 2008 to amend IAS 39 so as to allow entities to reclassify instruments from the fair value through profit or loss category under certain circumstances.

Tricky interaction with the other phases of the project, and with other current projects.

In a previous special study (see *Beyond the GAAP No 27*, October 2009) we have already discussed the complex interaction with the other phases of this revision project proposed by the IASB. We should also stress the difficulties raised by insurers who are still awaiting IFRS 4 Phase 2, which will cover insurance liabilities.

Currently IFRS 4 (Phase 1) contains provisions specifically drafted to manage measurement "mismatches" between financial assets recognised under IAS 39 and the insurance liabilities which are still covered by local standards.

The main practice is known as "shadow accounting". IFRS 9 now replaces IAS 39 without having amended the methods used in shadow accounting, which might pose implementation problems for insurance companies, in particular in the management of share portfolios managed in euro contracts.

A further illustration of the problematic interaction between IFRS 9 and IFRS 4 phase 2: commentators are wondering whether insurers will be able to review their classification choices for financial assets (in particular equity instruments and the use of the fair value option) when they know the treatment of insurance liabilities under the new standard. If the measurement method for liabilities changes, entities might legitimately wish to amend their classification choices for financial assets, in order to properly reflect the economic set-offs in their accounting.

➤ What are the next steps?

What is the real deadline for Europe in the endorsement process? *A priori* this should be the date of mandatory application of IFRS 9, currently set for 2013. In the meantime IFRSs as endorsed by the European Union will continue to be compatible with IFRSs as published by the IASB. However, if the European Union does not endorse IFRS 9 in time for European entities to apply it as from the date of mandatory application set by the IASB, the accounting standard applicable in Europe could no longer be considered to be consistent with the corresponding IFRS.

What, then, will be the next stage in these deliberations? The FASB is due to publish its own exposure-draft on financial instruments in early 2010. This will be an opportunity for interested parties to measure the degree of convergence between the two standards on this subject. The IASB has already mentioned that it might amend IFRS 9 with a view to convergence with the US standard. It is therefore important for entities applying IFRSs to follow the US debate closely, and to express their views in response to the FASB exposure-draft if this does not meet their needs.

2010 should also see the appearance of phases 2 and 3 of IFRS 9, devoted to impairment and hedging respectively. This last topic will be of particular concern to entities in every sector: industrial and services enterprises will keep an eye on the possibilities for hedging their turnover in foreign currency, or their financial liabilities, while banks will be waiting to discover whether they can hedge assets/liabilities in a way which reflects their management practices.

Publication of IFRIC Interpretation 19, Extinguishing Financial Liabilities with Equity Instruments

During the current period of financial crisis, debtors sometimes renegotiate the terms of their financial liabilities with their creditors. In some cases, a creditor may accept equity instruments in full or partial settlement of the liability. These transactions are commonly known as 'debt for equity swaps'.

The IFRIC interpretation 19, published on 26 November 2009, provides guidance for the treatment in the accounts of the debtor of these transactions extinguishing financial liabilities with equity instruments.

➤ What has been done in practice, in the absence of an interpretation?

Example: entity X (the debtor) owes a debt of 100 (accounting value) to Entity Y (the creditor). X and Y renegotiate the term of the liability, X agreeing to issue 40 of its own shares to Y, in return for the extinguishment of the liability.

In practice, there are two current accounting methods:

- some recognise the equity instruments at the carrying amount of the financial liability (and do not recognise any gain or loss in profit or loss when the debt is extinguished);
- others recognise the equity instruments at the fair value of either the liability extinguished or the equity instruments issued and recognise a profit or loss corresponding to the difference between this fair value and the carrying amount of the financial liability.

➤ What is the consensus presented in IFRIC 19?

IFRIC 19 opts for the following accounting treatment: the increase in equity is recognised at the fair value of the equity instruments issued, unless this fair value cannot be measured reliably, in which case the increase is recognised at the fair value of the liability extinguished.

Example: entity X owes a debt of 100 to Entity Y. X is in financial difficulties. X and Y renegotiate the term of the liability, X agreeing to issue 40 of its own shares to Y, in return for the extinguishment of the liability.

At the renegotiating date, the fair value of the equity instruments issued can be measured reliably at 80 (the fair value of a share in X is 2)

Fair value of X equity instruments issued =	(80)
Carrying amount of the liability extinguished =	100
Gain =	20

Before liability extinguished

Assets	Liabilities
Assets: 150	Equity: 50 Liabilities: 100

After liability extinguished

Assets	Liabilities
Assets: 150	Assets (excluding profit or loss): 130 (50+ 80) Profit: 20 Liabilities: 0 (100 – 100)

Under the existing approach (not adopted by IFRIC 19), the increase in equity would have been recognised at 100 (the carrying amount of the liability) and no profit or loss would be recorded.

The date of measurement of the instruments issued corresponds to the date at which the liability is extinguished, in accordance with the provisions of IAS 39.

The difference between the carrying amount of the liability extinguished and the amount recorded for the measurement of the instruments issued is recognised in profit or loss for the period. The IFRIC considers that the issue of an entity's equity instruments to extinguish a financial liability is consideration paid, which means that in accordance with IAS 39 the gain or loss arising from the repayment of the liability should be recognised in profit or loss.

The profit or the gain resulting from the difference is disclosed as a separate line item in profit or loss or in the notes.

If only a part of the liability is extinguished, the debtor must assess whether a part of the instruments is issued as consideration for the modification of the terms of the remaining liability. If so, the debtor must determine which instruments are issued as consideration for the extinguishment of the liability, and which are issued as consideration for the modification of the terms of the remaining liability.

It should be remembered that under IAS 39, when the terms of a debt are substantially modified the initial liability is extinguished and a new liability is recognised, with a possible impact on profit or loss. According to IFRIC 19, equity instruments issued as consideration for a modification of the terms of the outstanding liability are taken into account when determining whether the terms of the liability have been substantially modified.

➤ When will the application of IFRIC 19 be mandatory, and what are the arrangements for first application?

This Interpretation is mandatory for annual periods beginning on or after 1 July 2010 (subject to endorsement by the European Union and the absence of any change in the date of first application in the endorsement regulation). IFRIC 19 should be applied retrospectively.

The AMF, in its recommendations for the 2009 closure of accounts, has asked that the impact which the IFRIC 19 accounting treatment would have had should be disclosed, if a different treatment is adopted by the entity at that date.

In our view, IFRIC 19 could be applied as from the 2009 closure of accounts, in view of the fact that this interpretation does not conflict with any standard or interpretation currently in force.

Events/publications

“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.

Frequently asked questions

IAS / IFRS

- Investor's treatment of a TSSDI
- Accounting treatment of an ORAPA (variable-parity convertible bond) issue
- Consequence of the exercise of a put granted to non-controlling interests, the subsidiary's securities being remunerated by securities in the parent company
- Recognition of an asset arising from development: what approach should be taken in practice to demonstrate that IAS 38 criteria are met?
- Contract: recognition under IAS 11 or IAS 18?

Upcoming meetings of the IASB, IFRIC and EFRAG

IASB

14 - 18 December 2009
18 - 22 January 2010
15 - 18 February 2010

IFRIC

7 - 8 January 2010
4 -5 March 2010
6 -7 May 2010

EFRAG

11 - 11 December 2009
27 - 29 January 2010
24 - 26 February 2010

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