

# Beyond the GAAP

No 32 - March 2010

## Editorial

With a view to explaining its proposals more effectively and, if possible, convincing the stakeholders of their validity, the IASB multiplied its webcasts in March: replacement of IAS 37, presentation of items in OCI, classification and measurement of financial liabilities, amortised cost and impairment of financial instruments, lease accounting...!

Though the publication of a number of documents which were expected before 31 March has been delayed, the IASB is nevertheless demonstrating its determination to meet the G20 target of convergence with US GAAP by June 2011.

Enjoy your reading!

Michel Barbet-Massin

Jean-Louis Lebrun

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## News

### Sir David Tweedie addresses the ECOFIN Council

On 16 March, IASB Chairman Sir David Tweedie, addressed the EU's ECOFIN Council. He restated the IASB's intention to meet the objective set by the G20 summit in Pittsburgh last September: to achieve convergence with US GAAP by June 2011.

His speech also offered an opportunity to defend the project for the reform of IAS 39, at a time when Europe has postponed the endorsement of IFRS 9 until a still undetermined date. Sir David Tweedie reiterated that IFRS 9 was not intended to increase the use of fair value accounting.

Further, in response to the concerns emanating from Europe, the Chairman of the IASB recalled that the treatment of liabilities had been removed from the first version of the standard published last November. Sir David Tweedie also emphasised that the IASB's decisions to date regarding the classification and measurement of financial liabilities would not result in an increase in the use of fair value measurement.

## IFRS News

### ➤ Determination of functional currency of an investment holding company

In January 2010, the IFRIC received a request for guidance on the determination of the functional currency of an investment holding company in its separate financial statements.

The issue is whether an investment holding company should take into account the local currency of the country in which it has its registered office and in which it raises funds or the functional currency of its subsidiaries abroad.

IAS 21 provides a hierarchy of indicators, and states that when the indicators are mixed and the functional currency is not obvious, an entity should use its judgement to determine its functional currency. The IFRIC considered the question at its March meeting, and on the basis of this principle confirmed its decision not to provide an interpretation on this issue.

However, there exist divergent practices in this area. Some believe that the indicators listed in paragraph 9 of IAS 21 (in particular, which currency mainly influences sales prices and costs) are not applicable to an investment holding company. If this is so, only the indicators in paragraph 10 (in particular the currency in which funds from financing activities are generated) should be analysed. Therefore, the conclusion would be that the functional currency of a holding company is the currency of the country in which the holding company has its registered office.

However, others believe that the currency which influences an investment holding company's capacity to meet its obligations to repay its loans or meet its expenses is the functional currency of subsidiaries abroad. As the holding company's principal source of income is the dividends it receives from its subsidiaries, the conclusion would be that the functional currency of the holding company is the same as that of its subsidiaries.

Despite the comment letters received calling on the IFRIC to take up a position on this widespread issue, the IFRIC considered that any guidance it could provide would be in the nature of application guidance rather than an interpretation. The divergent practices might therefore continue.

### ➤ Application of IFRS 5 in the event of loss of joint control or significant influence

In March 2010, the IASB decided not to finalise the proposed amendment to IFRS 5 regarding partial disposals of jointly controlled entities or entities subject to significant influence.

This proposal, published last August as part of the third project for annual improvements to IFRS, aimed to present the whole of a holding in a jointly controlled entity or an associate as held for sale, when it is committed to a sale plan involving loss of joint control or significant influence.

The treatment proposed was thus analogous to that presented in IFRS 5 for a partial disposal of a subsidiary leading to loss of control.

At the time the proposal was justified by the IASB on the grounds that loss of control, loss of joint control and loss of significant influence are major economic events. The impact in terms of presentation and measurement on the balance sheet should therefore be identical.

This line of argument, however, arising out of debates in the course of Phase II of the Business combinations project, has been called into question by the February Board meeting during its deliberations on the joint ventures project (ED 9).

At that meeting, the IASB decided to remove all reference to 'a major economic event' in current standards or projects when addressing the issue of loss of control or of significant influence.

In this context, the initially proposed amendment to IFRS 5 presented above will be addressed in the forthcoming standard on joint arrangements.

## ➤ Presentation of items of OCI in a single statement: exposure draft expected shortly

At a joint meeting in October 2009, the IASB proposed to eliminate the option to present the comprehensive income in one or two statements provided by IAS 1R (that became effective since 1 January 2009). This proposal should be confirmed in a forthcoming exposure draft as part of the Presentation of Financial Statements project for which a further exposure draft is expected during the second quarter of 2010.

If this proposal is approved (final standard expected by the end of the year, for mandatory application no earlier than 1 January 2012), an entity will have to present in a single statement the income and expense forming the profit or loss, but also the other elements of the comprehensive income or OCI (i.e. those that are not recognised in profit or loss but as a component separate from equity).

This single statement would nevertheless present two distinct components: profit or loss and comprehensive income. Further, earnings per share would continue to be calculated on profit or loss. No measure of "comprehensive income per share" would be required.

The elimination of the option to present the comprehensive income in one or two statements was strongly criticised by a good number of commentators, mainly preparers, during the comment period following the publication of the discussion paper on Phase B of the Presentation of financial statements project.

If the IASB has decided to pass over these objections, it is principally because the FASB's decisions on recognition and measurement of financial instruments require increased use of the OCI category.

The IASB therefore hopes that the elimination of this option will bring more consistency to IFRS financial statements and make it easier to identify areas of divergence with the US GAAP as regards recognition of losses and gains in OCI.

This exposure draft should also be an opportunity to clarify the issue of recycling in profit or loss of items first recognised in OCI.

It would thus be proposed that components of the OCI which are likely one day to be reclassified should be presented separately from those which will never be reclassified.

Even though these proposals do not challenge the existence of the profit or loss, some commentators will probably claim that such proposals may weaken the importance of an aggregate that would become no more than a sub-total.

The IASB itself acknowledges that work is required to reach a conceptual definition of the performance of an entity in order to clarify the distinction between profit or loss and OCI.

## ➤ Debt/ equity distinction:

In the course of a joint meeting with the FASB, the IASB held further discussions on the amendments to IAS 32 to limit weaknesses in the standard as regards the debt / equity distinction.

Deliberations during March have thus been an opportunity to restate the principle which states that the contractual obligations of an instrument take precedence over "economic compulsion".

Therefore, if the issuer of an instrument has no contractual obligation to deliver cash or other financial assets to the holder of the instrument, the instrument should be classified as equity and not as a liability.

## ➤ Extension of the comment period for the IAS 37 exposure draft

At its March meeting, the IASB decided to extend the deadline for comments on its exposure draft on IAS 37. The comment period will now end on 19 May, and not on 12 April 2010 as initially proposed.

The final standard was anticipated during the second quarter of 2010, in accordance with the IASB work plan updated on 3 March. It is now very unlikely that this timetable will be met.

## ➤ **Conceptual Framework for Financial Reporting: The Reporting Entity**

On 11 March 2010, the IASB and the FASB published for comment the exposure draft entitled "The Conceptual Framework for Financial Reporting: The Reporting Entity".

This joint publication is part of the project to establish a conceptual framework common to the IFRS and the US GAAP. It follows the publication in May 2008 of a discussion paper on the reporting entity concept (see Beyond the GAAP, N° 12-May 2008).

Under the terms of the exposure draft, a reporting entity is a circumscribed area of economic activities whose financial information, which cannot be obtained directly, has the potential to be useful to investors, lenders and other creditors in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided.

The exposure draft states that an entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself.

Finally it proposes that a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished from the rest of the entity and financial information about that portion of the entity is useful in making decisions about providing resources to that portion of the entity.

Comments may be submitted until 16 July 2010.

This exposure draft can be consulted at <http://www.iasb.org/NR/rdonlyres/363A9F3B-D41C-41E7-9715-79715E815BB1/0/EDConceptualFrameworkMar10.pdf>

## ➤ **Future standard on joint arrangements: the IASB agrees transitional provisions.**

In March, the IASB discussed the transitional provisions which should be adopted in the future standard on joint arrangements (that will replace IAS 31 "Interests in Joint Ventures").

In respect of interests in jointly controlled entities previously accounted for using the proportionate consolidation method (IAS 31), and which would henceforth be accounted for using the equity method, the IASB decided that, at the transition date, there should be aggregation of the proportionate consolidated assets and liabilities into a single line item.

## ➤ **The IASB reviews the scope of its income tax project**

In response to the very negative comments regarding the exposure draft entitled "Income tax" published in March 2009, the IASB decided at the end of last year to review the scope of this project.

At the 18 March 2010 meeting, the Board decided to limit the scope of the project to questions of uncertain tax positions and deferred tax on investment properties at fair value. An exposure draft on these two topics should be published before the end of the second half of 2010.

Further, the Board also suggested amending IAS 12 by including a number of proposals which attracted a consensus among commentators on the previous exposure draft. These amendments could be ratified under the annual improvements process.

## European matters

### ⇒ Endorsement of annual improvements

The European Commission has endorsed the improvements to IFRS published by the IASB in April 2009.

The amendments (IFRS 2, IFRS 5, IFRS 8, IAS 1, IAS 7, IAS 17, IAS 36, IAS 38, IAS 39, IFRIC 9 and IFRIC 16) are applicable to the financial years starting after 31 December 2009 (for more details, see the special study published in our April 2009 edition).

The EU Regulation No 243/2010, 23 March 2010, can be consulted at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:077:0033:0041:EN:PDF>

### ⇒ Endorsement of the IFRS 2 amendments on intra-group transactions

The European Commission has endorsed the amendments to IFRS 2 published by the IASB in June 2009.

These amendments deal with issues in respect of intra-group transactions. They specify how a subsidiary should recognise in its individual financial statements transactions in which a share-based payment is made by another entity in the group.

These amendments are applicable to financial years starting after 31 December 2009.

The EU Regulation No 244/2010 23 of 2010 March 2010 can be consulted at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:077:0042:0049:EN:PDF>

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## The IASB updated its work plan

On March 3 the IASB published a revised work plan on its website. The changes in the work plan issued on 6 November 2009 take account of the IASB's revised estimates of progress on its current projects. Beyond the GAAP here reports the main changes to the IASB's work plan.

### Consolidation project

The consolidation project has been divided into two parts to take account of February's decision to combine the disclosures requirements for subsidiaries, joint ventures and associates within a comprehensive disclosure standard (see Beyond the GAAP, N°32 - February 2010).

This project will therefore include a section including the ED 10 proposals and a disclosures section. The FASB set a goal of publishing an Exposure Draft in the second quarter of 2010 on consolidation. The IASB will reconsider the draft in the light of the US comments and any stakeholder responses before the finalisation of the standard. The definitive standard replacing IAS 27 and SIC 12 should therefore be published in the last quarter of 2010, rather than the third quarter. The standard on disclosures is expected during the second half of the year.

### Derecognition

A new exposure draft will be published during the year, presenting a detailed alternative to the approach set out in the March 2009 exposure draft. This approach would derecognise (almost) all of the transferred cash flows, whether via disposal of an instrument followed by reinvestment or via a partial disposal (repo transactions<sup>1</sup> would form an exception to this principle).

The final standard is expected no earlier than the end of the year.

### Financial instruments - IAS 39 Replacement (IFRS 9)

Phase 1: Classification and Measurement: an exposure draft is expected by the end of the first half of the year to address financial liabilities (see page 13).

Phase 2: Amortised Cost and Impairment: the exposure draft comment period ends on 30 June 2010. The final standard is expected by the end of the year

Phase 3: Hedging: an exposure draft is expected by the end of the first half of the year. Some issues may be deferred to 2011.

### Discontinued operations

A new exposure draft, originally scheduled for the first quarter of 2010, will finally be published taking into account the IASB's major amendments to the proposals set out in the first exposure draft of September 2008.

The final standard is expected during the second half of the year.

### Income taxes

In October, the IASB decided to halt the project in its existing form (exposure draft published in March 2009). Before undertaking a more fundamental review of the principles for recognition and measurement of income taxes, the IASB decided in March to publish an exposure draft focusing on certain practical aspects (see page 4).

Publication is expected during the third quarter of 2010.

### Joint ventures

The publication of the standard which will replace IAS 31 has been postponed until the second quarter of 2010 (instead of the first quarter as scheduled in the November 2009 work plan).

### Post-employment benefits

One of the main proposals of the coming exposure draft on recognition of defined benefits (initially expected in the first quarter 2010) will be the recognition of actuarial gains and losses directly in other comprehensive income.

<sup>1</sup> Sale and repurchase agreement

## Revenue Recognition: where are we now?

In December 2008, as part of a project conducted jointly with the FASB, the IASB published a Discussion Paper on the recognition of revenue entitled *Preliminary Views on Revenue Recognition in Contracts with Customers*.

This DP outlines the main thrust of a future standard to replace IAS 18 *Revenue* and IAS 11 *Construction Contracts* by 2011. The Boards propose to adopt a single revenue recognition model, which could apply to both construction contracts and to the sale of goods and services.

During the comment period, which ended in June 2009, the two Boards received 211 comment letters (these can be accessed on the IASB web site).

Since the DP was published, the IASB has indicated that the future exposure draft will be based on the model set out in the DP and has provided further clarification regarding the concepts of performance obligation and transfer of control.

The ED is expected in the second quarter of 2010. Round tables will be held during the second half of the year and the final standard is expected during the second quarter of 2011. This standard will not be of mandatory application before 2013.

Application of the future standard should be fully retrospective. The IASB has not yet announced whether early application will be authorised.

Given the significant effect of this project for many entities, Beyond the GAAP has decided to provide an update on the progress of the tentative decisions taken by the IASB, alone or in concert with the FASB, in the run-up to the publication of the exposure draft.

### ➔ In brief, what did the comment letters say?

The analysis of the comment letters received in response to the DP was presented by the staff during the IASB meeting of July 2009.

It emerged from this analysis that although respondents supported the single model proposed by the Board for revenue recognition, they felt that the principles set out in the DP were not enough precise and that they needed to be developed if they were to be applied consistently. Application guidance and examples should be provided on the key issues, such as the identification and measurement of performance obligations, and the date on which these obligations are satisfied.

Many respondents believed that the concept of transfer of control (of goods or services) used to determine the date on which an obligation is satisfied needed clarification, since it was a central concept in the model. They claimed that indicators for determining when control is transferred were needed. Some believed that the current notion of risks and rewards in IAS 18 should be introduced in the model (at least as indicators of transfer of control).

Some respondents also noted that the principles set out in IAS 11 and IAS 18, although different from each other, worked well in practice and provided decision-useful information to users of financial statements. They believed that the principles set out in the DP would result in a loss of information.

Certain respondents also feared that the proposed requirements in the DP would prevent the use of the 'percentage of completion' method (in particular for some construction contracts) and require revenue recognition on completion of these contracts. Such respondents noted that such revenue recognition pattern would not provide decision-useful information.

Finally some European respondents (in particular the EFRAG) proposed an alternative model according to which revenue would be recognised continuously over the course of the contract as the contract progresses (i.e. based on the activity). They claim that this model would be a better way of presenting the entity's performance over the past period, and would thus provide users with better information.

## ➤ Scope of the future standard

The scope of the DP is very broad and targets all areas of activity (even though the DP does not suggest any possible exceptions).

During its deliberations, the IASB indicated that the scope of the ED would exclude:

- Insurance contracts <sup>1</sup> (in the scope of IFRS 4) ;
- Financial instruments (in the scope of IAS 39);
- Lease contracts (in the scope of IAS 17).

## ➤ Revenue recognition principle

According to the DP, revenue allocated to a performance obligation (i.e. to a component of the contract) is recognised when control of the good or service that relates to the performance obligation is transferred.

This transfer of control may be continuous and, therefore, may encompass the transfer situations set out in IFRIC 15 *Agreements for the Construction of Real Estate*.

According to the Board, control of an asset is defined as 'an entity's present ability to direct the use of and receive the benefit from that good or service'. The Board also indicated that an entity should assess the transfer of control from the perspective of the customer.

In practice, the Board proposed the following situations that indicate that the customer has obtained control (continuously or otherwise) of the promised asset:

- The customer has an unconditional obligation to pay for the asset (and the payment is non-refundable);
- The customer has legal title to the asset;
- The customer can sell the asset to (or exchange the asset with) another party;
- The customer has physical possession of the asset;
- The customer has the practical ability to take possession of the asset;
- The customer specifies the design or function of the asset;
- The customer has continuing managerial involvement with the asset;
- The customer can secure or settle debt with the asset.

<sup>1</sup> It should be noted that a DP on insurance contracts has been published in 2007.

Analysis will be required to validate the relevance of these indicators and to apply them to the actual contractual clauses. This analysis should make it possible to determine whether revenue from construction contracts may continue to be recognised under the percentage of completion method.

## ➔ Identifying performance obligations

This issue has already been tackled several times by the IFRIC (in particular in IFRIC 13 on *Customer Loyalty Programmes* and IFRIC 15, *Agreements for the Construction of Real Estate*). The DP suggests adopting an approach along the same lines as that adopted by the IFRIC, by separately identifying and recognising the revenue from each 'component' of the contract, known as a 'performance obligation'.

Identification of the different components of a contract is vital, because it determines the pattern of revenue recognition.

As many respondents stressed the difficulty of allocating the contract price to the different performance obligations, the IASB decided that allocation should be made by contract segment. The segment would be defined as the aggregate of different performance obligations marketed together and for which there are observable market data.

Allocation of the contract price to each segment would lead to identify a different margin for each segment, even though the price has been negotiated for the segments as a whole. This would thus introduce a significant change with the current IAS 11 provisions.

## Sale of goods with warranties

In the DP, the IASB assumed that a sale accompanied by a warranty would segment the contract into two separate performance obligations, the delivery of the good and the provision of the warranty. In the light of the comments received, the two Boards have taken this analysis further and have identified two types of warranty:

- If the objective of a warranty is to provide a customer with cover for latent defects (i.e. those that exist when the asset is transferred to the customer but which are not yet apparent), this warranty is not a performance obligation in itself, but is part of the obligation to deliver a compliant product. This type of guarantee should include legal warranties. Its accounting treatment requires the "neutralisation" of part of the revenue representing an estimate of the number of defective products or parts, and of the "recording" as inventories a part of the goods "supplied" (as if a part of the goods was placed on consignment with the customers) ;
- If the objective of a warranty is to provide a customer with cover for faults that arise after the product is transferred to the customer (eg optional warranties), which is equivalent to an insurance contract, this type of warranty represents a separate performance obligation and a portion of revenue should therefore be allocated to that obligation.

A portion of revenue would be deferred in both cases. However, in the first case above, deferred revenue would be measured on a cost-plus basis, whereas, in the second case above, deferred revenue would be measured on a market price or rate.

The entity's obligation in a given jurisdiction to pay compensation if its products cause harm or damage would not give rise to a separate performance obligation. Instead, the entity would account for such obligations in accordance with IAS 37 .

## Sale of goods with right of return

Goods may be sold with a right of return granted to customers, such as the customer's right to withdraw during a certain period, or buy-back clauses.

In the DP, the IASB identified the right of return as a separate performance obligation.

After deliberation, the Board concluded that:

- an entity should not recognise revenue for the goods that are expected to be returned but instead recognise a refund liability for the expected (probability weighted) amount of refunds to customers;
- this provision for refunds should be updated periodically;
- an entity should recognise an asset for its right to recover goods on settling the refund liability (on the basis of the expected present value and the original cost of the goods supplied).

## Sale of goods with the option to acquire additional goods or services

The Board also decided that, when recognising revenue, it was appropriate to take account of options for the supply of additional goods and services and options to renew.

- an option to acquire additional goods or services in a contract with a customer would be recognised as a performance obligation only if the option provides a material right to the customer that the customer would not receive without entering into that contract. The Board decided that an entity can use various methods to allocate consideration to those optional goods and services. In some cases, an entity can estimate the standalone selling price of an option as a basis for allocation. That estimate would reflect the discount the customer would obtain when exercising the option, adjusted for the discount that the customer could receive without exercising the option and the likelihood that the option would be exercised;
- for contracts with renewal options, an entity would allocate the transaction price to the optional goods and services by reference to the goods and services expected to be provided and the corresponding expected consideration (requirement similar to the proposals in the DP on lease accounting).

## ➤ Measurement of Revenue

According to the DP, total revenue that an entity may recognise corresponds to the consideration agreed in the contract (discounted where applicable). The recognition of revenue on the basis of fair value (or an "exit price"), at one time under consideration by the IASB, has therefore been abandoned for contracts within the scope of the DP.

The Board has confirmed that performance obligations (falling within the scope of the future standard and thus excluding insurance contracts, financial instruments and leases) would not be remeasured (except in the event of onerous contracts, see below).

The Board has confirmed that if a contract contains several performance obligations (components), the contractual price is allocated to each segment (a segment corresponding to the aggregate of different performance obligations marketed together, see above) proportionally to the sale price of each good or service relating to these obligations.

The sale price of each good or service corresponds to the price at which the entity sells or could sell this good or service separately.

## Estimates of uncertain consideration

The recognition criteria for uncertain consideration were not considered in the two Boards' preliminary discussions.

Contrary to the current practice, uncertain consideration should be recognised on the basis of revisable estimates (based on the probability of the possible outcomes).

However, this recognition would only occur if the entity can identify the possible outcomes and reasonably estimate the related probabilities. This would be the case if the entity:

- has experience with identical or similar types of contracts ; and
- does not expect circumstances surrounding those types of contracts to change significantly.

## ⇒ Onerous contracts

According to the DP, the amount of the contractual selling price initially allocated to each performance obligation is not subsequently remeasured unless the performance obligation becomes onerous. A performance obligation is deemed onerous when the expected cost of satisfying the performance obligation exceeds the amount initially allocated. In this case, a loss is immediately recognised for the difference.

The Board has confirmed that only performance obligations relative to onerous contracts will be remeasured.

The entity should carry out an onerous test:

- at segment level, and not for the contract as a whole. This decision, given that the Board has opted for the allocation of the transaction price by segment pro rata to the price for which the segments could be sold separately (see above) may in some cases lead to account for a loss initially (if there are significant differences in margin between segments). In this case, assuming that the contract as a whole is profitable, the conditions under which the transaction price are allocated are reviewed so that no segment is initially onerous (i.e. the loss takes the form of a "discount" allocated pro rata to the different segments).
- on a direct costs basis (that is, all costs that relate directly to the specific contract or that were incurred only because the entity entered into the contract).

## ⇒ Contract costs

The ED should contain the following provisions:

- the costs incurred in obtaining a contract (eg. selling, advertising and marketing costs), costs relating to the performance obligations already satisfied and abnormal amounts of wasted labour or material will be expensed immediately when they are incurred.
- if costs incurred to perform a contract do not meet the definition of an asset under other IFRS standards (for example inventories, PP&E or intangible assets), they will be capitalised if they generate a resource that the entity can use to satisfy its performance obligations, if they relate directly to a contract or a future contract, and if they will probably be recovered in the course of a contract.

It should be noted that in current practice, (see IAS 11), costs incurred in obtaining a contract are capitalised if it is probable that the contract will be obtained.

## ➤ Disclosures

Although disclosures remain to be specified, they may include:

- the nature of contracts concluded with customers, and the accounting policies;
- the principal judgements used in accounting for contracts with customers;
- a reconciliation of the beginning and ending net contract position(s) when relevant (eg. for construction contracts);
- information about onerous contracts (eg. the context and the reasons explaining the loss).

## Financial liabilities: a first look at the forthcoming exposure draft

On 12 November, the IASB published part one of IFRS 9 on financial instruments, which deals with the issues of classification and measurement of financial assets. At the last moment, the IASB decided to limit the scope of this standard to financial assets, postponing to a later date the publication of the part relating to financial liabilities in the form of an exposure draft.

Beyond the GAAP takes a look at the reason for this delay and sets out the main tentative decisions retained by the Board for the forthcoming exposure draft.

### ➤ Why was publication delayed?

IFRS 9 was originally intended to deal with issues relating to the measurement of financial assets and liabilities. Thus financial liabilities would have to be measured either at fair value, or at amortised cost. In the initial draft, financial liabilities were measured in their entirety at amortised cost as long as the following three conditions were met:

- a. the instrument is held within a business model whose objective is to hold the instrument to pay the contractual cash flows (by contrast with management on the basis of fair value);
- b. the instrument comprises only cash flows representing repayment of the principal or interest on the outstanding capital (time value of money and counterparty risk) ;
- c. the entity elects not to use the fair value option for this instrument.

If any of these three conditions was not met, the instrument had to be measured in its entirety at fair value on the statement of financial position.

At the time, some stakeholders felt that this approach could result in an increasing number of liabilities measured at fair value. In particular, this increase was explained by the removal of the concept of an embedded derivative, meaning that many "structured" liabilities would not satisfy the condition set out in point b above.

All financial liabilities classified in the "fair value" category would be remeasured through profit or loss. This type of treatment could thus lead entities to recognise gains in profit and loss each time that their credit quality deteriorated. This was criticised by many stakeholders who felt that it was counterintuitive<sup>1</sup>.

Given the concerns received by stakeholders, the Board decided to defer the publication of the part of the standard dealing with financial liabilities in order to further discuss this issue.

<sup>1</sup>For example, an entity issues a 10-year bond with a notional value of 100 at a rate of 5%. At the end of the first year, as a result of deterioration in its credit risk, the rate at which the entity is now in a position to borrow goes up to 7% (assuming that the risk-free interest rate remains unchanged). Consequently, the market value of the debt automatically changes from 100 to 87, generating a gain of 13 in profit or loss, even though the financial situation of the entity has deteriorated.

## ➤ What are the main tentative decisions of the Board?

Five months have passed since the first version of IFRS 9 was published. The IASB has taken advantage of this time to consult the various stakeholders and is preparing to publish an exposure draft presenting the model which it proposes to use. Beyond the GAAP presents the main tentative decisions.

The exposure draft is likely to propose four categories of financial liabilities:

- unstructured financial liabilities managed under a business model based on payment of contractual cash flows: these will be measured at amortised cost;
- structured financial liabilities managed under a business model based on payment of contractual cash flows: these will be treated on the basis of the existing provisions of IAS 39 on structured financial liabilities, i.e. by separating the embedded derivative from the host contract in order that the latter can be measured at amortised cost while the structured component is measured at fair value;
- financial liabilities not managed under a business model based on payment of contractual cash flows: these will be measured on the balance sheet at fair value. Changes in fair value will impact profit or loss;
- financial liabilities for which the entity elects voluntarily for fair value measurement: these will be measured on the statement of comprehensive income at fair value. Changes in fair value will be recognised in Other Comprehensive Income for the part relating to the "credit risk" component only, while the residual change will affect profit and loss.

The IASB presents this approach as a marginal development of the current provisions of IAS 39 (the main changes being limited to the "Fair Value Option" category).

## ➤ What are the main issues of these proposals?

In anticipation of the exposure draft and clarification of how this approach would be implemented, Beyond the GAAP lists the main issues of these proposals:

- no symmetry between financial assets and financial liabilities: earlier raised by the IASB, the symmetry of analysis and treatment between assets and liabilities in IFRS 9 is unlikely to be retained;
- the embedded derivative concept is back: removed from the treatment of financial assets in phase one of IFRS 9 with the aim of simplification, the concept would be reintroduced on the liabilities side;
- a new measurement method: IAS 39 currently includes three measurement methods (amortised cost, separation of the embedded derivative and fair value through profit or loss). IFRS 9 is likely to add a fourth measurement method based on fair value with recognition of the "credit risk" component in Other Comprehensive Income;
- a new operational difficulty: measuring the "credit risk" component separately. In the aftermath of the financial crisis, characterised by lasting tensions in the market for liquidity, it will be interesting to see how the IASB will define this "credit risk" component.

Beyond the GAAP will propose an in-depth analysis of the exposure draft as soon as it is published and report on the first stakeholders' reactions.

## 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 25 June, 24 September and 10 December 2010.

To register, please contact Francis Lefèbvre Formation – [www.flf.fr](http://www.flf.fr), +33 (0)1 44 01 39 99.

## Frequently asked questions

### IAS/IFRS

- Analysis and proposed accounting treatment of a PPP (Public-Private Partnership) from the point of view of the grantor;
- Accounting treatment of an adjustment to the cost of an investment in an associate;
- Construction contract: accounting treatment for indemnities due to the customer.

## Upcoming meetings of the IASB, IFRIC and EFRAG

### IASB

19 - 23 April 2010

17 - 21 May 2010

14 - 18 June 2010

### IFRIC

6 - 7 May 2010

8 - 9 July 2010

2 September 2010

### EFRAG

5 - 7 May 2010

9 - 11 June 2010

14 - 16 July 2010

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