Beyond the GAAP

Some people are (still?) questioning the future of proportionate consolidation under IFRS. Would the IASB also aim at challenging the equity method? As of today, there is no official answer. However, the Board asked the staff to identify interactions between the consolidation project and IAS 28. The staff is specifically required to prepare an analysis of the concept of significant involvement being currently developed by the Board and significant influence.

Are these preliminary discussions before removing the equity method? To be continued....

Happy reading and have a great summer!

Michel Barbet-Massin     Jean-Louis Lebrun
**The IASB reviews its constitution**

On 21 July, the IASB Foundation, the IASCF, published the first stage of reforms to the international standard setter’s constitution. As Beyond the GAAP announced in April, the IASCF is proposing:

- The creation of a Monitoring Group which will be notably responsible for reviewing the strategy of the IASB and its efficiency. The proposed members of the Monitoring Group are:
  - The Chief Executive of the International Monetary Fund,
  - The Chairman of the Emerging Markets Committee of the IOSCO,
  - The Chairman of the Technical Committee of the IOSCO,
  - The Chairman of the Japanese Regulator (Japanese Financial Services Agency),
  - The Chairman of the SEC,
  - The Chairman of the World Bank,
  - The designated representative of the European Commission.

- An increase in the number of members of the IASB from 14 to 16. The draft modification also plans for an equal breakdown of members based on their geographic region of origin.

Comments on the proposal will be accepted until 20 September 2008.

**Guidelines for fair value recognition**

The debate on the opportunity to retain the reference to “fair value” in IFRS has highlighted the diverging views between Board members regarding, firstly, the scope of regulations under the US standard and, secondly, the direction to take regarding more general assessment under IFRS.

**Consolidation**

The Board is planning to define the “significant involvement” of one entity in another in the exposure draft for the future standard governing consolidation. It will involve significant economic interaction without control. The idea arose from the discussion to remove the notion of “associate” which no longer seems necessary... and the corresponding accounting treatment, i.e. the equity method.

**Leases**

The Board continued its discussions regarding its project on leases. At its meeting in July 2008, the IASB voted to abandon the lessee’s requirement to distinguish between operating and finance leases. All contracts shall be recognised according to the finance lease model. The accounting treatment for this type of contract as it currently appears in IAS 17 will be revised, but will not be subject to major change.

**Revenue recognition**

As part of the discussions regarding the drafting of the Discussion Paper, the majority of the IASB members voted to assess revenue according to the customer consideration model. This decision was made in June and the Board has already decided to abandon the idea of a single model for all activities. The question now is what should be excluded from the scope of application of the future standard: Insurance? Financial instruments? Leases? Guarantees and maintenance? Long-term contracts? The challenge for the Board is not to call into question what it considers to be progress (discussions on insurance contracts for example) and to avoid overlappings and contradictions between the future standard governing revenue recognition and the revised IAS 37 (Provisions).
REACH – what accounting treatment should be used for expenses incurred by conforming to standards?

The implementation of the European regulation REACH (Registration, Evaluation, Authorisation of Chemicals) generated expenses for many entities which were incurred by necessary changes in order to conform to the regulation. Practice revealed many different accounting treatments for these costs.

The REACH regulation, which came into effect on 1 June 2007, involves the registration of chemical substances produced or imported in quantities of one ton or more per year per company. All substances concerned shall be subject to a registration request made to the European Chemicals Agency (ECA) in Helsinki, Finland. If substances are not registered, they may not be produced or imported in the European Union. This regulation applies to all existing and created chemical substances.

There are two types of costs incurred by REACH:
- direct costs linked to the drafting of a registration file including the tax to be paid to the ECA and the cost of testing;
- indirect costs which correspond to R&D expenses in order to replace certain hazardous substances by other substances.

At its meeting in July 2008, the IFRIC stated that similar regulations existed outside Europe. The IFRIC therefore requested that these practices be analysed to determine an accounting treatment based on general principles and not specific regulations.

Publication of the amendment to IAS 39 on eligible hedged items

On 31 July 2008, the IASB published Eligible Hedge Items, an amendment to IAS 39.

Many respondents had raised concerns about the rule-based approach proposed by the Board in the exposure draft rather than the application of principles. In particular, their responses indicated that there was little diversity in practice regarding the types of risk which could be designated as hedged items.

Finally, the IASB abandoned the approach proposed in the exposure-draft. The published amendment gives additional guidance on the designation of:
- A one-sided risk (i.e. taking into account the time value of options in hedging relationship);
- Inflation in a financial hedged item.

IAS 39 permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. It is a possibility and not an obligation in terms of the current IAS 39. The IFRIC received submissions requesting guidance on whether the time value could be included in the hedged portion. The IFRIC concluded that the requirements of IAS 39 were unclear and transmitted the submission to the Board.

The amendment published at the end of July stipulates that the time value may not be included in a hedging relationship. There is no doubt that this position will provoke a major reaction as the exposure draft indirectly covered this essential point in a particularly abstruse paragraph.

Moreover, our comment letter drew the Board’s attention to the challenges of this topic and the need for a real debate on this point. Once again, the comments went unheeded.

The IASB confirmed that inflation may be designated as the hedged risk if it is a separately identifiable component of the contract.

In practice, this means that:
- The impact of inflation on a fixed-rate instrument may not be designated as a hedged risk. The Board does not deny that inflation has an impact on the instrument but this impact cannot be measured separately.
- However, the impact of inflation on an instrument with a return of 3% plus inflation plus 25bp for example may be designated as a hedged risk. In the above example, inflation is contractually tied to the instrument. Its impact can be clearly identified.

This amendment is applicable to financial years beginning on or after 1 July 2009. Early application is permitted.
In the IASB calendar, 2008 is the year of major reflection on financial instruments. No less than three discussion papers will have been published by the standard setter on reporting financial instruments. Invitations to comment on two of them, also presented for discussion by the FASB, will be open until 19 September:

- Financial instruments with characteristics of equity;
- Reducing complexity in reporting financial instruments.

A third document on derecognition should be published before the end of 2008.

Beyond the GAAP covers the main characteristics of each of these documents and the challenges for the preparers of financial statements.

**Financial instruments with characteristics of equity**

Published in February 2008, this discussion paper is part of the convergence process between IFRS and US GAAP. This topic is a major source of divergence and restatement between the two sets of accounting standards. Regulations are complex and often formal in each of the sets of accounting standards. We should remind ourselves that economic compulsion (i.e. beyond simply legal compulsion) is not recognised under IFRS as a criterion which enables debt and equity instruments to be distinguished.

This project is led by the FASB which proposed three possible approaches at the end of 2007:

- The basic ownership approach
- The ownership settlement approach
- The reassessed outcome approach

These approaches were taken over by the IASB which put the FASB’s proposals in perspective with the current version of IAS 32.

As part of its PAAInE (Proactive Accounting Activities in Europe) programme, the EFRAG published a fourth possible approach: the loss absorption approach.

The project’s general philosophy is based on:

- Seeking convergence between US GAAP and IFRS
- A desire to simplify the distinction between debt and shareholders’ equity
- The desire to positively define shareholders’ equity: instruments which are not equity are debts
The Basic Ownership Approach

This approach defines equity as instruments subordinate to all other claims which give the holder a claim to a share of the net residual assets in the event of liquidation. The fact that they are redeemable on the holder’s initiative does not influence their classification.

Under the basic ownership approach, only basic ownership instruments would be classified as equity. Equity derivatives and perpetual instruments would be classified as debts. This approach has the obvious advantage of simplifying the presentation of equity and the debt/equity analysis. Split accounting would be considerably reduced.

In contrast, this approach significantly increases the number of debt instruments and makes their accounting more complex. The analysis must be reviewed in the event of an issue or redemption of subordinate instruments. It should also be noted that this approach is likely to increase the volatility of earnings as equity derivatives are classified as debts.

The Ownership settlement Approach

This approach is, without doubt, the closest to the current version of IAS 32, following the recent amendments. It defines equity as equity instruments under the basic ownership approach and adds:

- perpetual instruments;
- and certain equity derivatives whose value changes in the same way as equity.

The Reassessed Outcome Approach

According to this approach, equity is made up of redeemable or non-redeemable basic ownership instruments and equity derivatives. Split accounting must be carried out for all instruments based on the probability of cash inflows or outflows. Moreover, all redeemable equity instruments or derivatives are revalued by profit or loss.

The FASB favours the Basic Ownership Approach, mainly due to its simplicity which contrasts with the essentially rule-based approach currently used in this area under US GAAP.

When the new joint work plan for the IASB and FASB was defined, this research project was defined as low priority. It will not be completed before 2011, which is when the mandates of the current IASB members will expire.

Reducing complexity of reporting financial instruments

Here is a project title that should bring joy to preparers, auditors and users of financial statements. Before identifying the possible means of simplification, the IASB defined the regulations and parameters which should govern the simplification process. The standard-setter has now identified certain regulations which are deemed to be non-negotiable:

- A proposal for simplification should not end up with a reduction in the use of fair value compared to what is stipulated by existing standards;
- The proposed changes shall ideally improve the relevance and comprehension of financial information.
The approach adopted by the IASB is based around three stages:

- The IASB considers that a major part of the complexity surrounding the recognition of financial instruments resides in the large amount of possible recognition and assessment methods (fair value vs. amortised cost, five categories of financial assets, etc.). As an avenue for discussion, the IASB therefore proposes to reduce the number of categories.

- In the long term, the IASB plans to recognise and assess all financial instruments using just one method. The international standard-setter explains in this context why using fair value is the best possible method.

- In the medium term, the use of fair value for all financial instruments poses problems which cannot be resolved quickly. The IASB proposes several possible developments with a view to a short- or medium-term solution: maintaining mixed methods (fair value and cost), broaden the fair value option, develop hedging regulations, etc.

The detailed study of the proposals to simplify procedures in the short or medium term reveals that the approaches envisaged by the standard setter are relatively far away from the practical difficulties encountered by the preparers of financial statements and auditors. As an example:

- The IASB plans to remove the assets held to maturity category. In practice, this category is not used by industrial and commercial groups. Among banks and insurance companies, only a few groups have chosen to use this highly restrictive category. It would seem that removing this category would not simplify procedures. It is most likely that comments submitted will request a relaxation of the restrictions in order to make this category more useable, rather than its removal.

- Another approach envisaged by the Board consists in removing the AFS category and imposing recognition at fair value through profit or loss. The apparent simplification provided by this measure would be the opposite of the intention given by management upon initial classification. A measure of simplification could, on the other hand, be found in the regulations for recognising impairment, notably the possibility of allowing certain reversals of impairment.

- In terms of hedging, the approaches proposed by the IASB include the removal of fair value hedging and a broadening of the fair value option. These approaches seem not to be the type that will resolve the difficulties encountered by the banks (dynamic and macro hedging) and insurance companies (mismatch between assets and liabilities). Nor will these measures alleviate recognition for industrial or commercial companies. They need development in the hedging of non-financial assets or foreign exchange risk hedging. It is certain that the comments will highlight the incomprehensible impact on profit or loss of recognising changes of fair value of the interest part of a forex forward hedging a classic trade receivable.

The IASB’s analysis is based on a premise that will be widely discussed: the complexity arises from the multiple categories of financial assets. In the document published by the standard setter, the issue is not questioning the importance of anti-abuse measures, not taking into account management intentions or whether the standard is adequate for the reality of financial instrument management by companies, banks or insurance companies.

Lastly, the long-term solution proposed is based on the generalisation of the principle of fair value. We should remind ourselves that the demonstration of the relevance of the full fair value model compared to a mixed historical cost – fair value system has not yet been produced...
Derecognition and securitisation

This is the subject of the third research document which was initially expected to be published during the second half of 2008. This subject was recently added to the IASB’s active agenda. The new work schedule has not yet been published.

Work currently seems to be based around a very legal analysis of disposals of financial instruments. Conditions for derecognition are essentially based on a study of the entity’s contractual rights. In the event that the conditions for derecognition are not met, principles could stipulate a linked presentation between non-derecognised assets and liabilities which are constituted due to the obligation to reallocate the economic benefits withdrawn from assets. As such, any pass through agreement would give rise to the presentation of an asset and a liability. There is no need to remind you that this problem is critical for derecognition (factoring, etc.) and securitisation transactions.

These are only preliminary indications for which confirmation will be requested when the discussion paper is published. This subject should be debated at the joint IASB / FASB meeting in October 2008.
Reforms at the EFRAG: Europe at the heart of the debate on international standards?

Over 2007, the members of European Parliament called on the European Commission to federate European expertise and resources in order to strengthen Europe’s influence in the debate on international accounting standards. At a time when the adoption of IFRS is envisaged (or even decided) in other major financial markets (United States, Canada, Japan), it is essential that Europe be in a position to exercise a real influence in this debate. After almost one year of discussions involving all stakeholders, the EFRAG, European Commission, National Standard Setters and National Funding Mechanisms, the parties came to an agreement on 17 June. They agreed to strengthen the EFRAG and enable it to achieve its even more ambitious objectives in terms of pro-active discussion, public responsibility and transparency in its operations.

We should remind ourselves that, since its creation in 2001, the EFRAG has remained a private body, run by private organisations that contributed to its creation. These organisations mainly represent issuers, auditors, financial analysts and investors. In 2006, the European Commission had recognised the EFRAG as the technical consultant it would use and continue to rely upon in the process of adopting international standards in Europe.

Stronger governance

The reform proposed this year, with an invitation to comment ongoing until 22 September and implementation planned for the first half of 2009, includes some basic reforms, principally in terms of governance.

- The EFRAG General Assembly (GA) will continue to consist of only representatives of the European organisations that founded EFRAG or that will join EFRAG. The GA will retain its roles of approving EFRAG’s activity report and accounts, budget and policies. It will continue to appoint the members of the Supervisory Board (SB), based on the recommendations provided by the Nominating Committee.

- The GA will establish a Governance and Nominating Committee to make recommendations to the GA on the appointment of SB members. Two-thirds of the members of the Committee will be appointed from among GA members and one third from among the National Funding Mechanisms;

- The members of the Supervisory Board will take part in the GA, not as representatives of a group of interests but under their own name. They will be duly selected based on their own abilities from a public request for applications. The 17 members will include four members representing the public interest and whose appointment will have been proposed by the European Commission to the GA Nominating Committee. The other 13 members will have diverse professional origins: five from industry, commerce and financial institutions, one from an SME, three accountants, four users (investors or analysts, two of which will have investment experience in financial institutions). The European Commission will retain its role as an observer on the Board. All Supervisory Board meetings will henceforth be public.

The detailed and formalised role of the national standard setter

The second part of this reform aims to better formalise the involvement and coordination of national standard setter within the EFRAG, as part of the EFRAG’s pro-active discussion activities, known as “PAAinE”, “Pro-Active Activities in Europe” for the last two or three years.

For this purpose, the Planning and Resource Committee (PRC), whose meeting will also be public, was created. This
committee will be chaired by the Vice Chairman of the Supervisory Board. It will have nine members in total, appointed by the Supervisory Board after a public request for candidates, of which four national standard setters normally represented by their Chairmen (these national standard setters will be selected for their aptitude and their desire to commit resources to the EFRAG’s pro-active work and should, at least initially, include the German, British and French national standard setters, as well as a fourth country to be determined), two members of the Supervisory board, two qualified personnel, who may have other professional backgrounds or alternatively could be members of the Supervisory Board, and the Technical Expert Group (TEG) Chair.

The PRC will be responsible for commenting on the IASB agenda, approving the launch of upstream technical studies and monitoring their progress, recommending the appointment of technical personnel to different upstream projects (whether these personnel are from the EFRAG or from national standard setters) and, more generally, will have to identify the main challenges for international accounting standardisation in Europe. Identifying these challenges may be done through practical studies or consultation by the Consultative Group which the PRC will be responsible for coordinating, and which will replace the present Advisory Forum. The standpoint of this Advisory Forum will be more strategic than technical. Members of the group might be drawn from CFOs of major European commercial, industrial and financial services enterprises, and high level representatives from the accountancy profession, users and the academic world.

The TEG’s powers are confirmed

The TEG, Technical Expert Group, remains unchanged, both in terms of its powers, its method of nomination and composition. In particular, all technical contributions submitted under the EFRAG name (discussion papers, comments letters, adoption recommendations, effect studies, etc.) must have been analysed and approved by the TEG before publication. All these technical contributions will remain subject to the public consultation process which has been in effect since the EFRAG was founded.

Adapted resources

Lastly, this wide reaching reform would not be efficient without a significant increase in the resources allocated to the EFRAG. Future financing for the EFRAG should come from three distinct sources:

- contributions from EFRAG members;
- financing collected from the National Funding Mechanisms, some of which already exist (France, UK, Germany) or being created (Netherlands, Italy), and which the European Commission will encourage all member countries to set up;
- and lastly, from the European Commission, with the provison that its contribution will be capped at 50% of the EFRAG’s total financing.

These new resources should enable the EFRAG to have available all the necessary technical resources to successfully carry out all of its activities and, more specifically, develop the technical contributions upstream of IASB projects. All stakeholders (the European Commission and Parliament included) believe that these upstream contributions are the only really efficient way to proceed in a world which is progressively adopting IFRS.

1 National bodies responsible for collecting funds for the IASB and/or the EFRAG which were recently established or in the process of being established.
Seminars on “Current developments in IFRS” and “Preparing financial statements”

Mazars’ Technical Department will host a number of seminars throughout 2008 dedicated to current developments in IFRS. These seminars, organised in Paris, France, will be held on 26 September and 19 December 2008.

A two-day seminar dedicated to the preparation of accounts will also be held at the end of 2008 in Paris, France.

Registration forms can be obtained from Francis Lefèbvre Formation, 13-15 rue Viète, 75017 Paris, France.

Frequently asked questions

- Derecognition of tax credit receivables
- Should a break of a covenant result in the financial liability reclassified as a short-term liability?
- Are excise duties paid to the state on the sale of alcohol and rebilled to end-users included in revenue?
- Classification of the gain on disposal of an investment in an associate in the profit and loss statement?
- Hedging of foreign exchange risk of a highly probable future transaction according to the forward exchange rate method.
- Constitution of a provision for moving premises in the case of a business combination.

Upcoming meetings of the IASB, IFRIC and EFRAG

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