

Beyond the GAAP

Mazars' newsletter on accounting standards

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Editorial

July was a busier period for Europe than for the IASB. The European Commission sent two draft texts (deferred application of IFRS 9 for insurers and financial conglomerates, and IFRS 16 on Leases) to the European Parliament and Council for endorsement before the end of the year, while ESMA published three documents on financial information and its enforcement activities.

Meanwhile the IASB confirmed the IFRS IC's tentative decision on the modification of financial liabilities under the new IFRS 9. The Interpretations Committee had expressed some doubts at its last meeting in the light of the comments received. The far-reaching impacts of this decision are discussed in this edition's special study.

All the team at Beyond the GAAP hope you have had an enjoyable break and welcome you back to work after an August free of any accounting news!

Enjoy your reading!

Edouard Fossat

Isabelle Grauer-Gaynor

European Highlights

ESMA report on IFRS 13 implementation

On 12 July 2017 ESMA issued a report on the implementation by European issuers of the fair value measurement and disclosure requirements of IFRS 13. This report was prepared on the basis of the 2015 annual reports of 78 European issuers and of the enforcement actions taken by European regulators relating to financial years 2013, 2014 and 2015. The report focuses in particular on the following major points:

- disclosures on fair value,
- the unit of account,
- the impact of the decrease in the level of market activity on fair value, and
- valuation adjustments for derivatives' fair value (CVA – Credit Valuation Adjustment, DVA – Debit Valuation Adjustment, FVA – Funding Valuation Adjustment).

The report concludes that, overall, issuers in the sample are implementing IFRS 13 satisfactorily, but that there is room for improvement in areas such as compliance and comparability in the application of the standard, in particular in terms of disclosures on fair value in the notes and of the assessment about when transaction prices and quoted prices do not represent fair value. The report also notes that IFRS 13 could be improved to bring more clarity in areas where uncertainty in practice still exists.

This report will be submitted to the IASB to contribute to its post-implementation review (PIR) on IFRS 13 launched last May (see Beyond the GAAP no 112, June 2017). ESMA also expects issuers and their auditors to consider the findings of the report in the future.

The report is available on ESMA's website at the following address:

<https://www.esma.europa.eu/press-news/esma-news/esma-reviews-application-ifs-13-%E2%80%93-fair-value-measurement-requirements>

ESMA publishes new Q&As on its Alternative Performance Measures (APM) guidelines

On 12 July 2017 ESMA published four new questions and answers on the implementation of its guidelines on Alternative Performance Measures which came into effect in July 2016. The new Q&As address the application of APM guidelines in interim financial statements, the concept of "prominence", the 'compliance by reference' principle and the definition of an APM.

These Q&As, of which there are now eleven, are intended to promote common supervisory approaches and practices in the application of ESMA's Guidelines on APMs.

Both the guidelines and the Q&A are available on ESMA's website at the following address:

<https://www.esma.europa.eu/press-news/esma-news/esma-publishes-new-qa-alternative-performance-measures-guidelines-0>

European Commission publishes a draft text allowing financial conglomerates to defer application of IFRS 9

On 11 July 2017 the European Commission published the draft text sent to the European Parliament and Council approving the amendments to IFRS 4 issued by the IASB in September 2016 and enabling insurance entities to defer application of IFRS 9 until 1 January 2021, the effective date of the new insurance standard - IFRS 17.

The European Commission has extended authorisation to defer application of IFRS 9 to insurance entities within a financial conglomerate (for example, bancassurers). However, this deferral is subject to restrictions regarding the transfer of financial instruments between insurance activities and other sectors within the conglomerate, and to requirements in terms of disclosures of financial information.

The European Parliament and Council have until 7 October 2017 to rule on the draft.

The European Commission's text may be consulted at the following address:

http://ec.europa.eu/transparency/regcomitology/index.cfm?do=search.documentdetail&Dos_ID=14524&DS_ID=51300&Version=2

ESMA publishes results of the peer review of the implementation of its guidelines on the supervision of financial information in seven countries

On 18 July 2017 the European Securities and Markets Authority (ESMA) published the results of a peer review conducted in seven European Union Member States to assess the level of the compliance of national competent authorities with its Guidelines on enforcement of financial information.

The report identifies that further improvements are needed in relation to:

- how issuers are selected to examine their financial information;
- the depth of inquiries submitted by national competent authorities to the controlled issuers; and
- the financial and human resources available to national competent authorities.

ESMA found that five of the reviewed jurisdictions do not fully comply with the guideline concerning the way in which issuers are chosen for scrutiny.

As a consequence of the review's findings, ESMA will make a number of recommendations both for ESMA itself and for national competent authorities to remedy the situation. The shape that these recommendations will take (amendments to the Guidelines or other work in this area) remains to be decided.

The findings of ESMA's review may be consulted at the following address:

<https://www.esma.europa.eu/press-news/esma-news/esma-recommends-improvements-in-financial-information-enforcement>

IFRS 16 endorsement submitted to the European Parliament and Council for approval

In July 2017 the European Commission submitted to the European Parliament and Council the draft text approved by the Accounting Regulatory Committee on 29 June 2017 endorsing IFRS 16, *Leases*.

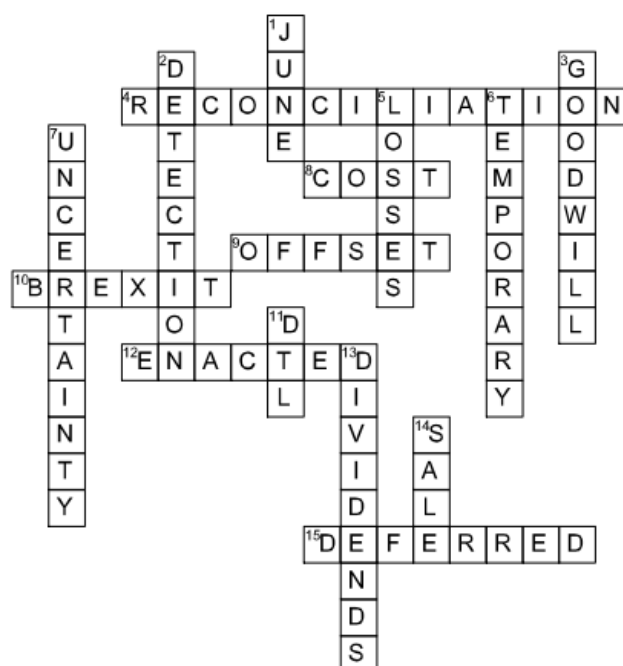
The European Parliament and Council have until 7 October 2017 to rule on the draft. In the statement of Accounting Regulatory Committee decisions, the European Commission notes that, in the absence of objections from co-legislators, IFRS 16 will be adopted in October this year. This will enable entities who wish to do so to anticipate application of the standard as from 2018, at the same time as IFRS 15 *Revenue from Contracts with Customers*.

The record of Accounting Regulatory Committee decisions is available at:

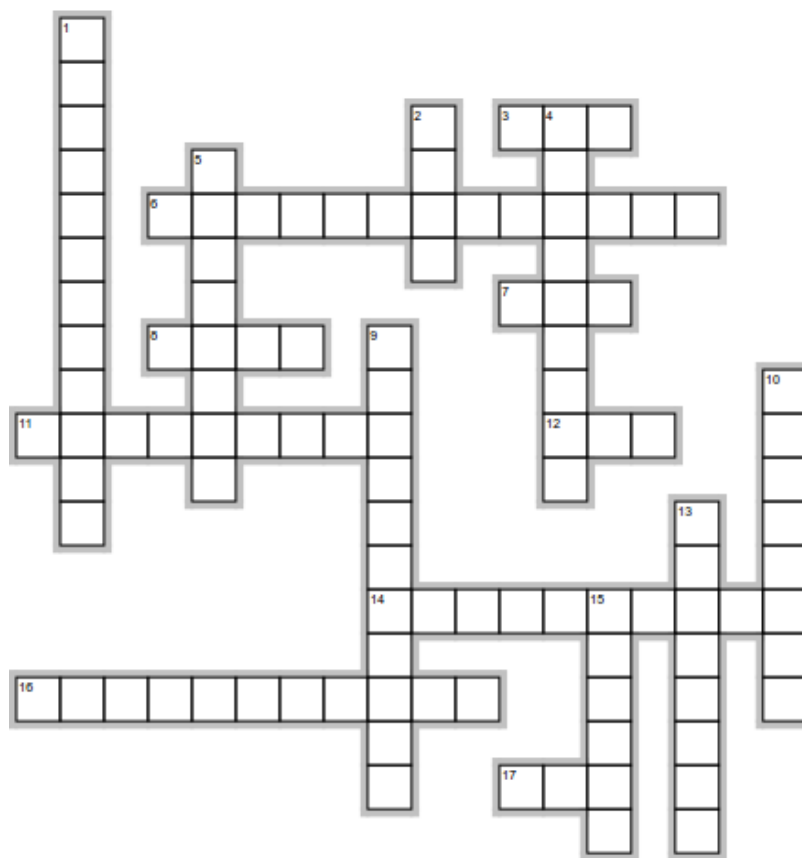
https://ec.europa.eu/info/files/170629-arc-decision_en

Crossword: last month's solution

Quick IFRS tax test



Crossword: To impair or not to impair, that is the question



Down

1. When an asset shows such a sign, it is time to conduct an impairment test and review its depreciation period
2. The rate commonly used in finance when estimating the discount rate used to calculate value in use (acronym)
4. Term used for assets that contribute to the cash flows of several CGUs
5. These values often represent a significant part of the value in use of an asset or CGU
9. IAS 36 requires these analyses if impairment tests of a CGU that include significant goodwill (or an intangible asset with an indefinite useful life) based on value in use reveal a reasonably possible scenario that could lead to impairment
10. They recommend investment strategies for listed securities and regularly publish research that can be valuable for assessing the consistency of the scenarios adopted by entities in their own impairment tests
13. An impairment loss related to it can never be reversed, according to IAS 36
15. Minimum frequency of impairment testing under IAS 36 for intangible assets that have an indefinite useful life (or which are not yet available for use) and goodwill

Across

3. Calculation method for measuring an asset's value in use (acronym)
6. The impact of such a plan on future cash flows must be excluded when determining the value in use of a CGU (or a group of CGUs), unless the entity is obliged (under IAS 37) to implement it at the end of the reporting period
7. The balance sheet asset introduced by IFRS 16 which falls under scope of IAS 36 for impairment (acronym)
8. Maximum number of years of cash flow forecasts used to measure an asset's value in use (beyond which an explanation is required by IAS 36)
11. Included in market rates, it must be considered consistently in cash flow forecasts when the discount rate has not been restated to reflect its impact
12. IAS 36 requires that the discount rate used to determine the value in use of a CGU excludes its impacts
14. At the end of each reporting period, they need to be assessed as they determine whether an impairment test is to be carried out
16. IAS 36 recommends excluding them from the net carrying value of a CGU calculated for impairment testing, except where its recoverable value cannot be determined without taking them into account
17. Balance sheet tax-related asset to which IAS 36 does not apply (acronym)

A Closer Look

IFRS 9: towards upheaval for the accounting treatment of modifications of financial liabilities

For several years now, entities have taken advantage of the low rate environment to renegotiate the contractual terms of their financial liabilities in order to optimise their costs and/or extend their maturity. Hitherto these entities have been able to benefit, under certain conditions, from an accounting treatment under IAS 39 enabling them to spread the impacts of these renegotiations over the lifetime of the new renegotiated liability. This practice may be overturned as a result of an IASB decision clarifying the IFRS 9 provisions on modifications of financial liabilities that do not result in derecognition. This may represent a significant change by comparison with previous practice.

1. Background

When an entity renegotiates, restructures or exchanges a financial liability, International Financial Reporting Standards call for an analysis of the transaction to establish whether it should be accounted for:

- as an extinguishment of the original financial liability and the issue of a new instrument; or
- as a modification of an existing financial liability.

In the great majority of cases, the transactions carried out in recent years have fallen into the second category: the modification of an existing liability.

This classification enabled entities to spread transaction costs and fees over the lifetime of the new liability. Likewise, the interest rate resulting from the renegotiation was applied from the renegotiation date. No impact was recognised in profit or loss at the restructuring date.

IFRS 9 has not amended the paragraphs applicable to these transactions by comparison with IAS 39. Most stakeholders, therefore, had not anticipated any changes in this area.

However, a paragraph on the modification of financial assets has been added to the new IFRS 9. This paragraph (IFRS 9 5.4.3) requires the recognition of an immediate impact in the income statement reflecting the difference between:

- the contractual cash flows expected before the modification (excluding credit losses) discounted at the original effective interest rate of the instrument; and
- the contractual cash flows expected after the modification (excluding credit losses) discounted at the original effective interest rate (before modification) of the instrument.

In practice, this paragraph fills a gap in IAS 39, which gave no guidance on the accounting treatment of the modification of an asset.

During 2016, the IFRS IC was asked to clarify whether, under IFRS 9, this treatment for modifications of financial assets ought also to be applied to financial liabilities.

2. Arguments in support of both approaches

Approach 1: recognition of an impact in profit or loss at the modification or renegotiation date

Supporters of this approach believe that, following the clarification in respect of modifications of financial assets, any change in expected future cash flows, including those due to a modification or exchange of a financial liability that does not result in derecognition, must lead to a recalculation of the amortised cost of the liability. The impact of this recalculation should then be recognised in profit or loss at the recalculation date.

This approach considers that the new paragraph on the modification of financial assets simply reflects the principle set out in paragraph B5.4.6, which clarifies the accounting treatment of a financial instrument measured at amortised cost when its estimated contractual flows are revised.

Approach 2: the impact on P&L is not recognised at the modification date but is spread over the residual term of the “new” liability

Supporters of this approach claim that:

- the changes to IFRS 9 are not such as to call into question the practice that was widespread under IAS 39 regarding the modification of financial liabilities;
- paragraph B5.4.6 of IFRS 9 only applies to cash flow revisions without modification of contractual terms;
- the change in the contractual cash flows of a liability that is not derecognised is reflected in future periods through the new effective interest rate (as is the case for the costs and fees incurred during the modification of a liability);
- this new treatment would in some cases lead to accounting which does not reflect the economic reality of the entity.

3. Before referring the matter to the IASB, the IFRS IC had inclined towards approach 1.

In its March 2017 tentative decision, the IFRS IC stated that paragraph B5.4.6 should apply to all revisions of estimated future cash flows, without differentiating the treatment of the revision of future cash flows estimates of an asset or liability (e.g.: a change in an entity's estimate of using a prepayment option) from that of modifications of contractual terms that do not result in derecognition.

The IFRS IC therefore initially opted for approach 1.

The Committee revisited this topic at its meeting in June 2017 to finalise its position in the light of the comment letters it had received. These had revealed:

- a number of disagreements with the IFRS IC's tentative decision in favour of approach 1; and/or
- the significance of the change of practice this position would entail, with IFRS 9 providing for no transitional arrangements in this area.

Although confirming the technical analysis of March 2017, in the light of the comments received, the Committee decided not to finalise the agenda decision and instead referred the matter to the Board.

In July 2017, the IASB considered the matter referred by the IFRS IC and decided neither to amend IFRS 9 nor to publish

an interpretation on the topic. The Board would simply confirm the IFRS IC's decision in the Bases for Conclusions in IFRS 9. This modification of the Bases for Conclusions would be introduced at the same time as the future amendment on the treatment of prepayment options in respect of the criteria for the classification of financial assets.

4. What are the expected impacts in practice?

It will be recalled that this change concerns the restructuring or renegotiation of financial liabilities that do not result in derecognition. The accounting treatment is therefore that of a modification of financial liability.

In the absence of any transitional arrangements, this new approach will be applied retrospectively. Entities will therefore have to analyse the existing financial liabilities on their balance sheet at the transition date, and retrospectively restate all the modifications they have undergone in the past.

The impacts may be significant for those entities that have taken advantage of rate falls in recent years to renegotiate their financial liabilities.

The table below summarises these two approaches to accounting for a modification or exchange that does not result in derecognition.

Approach currently applied under IAS 39 in most cases		IFRS IC approach	
Step 1	Measure the amortised cost before the modification / exchange	Measure the amortised cost before the modification / exchange	Step 1
		Measure the NPV (net present value) of the modified liability's future cash-flows by discounting them using the original effective interest rate (EIR)	Step 2
		Adjust the amortised cost to the NPV amount calculated in step 2, with a P&L impact (referred to as the modification gain/ loss)	Step 3
Step 2	Adjust the amortised cost for the costs or fees incurred to be amortised	Adjust the amortised cost for the costs or fees incurred to be amortised	Step 4
Step 3	Determine the new EIR that discounts the modified cash-flows to the amortised cost calculated in step 2	Determine the new EIR that discounts the modified cash-flows to the amortised cost calculated in step 4	Step 5
Step 4	Amortise the incurred costs and fees according the EIR method over the new residual life of the liability	Amortise the incurred costs and fees as well as the modification gain/loss according to the EIR method over the new residual life of the liability	Step 6

Worked example

The following worked example illustrates the impact of a modification of a financial liability on an entity's accounts depending on which of the two approaches is applied.

Transaction scenario

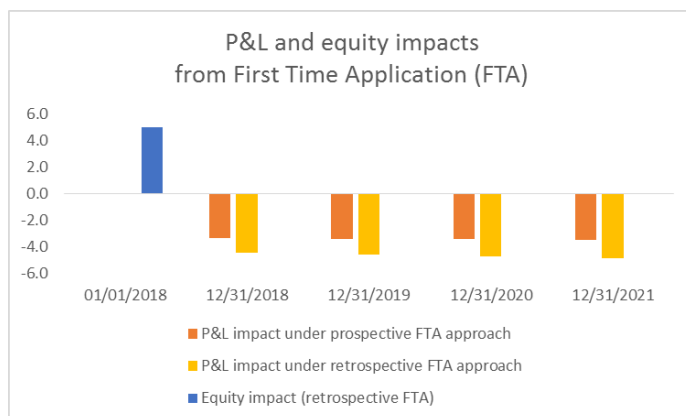
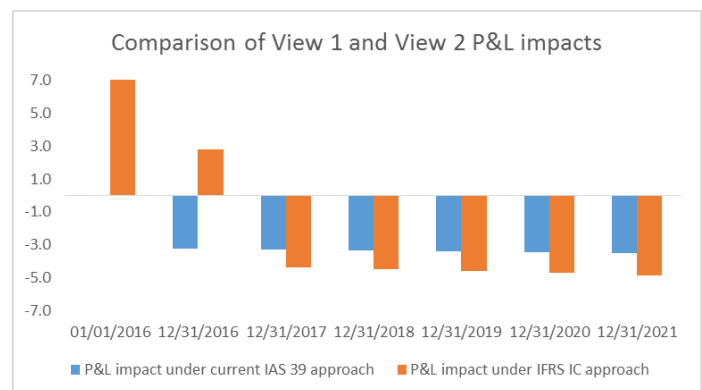
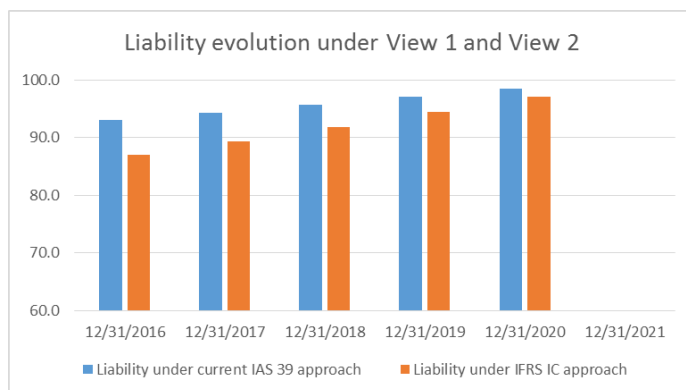
- On 1 January 2014 the entity issued a nominal liability of €100 m maturing at 31 December 2018. This liability carries a 5% coupon and no transaction costs were incurred in its issue.

- 1 Amortised cost before renegotiation
- 2 Amortised cost modified by change in contractual C
- 3 P&L impact due to renegotiation (1-2)
- 4 Transaction costs / fees
- 5 New amortised cost (2+4)
- 6 New effective interest rate

- The entity renegotiated this debt on 1 January 2016 to extend its maturity. The new debt carries a 2% coupon and reaches maturity in February 2021. Renegotiation fees amount to €8.2 m (which corresponds to the discounted value of the loss incurred by the lender over the residual initial term of the liability).

The tables and diagrams below summarise the differences between the two approaches:

Current IAS 39 Treatment	IFRS IC Approach
100.0	100.0
100.0	93.0
0.0	7.0
-8.2	-8.2
91.8	84.8
3.5%	5.0%



5. Next steps

The IASB should publish the amendment to the Bases for Conclusion in IFRS 9 by the end of 2017. However, any new developments in this area seem unlikely at present.

Affected entities therefore have just a few months to analyse and anticipate the impact of this new approach.

These impacts will probably call for changes in the financial communication of the entities concerned, as well as more education efforts from finance departments to present the effects of the approach recommended by the standard-setter.

This is because in some cases the interest expense recorded for accounting purposes will be sharply higher than under the previous approach, and in particular higher than is actually disbursed in cash.

Key points to remember:

- The new paragraph IFRS 9 B5.4.6 on modifications of financial assets calls for the recognition of an immediate impact in P&L reflecting the difference in net present value between the cash flows expected before and after modification.
- The IASB has confirmed the IFRS IC's view that this new paragraph must also apply to modifications of financial liabilities.
- Renegotiations of liabilities that do not result in the extinguishment of the original liability will in future have an impact in P&L at the renegotiation date, and it will no longer be possible to spread that impact over the residual term of the new liability.
- An amendment to the Bases for Conclusion in IFRS 9 is expected by the end of the 2017 to clarify this position.
- *A priori*, this accounting treatment will be retrospective, requiring entities to restate the past modifications of existing liabilities at the first application date.

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Events and FAQ

Frequently asked questions

IFRS

- Takeover and previously held equity;
- Determining the grant date of a share-based payment;
- Business combination and payment based on acquiree's shares;
- Derecognition effect of contracts assigning receivables.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IFRS		EFRAG	
IASB	Committee	Board	TEG
23-27 October	20-21 November	10 October	25-27 October
13-17 November	16 January	9 November	22-24 November
11-15 December	13-14 March	14 December	18-19 December

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