

Beyond the GAAP

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Editorial

The IASB's first exposure draft of 2010 deals with the measurement of liabilities in IAS 37. This "limited re-exposure" – which covers only some of the Board's proposals from the first exposure draft in 2005 – could have major impacts on companies' accounting practices. In light of this, we predict that the subject will provoke a high level of interest and, once again, a flood of protests to the IASB. In this issue, Beyond the GAAP looks at the key issues in the debate.

Enjoy your reading!

Michel Barbet-Massin

Jean-Louis Lebrun

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News

Bound Volumes

This year, the IASB will publish two Bound Volumes (collections of the standards and interpretations published by the IASB):

- the first (to be published March 2010, with a red cover) will include all the documents published as of 1 January 2010, including those with an effective date after 1 January 2010;
- the second (with a blue cover) is already available and covers all the documents with an effective date no later than 1 January 2010.



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IFRS News

➤ Hedge accounting

It is difficult at this stage to tell what the IASB's proposals will be regarding hedge accounting. However, the Board has restated its intention of addressing hedge accounting comprehensively – although the schedule for publication of its proposals is extremely tight. The proposals are expected to be published in two stages:

- the proposals on hedge accounting for financial items, and any proposals which relate to the existing decisions on the classification and measurement of financial instruments, will be published by the end of March 2010;
- the IASB will address hedge accounting for non-financial items, and portfolio hedge accounting, by the end of June 2010.

More specifically, the IASB decided in January that it needed to define a general objective for hedge accounting, to act as a point of reference for the decisions to be made. However, the IASB has not yet approved any staff proposal on the subject.

The Board also decided that any financial risk component should be eligible for hedge accounting if it was separately identifiable and measurable. Furthermore, the Board agreed that the same principles should apply to financial and non-financial items. It remains to be seen how this might work in practice.

➤ Debt / Equity

After several months of unprofitable joint discussions, the IASB and the FASB have still not managed to reach an agreement on the principle to be used for deciding whether an instrument should be classified as debt or equity.

As a result, they have asked their respective staffs to propose amendments to IAS 32 to address the greatest weaknesses in the standard. Convergence will thus be achieved via an amended version of IAS 32.

➤ Information to be disclosed in the notes

During its January meeting, the IASB discussed the proposals on information to be disclosed in the notes to the financial statements in order to clarify and contextualise the accounting treatment used for the following:

- revenue; and
- liabilities for pensions and other retirement benefits.

In the discussion, the Board was keen to ensure that it only required information which could be shown to be genuinely useful. It is therefore expected to issue clearer and more targeted proposals in the near future – a development which is well worth mentioning.

➤ IFRIC will not address interactions between IAS 36 and IFRS 8

In January 2010, the IFRIC looked at the issue of interactions between IAS 36 – Impairment of Assets and IFRS 8 – Operating Segments. The problem at issue was how to recognise any impairment loss for goodwill relating to changes in segment definitions following the initial application of IFRS 8:

- as a prior period adjustment?
- as an adjustment to profit or loss for 2009?

The IFRIC tentatively decided not to add the issue to its agenda (though this decision will probably be confirmed in March). Its response did not give any indication as to which approach should be used. The IFRIC justified this decision by pointing out that it would probably not be able to reach a decision within the available time period, given that the question only relates to the 2009 reporting period.

➤ Mining: accounting for production stripping costs

Following last November's meeting, the IFRIC had decided to address the following issue: how should an entity account for the stripping costs incurred in the production phase of a mine?

The IFRIC is currently working on defining the scope of a future interpretation, before looking at the accounting treatment itself.

At this stage, the IFRIC staff seems to want to restrict the scope to certain extractive activities. The future interpretation is likely to only apply to:

- surface mines (underground mines would be excluded);
- extraction of minerals (extraction of oil and gas would be excluded).

It should be noted that there is currently no consensus on the accounting treatment of these costs. In practice, they may be:

- recognised as expenses for the period; or
- capitalised using a variety of methods (incorporated in the cost of inventory or recognised directly as assets).

A future interpretation could therefore have significant impacts on the accounts of mining companies under IFRSs.

➤ Annual improvements to IFRSs: what's new in 2010

In July 2006, the IASB decided that it would publish an annual exposure draft, bringing together minor and non-urgent proposed amendments to existing standards.

The IFRIC is now taking over this process. Henceforth, it will investigate the issues, propose changes and transmit its suggestions to the IASB for ratification. This procedure is similar to that used for the publication of interpretations.

The current pressure to publish new standards (due primarily to the financial crisis, but also to the decision by an increasing number of jurisdictions to adopt IFRSs) has created a large amount of additional work for the members of the IASB. To ensure that progress continues to be made on current projects, the above changes have been made to the procedure for improvements to IFRSs.

The new procedure will come into effect with the publication of the 2010 annual improvement standard, expected in April (exposure draft published by the IASB in August 2009, cf. Beyond the GAAP No. 27).

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Liabilities Project – Key points in 25 questions & answers

Following the publication of the exposure draft on "Measurement of liabilities in IAS 37" on 5 January 2010, we decided to provide our readers with an update on the progress of this project.

The following questions and answers therefore present the most significant changes in the exposure draft.

Question no.	Question title
1	Why publish a new exposure draft?
2	When is the final standard expected to be published?
3	When is the expected effective date of the revised standard?
4	Can we treat this standard as final?
5	What are the main changes expected from the Liabilities Project?
6	Has the concept of an obligation changed?
7	Is the existence of an obligation affected by events after the balance sheet date?
8	Is a probable outflow of resources always necessary for a provision to be recognised?
9	What is the expected impact on the recognition of litigation liabilities?
10	Will this have consequences for the decision tree?
11	What is the general principle set out in the exposure draft for the measurement of liabilities?
12	How were provisions measured under IAS 37?
13	Is this likely to change current practice?
14	In practice, how will a provision be measured?
15	How will an entity measure the present value of the resources required to fulfil the obligation?
16	Must <u>all</u> the various possible outcomes be taken into account in the measurement?
17	Will the measurement be different when the obligation involves undertaking a service?
18	What margin should be used to measure a provision?
19	Are there other possible consequences of including a margin on services undertaken by the entity?
20	Does the exposure draft still make an exception to the rule on recognising provisions if a provision cannot be measured reliably?
21	What about restructuring provisions?
22	Is the accounting treatment of contingent liabilities affected by these new rules?
23	Has the measurement of onerous contracts changed?
24	What should the decision tree look like under the revised standard?
25	What are the key points to remember?

1. Why publish a new exposure draft?

The so-called BC2 project (Business Combinations – Phase 2), which was launched in 2005, focused primarily on business combinations and certain issues relating to consolidation (notably variations in the percentage ownership of subsidiaries). However, it also had implications for IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, and IAS 19 – Employee Benefits.

For a reminder of the main changes introduced by the publication of IFRS 3R and IAS 27R, see our Mazars Insight: "Business combinations and consolidation – Key points of the new standards in 40 questions and answers".

In view of the various different phases which this project has gone through, and the clarifications made on the measurement of liabilities, the Board felt it would be better to publish an exposure draft which was limited to measurement alone.

Remember that the comment period for the exposure draft published on 5 January 2010 will close on 12 April 2010.

2. When is the final standard expected to be published?

The IASB is expecting to publish the final standard, which is likely to take the form of a new IFRS rather than a revised IAS 37, in the third quarter of 2010.

From February 2010, prior to the publication of the final standard, the IASB is expected to publish a revised proposed standard on its website. This standard will include all the Board's proposed revisions to IAS 37.

The purpose of publishing this quasi-final draft is to allow users to see the new proposals in the context of the new standard as a whole.

3. When is the expected effective date of the revised standard?

Assuming that the final standard is adopted during 2010, it will be effective from 2012 at the earliest.

The IASB announced in its December 2009 meeting that the effective date for standards published in 2010 would be no earlier than 1 January 2012 (cf. Beyond the GAAP No. 29).

In the event that the revised standard is not adopted until 2011, it will then become effective from 2013 at the earliest.

4. Can we treat this standard as final?

No, because the IASB is planning a specific accounting treatment for onerous contracts arising from transactions within the scope of IFRS 4 – Insurance Contracts or IAS 18 – Revenue.

For these contracts, while awaiting the finalisation of the standards which will replace IFRS 4 and IAS 18, the IASB proposes retaining the current measurement rules, which involve measuring liabilities on the basis of the costs the entity expects to incur to fulfil its contractual obligations.

5. What are the main changes expected from the Liabilities Project?

The main changes are expected to be as follows:

- assessment at the level of single obligations in all situations (even in the case of a restructuring provision) (see question 6);
- elimination of the “probability of outflows” criterion for recognising provisions (see question 8);
- now obligatory to take the various possible outcomes for settling the obligation into account in the measurement (see question 16);
- obligatory to take a margin into account when measuring the amount of the liability if the entity expects to fulfil the obligation by undertaking a service (see question 17).

6. Has the concept of an obligation changed?

This concept has been refined, rather than changed. The exposure draft requires decisions to be made at the level of single obligations.

In the case of a restructuring, the current IAS 37 states that a provision shall only be recognised if there is a detailed formal plan for the restructuring, which has either started to be implemented or been communicated to those affected.

Thus, in the case of large-scale restructuring plans, which involve (for example) leaving rented premises, dismissing the personnel from the site in question, and breaking contracts with local suppliers, a provision shall be recognised once the detailed formal plan has been announced.

In this situation, the provision shall be recognised for all components of the restructuring plan, irrespective of whether or not there is an obligation relating to each component (for example, even if the letter announcing the departure from rented premises has not yet been sent to the landlord).

The revised standard is not expected to cover any specific rules on liabilities for restructuring. As a result, a liability can only be recognised for each component once the obligation actually exists (i.e. a single event cannot generate an overall liability) (see also question 21).

7. Is the existence of an obligation affected by events after the balance sheet date?

No. The appendix to the exposure draft clarifies that events after the balance sheet date cannot affect the existence of an obligation at the balance sheet date.

Thus, according to the exposure draft, the adoption of new legislation at the beginning of reporting period N+1 does not mean that an obligation existed at the end of reporting period N.

Remember that, according to IAS 37, an obligation arises only when it is virtually certain that the legislation or regulations will be adopted as drafted.

Thus, in practice, an obligation was sometimes considered to exist at the end of reporting period N when it resulted from a law passed at the beginning of reporting period N+1 and when indicators suggested that adoption was virtually certain. However, the phrasing used by IAS 37 left some room for interpretation.

However, events after the balance sheet date can be used to help measure liabilities (e.g. anticipation of lower expenses in the future, thanks to new technologies for decontamination of a site).

8. Is a probable outflow of resources always necessary for a provision to be recognised?

No. As a result, a provision may have to be recognised even in the event that the entity is not expecting an outflow of resources.

This change is likely to have a considerable impact on practice, since many obligations have not historically given rise to the recognition of a provision.

Thus, particularly in cases where it was difficult to judge whether or not an obligation existed (e.g. litigation), the “probability of outflows” criterion was frequently used in practice to assess whether a provision should be recognised.

Application of the revised standard is therefore likely to lead to an increase in the number of provisions (which is not to say that there will necessarily be an increase in the overall amount of liabilities).

The fact that an outflow of resources is not probable will, however, affect the amount of the provision (see question 16).

9. What is the expected impact on the recognition of litigation liabilities?

In the case of litigation, the entity will have to ask its lawyers for details of the various possible outcomes, even in cases where the risk is low and the entity does not expect to have to make any payment.

Thus, in addition to the impact on the amount of provisions recognised, this will have significant impacts at the operational level.

The information provided by the lawyers must include both the estimated impact of each outcome, and the likelihood that the various outcomes will occur (see question 16).

It should be noted that a provision shall be recognised even if the risk is low and the entity does not expect to have to make any payment.

In practice, an entity's ability to obtain the information necessary to measure these liabilities from the lawyers in charge of the various cases will also be affected by its geographical location.

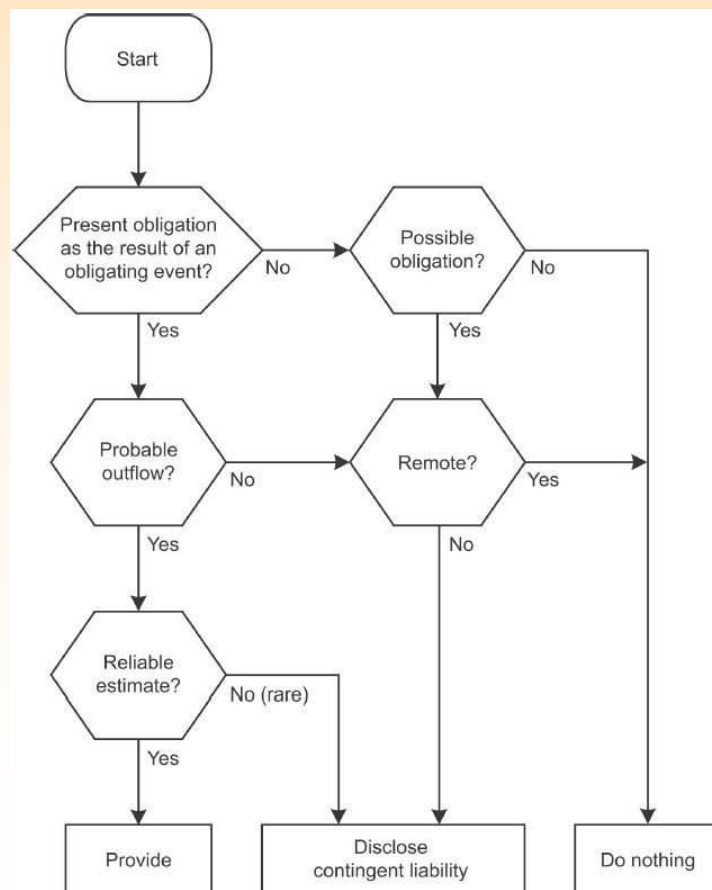
In the US legal environment, information sent by lawyers to auditors would risk losing its status as privileged information, thus allowing third parties to gain access to it.

As a consequence, it will be more difficult to obtain this type of information in certain regulatory environments (starting with the US environment).

10. Will this have consequences for the decision tree?

Yes. The decision tree provided in appendix B of IAS 37 (reproduced below) will no longer be applicable due to the change in the standard relating to the probability of outflows.

In fact, under the revised standard, a provision will be recognised even in the event that it is not probable (in the sense of more probable than improbable) that settling the obligation will result in an outflow from the entity of resources embodying economic benefits (see question 8).



11. What is the general principle set out in the exposure draft for the measurement of liabilities?

The exposure draft introduces the general principle that a provision shall be measured at the amount that the entity would rationally pay at the end of the reporting period to be relieved of the obligation.

Details of the implementation of this general principle are given in the exposure draft and in appendix B (see question 14).

12. How were provisions measured under IAS 37?

Remember that the current IAS 37 states that the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period; in other words, the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

This principle is similar to that used in the exposure draft, according to which the liability shall be measured at the amount that the entity would rationally pay at the end of the reporting period to be relieved of the obligation.

However, this concept of the “best estimate” was interpreted in a variety of different ways in practice, on the basis of other elements of IAS 37:

- some entities felt that the best estimate equated to the most probable individual outcome;
- some entities calculated the amount of the provision based on a weighted average of the various possible outcomes;

IAS 37 only required this type of approach in the case of obligations relating to large populations (e.g. provisions for warranties).

This approach was not generally implemented.

- in any case, entities generally calculated the amount of the provision on the basis of the cost to the entity, even in cases where the obligation took the form of a service to be undertaken by the entity (e.g. provisions for warranties).

IAS 37 stipulated that the estimate of the amount that the entity would rationally pay to settle or transfer the obligation provided the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Some felt that these stipulations required provisions to be measured at an amount other than cost, as the amount required by a third party in exchange for taking on the obligation would be based on a market price (i.e. including the normal profit margin for the service in question and the risk relating to taking on the obligation).

However, the frequent references to cost in the standard led most entities to measure provisions on a cost basis (rather than on the basis of the market value of the service in question).

13. Is this likely to change current practice?

Yes, particularly in view of:

- the obligation to take all the various possible outcomes into account when measuring the provision (the concept of “expected value”, see also question 16); and
- the need to take a margin into account when measuring provisions relating to obligations which involve undertaking a service (see question 17).

The rules on measurement of liabilities in the exposure draft will mean that provisions will henceforth be measured at an amount close to fair value.

Remember that fair value is defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”

As indicated in question 12, going beyond the general principles, the current practice for measurement of provisions is generally based on the cost to the entity, whereas the exposure draft requires general use of fair value (although the term is not used).

Moreover, some sections of the exposure draft suggest the worrying possibility that the use of fair value could be extended to certain assets (see question 19).

14. In practice, how will a provision be measured?

The exposure draft clarifies the concept of “**the amount that an entity would rationally pay to settle the liability**” by explaining that this equates to whichever amount is the lowest of:

- the present value of the resources required to fulfil the obligation;
- the amount that the entity would have to pay to cancel the obligation (i.e. by negotiating with the counterparty);
- the amount that the entity would have to pay to transfer the obligation to a third party.

(For a discussion of the concept of “the lowest amount”, see question 23).

In the most frequent case, where it is not possible to negotiate with the counterparty to cancel the debt, or to transfer it to a third party, the exposure draft refers the user to appendix B for details on how to measure the provision (see question 15).

15. How will an entity measure the present value of the resources required to fulfil the obligation?

In practice, the exposure draft requires that the following should be taken into account in this situation:

- all the various possible outcomes when estimating the outflows (i.e. the concept of "expected value", see also question 16);
- the effect of the time value of money (i.e. discounting of the provision when the effect is significant);
- market prices when they are available;
- the risks linked to the existence of an obligation (notably the risks relating to the timing and amount of outflows).

Moreover, if the obligation is fulfilled by a cash payment to a counterparty, the exposure draft stipulates that the amount of the provision should comprise the amount paid to the counterparty plus the associated costs (such as legal fees or the cost of internal legal advisors).

It should be noted that the exposure draft does not use the concept of "costs that are directly attributable", but rather the concept of "associated costs", which is both broader and less clearly defined.

Finally, the exposure draft includes specific rules for measurement of a provision when the obligation is fulfilled by undertaking a service (see question 17).

16. Must all the various possible outcomes be taken into account in the measurement?

In the general case of obligations which are measured on the basis of the present value of the resources required to fulfil the obligation, the exposure draft requires entities to take into account the relative probabilities of the various possible outcomes.

However, according to appendix B, it seems that entities are not necessarily obliged to take all possible outcomes into consideration, particularly in the event that there are many possible outcomes; however, the measurement should obviously take the most likely outcomes into account.

In other words, the general principle of measurement on the basis of expected value should certainly lead entities to weight the various possible outcomes according to their respective probabilities, but this does not necessarily entail consideration of literally all possible categories and sub-categories of outcome (assuming, of course, that the various possible outcomes considered are those with the highest probability of occurring).

17. Will the measurement be different when the obligation involves undertaking a service?

Yes, because the exposure draft stipulates in this case that the outflows should be based on the amounts that the entity would rationally pay a contractor to undertake the service on its behalf.

- If there is a market for the service in question, the outflows are based on the price that a contractor would charge the entity.

It should be noted that the market under discussion is a market for the service in question, not a market for the transfer of the obligation itself.

In some cases, there may be a market for undertaking a service, but no market for the obligation itself.

In particular, this may occur when the obligation relates to a service to be undertaken in the fairly distant future (dismantling of infrastructure, rehabilitation of the site, depollution, etc.) or when the risks specific to the obligation are difficult to measure (e.g. nuclear power stations).

It should be noted that the transfer of the obligation includes the transfer of the associated risks (risk related to the timing of the operation, risk of price changes, etc.) as well as the undertaking of the service itself.

- If there is not a market for the service in question, the outflows are based on the price that the entity would charge another party to undertake the service.

The exposure draft makes it clear that this amount shall include not only the **costs** the entity expects to incur, but also the **margin** it would require to undertake the service for the other party (see question 18).

Therefore, this measurement method seems to result in an amount which is broadly equivalent to that which would result from an approach based on the allocation of total revenue to the various obligations (i.e. deferring the recognition of revenue).

As a consequence, since the amount will be essentially the same, there will only be a limited impact resulting from the inclusion of these obligations (i.e. those relating to a service to be undertaken by the entity) within the scope of the standard intended to replace IAS 18 or the new standard on liabilities.

There is an exception: if the obligation is an onerous contract arising from a transaction within the scope of IFRS 4 – Insurance Contracts or IAS 18 – Revenue, the provision is measured on the basis of the costs the entity expects to incur, rather than according to the rules described above (see also question 4 on the reason for this exception).

18. What margin should be used to measure a provision?

Remember that, if the obligation involves undertaking a service, and if there is not a market for the service in question, the outflows shall include the margin the entity would require to undertake the service for another party, in addition to the costs it expects to incur.

The exposure draft does not give details of the margin to be used. This may be due to the fact that the IASB believes there is generally a market for services (for the difference between a market for the transfer of the obligation and a market for undertaking the service in question, see question 17).

Several members of the IASB (6 out of 15) criticised the proposal that an entity should take a profit margin into account when measuring the provision. They pointed out that this internal margin is a hypothetical amount.

If the entity expects to undertake the service itself, rather than using a contractor, this approach automatically releases a profit in the period during which the service is undertaken.

These members also pointed out that there is no guidance in the standard on the margin to be used, which could lead to significant differences in practice. This runs counter to the Board's objective.

In practice, in the case of warranty liabilities, the margin could be calculated from the overall margin generated by the sale of the goods in question (i.e. taking into consideration that the cost of the guarantee is just as necessary as the production of the goods).

19. Are there other possible consequences of including a margin on services undertaken by the entity?

The IASB says that undertaking the service shall release a profit or a loss, in the same way as the entity's other activities.

The exposure draft gives the example of an oil production company. All the processes necessary to produce and sell oil (such as the construction, operation and dismantling of the oil rig) are held to contribute to profit or loss.

If the Board retains this approach, its logical upshot would be that the entity includes a margin (internal hypothetical margin) when constructing an asset for itself. Under this approach, this margin would correspond to the surcharge which the company has avoided by carrying out the work itself rather than employing a contractor.

Carrying this logic to its extreme, it would even be possible to include a margin relating to the production of goods. This approach would be similar to measuring inventory at fair value in the context of business combinations (purchase price allocation).

It is therefore imperative to keep a close eye on the future progress of this project, keeping in mind the repercussions that this approach could have on the measurement of assets.

20. Does the exposure draft still make an exception to the rule on recognising provisions if a provision cannot be measured reliably?

Yes, this section of IAS 37 is expected to be retained as in the original document.

Remember that IAS 37 permits an entity to not recognise a provision in the extremely rare event that a reliable estimate cannot be made.

In practice, this rule should primarily relate to situations where the obligation is fulfilled by a cash payment, particularly lawsuits (cf. the decision tree in question 24).

In practice, if the obligation involves services, it is difficult to imagine that it would be impossible to measure the costs that would be necessary to fulfil the obligation, even if there is not a market for the services in question.

In this situation, IAS 37 requires additional information on contingent liabilities to be disclosed in the notes.

21. What about restructuring provisions?

One of the changes introduced by the new standard relates to the need to operate at the level of single obligations taken in isolation (see question 6).

In practice, in the case of restructuring plans which involve several components, it will be necessary to break down the overall plan into several obligations, and to ensure that each obligation complies with the conditions for recognition.

As a consequence, some components of the restructuring plan will be recognised at a later date, compared with current practice.

It is likely that the IASB will require entities to disclose additional information in the notes, in order to mitigate the negative impact on financial communication which could potentially result from extending the period over which the restructuring is recognised.

22. Is the accounting treatment of contingent liabilities affected by these new rules?

Yes, completely, given that contingent liabilities have been eliminated.

First, remember that contingent liabilities as defined by IAS 37 include both:

- possible obligations whose existence will be confirmed or otherwise by future events; and
- present obligations that are not recognised (either because the obligation cannot be measured reliably, or because it is not probable that an outflow of resources will be required).

The IASB now believes that contingent liabilities which take the form of present obligations are liabilities and should therefore be recognised (taking into account the uncertainties relating to outflows of resources). Meanwhile, contingent liabilities which take the form of possible obligations do not meet the definition of a liability (and are therefore not recognised).

This approach is already applied in IFRS 3R, which holds that in the context of a business combination, the only contingent liabilities which can be recognised are those in the form of present obligations which can be measured reliably but for which an outflow of resources is not probable.

Thus, the new standard on liabilities proposes to standardise the accounting treatment of liabilities, whether or not they are recognised in the context of a business combination.

As a result, the rules on subsequent measurement of contingent liabilities in IFRS 3R are no longer required.

Remember that IFRS 3R stipulates a specific accounting treatment for contingent liabilities recognised in the context of a business combination in order to avoid having to recognise them in profit or loss at the first balance sheet date after the business combination (given that the criteria for recognition of liabilities differ between IAS 37 and IFRS 3R).

23. Has the measurement of onerous contracts changed?

Yes. Onerous contracts are measured like other obligations, with the exception of those within the scope of IFRS 4 or IAS 18.

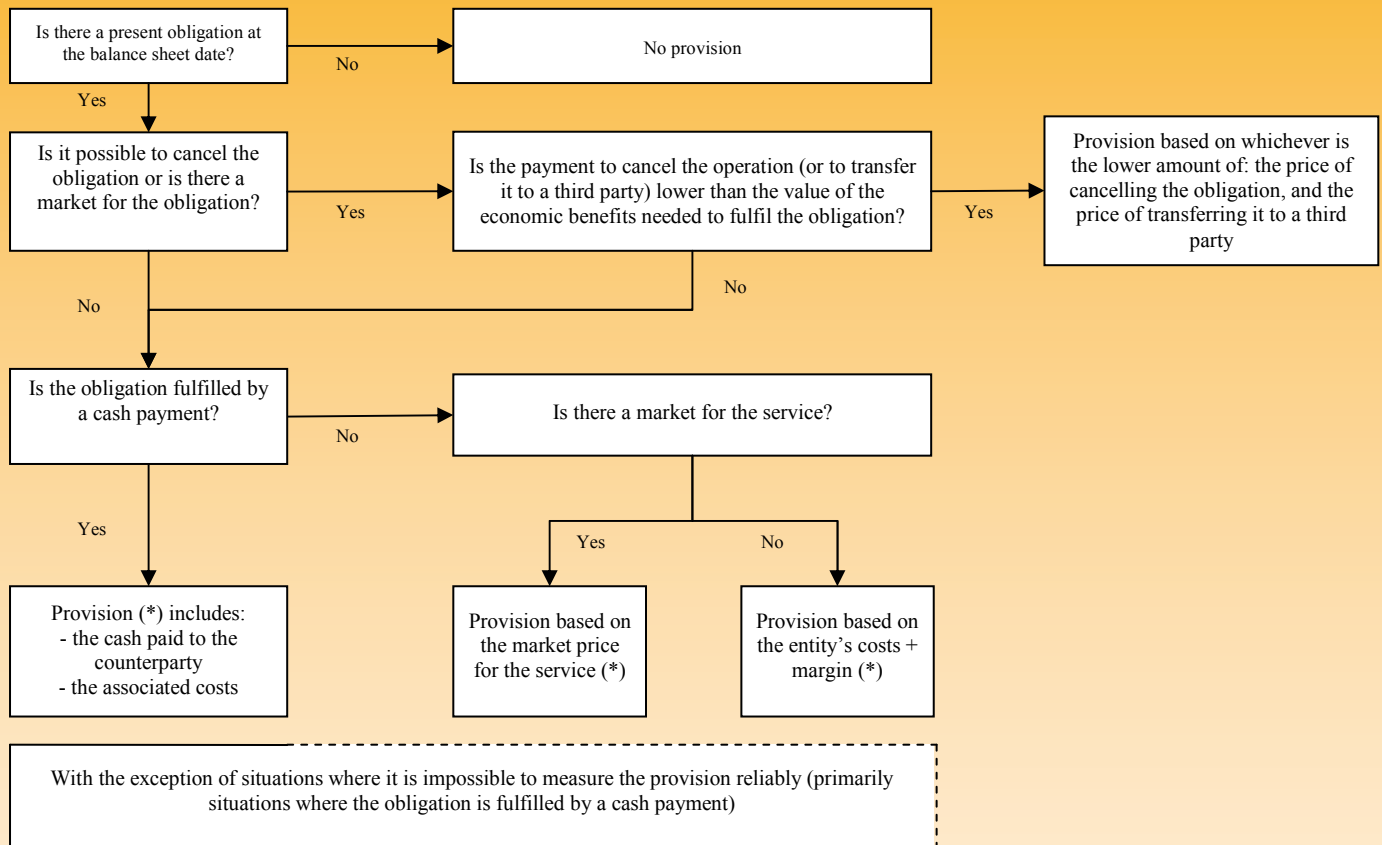
As stated in question 4, while awaiting the publication of the revised standards, the IASB proposes retaining the current measurement rules, which involve measuring liabilities for onerous contracts on the basis of the costs the entity expects to incur to fulfil its contractual obligations.

Furthermore, additional guidance is expected in the final standard to clarify the fact that, for lease contracts, the amount of the liability shall take into account sublease rentals that could be received by the entity (whether or not the entity intends to sublet the asset).

This clarification is in line with the measurement principle used in the exposure draft, according to which the liability is measured at the lowest amount (see question 14).

24. What should the decision tree look like under the revised standard?

We have endeavoured to draw up a decision tree based on the exposure draft, reflecting the new rules on measurement of liabilities.



(*) The following must also be taken into account: the various possible outcomes, the effect of any discounting, and the risk that the actual outflows might ultimately differ from the expected outflows

25. What are the key points to remember?

The key points to remember are as follows:

- the effective date will be 2012 at the earliest (if the final standard is adopted in 2010);
- it is obligatory to take the various possible outcomes into account in the measurement (i.e. the weighted average of the various outcomes);
- a provision must be recognised even if the entity does not expect to have to make any payment (i.e. elimination of the "probability of outflows" criterion);
- the provision is determined on the basis of the market price / the price that the entity would charge another party to undertake the service (in the absence of a market) if the obligation involves undertaking a service; this includes a hypothetical margin;
- restructuring provisions are recognised in the accounts over a longer period of time, compared with the current standard (they are recognised once the obligation actually exists; a single event can no longer be held to generate an overall liability);
- there is a risk that the inclusion of a margin could be extended to the measurement of assets (notably fixed assets and inventory).

Expected loss impairment model: the main principles of the exposure draft

In previous issues, we have covered the IASB's replacement of IAS 39. Beyond the GAAP has already looked in detail at the first phase of this project, which ended with the publication of IFRS 9 – Financial Instruments: Classification and Measurement.

This month, we present the exposure draft, "Financial Instruments: Amortised Cost and Impairment", which corresponds to phase 2 of the replacement of IAS 39.

After a brief reminder of the background, this article will sketch out the broad principles proposed in this exposure draft. Next month, we will look in more detail at the subjects which are provoking debate among stakeholders.

➤ Reminder of the background

In the wake of the financial crisis, there has been much criticism of the impairment model for financial instruments recognised at cost, which is based, in IAS 39, on incurred losses. In particular, this model has been accused of being too "pro-cyclical" and of not permitting users of the financial statements to make a correct assessment of the risks borne by companies on the eve of the crisis.

The IASB is therefore looking into the possibility of replacing the current "incurred loss" model with an approach based on "expected losses". As part of this review, it published a Request for Information in June 2009, seeking opinions from interested parties on the practical difficulties of implementing an expected loss model (constraints relating to operational issues, timing and costs).

Following the comment period, the IASB decided to continue down this road by publishing an exposure draft in November 2009. The objective this time is to gather opinions from all stakeholders on the appropriateness of the expected loss model.

The IASB has also established an Expert Advisory Panel, which will advise the Board on the operational aspects of implementing the approach.

➤ The main principles of the approach

1. Recognition based on "incurred losses" vs. "expected losses"

Under the current IAS 39, an impairment can only be recognised if a loss event is identified and there is objective evidence of impairment. The spirit of this rule is that a loss should be recognised for the reporting period in which it occurs.

In this exposure draft, the IASB proposes to abandon this approach in favour of recognition on the basis of losses expected by the management. In this case, the spirit of the rule is to recognise expected losses with the same regularity as interest revenue. The mechanism is incorporated into recognition at amortised cost using the effective interest rate, which is the method used for recognition in IFRS 9.

2. Retention of an effective interest method

The current IAS 39 calculates the effective interest rate of a debt instrument based on its expected cash flows excluding credit risk.

The exposure draft simply proposes to use the same calculation method, but to base it on expected cash flows including credit risk.

Let us take the example of a loan with a nominal value of 100, redeemable at par after five years, and with a contract rate of 5%. To keep things simple, let us assume that the loan has been issued without fees and that early redemption is not expected. Moreover, the management expects a loss of 2 on the interest to be received in year 3.

As shown in the table below, the effective interest rate of this loan under the current approach will be 5%. The expected loss of 2 is not taken into account in the initial recognition of the instrument on the balance sheet, as it is not an incurred loss.

Effective interest rate calculated		5,00%
Year	Expected cash flows excluding credit losses	Present value discounted at effective interest rate
1	5,00	4,76
2	5,00	4,54
3	5,00	4,32
4	5,00	4,11
5	105,00	82,27
		100,00

If the loss is incurred as expected, the impact on profit or loss and the value of the loan would be as follows:

Year	Amortised cost at beginning of period	Impact on profit or loss	Cash flows	Amortised cost at end of period
1	100,00	5,00	5	100,00
2	100,00	5,00	5	100,00
3	100,00	3,00	3	100,00
4	100,00	5,00	5	100,00
5	100,00	5,00	105	-

Now let us look at the same example using the approach proposed in the exposure draft.

Effective interest rate calculated		4,60%
Year	Expected cash flows including credit losses	Present value discounted at effective interest rate
1	5,00	4,78
2	5,00	4,57
3	3,00	2,62
4	5,00	4,18
5	105,00	83,85
		<u>100,00</u>

It will be noted that the effective interest rate calculated using the expected loss model is lower than that calculated using the current method. This is because the expected loss of 2 in year 3 has been taken into account.

Year	Amortised cost at beginning of period	Impact on profit or loss	Cash flows	Amortised cost at end of period
1	100,00	4,60	5	99,60
2	99,60	4,58	5	99,18
3	99,18	4,56	3	100,75
4	100,75	4,64	5	100,38
5	100,38	4,62	105	-

It is clear that the expected loss approach enables the expected remuneration from the loan (net of the credit risk losses expected by the lender) to be reflected in financial income, assuming the expected losses are estimated correctly. This results in more regular recognition of income.

Another notable phenomenon is that the loss of 2 in year 3 is spread over the entire lifespan of the instrument. This is economically justified because the recognition of interest (including the credit risk component) is also spread over the lifespan of the instrument. However, in year 3, the loss of 2 is incurred but is only partially recognised, as a portion of the loss must be spread over years 4 and 5.

3. Impact of changes in estimates

Since estimates of losses are by nature subject to change, the IASB has explicitly addressed the issue of changes in estimates.

The exposure draft stipulates that an entity shall revise expected cash flows on the basis of new estimates of losses, discount them at the original effective interest rate and therefore adjust the amortised cost of the instrument in profit or loss. This mechanism already exists in the current IAS 39, paragraph AG 8, and is frequently called the "catch-up method".

As a result, a change in an estimate (whether positive or negative) will have an impact on profit or loss for the period.

Let us revisit the example above with the following modification: in the end, no loss is incurred in year 3. The management becomes aware of this in year 2.

The current approach gives us the following table:

Year	Amortised cost at beginning of period	Impact on profit or loss	Cash flows	Amortised cost at end of period
1	100,00	5,00	5	100,00
2	100,00	5,00	5	100,00
3	100,00	5,00	5	100,00
4	100,00	5,00	5	100,00
5	100,00	5,00	105	-

Since losses are only recognised once they are incurred, the change in the estimate is not reflected in the accounts.

The approach proposed in the exposure draft gives us the following table:

Year	Amortised cost at beginning of period	Impact on profit or loss	Cash flows	Amortised cost at end of period
1	100,00	4,60	5	99,60
2	99,60	6,49	5	101,10
3	101,10	4,65	5	100,75
4	100,75	4,64	5	100,38
5	100,38	4,62	105	-

The impact of the change in the estimate in year 2 is reflected by a positive impact on profit or loss.

The expected loss approach thus requires the utmost vigilance as to the quality of loss estimates, or else potentially significant impacts on profit or loss may have to be recognised in the accounts if the estimates are revised at a later date.

4. An exposure draft which sticks to the principles

The IASB emphasised in its exposure draft that it wanted to provide a more principle-based approach. The exposure draft is thus intended to provide only a limited amount of guidance, to allow companies to apply the principles in the most appropriate manner for their environment and management practices.

As an example, the exposure draft permits entities to choose between making estimates at the individual level or at the portfolio level, as appropriate. Similarly, the exposure draft gives entities the option of using simplified methods (provision matrix). However, the use of simplified methods is strictly controlled, as the entity must demonstrate that they do not produce a significantly different outcome from a more complex method.

5. Specific rules for trade receivables

The exposure draft specifically mentions the issue of trade receivables. Short-term instruments continue to benefit from an exemption to the rule on recognising interest. Therefore, the effective interest method is not used.

However, the expected loss model is still used. In the absence of a mechanism for recognising interest revenue, the expected losses are deducted directly from the initial value of the receivable. This loss is recognised in the accounts as a deduction from revenue. However, the gross revenue and the revenue net of credit risk losses are presented in profit or loss.

6. Disclosures in the statement of comprehensive income and in the notes

The exposure draft requires entities to disclose the following information in the statement of comprehensive income:

- gross interest revenue before expected losses are taken into account;
- the effect of allocating the expected credit losses;
- net interest revenue (the subtotal of the two items above);
- the impact of changes in estimates.

Moreover, as the approach proposed in the exposure draft is based around management estimates, a large amount of information relating to these estimates will be required in the notes.

Examples include:

- a description of the methods used to estimate future cash flows;
- a description of the reasons for changes in estimates and information on the new data used.

7. Adjustments to transition requirements

In response to the comments received in the context of the Request for Information on the operational feasibility of an expected loss model, the IASB said it was aware of the systemic implications of this exposure draft. As a result, the effective date is expected to be at least 3 years after the publication of the final standard. In particular, this will allow companies to collect the historic loss data necessary to build statistical models for predicting cash flows.

The transition section of the exposure draft proposes retrospective application. However, the IASB recognises the difficulty of retrospectively recalculating effective interest rates including expected losses, and has proposed some adjustments.

➔ Upcoming next month

Next month, Beyond the GAAP will provide readers with a more detailed analysis of the subjects currently being discussed by stakeholders.

The comment period for this exposure draft closes on 30 June 2010.

Events/publications

Seminars on "Current developments in IFRS"

Mazars' Technical Department will host a number of seminars throughout 2010 dedicated to current developments in IFRS. These seminars, organised by Francis Lefèbvre Formation, will be held at the end of each quarter. To register, please contact Francis Lefèbvre Formation – www.flf.fr , +33 (0)1 44 01 39 99.

Frequently asked questions

IAS / IFRS

- Restructuring plans: recognition of retention bonuses granted to employees who have been made redundant or transferred to a new position;
- Long-term public/private concession arrangements granted for the construction and rehabilitation of a facility, followed by a lease: recognition of the operation from the point of view of the contracting authority;
- Accounting treatment of vouchers given to customers when services provided have failed to meet appropriate standards;
- Impact of debt restructuring and modification of share subscription warrants;
- Issuance of convertible bonds: "split accounting", subsequent accounting treatment in the case of early conversion, repurchase or redemption.

Upcoming meetings of the IASB, IFRIC and EFRAG

IASB

15 - 19 February 2010
15 - 19 March 2010
19 - 23 April 2010

IFRIC

4 -5 March 2010
6 -7 May 2010
8 -9 July 2010

EFRAG

24 - 26 February 2010
24 - 26 March 2010
5 - 6 May 2010

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