In October, the IASB continued its work, often conjointly with the FASB, on a wide range of subjects, giving pride of place to the revision of IAS 39 and issuing additions to IFRS 9 for financial liability accounting. Each new step in this process appears to widen the gap with US GAAP: whereas IFRS 9 does not challenge the IAS 39 model for measuring financial liabilities (by default, at amortised cost), the FASB is leaning at present towards an extension of financial liabilities measured at fair value. This particular project raises the real possibility that world-wide accounting convergence fail to materialise, unless the FASB decides to backpedal...

Enjoy your reading!

Michel Barbet-Massin

Jean-Louis Lebrun

New chairman at the IASB from June 2011.

On 12 October, the Trustees of the IFRS Foundation (formerly IASCF), the oversight body of the IASB, announced the appointment of Hans Hoogervorst as chairman and Ian Mackintosh as vice-chairman of the IASB.

Mr Hoogervorst will succeed Sir David Tweedie on his retirement as chairman of the IASB at the end of June 2011, when Sir David will have spent ten years at the head of the IASB.

Mr Hoogervorst is currently chairman of the AFM, the Dutch securities and market regulator, chairman of the Technical Committee of the International Organization of Securities Commissions (IOSCO) and co-chair of the Financial Crisis Advisory Group (FCAG), established in October 2008 by the IASB and the FASB.

Mr Mackintosh is currently chairman of the UK Accounting Standards Board and chairman of the group of national accounting standard-setters, a body in which more than 20 national and regional accounting standard-setting organisations participate.
The IASB updates its work plan

On 12 October the IASB updated its work plan to take into account the redeliberations of current projects that have taken place since June. However, given the decisions taken in the following days, in particular on the Financial Statement Presentation project and the debt/equity distinction project (see IFRS News in this edition), this new work plan is no longer up-to-date!

The major changes to the IASB work plan include:

- the addition of two consultations: one on the mandatory application dates for the new standards (see Highlights in this edition), the other on the IASB’s work plan for the forthcoming three-year period (document to be published by the end of 2010);
- a new exposure draft to be published after June 2011 on the revision of IAS 37 (see Beyond the GAAP, September 2010).

The June 2011 deadline has been confirmed by the IASB and should result in the publication of definitive standards on revenue recognition and lease accounting. IFRS 9 on financial instruments should also be finalised at this date.

Finally, the future standard on joint arrangements (replacing IAS 31) should be published by the end of the year, at the same time as the publication of final standards on consolidation (the replacement of IAS 27 and a specific IFRS on disclosures).

Defined benefit plans: the IASB confirms the main proposals of the exposure draft

After considering the comments received, the IASB confirmed in October 2010 the main proposals of the exposure draft on the amendment of IAS 19 regarding defined benefit plans (see Beyond the GAAP, May 2010):

- elimination of the corridor approach and immediate recognition of actuarial gains and losses. Nevertheless, the Board has still to decide whether the remeasurement of the obligation should be presented in profit or loss or in other comprehensive income (OCI);

- the immediate recognition in profit or loss of unvested past service costs resulting from a change in the plan;
- measurement of the expected returns on plan assets using the discount rate of the obligation, which means calculating the financial cost of the net obligation;
- disaggregation of the changes in the obligation and in the value of plan assets into three components in the statement of comprehensive income.

Debt/equity distinction: the IASB decides to defer the project

At a joint meeting with the FASB in October 2010, the Board decided to defer its project to improve IAS 32 on the distinction between debt instruments and equity instruments.

The discussion paper issued in February 2008 included US proposals. Since that, the debate has gradually evolved into a discussion of how to make limited amendments to IAS 32 to resolve practical difficulties in application. The last point that was supposed to be addressed under the project was the issue of puts on non-controlling interests (see Beyond the GAAP, September 2010). An exposure draft was expected in early 2011.

The IASB now considers that this is not a major project and that priority should be given to those projects that will lead to significant progress on convergence with US GAAP by June 2011.

The IASB thus recognises that it has insufficient resources to complete this project successfully within the original time frame. Work on the debt/equity distinction should resume after June 2011.

A new delay for the project on Financial Statement Presentation

In October 2010 the IASB and the FASB also considered the outreach activities conducted in respect of the Financial Statement Presentation project following the publication last July of a staff draft setting out the
Consultation on the effective dates of new standards

On 19 October, the IASB and the FASB launched a consultation, Request for Views on Effective Dates and Transition Methods, on the timetable for the application of the new standards or amendments to standards, most of which are anticipated for 2011:

- Fair value measurement;
- Financial instruments;
- Revenue from contracts with customers;
- Insurance contracts;
- Leases;
- Post-employment benefits - Defined benefit plans;
- Presentation of items of other comprehensive income.

The results of this consultation should enable the IASB to draw up an implementation plan for those new IFRSs that helps interested parties (existing users and future adopters) to manage the pace and cost of change.

The consultation period is open until 31 January 2011.

The document is available via the following link: http://www.ifrs.org/NR/rdonlyres/00843740-4E15-40A8-A7EF-8B634F904B46/0/RequestViewsNFDOct10.pdf

Presentation of OCI in a single statement: are IASB and FASB having second thoughts?

At their monthly joint meeting in October 2010, the IASB and the FASB analysed the responses received to their invitation to comment on the presentation of other comprehensive income (OCI). It should be noted that, had the Boards’ proposals been accepted, net income and other comprehensive income would be presented in a single statement of comprehensive income.

The option to present two separate statements that is currently proposed in IAS 1 as revised would therefore be eliminated.

In the light of the criticisms of respondents, the IASB and the FASB have decided to postpone any decision to a future joint meeting. Therefore, it seems to be possible that the two Boards will give up the idea to require the presentation of a single statement of performance.

IFRS 9 supplemented with provisions on financial liabilities

On 28 October 2010, the IASB published a new version of IFRS 9. This text now includes provisions for the classification and measurement of financial liabilities. These are broadly the same as those in IAS 39.

However, it should be noted that there are new provisions regarding the accounting for the entity’s own credit risk related to the fair value option for financial liabilities. Therefore, an entity that opted to measure a liability at fair market value (FVMO) has to consider the impact of its own credit risk on the fair value of its financial liabilities.

Several reasons have led the two Boards to reconsider the timetable set out in their work plan:

- the efforts preparers will have to make in the next few months due to the revision of major standards (IAS 18, IAS 17, IAS 39, etc...) will be considerable. It is not desirable to increase their burden by adding a project designed to dramatically change the presentation of financial statements;
- many criticisms have been expressed about this project, in particular that there has been no conceptual analysis to define what performance is;
- costs to implement changes in information systems to meet the new requirements for the presentation of financial information would be very high.

In these circumstances, the publication of an exposure draft, initially scheduled in early 2011, has been postponed. The two Boards wish to benefit from their discussions with stakeholders before amending their proposals. Work will therefore resume on the project after June 2011.
value will present the portion of the change in fair value related to the changes in the entity’s own credit risk in other comprehensive income, with no subsequent recycling in profit or loss (even in the event of disposal or repayment).

This new version of IFRS 9 is applicable to annual periods starting as of 1 January 2013. Early application of the new provisions for financial liabilities is permitted, provided that the requirements of IFRS 9 on financial assets published in November 2009 are also applied. In Europe, the application of the new version requires the endorsement of IFRS 9 by the European Commission. This has not been reached yet.

**Disclosures for transfers of financial assets**

On 7 October 2010, the IASB published amendments to IFRS 7 entitled “Disclosures – Transfers of Financial Assets”.

These amendments resulted from the exposure draft entitled “Derecognition” published by the IASB on 31 March 2009 (See Beyond the GAAP, March 2009) that proposed in its initial version:

- to amend IFRS 7 in respect of financial information on the transfer of financial assets;
- to amend IFRS 39 in respect of derecognition provisions.

It should be noted that in June 2010, due to the criticisms expressed by stakeholders, the IASB finally gave up its plan to amend the IAS 39 derecognition model. Therefore, the existing derecognition requirements in IAS 39 will be identically carried over in IFRS 9.

The published amendment will allow users of financial statements to:

- improve their understanding of transfer transactions of financial assets (for example, securitisations);
- evaluate the possible effects of any risks that may remain with the entity that transferred the asset (“continuing involvement”).

Furthermore, additional disclosures are required if a disproportionate amount of transfer transactions leading to the derecognition of financial assets with continuing involvement are undertaken around the end of a reporting period.

These amendments are applicable to annual periods starting from 1 July 2011. Early application is authorised. At the time of first application, entities will not be asked to disclose comparative information.

**Hedge accounting: imminent publication of an exposure draft**

The Board met three times during October 2010 to continue its work on hedge accounting.

The main tentative decisions taken by the Board during the month, and which may introduce significant changes to current practice, are:

- it will no longer be possible to designate a derivative embedded in a financial asset as a hedging instrument. The Board has thus taken note of the decision to remove the bifurcation requirements for financial assets made during phase 1 of the project to revise IAS 39 (classification and measurement of financial assets).
- the Board proposed to remove the entity’s ability to de-designate a hedge relationship when all criteria qualifying for hedge accounting continue to be met. The Board considers that it is not consistent to allow the de-designation, at the entity’s choice, of a hedging relationship from an accounting perspective, while the eligibility criteria continue to be fulfilled and the hedging is still a part of the entity’s risk management policy.
- in contrast to the current situation under IAS 39, it would be possible, under certain conditions, to document hedging relationships on a net basis in fair value and cash flow hedging.
- The Board plans to propose a new approach allowing to neutralise volatility in profit or loss arising from changes in the “time value” component of options documented in hedging relationships.

Finally, the Board has decided to publish an exposure draft in the very near future on the general model for hedge accounting, with a comments period limited to 90 days.

During the exposure draft period, the Board will continue
On 25 July, the CESR (Committee of European Securities Regulators) published the 9th extract from its Database of Enforcement. The CESR has thus publicised 9 decisions taken by European regulators, on the following topics:

- classification of financial liabilities;
- financial instruments - hedge accounting
- revenue recognition;
- intangible assets;
- impairment of non-financial assets;
- consolidation;
- share-based payment;
- financial instruments - disclosure;
- impairment of non-financial assets disclosure.

This 9th extract from the CESR Database of Enforcement is available via the following link: [http://www.cesr.eu.org/popup2.php?id=7293](http://www.cesr.eu.org/popup2.php?id=7293)

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In the previous edition of Beyond the GAAP we presented the general principles of the exposure draft on leases, and provided an update on the single model of lease accounting for lessees. It should be noted that under this single model, the lessee recognises a right of use (of the leased asset) and a debt (the obligation to pay rentals).

In principle, the IASB’s work on lessor accounting should have led to an accounting treatment that reflects that applied by the lessee, i.e. that the lessor would dispose of a right of use from inception. No such thing.

The IASB finally developed a hybrid approach based on the economic characteristics of the lease. Thus the lessor will apply either a ‘performance obligation’ approach, or a ‘derecognition’ approach.

In this issue of Beyond the GAAP, we address the exposure draft’s main proposals for lessor accounting (for the scope, see the first part of the special study published in the September edition).

A hybrid approach

As explained above, the approach to the recognition of leases in the lessor’s financial statements differs from the approach applied by the lessee. The IASB proposes a hybrid approach for lessor accounting, rather than a single approach, based on the economic characteristics of the lease and more particularly an analysis of the exposure to the significant risks or benefits associated with the underlying asset.

That analysis determines the accounting treatment of a lease by the lessor, in accordance with one of the two approaches set out in the exposure draft:

- either the ‘performance obligation’ approach;
- or the ‘derecognition’ approach.

Does lessor retain exposure to significant risks or benefits?

<table>
<thead>
<tr>
<th>NO</th>
<th>YES</th>
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<tbody>
<tr>
<td>DERECOGNITION APPROACH</td>
<td>PERFORMANCE OBLIGATION APPROACH</td>
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A Closer Look

Exposure draft on leases: part two
**Performance obligation approach**

Under this approach, the lessor who retains exposure to significant risks or benefits associated with the underlying asset continues to account for the leased asset in its statement of financial position. It therefore recognises in the statement of financial position:

- the underlying asset (i.e. the leased asset);
- a customer receivable representing its right to receive payments (the rentals);
- A lease liability, representing the lessor’s “performance obligation”, i.e. the obligation to grant the lessee the right to use of the underlying asset throughout the term of the lease.

Income is recognised as the performance obligation is satisfied.

**Initial measurement**

At inception, the right to receive lease payments (i.e. the receivable) is measured at the present value of the lease payments, using the rate charged by the lessor to the lessee as the discount rate.

The present value of the lease payments is determined over the longest possible term of the lease that is more likely than not to occur. This term is estimated taking into account:

- Renewal and early termination options;
- Business factors, such as the lessee’s need to lease the asset to conduct its business;
- The lessee’s intention and past practice.

The present value of the lease payments should also take into account of:

- an estimate of contingent rentals and residual value guarantees if they can be measured reliably, and
- an estimate of termination penalties,
- while applying the probability-weighted average of the cash flows for a reasonable number of outcomes.

For the same reasons as those mentioned when describing the accounting model for lessees, the exercise price of a purchase option is not taken into account in determining the lessor’s receivable.

Finally, the lease liability (the performance obligation) is measured at inception at the amount of the receivable less any direct initial costs (e.g. commissions and fees) attributable to the negotiation and conclusion of the lease.

**Subsequent recognition and measurement**

- **The receivable**

  Throughout the lease, the receivable is measured at amortised cost using the effective interest rate method. The discount rate applied at inception is not revised, even if the estimated term of the contract is changed.

  As the receivable carries interest, the payments received during the lease must be allocated between amortisation of the receivable and financial income. Where appropriate, the receivable will be depreciated in accordance with IAS 39 (standard on financial instruments).

  The exposure draft also states that if the “facts and circumstances” suggest that the value of the receivable has changed significantly, the lessor must reassess:
The length of the lease term;
- The amount of contingent rentals, and the amounts that it would expect to receive as residual value guarantees and termination penalties.

Any change in the receivable due to a change in the lease term is reflected in the lease liability, i.e. the performance obligation (the change would therefore have no impact on profit or loss).

Any change in the receivable due to a change in contingent rentals, residual value guarantees or termination penalties would affect:
- the performance obligation, for re-estimates relating to future periods;
- profit or loss, for re-estimates relating to current and past periods.

### The underlying asset

The underlying asset is recognised in accordance with IAS 16, standard related to property, plant and equipment. Like any tangible asset it is amortised over its useful life. Finally, if appropriate, it will be impaired in accordance to IAS 36.

### The lease liability (performance obligation)

Throughout the lease, the lease liability will be adjusted as lease income is recognised:
- reflecting the pattern of use of the underlying asset by the lessee, or
- using the straight-line method if the pattern of use by the lessee cannot be determined.

### Presentation in the financial statements (IAS 1 and IAS 7)

The exposure draft set out the following proposals for the presentation of lease contracts in the lessor’s statement of financial position when the performance obligation approach is applied:
- a net lease asset or a net lease liability would be presented in the statement of financial position as a separate line item;

The amount presented would thus be the net of the receivable, the underlying asset and the performance obligation.

- Interest income, lease income and amortisation expense would be presented separately in profit or loss from other interest income, other revenues and other amortisation expenses;
- cash flows from rentals received would be presented within ‘operating activities’ in the cash flow statement, either separately from other cash flows from operating activities or separately from the changes in other operating receivables, depending on which method is used (the direct or indirect method).

### Derecognition approach

As said earlier, the lessor would apply the derecognition approach if it transfers to the lessee significant risks or benefits associated with the underlying leased asset. Following this analysis, the lessor has in substance ‘sold’ a portion of the asset to the lessee.

Consequently, at the date on which the asset is made available to the lessee, the lessor would:
- recognise a receivable corresponding to its right to receive rentals over the term of the lease, and immediately recognise revenue corresponding to the right-of-use transferred to the lessee (i.e. the income from the ‘sale’ of
Initial measurement

At the date of inception of the lease, under the derecognition approach, the lessor would have to determine the amount derecognised, the residual asset, and the receivable.

The exposure draft states that:

- the portion of the asset to be derecognised is determined as follows:

\[
\text{Carrying amount of the underlying asset} \times \frac{\text{fair value of the right to receive payments}}{\text{Fair value of the underlying asset}} = \text{the receivable at inception}
\]

- the residual asset is initially measured at the difference between the carrying value of the leased asset and the derecognised portion:

\[
\text{Residual asset} = \text{carrying amount of the underlying asset} - \text{derecognised portion of the asset}
\]

- the receivable is measured at the present value of lease payments with the same method as that used in the ‘performance obligation’ approach:
  - the discount rate is the rate charged to the lessee by the lessor;
  - the receivable is estimated over the longest possible lease term that is more likely than not to occur;
  - the receivable includes contingent rentals and residual value guarantees if they can be measured reliably;
  - the receivable also takes into account an estimate of termination penalties;
  - purchase options are not considered when measuring the receivable;
  - finally, initial direct costs incurred by the lessor are deducted from the amount of the receivable.

Subsequent recognition and measurement

- **The receivable**

Subsequent measurement is similar to the approach used in the performance obligation approach:

- the receivable is measured at amortised cost using the effective interest rate method;
- The discount rate applied at inception is not revised, even if the estimated term of the contract is changed;
- As the receivable carries interest, the payments received in rentals during the lease must be allocated between amortisation of the receivable and financial income;
- Where appropriate, the receivable would be amortised in accordance with IAS 39.

As the ‘performance obligation’ approach, if the ‘facts and circumstances’ suggest that the value of the liability has changed significantly, the lessor must reassess:

- The length of the lease term;
- The amount of contingent rentals, and the amounts that it expects to receive as residual value guarantees and
termination penalties.

However, the impact of these re-estimates is not the same as under the ‘performance obligation’ approach:

- A re-estimate of the lease term would lead to an adjustment in the amount of the receivable and, automatically, in that of the residual asset, with an adjustment to profit or loss;
- Any change in the receivable due to a change in contingent rentals, residual value guarantees or termination penalties would affect profit or loss, with no change in the residual asset.

**The residual asset**

The residual asset would not be amortised, but if appropriate it would be impaired in accordance to IAS 36.

In the event of remeasuring the residual asset when the term of the lease is revised, the residual asset is automatically adjusted:

- if the term of the lease is increased, an additional portion of the residual asset would be derecognised, thus reducing the residual asset;
- if the term of the lease is decreased, a portion of the asset that was initially derecognised would be re-recognised, thus increasing the residual asset.

**Presentation in the financial statements (IAS 1 and IAS 7)**

The exposure draft sets out the following proposals for the presentation of leases in the lessor’s financial statement when the derecognition approach is followed:

- The receivable is presented separately from other financial assets;
- the residual asset is presented separately within property, plant and equipment;
- Lease income and lease expense are presented in profit or loss, either in separate line items or net in a single line item, depending on the lessor’s business model;

If the lessor’s business model involves manufacturing and then realising value either by selling or by leasing the asset, lease income and lease expense are presented in separate lines. In this case, the lessor would present revenue and cost of sales so that income and expenses from sold and leased items are presented consistently.

If a lessor’s business model is primarily providing finance, lease income and lease expense are presented in a single line item.

- interest income is presented separately from other interest income;
- in the cash flow statement, cash receipts from lease payments would be presented within ‘operating activities’, either separately from other cash flows from operating activities or separately from the other changes in other operating receivables, depending on the presentation method used (the direct or indirect method).

**Short-term leases**

The exposure draft proposes an option to adopt a simplified accounting treatment for short term leases, i.e. leases with a maximum possible term of 12 months, including options to renew or extend.
In the case of short-term leases, the lessor recognises no asset or liability in respect of the lease. The leased asset remains in its statement of financial position while lease payments are recognised in profit or loss over the lease term.

**Sale and leaseback transactions**

Sale and leaseback transactions are transactions in which an entity sells an asset and leases it back immediately. Such transactions are recognised in accordance with the exposure draft if the contracts (the sale contract and the lease) are:

- concluded at the same time,
- negotiated simultaneously for the same commercial purpose, or
- performed simultaneously or consecutively.

If the transaction (sale + lease) is a sale and leaseback transaction, attention must be given to the economic substance of the transaction as a whole in order to determine whether it represents a purchase or sale (i.e., a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity).

If the asset has been sold, then the purchaser (i.e., the lessor) would account for a purchase, followed by a lease under the performance obligation approach.

If the asset has not been sold, then the purchaser (i.e., the lessor) would not recognise the transferred asset. It would then only recognise the amount paid as a financial receivable.

Furthermore, if the sale or the leaseback is not at a market price (i.e., at fair value), the assets, liabilities, gains or losses are adjusted to reflect lease market prices. Also, the adjustment to the leased asset would be reflected in the performance obligation.

**Disclosures to be provided in the notes**

The exposure draft requires more detailed disclosures in the notes than at present. An entity should:

- provide quantitative and qualitative financial information that explains the amounts recognised in the statement of financial position and the income statement, and
- describe how leases may affect the amount, timing and uncertainty of the entity’s future cash flows.

The exposure draft lists a number of disclosures that would be provided in order to comply with these requirements, including:

- the characteristics of lease arrangements, (general description, contingent rentals, renewal and termination options, residual value guarantees, amortisation methods, initial direct costs etc.);
- disclosures on short-term leases, sale and leaseback transactions and sub-leases;
- a reconciliation between the opening and closing position of balance sheet items (financial receivable, lease liability or performance obligation, residual asset);
- the entity’s exposure to the risks or benefits associated with the underlying asset, thus explaining the use of the performance obligation approach or the derecognition approach;
- losses and impairments recognised, distinguishing between those recognised under the performance
obligation approach and those recognised under the derecognition approach;
- the nature and the amount of each category of residual assets (under the derecognition approach);
- the nature of significant service obligations related to leases;
- a maturity analysis of the receivables (lessor), showing the undiscounted amounts;
- the presentation of the minimum lease obligations/receivables (excluding contingent rentals, penalties and residual value guarantees);
- etc.

Summary of the proposals on lessor accounting

The exposure draft sets out a hybrid approach for the recognition of leases, based on the transfer of the significant risks or benefits of the underlying asset to the lessee, requiring the lessor to adopt:
- either the ‘performance obligation’ approach,
- or the ‘derecognition’ approach.

The length of the lease term assumed in the exposure draft does not correspond to the fixed term of the lease, but the longest possible term that is more likely than not to occur, taking into account of renewal and termination options.

The exposure draft proposes the option to adopt a simplified accounting treatment for short term leases, i.e. leases not exceeding a period of 12 months, renewal options included.

More detailed disclosures would be included in the notes.
A Closer Look

FASB proposals on financial instruments: reactions and impact on convergence

On 26 May 2010, the US standard setter (FASB) published an exposure draft entitled *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* proposing to amend the accounting for financial instruments under US GAAP.

The IASB asked stakeholders applying IFRSs to respond in writing to the FASB proposals. In response to an urgent call from the G20 in the context of the financial crisis, the aim of the two Boards is to draft a single, high quality standard on the accounting for financial instruments. It is therefore important for the FASB to take account of the comments of the international financial community when the exposure draft is re-deliberated. These comments will also be of use to the IASB when analysing how to reconcile the remaining differences between IFRS and US GAAP proposals. Mazars submitted its comment letter to the FASB on this project.

Beyond the GAAP here presents the main provisions in the FASB exposure draft and highlights the main points of divergence from the approach adopted by the IASB. We also present the main lessons to be drawn from the 2,812(!) comment letters so far addressed to the FASB, and their consequences for the convergence project.

† Summary of the main proposals of the FASB

The FASB exposure draft deals with the classification, measurement and impairment of financial instruments and also with hedge accounting. It is based on a fair value measurement model in which financial assets and financial liabilities are measured by default at fair value through profit or loss.

Financial assets: classification and measurement

As in IFRS 9, the FASB establishes two different types of treatment for debt instruments and equity instruments. The main proposals applying to financial assets are summarised in the diagram below.

[Diagram showing classification and measurement of financial assets]

- **Equity instruments**
- **Financial assets**
- **Debt instruments**

Does the financial instrument meet all of the 3 following criteria?
1. Cash-flow characteristics correspond to basic loan features
2. The business strategy is to collect the contractual cash-flows
3. The financial instrument is not a hybrid instrument for which the current guidance under US GAAP would require bifurcation

Is the financial instrument a short-term trade receivable?

- **No**
- **Yes**

- Amortized cost

- **OR**

- Fair value through equity (OCI)

- **OR**

- Fair value through P&L

- **OR**

- Fair value through P&L

M A Z A R S
The following points on this diagram should be noted:

- all financial assets would be measured in the balance sheet at fair value, except short-term trade receivables that may optionally be measured at amortised cost. It should be noted, however, that the difference between fair value and amortised cost is generally not significant for this type of financial asset;
- the “fair value through equity (OCI)” category would be measured similarly to the current “available for sale” category (see however the FASB’s proposals concerning impairment provisions). For these instruments, both amortised cost and fair value shall be disclosed on the face of the balance sheet;
- bifurcation requirements would be eliminated for derivatives: the financial asset would be recognised in its entirety at fair value through profit or loss;
- the asset is initially classified in a category and all subsequent reclassification between categories would be forbidden.

Financial liabilities: classification and measurement

The main proposals applying to financial liabilities are summarised in the diagram below:

The following points in this diagram should be noted:

- just as for financial assets, all financial liabilities would be measured in the balance sheet at fair value, except short-term trade liabilities which may optionally be measured at amortised cost. The FASB’s proposals would thus lead banks to measure virtually all their financial liabilities at fair value. Corporates, however, could continue to recognise their financial liabilities at amortised cost thanks to the option aimed to reduce accounting mismatches.
- the criteria for assessing whether fair value measurement causes or exacerbates an accounting mismatch would be as follows:
  - (i) the financial liability is contractually linked to an asset which is not measured at fair value, or
  - (ii) the financial liability is issued and evaluated by the chief operating decision-maker in an operating segment (or consolidated subsidiary) in which less than 50 percent of the assets are measured at fair value.
the bifurcation requirements would be eliminated for derivatives: the financial liability would be recognised in its entirety at fair value through profit or loss;
core demand deposits would be measured in accordance with a new measurement method, the remeasurement approach.

Core demand deposits correspond to deposits with no contractual maturity that are regarded by management as a stable source of funding.

Under the exposure draft, those deposits would be measured at the present value of the average cost deposit amount during the period discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits.

the financial liability is initially classified in a category and all subsequent reclassification between categories is forbidden.

Impairment of financial assets
In its exposure draft, the FASB proposes to move from an "incurred loss" model to an "expected loss" model. Following the proposed model, the entity would recognise an impairment when it does not expect to collect all contractual cash flows (for issued financial assets) and all cash flows initially anticipated at the purchase date (for purchased financial assets).

The expected loss model would remove the existing "probable" threshold for recognizing impairments. It relies on the analysis of the impact of past and existing conditions on the collectibility of cash flows; however, the entity would not forecast future events or economic conditions.

The proposed method would lead to recognise all expected losses over the economic life of the financial asset the day after its initial recognition.

Hedge accounting
The FASB exposure draft proposes some minor changes to simplify the application of hedge accounting:

the minimum threshold to qualify for hedge accounting would be lowered from "highly effective" to "reasonably effective" (removal of the 80%-125% bright line);
a qualitative assessment would be performed to assess hedge effectiveness; a quantitative assessment would be mandatory only if qualitative assessment cannot establish hedge effectiveness;
the assessment of hedge effectiveness would be performed at hedge inception; a subsequent assessment would be required only if circumstances change.

However, entities would need to record any ineffectiveness in profit or loss. The "short-cut" method and the "critical-terms-match" method would therefore be eliminated.

The FASB further proposes to remove an entity’s ability to de-designate a hedging relationship. A hedging relationship could therefore be discontinued only:

if the qualifying criteria for hedge accounting are no longer met, or
if the hedging instrument is sold, terminated, or exercised.

If adopted, this provision of the exposure draft would complicate the accounting for dynamic hedging for corporates.
Main differences from the approach adopted by the IASB

When considering the approaches adopted by the two Boards (FASB and IASB), we note that there are some fundamental differences. Those divergences are an obstacle to the aim of convergence required by the G20. They are the result of different choices, both on the content and in the method adopted.

Timetable

The IASB has adopted a phased approach to the replacement of IAS 39, involving the publication of successive exposure drafts treating specific aspects. These different phases will then be aggregated in a single standard, IFRS 9, which will eventually replace IAS 39 as the diagram below shows.

Classification and measurement

The IASB proposal is based on a mixed measurement model that gives greater importance to amortised cost than does the FASB. The FASB proposes to apply a measurement model based on fair value, where financial assets and liabilities are measured by default at fair value through profit or loss (a model close to “full fair value”).

The main differences between the two proposals on classification and measurement are summarised below:


**Impairment of financial assets**

Both Boards propose to move from an incurred loss model to an expected loss model. This change is materialised by the removal of the principle according to which an impairment is recognised only when it becomes probable because a credit event has occurred. This principle raised a lot of criticisms during the financial crisis, since it was said to be responsible for delaying the recognition of impairments (“too little, too late”).

According to the FASB, an entity should limit its analysis to past and existing information when measuring an impairment. The IASB proposal relies more on management estimates, because it takes into account anticipated evolution of the economic environment.

Finally, the two approaches also contrast in the timing and accounting mechanism for impairments. According to the IASB, the expected loss is spread over the life of the financial asset using the Effective Interest Rate mechanism (EIR). In the FASB’s exposure draft, impairments are recognised in profit or loss at inception on the basis of all the losses expected over the life of the asset; this impairment is decoupled from the EIR mechanism.

**A first glance at the comments received by the FASB**

The US “full fair value” project provoked strong reactions, commentators being generally very critical of the FASB proposals. One Board member, Lawrence Smith, told the Reuters press agency on 28 September 2010 that he had only read one single comment letter supporting the project, among the 1,500 or so letters received by the FASB at that date. It should be noted that Lawrence Smith was one of the two out of the five FASB Board members who had opposed the publication of the exposure draft.

On 29 September 2010, the FASB also published a summary of the exchanges it had conducted with investors and users of financial statements before the publication of the exposure draft: *An overview of outreach provided through meetings and teleconferences with the users of financial statements for the FASB’s Accounting for Financial Instruments Proposal*. This summary stresses the concerns of investors and financial statement users about the FASB’s project.
Criticisms essentially focus on the “full fair value” model proposed by the FASB. A majority of commentators are not convinced that fair value is the best method for measuring basic debt instruments (assets and liabilities) held by an entity with a view to collecting/paying the contractual cash flows rather than selling them. Commentators justify their opposition notably in terms of the procyclic impact of measuring at fair value virtually all banks’ financial assets and liabilities. They are also concerned about the potential negative impact of the FASB project on the regulatory ratios of banks and insurance entities.

The main criticisms expressed in the comment letters
The main criticisms expressed in the comment letters are summarised by topic below:

- **Classification and measurement:**
  - measurement model too heavily based on fair value;
  - insufficient importance given to business model;
  - presentation at both amortised cost and fair value on the face of the balance sheet for some financial instruments measured at fair value through equity (OCI);
  - reclassification between categories not permitted;
  - recognition in profit or loss of the impact of changes in value of financial debts related to the entity’s own credit risk;
  - Removal of bifurcation requirements for liabilities;
  - changes to the conditions of use for the equity method;
  - measurement of core demand deposits using the “remeasurement” approach.

- **Impairment:**
  - expected losses are recognised at inception and not spread over the life of the financial asset (symmetrically to the remuneration of credit risk);
  - future events and conditions are not taken into account when measuring the amount of impairment.

- **Hedge accounting:**
  - removal of asymmetric accounting for ineffectiveness in the case of cash flow hedging;
  - removal of the entity’s ability to de-designate a hedging relationship;
  - hedging of portions of financial risks has not been addressed.

The main positive comments expressed
The main positive comments made in the letters relates to the simplification of the provisions for impairment and hedge accounting:

- **Impairment:**
  - single impairment model;
  - move from an incurred loss model to an expected loss model;
  - removal of the existing “probable” threshold for recognizing impairments;
  - impairment mechanism decoupled from the EIR.

1The impairment methods currently applicable in US GAAP differ depending on the nature of the financial asset (e.g. listed securities vs unlisted loans). The current provisions are included in Topics 310, 320, 325 and 450.
Hedge accounting:

- Effectiveness criteria for hedge accounting is lowered from “highly effective” to “reasonably effective”;
- Simplification of the documentation for retrospective assessment of effectiveness (increased importance of qualitative testing).

Next steps in the FASB project and impact on convergence with the IASB

The FASB is in the process of analysing the comment letters and held round tables on the exposure draft in the period ending on 19 October 2010. However, it seems that the US standard setter has already taken note of the fairly cold reception of its proposals. In particular, commentators agree that it is very likely that the FASB will withdraw its most controversial proposal, meaning the fair value measurement of virtually all financial assets and liabilities.

The resignation of the FASB chairman, Robert Herz, announced last August and effective from 1 October 2010, occurred concurrently to an expansion of the Board from 5 to 7 members. These changes give the FASB an opportunity to reconsider certain aspects of its project on financial instruments. Note that Robert Herz defended a “full fair value” approach at the time of the publication of the exposure draft, whereas the new interim chairman, Leslie F. Seidman, supported a mixed measurement model.

Should the FASB opt to give greater importance to amortised cost, this would give a boost to the project for the convergence of US GAAP and IFRSs. The G20’s aim of establishing a single standard on financial instruments before the end of June 2011 still stands. However, we have to admit that the timetable is very tight, particularly if there is a need to re-expose some phases of the project.

Beyond the GAAP will not fail to keep you informed of the developments in this convergence project that will significantly change the accounting for financial instruments. The next stage is expected before the end of 2010, with the IASB’s publication of an exposure draft on hedge accounting.
### 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. The last seminar, organised by Francis Lefèbvre Formation, will be held on 10 December 2010.

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

### Frequently asked questions

**IAS/IFRS**

- Business combinations: treatment of a lease termination indemnity paid for the seller
- Hedging of exchange rate linked to an acquisition
- Accounting for a prepaid call option
- Combination of business under joint control

### Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

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