December 2010 saw the publication of the exposure draft on hedge accounting (proposals on macro-hedging will have to wait until 2011). The IASB should, for once, draw on fairly wide support. The proposals do aim to simplify hedge accounting and make it possible to hedge more risks.

Also in December, the IASB began the analysis of almost 1,000 comment letters received in response to the exposure draft on revenue recognition. The redeliberations are scheduled up to June and are likely to be tense, given the extent of criticism.

Best wishes from the whole editorial team at Beyond the GAAP.
Publication of a limited amendment to IFRS 1 for entities preparing IFRS financial statements after a period of severe hyperinflation

On 20 December the IASB published an amendment to IFRS 1, First-time Adoption of International Financial Reporting Standards. This amendment is intended to offer a limited exemption to entities emerging from a period of severe hyperinflation, during which they were unable to comply with IFRSs (more specifically to IAS 29).

This amendment allows an entity to measure assets and liabilities recognised before the normalisation date (i.e. the date when the entity emerges from severe hyperinflation) on the basis of fair value at the date of transition to IFRSs, using this fair value as the deemed cost.

When the normalisation date falls within a 12-month comparative period, the comparative period presented may be less than 12 months, provided that a complete set of financial statements under IAS 1 is provided for this shorter period.

This amendment applies to entities that already applied IFRSs in periods before the period of severe hyperinflation as well as to entities that had never applied IFRSs. It is effective for accounting periods beginning on or after 1 July 2011. Early application is authorised.

Limited amendment to IFRS 1: elimination of the fixed application date

On 20 December the IASB published a limited amendment to IFRS 1, First-time Adoption of International Financial Reporting Standards. This amendment is effective from 1 July 2011.

This amendment removes the references to the fixed date of “1 January 2004” and replaces it with a moving application date, the “date of transition”. A first-time adopter will therefore not be required to restate past derecognition transactions that occurred before the date of transition to IFRSs.

This amendment simplifies the transition to IFRSs as additional jurisdictions adopt IFRSs, the date of 1 January 2004 having originally been set at a time when European countries adopted IFRSs.

Publication of a limited amendment to IAS 12

On 20 December the IASB published an amendment to IAS 12, effective for accounting periods beginning on or after 1 January 2012. This publication followed an exposure draft issued in September 2010 (see Beyond the GAAP, September 2010).

The revised standard states that, in the case of investment properties measured at fair value (IAS 40), the measurement of the associated tax assets and liabilities should reflect the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely through sale.

This amendment aims to limit the practical problems faced by some preparers in situations where the value of an investment property is recovered partly by use and partly by sale.

We will discuss practical application of this amendment in a future edition, where we will also compare the final amendments to the proposals in the exposure draft.
Now that accounts are being finalised for 31 December 2010, Beyond the GAAP presents an overview of the IASB’s most recent publications. For each text, we clarify whether application is mandatory for this reporting period, or whether early application is permitted, based on the status of the European adoption process.

As a reminder, the following principles govern the first application of IASB’s standards and interpretations:

- IASB’s draft standards cannot be applied as they are not yet finalised nor part of IFRSs.
- IFRIC’s draft interpretations may be applied if the two following conditions are met:
  - The draft does not conflict with currently applicable IFRSs;
  - The draft does not modify a currently effective interpretation.
- Standards published by the IASB but not yet endorsed by the European Union at the end of the reporting period may be applied if the European adoption process is complete before the date when the financial statements are authorized for issue by the relevant authority (i.e. usually the board of directors).
- Interpretations published by the IASB but not yet adopted by the European Union at the end of the reporting period may be applied unless they conflict with standards or interpretations currently applicable in Europe.

Please also note that the financial statements disclosures of an entity applying IFRSs must include the list of standards and interpretations published by the IASB that are not subject to early application by the entity. In addition to this list, the entity must provide an estimate of the impact of the application of those standards and interpretations.

**Update on the European adoption process for standards and amendments published by the IASB**

<table>
<thead>
<tr>
<th>Standard</th>
<th>Subject</th>
<th>Effective date according to the IASB</th>
<th>Date of publication in OJEU</th>
<th>Application status on 31 December 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 3R</td>
<td>IFRS 3 revised following the Business Combinations phase II project</td>
<td>1/07/2009</td>
<td>12 June 2009</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IAS 27R</td>
<td>IAS 27 revised following the Business Combinations phase II project</td>
<td>1/07/2009</td>
<td>12 June 2009</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IAS 39 amendment</td>
<td>Eligible hedged items</td>
<td>1/07/2009</td>
<td>16 September 2009</td>
<td>Mandatory</td>
</tr>
</tbody>
</table>

¹ Excluding amendments to IFRS 1 “First-time Adoption of International Financial Reporting Standards”
<table>
<thead>
<tr>
<th>Standard</th>
<th>Subject</th>
<th>Effective date according to the IASB</th>
<th>Date of publication in OJEU</th>
<th>Application status on 31 December 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual improvements</td>
<td>Amendment to IFRS 5 on partial disposals of investments in subsidiaries (text published by the IASB in May 2008)</td>
<td>1/07/2009</td>
<td>24 January 2009</td>
<td>Mandatory</td>
</tr>
<tr>
<td>Annual improvements</td>
<td>Annual improvements to various standards (text published by the IASB in April 2009)</td>
<td>Varies for individual amendments (earliest 1/07/2009)</td>
<td>24 March 2010</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IFRS 2 amendments</td>
<td>Amendments on group cash-settled transactions (IFRIC 8 and IFRIC 11 incorporated)</td>
<td>1/01/2010 Early application permitted</td>
<td>24 March 2010</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IAS 32</td>
<td>Amendment on classification of rights issues</td>
<td>1/02/2010 Early application permitted</td>
<td>24 December 2009</td>
<td>Early application permitted</td>
</tr>
<tr>
<td>IAS 24R</td>
<td>Revision of the standard on related party disclosures: clarification of the current definition and removal of inconsistencies, partial exemption of disclosures concerning transactions between enterprises which are fully or jointly controlled or under significant influence by the same “State”</td>
<td>1/01/2011 Early application permitted (for the exemption alone or for the whole revised standard)</td>
<td>20 July 2010</td>
<td>Early application permitted</td>
</tr>
<tr>
<td>IFRS 9</td>
<td>Financial instruments (standard intended to progressively replace the provisions of IAS 39)</td>
<td>01/01/2013 Early application permitted</td>
<td>Adoption process suspended by the Commission</td>
<td>Not permitted</td>
</tr>
<tr>
<td>Annual improvements</td>
<td>Annual improvements to various standards (text published by the IASB in May 2010)</td>
<td>Varies for individual amendments (earliest 1/07/2010)</td>
<td>Awaiting adoption by the EU (Q4 2010)</td>
<td>Possible if adopted by the EU before the date when the financial statements are authorised for issue or if the amendment clarifies an existing standard and does not conflict with current IFRSs</td>
</tr>
<tr>
<td>IFRS 7</td>
<td>Disclosures for transfers of financial assets</td>
<td>1/07/2011 Early application permitted</td>
<td>Awaiting adoption by the EU (Q2 2011)</td>
<td>Early application permitted</td>
</tr>
</tbody>
</table>
### Update on the European adoption process for interpretations published by the IFRS Interpretations Committee

<table>
<thead>
<tr>
<th>Interpretation</th>
<th>Subject</th>
<th>Effective date according to the IASB</th>
<th>Date of publication in the OJEU</th>
<th>Application status on 31 December 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRIC 12</td>
<td>Service concession arrangements</td>
<td>1/01/2008</td>
<td>26 March 2009 (EU: effective date put back to 29/03/2009)</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IFRIC 15</td>
<td>Agreements for the construction of real estate</td>
<td>1/01/2009</td>
<td>23 July 2009 (EU: effective date put back to 01/01/2010)</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IFRIC 16</td>
<td>Hedges of a net investment in a foreign operation</td>
<td>1/10/2008 Early application permitted</td>
<td>5 June 2009 (EU: effective date put back to 01/07/2009)</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IFRIC 17</td>
<td>Distributions of non-cash assets to owners</td>
<td>1/07/2009</td>
<td>27 November 2009 (EU: effective date put back to 01/11/2009)</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IFRIC 18</td>
<td>Transfers of assets from customers</td>
<td>1/07/2009</td>
<td>1 December 2009 (EU: effective date put back to 01/11/2009)¹</td>
<td>Mandatory</td>
</tr>
<tr>
<td>IFRIC 14 amendments</td>
<td>Prepayments of a minimum funding requirement</td>
<td>1/01/2011 Early application permitted</td>
<td>20 July 2010</td>
<td>Early application permitted</td>
</tr>
<tr>
<td>IFRIC 19</td>
<td>Extinguishing financial liabilities with equity instruments</td>
<td>1/07/2010 Early application permitted</td>
<td>24 July 2010</td>
<td>Early application permitted</td>
</tr>
</tbody>
</table>

¹ Given the mandatory effective date for European listed companies, IFRIC 18 will generally be applied for the first time in 2010. To comply with the IASB’s rules on first-time adoption, we believe that transactions since 1 July 2009 which fall within the scope of IFRIC 18 should be restated for the comparative period presented.
In June 2010, as part of a joint project with the FASB, the IASB published an Exposure Draft on revenue recognition (Revenue from Contracts with Customers).

This exposure draft sets out the outlines of a future standard to replace IAS 18 and IAS 11. The draft proposes to adopt a single revenue recognition model, based on the transfer of control. This model would be applicable to construction contracts, the sale of goods and the rendering of services.

The two Boards received almost 1,000 comment letters (posted on the IASB web site), showing the lively interest arising from this subject. Almost three-quarters of the responses came from North America, where large numbers of unlisted entities (mainly in the construction sector) responded to the FASB.

During the second half of 2010, the IASB also organised round tables in order to introduce its draft and gather preliminary feedback.

The IASB staff has just published a summary of responses to the ED and the comments received during the round tables. It is worth noting that the two Boards’ proposal have stimulated a number of reactions, the majority of which are negative.

Main criticisms relate to:

- the concept of the transfer of control, considered difficult to apply in practice to the rendering of services and to construction contracts;
- the principle of identifying the separate components in a contract (“performance obligations”), believed to entail inappropriate and complex analysis.

Many comments suggested that the proposals in the exposure draft will not be applied consistently across sectors, and will lead to results that do not reflect the substance of the transactions. Some commentators considered that construction contracts should be the subject of a separate standard, given their specific features.

Responses also revealed concerns with respect to the following proposals:

- measurement of variable consideration at a probability-weighted amount;
- recognition of contract modifications on a cumulative basis;
- recognition of onerous obligations, as appropriate, at the level of each contract component rather than for the contract as a whole;
- recognition of product warranties as deferred revenue (and not as a cost accrual);
- systematic allocation of the transaction price to each component on a relative standalone selling price basis (without the option to use a residual method);
- initial measurement of revenue including customer credit risk;
- quantity of disclosures required in the notes to the accounts;
- retrospective application of the standard, and the absence of transitional provisions.

Given these aspects, and in order to achieve the objective of publishing a final standard by June 2011 at the latest, the two Boards have drawn up an ambitious timetable of the points that require redeliberation during the first half of the year.
All the points listed above will be the subject of further discussions, including the key concepts of transfer of control and separate performance obligation.

The two Boards also intend to pursue discussions with those concerned before publishing the final standard, in order to test any changes made to the exposure draft.

At this stage, it is difficult to say whether there will be any significant amendments, but it is clear that the two Boards listened so far to criticisms received. In any event the new standard should include:

- a model for the rendering of services distinct from the model for the sale of goods (even if these two models are based on the same principle of transfer of control);
- application guidance for each sector based on the principles already included in the standard.

For now, the two Boards do not anticipate the publication of a new draft. Consequently, the final standard is still expected to be published at the end of June 2011. However, it should not be effective before 2013 at the earliest.

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On 8 December 2010 the IASB published a document entitled Management Commentary: a framework for presentation. This publication is something of an innovation, since it is not a standard but an “IFRS Practice Statement”.

Entities that prepare their financial statements in accordance with IFRSs will not be required to comply with this text in order to assert that they are compliant with IFRSs. However, an entity presenting a management commentary in a financial document including financial statements prepared under IFRSs should indicate the extent to which the IASB framework was followed. Compliance can only be claimed in the management commentary if the entire framework for the presentation of management commentary was followed.

This text aims to improve the international comparability of information provided within management commentary. The IASB regards management commentary as a critical part of the annual report, since it places the financial statements into context, presents the entity’s strategy and provides information on non-financial matters (such as the entity’s impact on the environment). Therefore, this text aims to foster good practice, and fill the gap in some jurisdictions.

In more detail, the framework for management commentary presentation presents the principles, qualitative characteristics and elements that are necessary to provide users of financial statements with useful information.

**Principles and qualitative characteristics for the presentation of management commentary**

The IASB framework sets out two main principles for the preparation of the management commentary:

- to provide management’s view of the entity’s performance, position and progress; and
- to supplement and complement information presented in the financial statements by describing the conditions and events that shaped that information. Management commentary should also include information about the entity and its performance that is not presented in the financial statements but is important in specific situations.

In practice, this means communicating on the entity’s perspectives, reflecting its objectives and the strategies for achieving those objectives. This forward-looking information may be qualitative or quantitative.

The assumptions on which this forward-looking information is based should also be disclosed. Management should explain to what extent the entity achieved the forward-looking information presented in the prior management commentary. An analysis of variances between actual and forecast performance should be provided. Management should also explain what those variances entail for current forecasts.

Information in management commentary should possess the qualitative characteristics of relevance and faithful representation, comparability, verifiability, timeliness, understandability and materiality.

**Components of management commentary**

The IASB framework for the preparation of the management commentary does not impose any precise format.
However, the IASB stresses that the management commentary should be consistent with its related financial statements (for example, if the financial statements include segment information, the information presented in the management commentary should reflect that segmentation). The IASB also notes that management should avoid duplicating (without further analysis) in its management commentary the disclosures made in the notes to its financial statements. Finally, the management commentary should only include information which is genuinely important to the entity.

The IASB states that management commentary should include information that is essential to an understanding of:

- the nature of the business: the sectors in which the entity operates, the entity’s main markets and competitive position within those markets, main products and services, etc.
- management’s objectives and its strategies for meeting those objectives: for example, how management intends to address difficulties in its sector, or seize market opportunities;
- the financial and non-financial resources available to the entity in order to meet its needs, an entity’s principal risk exposures (strategic, commercial, operational and financial) and its most significant relationships;
- the results and prospects for performance;
- the key performance indicators (both financial and non-financial) that are used by management to assess progress against its stated objectives. This information is more useful if it is comparable with other entities in the same sector. These indicators should also be consistent over time, unless a change of strategy or objective justifies a change in the indicators. Where the financial indicators used have been adjusted in comparison to the aggregates communicated in the financial statements that have been prepared in accordance with IFRSs, these indicators should be reconciled to the aggregates from which they derive. These indicators should be defined and explained, with an explanation of the relevance of the measure to users in assessing the entity’s performance.

It will be interesting to see to what extent entities choose to follow this guidance, particularly in those jurisdictions where constraints imposed on the preparation of management commentaries are already high (in law, or because of the information required by regulators, etc.)
On 9 December the IASB published its exposure draft on hedge accounting. Following “Classification and measurement” and “Amortised cost and impairment”, the Board has thus launched the third phase of its revision of IAS 39. Beyond the GAAP introduces below the main proposals. The comment period ends on 9 March 2011.

**An approach to hedge accounting in two parts**

The Board decided to separate its work on hedge accounting in two parts from an early stage.

- The first part focuses on the general principles of hedge accounting and the methods applicable to micro-hedging. This is the subject of the newly published exposure draft.
- The second part will address macro-hedging, from the management of open portfolios held by financial institutions perspective. As of today, the publication of the standard is expected in the second quarter of 2011.

**A new approach based on principles designed to be closer to entities’ risk management practices**

IAS 39 was the subject of numerous criticisms, not least regarding its provisions for hedge accounting. The standard was thought to be too much rules-based, and insufficiently principles-based. Some critics even accused it of disrupting entities’ risk management practices. For example, the systematic recognition in profit or loss of changes in the “time value” component of options led some entities to give up the use of option strategies in the risk management policies.

Aware of these difficulties, the Board aimed to propose a principle-based approach which better takes into account an entity’s rules for risk management.

Nevertheless, hedge accounting remains optional. An entity may still choose to perform actual economic hedging with derivative instruments without documenting any hedging relationship accountingwise.

**The three types of hedging relationships would be retained**

The exposure draft proposes to retain the three current types of hedging relationships, namely fair value hedge, cash flow hedge and net investment hedge.

These three types of hedging relationships thus continue to apply to the same situations as they did under IAS 39. For example, the hedge of a firm commitment might still qualify, at the entity’s choice, as a fair value hedge or a cash flow hedge.

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1. A closed portfolio consists of a number of instruments determined and identified when it is created. The contents of this portfolio will remain unchanged. It will therefore be empty when the instruments which make it up reach maturity. In contrast, an open portfolio is constantly fed by new instruments sharing a number of characteristics. An open portfolio will therefore not be empty until the entity chooses to cease the related activities.
Nor has the Board opted for an amendment of the measures that apply to the hedge of a net investment. Tackling this additional topic would have meant revising IAS 21 *The Effects of Changes in Foreign Exchange Rates*, something that the Board was reluctant to undertake in view of the time allotted.

**Amended presentation of hedging effects in the statement of financial position**

The exposure draft proposes to make some amendments to the method of presenting the effects of hedge accounting in the statement of financial position.

For fair value hedges, the Board proposes that changes in the value of the hedging instrument and the hedged item should be recognised in Other Comprehensive Income, and no longer in profit or loss. This amendment means that the effective portion of the changes in the fair value of a derivative classified as a hedging instrument will be recognised in the same place in the statement of financial position as a fair value hedge or a cash flow hedge. The ineffective portion would continue to be recognised directly in profit or loss.

However, this change should have no impact on Other Comprehensive Income insofar as only the effective portion, and hence the portion neutralised by the remeasurement of the hedged item, would be recognised there. The only exception to this concerns the treatment of the time value of an option, which will be discussed later in this study.

The second amendment also relates to fair value hedge relationships. Any remeasurement of the hedged item should be presented as a separate line item in the statement of financial position. Therefore, in the case of a liability initially measured at amortised cost, establishing a fair value hedge for the exchange rate risk would bring about the remeasurement of the hedged item on a separate line in the statement of financial position, adjacent to the line presenting the hedged liability which continues to be measured at amortised cost. This new presentation would avoid the presentation of measurements which mix amortised cost and the impact of remeasurement due to the fair value hedge.

The approach known as “basis adjustment” would become mandatory when a hedge of firm commitment or future transaction leads to the recognition of a non-financial asset or liability in the statement of financial position. In practice, when the hedged non-financial item is recognised in the statement of financial position, the cumulative performance of the hedge previously recognised in Other Comprehensive Income is included as an adjustment to the initial carrying amount of the hedged item.

**Documenting non-derivative instruments as hedging instruments**

The exposure draft does not amend the conditions under which a derivative instrument may be eligible for designation as a hedging instrument. The provisions regarding the possibility of designating written options or intragroup derivatives as hedges thus remain unchanged. The possibility of designating the foreign exchange component of a non-financial instrument as a hedge will also be retained.

However, the Board proposes to introduce the possibility of designating any financial instrument as a hedging instrument on the sole prior condition that it is measured in the fair value category, with changes in value recognised in profit or loss. In this instance, changes in the value of the instrument as a whole would be taken into account for the purposes of hedge effectiveness testing. It would thus not be possible to designate just one component of the instrument as a hedge. For preparers, this new provision might represent an alternative to the fair value option.

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2 This approach already existed in IAS 39 for cash flow hedging relationships, but was only optional.
De facto prohibition to document hedging relationship on equity instrument

Phase 1 of the IFRS 9 project requires entities to opt to account for their shares in one of the following two ways:

- **default accounting**: fair value, with recognition of changes in fair value in profit or loss;
- **optional accounting**: fair value, with recognition of changes in fair value in Other Comprehensive Income. Changes in value thus recognised in Other Comprehensive Income will not be available for recycling in profit or loss, even in the event of disposal. Only the dividends are systematically recognised in profit or loss.

In parallel, the Hedge Accounting exposure draft proposes to follow-up on the two principles that currently exist in IAS 39:

- It is not possible to designate a hedging relationship on an instrument recognised at fair value, with recognition of changes in fair value in profit or loss;
- It is not possible to designate a hedging relationship on a risk which will not ultimately impact the consolidated profit or loss.

The combined impacts of these proposals make it de facto impossible to designate a hedging relationship on shares.

Consequently, where an entity chooses to retain the optional classification (recognition of changes in value in Other Comprehensive Income) for a given equity instrument, any hedging strategy using a derivative instrument would result in profit or loss volatility. Since the designation of a hedging relationship on equity is impossible, the derivative instrument will be classified by default in the fair value category, with recognition of changes in fair value in profit or loss.

The possibility of hedging portions of risks would be extended to non-financial instruments

One of the main criticisms of IAS 39 relates to the prohibition of hedging a risk component on a non-financial instrument, with the exception of the foreign exchange rate risk component. This provision did not apply to financial instruments that could be hedged for a portion of risk provided that it was identifiable and measurable (e.g., risk-free rate of a bond).

The exposure draft proposes to extend the options for hedging risk components to non-financial instruments. For example, it explicitly raises the possibility of hedging the crude oil component of a jet fuel exposure.

In practice, all contractually explicit indexations could therefore be subject to hedge accounting, which is a definite improvement for corporate entities using contractual arrangements of this type. In the case of risk components which are not contractually explicit, it will probably be necessary to make a judgment as to whether they are “identifiable and measurable”.

Note that the exposure draft does not introduce more flexibility into the arrangements for the inflation component of a risk-free rate, and the Basis for Conclusions questions whether the credit risk in a bond is “identifiable and measurable”. The practical application of this principle is thus likely to be complex, even for financial institutions.

Finally, the exposure draft maintains the prohibition on hedging the Libor component of a contract whose effective rate is Libor minus a margin. This proposal, currently subject to the European “carve-out”, is likely to trigger comments from financial institutions.
**Hedging a synthetic position authorised**

Another innovation in the exposure draft is that it explicitly authorises the designation of a hedging relationship on a synthetic exposure (comprising, for example, a debt and a swap). This may seem trivial, but it is not.

Let us take the example of a euro functional currency entity that issues a fixed-rate loan in USD concomitant to a USD swap receiving a fixed rate and paying a variable EUR rate. The entity decides to document a fair value hedge relationship between the debt and the derivative. Subsequently, it supplements this hedge with a swap receiving a variable EUR rate and paying a fixed EUR rate. IAS 39 prohibited the designation of this second swap as a hedge of the synthetic position “USD debt + Swap paying variable EUR rate”; it was necessary to discontinue the hedging relationship initially designated in order to designate the combination of the two swaps as a hedge of the USD debt. This mechanism involved several consequences that had a complex impact in terms of disclosures, effectiveness and accounting entries. The option to designate the second swap as a hedge of the initial synthetic position should therefore greatly simplify life for entities.

**Extended hedging possibilities for closed portfolios**

The exposure draft also proposes to extend the hedging possibilities for closed portfolios (open portfolios will be addressed in the second part of the project that will be published in the first half of 2011).

This removes the criterion of “similar assets or liabilities” in IAS 39, which stated that changes in the value of an item in the group should be proportional to the overall change in fair value attributable to the hedged risk of the group of items.

The exposure draft proposes to replace this with two new conditions:

- each of the items in the group are individually eligible to be hedged items;
- the items in the hedged group must be managed together on a group basis for the entity’s risk management purposes (i.e. designation of the hedged group of items in accounting terms is consistent with the entity’s actual risk management).

**Hedging by “layer component” extended to fair value hedges**

IAS 39 authorised the designation of a hedge on a proportion of exposure. However, hedging identified cash flows such as a layer of exposure, for example the hundred first USD of revenue at a given date, was only possible in a cash flow hedge relationship. The prohibition on extending this principle to fair value hedges\(^3\) made the management of some situations complex.

For example, an entity with a fixed-rate debt of 100 EUR wanting to hedge against the interest rate risk using a swap of a nominal 20 EUR had to designate 20% of its debt as a hedged item. If subsequently the entity proceeded to prepayment of its debt for 30 EUR of capital, it would be obliged to discontinue a proportion of its hedging relationship since the hedged item had been reduced to 20% x 70 EUR = 14 EUR.

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\(^3\) Except in the specific case of a rate risk hedge on a portfolio basis for European entities benefiting from the European “carve-out”.

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**A Closer Look**
The exposure draft proposes to make it possible to designate a fair value hedging relation on a “layer” of the exposure, provided this is consistent with its risk management objectives. For example, it would be possible to hedge the last 20 EUR of capital repaid.

This provision nevertheless contains a significant limitation, since the exposure draft requires the absence of a prepayment option whose value is affected by changes in the hedged risk. In other words, it would not be possible to hedge the interest rate risk of a loan embedding a prepayment option at par value. This provision considerably limits the scope of this “layer component” approach, in particular for financial institutions.

An approach to the hedging of net positions

The exposure draft proposes to authorise the hedging of a net position, provided that the entity actually manages its exposure on a net basis. In other words, this is not just a condition for designation. It will thus be necessary to demonstrate that the entity’s risk management tools are based on net cash flows.

The hedging designation should also clearly indicate the gross positions which are components of the net exposure. This should make it possible to identify and measure the hedged item over time.

The performance of a derivative designated as a hedge of a net exposure may not, however, be reassigned in profit or loss, but rather presented as a separate line item. For example, the hedge of a net exposure of 20 USD determined by the difference between income of 100 USD and costs of 80 USD will not lead to recognition of the income and costs at the hedged rate.

Documentation requirement is maintained

The exposure draft proposes to retain the requirement to provide documentation for each hedging relationship. The content will be substantially identical to that required by IAS 39, though it is probable that more explanations will be required on the way a hedging relationship contributes to the entity’s general risk management policy.

Easing the analysis of effectiveness

The exposure draft also differs from IAS 39 in that it eases the effectiveness requirements. The basis of this step lies in relaxing the quantitative requirements by relying on the entity’s risk management policy. One of the most striking changes is the elimination of the famous “effectiveness range” (80-125%) of IAS 39.

The exposure draft therefore proposes to authorise hedge accounting whenever the hedging relationship has an effect which is:

- unbiased: i.e. where the entity does not expect the hedging relationship to be structurally over or under-effective;
- minimising ineffectiveness: an entity is obliged to document the optimal amount of the hedging instrument (hedge ratio) to minimise the ineffectiveness of a hedging relationship;
- other than accidental: if the underlying of the hedging instrument is different from the hedged exposure, it will be necessary to demonstrate the existence of an economic relationship between these two variables to explain the basis of the hedge.
Under the proposals in the exposure draft, the forward analysis of effectiveness should take place at inception of the hedging relationship and as a minimum at each reporting date. No method is specified. A qualitative analysis may be sufficient for simple hedging relationships, where the characteristics of the hedging instrument and the hedged item are closely aligned. A quantitative analysis will still be necessary for more complex hedging relationships. In any event, the entity’s risk management objectives must be taken into account to measure the effectiveness of a hedging relationship.

No retrospective analysis will be required apart from the quantification of the ineffectiveness to be recognised in profit or loss for the accounting period.

**Ineffectiveness would continue to be recognised in profit or loss for the period**

Though the assessment of effectiveness for hedge accounting may be eased, any ineffectiveness in a given period would nevertheless continue to be quantified and recorded in profit or loss at each reporting date. The measurement method would remain the same as the current method under IAS 39.

**Treatment of the time value of options used as hedging instruments**

IAS 39 analyses the time value component of options as an ineffective component in the hedging relationship. Consequently, subsequent changes in value were systematically recognised in profit or loss for the period, generating a de facto volatility in the net result.

The exposure draft proposes to adopt a significantly different approach. The option premium would be analysed as an insurance premium which the entity has chosen to pay in order to benefit from hedging. As a result, subsequent changes in the time value component would no longer be analysed as ineffectiveness and would no longer systematically impact profit or loss.

The exposure draft proposes to operate three distinctions:

- A distinction between the changes in time value relating to the hedged item and other changes in time value. Only changes in time value related to the hedged item could not be recognised directly in profit or loss. In other words, if a hedge contains an imperfection, only changes in the time value of the ‘perfect’ component would benefit from the new treatment proposed by the exposure draft.

- A distinction between the initial time value and subsequent changes in value. The initial time value of an option, equal to the premium paid by the buyer of the option, is economically ‘consumed’ over the life of the option, and ends at zero. Further, changes in market conditions may cause the time value to vary upwards or downwards over the life of the option. The exposure draft proposes a specific treatment for the initial time value of the option which we set out below. Subsequent changes in value which are related to market conditions would be recognised in Other Comprehensive Income. The aggregated change in value over the life of the option will be equal to zero.

- A distinction between strategies hedging a transaction from strategies hedging time periods. When the entity hedges a given period, the time value is gradually amortised in profit or loss over the life of the strategy. When the entity hedges an identified transaction, the initial time value would be:
  - either recycled in profit or loss at the time when the hedged transaction impacts profit or loss;
  - or included in the initial value of the hedged item in the case of non-financial exposure (basis adjustment).

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4 With the sole exception of the particular case of a hedge which itself offsets an option
When the hedged exposure disappears, however, the whole performance recorded in Other Comprehensive Income would be recycled immediately in profit or loss.

New provisions for discontinuing hedge accounting

In accordance with its approach based on an entity’s risk management model, the exposure draft proposes to prohibit the voluntary discontinuation of a hedging relationship.

A hedging relationship could therefore only be discontinued in the following cases:

- the hedging instrument reaches maturity;
- the hedged item disappears;
- the entity changes its risk management policy;
- the hedging relationship no longer meets the effectiveness conditions.

Conversely, if the effectiveness of a hedging relationship no longer achieves unbiased results without an adjustment to the hedging ratio (i.e. a reduction in the nominal percentage of the hedging instrument), it becomes mandatory to rebalance the hedging relationship.

These new measures, summarised in the decision tree below, might complicate the accounting management of some hedging relationships.

[Diagram showing decision tree with decision points labeled as follows:
- Does the hedging relationship meet the qualifying criteria for hedge accounting?
- Did the risk management objective remain the same for the hedging relationship?
- Does the hedging relationship still achieve other than accidental offsetting?
- Proactive rebalancing of the hedging relationship because it is expected to fail the objective of the hedge effectiveness assessment?
- Partial discontinuation may arise]
Scope amendment for contracts for the physical delivery of a non-financial item

Appendix C of the exposure draft proposes an amendment to IAS 32 to amend the scope of the standard regarding contracts which lead to the physical delivery of a non-financial item (Own use contracts).

The exposure draft proposes to add a condition to the exclusion of these contracts from the scope of IAS 32 and IFRS 9. Contracts where the entity’s effective management model is based on fair value will systematically fall under IAS 32 and IFRS 9 even if the entity usually concludes these contracts with the physical receipt or delivery of a non-financial item in accordance with its business requirements.

More disclosures required in the notes

The IASB engaged in outreach activities with users of financial statements to understand what they expect from disclosures on hedging operations. In its Basis for Conclusions, the Board reports that users do not find the disclosures in IFRS 7 useful or transparent in this regards.

The exposure draft therefore proposes that the notes should contain a number of detailed disclosures on an entity’s risk management strategy and how it is applied to manage risk; how the entity’s hedging policy impacts its future cash flows; and the effect that hedge accounting has had on the entity’s statement of financial position, statement of comprehensive income and statement of changes in equity.

Arrangements for first application and transition

The exposure draft proposes that an entity shall apply these provision for annual periods beginning on or after 1 January 2013.

Early application would be permitted only if all the published requirements of the other phases of IFRS 9 are also applied.

The exposure draft suggests the following transitional arrangements: hedging relationships existing before the transition date (i.e. meeting the conditions of IAS 39) and satisfying the conditions of IFRS 9 at the transition date will be regarded as continuing. Therefore, it will not be necessary to discontinue systematically the existing hedging relationships.

However, it will be necessary to discontinue any hedging relationships which do not meet the conditions required under IFRS 9 at the transition date.

Finally, hedging relationships not designated in the past could be designated prospectively from the transition date if the conditions of IFRS 9 are met.
**Events/publications**

Seminars on “Current developments in IFRS”

Mazars’ Technical Department will host a number of seminars throughout 2011 dedicated to current developments in IFRS. These seminars, organised by Francis Lefèbvre Formation, will be held on 25 March, 24 June, 23 September and 9 December 2011.

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

**Frequently asked questions**

IAS/IFRS

- Hedging an exchange rate risk in a business combination
- Allocation of goodwill to a cash-generating unit in connection with the information provided as regards operating segments
- Disposal of a business: when is it a discontinued operation under IFRS 5?
- Transfer of financial assets in such a way that all of the financial assets do not qualify for derecognition: classification of financing as current/non-current, and accounting treatment of fees incurred for setting up the financing
- Interest in assets under joint control: accounting treatment of expenses incurred in an R&D programme leading to joint control of the assets developed

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

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<th>IASB</th>
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