Hardly had Hans Hoogervorst taken up his position at the head of the IASB than he had put his stamp on the institution. His position on the provisioning of exposure to the Greek risk by banks and insurers expresses a wish to ensure that IFRSs are applied consistently in the world. This concern is not new in principle, but it is so in form!

Enjoy your reading!

Michel Barbet-Massin    Edouard Fossat

IASB work plan

On 14 September 2011, the IASB updated its work plan.

Two weeks later, the IASB has already made changes, revising its forecast timetable for the publication of the documents relating to a number of current projects:

- Revenue recognition: the new exposure draft is expected during Q4 2011;
- Hedge accounting: the “Review draft” is expected to be published in November, with a view to the publication of the final standard in the first half of 2012;
- Leases: the new exposure draft is expected in the first half of 2012;
- Annual improvements 2010-2012: the exposure draft is scheduled for December;
- IFRIC 20: the interpretation should be published in mid-October.

# IFRS News

## Puts on non-controlling interests: IASB rejects Interpretations Committee proposals

In March 2011, the IFRS Interpretations Committee (formerly IFRIC) examined a draft amendment to IAS 32 proposing that put options meeting specific criteria should be excluded from the scope of IAS 32 and should therefore be accounted for in accordance with IAS 39 (as derivative instruments - see Beyond the GAAP No 43 - March 2011).

The committee proposed to limit exclusion from the scope of IAS 32 to contracts which **cumulatively** meet the following conditions:

- only put options would be affected (i.e. not forward contracts);
- separate put options (i.e. not embedded in a larger contract, for example puttable shares);
- puts relating to shares in a subsidiary (i.e. not puts on shares of the parent company);
- puts resulting in physical settlement (i.e. no ‘net settlement’).

In practice, the measurement of puts in accordance with IAS 39 (i.e. as derivatives) would result in the disappearance of the liability (as such, though this would not stand in the way of recognition of a derivative liability) and all changes in fair value would be accounted for in profit or loss.

It should be remembered that during the initial discussions:

- the preferred position of the staff, and of a large majority of Committee members, was the recognition of variations in the value of the debt in profit or loss (given the fact that IAS 32 refers back to IAS 39);
- an alternative, the recognition of variations in the value of the debt in equity (an approach based on the provisions of IAS 27R on the purchase of equity instruments), was also considered, before being rejected by a majority of Committee members during the January 2011 meeting.

Ultimately the IASB did not want to amend the scope of IAS 32, though it wished to clarify the accounting treatment of subsequent variations in the debt.

We will not fail to report on the progress of discussions of this sensitive subject.

## IASB ratified the IFRIC Interpretation 20

During the September 2011 meeting, the IASB ratified the IFRIC Interpretation 20 *Stripping Costs in the Production Phase of a Surface Mine* on the recognition of these costs.

The IASB has decided that this Interpretation:

- should be applicable for financial periods beginning on or after 1 January 2013 with earlier application permitted;
- should be applied to the costs incurred on or after the beginning of the earliest period presented; and
- should provide transitional guidance for pre-existing assets resulting from stripping activities prior to this date.

The publication of this new interpretation is expected during October.

## Call for comments on the SMEIG’s draft Q&As

On 28 September 2011, the SME Implementation Group (SMEIG) published five draft Questions & Answers (Q&As) on the following topics:

- **Prescription of the format of financial statements by local regulation**
- **Departure from a principle in the IFRS for SMEs**
- **Jurisdiction requires fallback to full IFRSs**
- **Interpretation of ‘undue cost or effort’ and ‘impracticable’**
- **Application of IFRS for SMEs for financial periods ending before the IFRS for SMEs was issued**

These draft Q&As are open for comment until 30 November 2011.

These draft Q&As are available on the IASB site at the following address:

ESMA (formerly CESR): 11th extract from the database of enforcement

On 16 August 2011, the ESMA (The European Securities and Markets Authority), formerly CESR, published the 11th Extract from the EECs its Database of Enforcement.

The nine decisions of the European enforcers thus published concern the following areas:

- Determination of the fair value less costs to sell of non-current assets held for sale
- Classification of subsidiary held for sale
- Impairment of financial assets
- Aggregation of operating segments
- Distribution of non-cash assets to shareholders
- Fair value of investment properties
- Disclosures on financial instruments (2 decisions published)
- Presentation of fair value changes in the Profit and Loss account

Two decisions in particular have attracted our attention.

The first relates to the aggregation of operating segments. It will be remembered that IFRS 8 enables the aggregation of two or more segments in a single segment, provided that aggregated segments have the same economic characteristics and present similar characteristics in terms of products or services, production processes, customers, distribution circuits or regulatory environment.

The decision which has just been published concerns the case of a passenger transport company with three operating segments: bus, train and aviation.

The enforcer decided that the “City bus operations” and the “Major Towns’ bus operations” could not be aggregated into a single segment, because the customers were different (local transport authority vs. passengers), and because the tariff mechanism was different and did not expose the company to the same risk (cost per mile basis following a competitive tender process vs. passenger fares).

The second concerns the distribution of non-cash assets to shareholders. The IFRIC 17 interpretation, Distribution of non-cash assets to owners, states that:

- a liability must be recognised in equity at the date at which the distribution is authorised, on the basis of the fair value of the non-cash assets to be distributed;
- the distribution liability must be remeasured and recognised in equity at the end of each reporting period and at the settlement date;
- any difference between the carrying amount of the non-cash assets distributed and the distribution liability is recognised in profit or loss at the dividend settlement date.

The newly-published decision concerns the remeasurement of the distribution liability at the dividend settlement date, in the case of a share distribution immediately followed by the listing of the company whose shares had been distributed. The enforcer considered that the carrying amount of the dividend payable should be adjusted at the date of its settlement on the basis of the quoted market price of that day.

This 11th Extract from the EECs Database of Enforcement can be consulted at the following address: http://www.esma.europa.eu/popup2.php?id=7700
In May 2011, the IASB published its new standards on consolidation:

- IFRS 10, Consolidated financial statements, amending IAS 27 for individual accounts and replacing it for consolidated accounts;
- IFRS 11, Joint Arrangements, replacing IAS 31 and eliminating proportionate consolidation in the event of joint control;
- IFRS 12, Disclosure of Interests in Other Entities, indicating the disclosures required for non-consolidated investments.

Many commentators raised the issue that consolidation rules were not relevant to an investment company, as they do not enable shareholders and investors to judge the fair value of an investment entity’s investments.

The IASB therefore decided, together with the FASB under a joint project, to add a final strand to its revision of the standards on consolidation, and on 25 August 2011 published an exposure draft entitled Investment Entities.

Consolidation exemption for investment entities

The exposure draft quite simply proposes to exempt investment companies from the obligation to consolidate the entities which they control. Instead, these subsidiaries would be recognised like shares, and measured at fair value through profit or loss.

Determining when an entity is an investment entity

Consequently, the main issue for this draft standard is to define an investment entity: any company failing to meet the proposed definition will be obliged to consolidate the entities it controls.

The exposure draft identifies six criteria which together define an investment entity:

1. The entity’s only substantive activities are investing in multiple investments for capital appreciation, investment income, or both. The investment entity must not have access, for whatsoever reason, to income from the investment which the other investors do not;
2. The entity makes an explicit commitment to its investors to earn, through its investments, capital appreciation or investment income;
3. Ownership in the entity is represented by units of investments to which proportionate shares of net assets are attributed;
4. A significant part of the entity’s capital is held by investors that are unrelated to the parent entity, so that the investors can benefit from professional investment management. Thus, an investment entity cannot have a single shareholder in the long-term, unless it is also an investment entity held by several investors and created in relation with the creation of the entity;
5. Substantially all of the investments of the entity are managed, and their performance is measured, on a fair value basis;
6. The entity provides financial information about its investment activities to its investors.
Accounting treatment of an investment entity by the parent

While an investment entity must recognise its investments, even if controlled, at fair value through profit or loss, the same is not true of the parent. The IASB draft proposes no consolidation exemption for subsidiaries held through a controlled investment entity unless the parent is itself an investment entity. Therefore, all investments controlled by the investment entity should be reconsolidated at a higher level.

The FASB, whose exposure draft should be published shortly, expects to maintain the recognition of investments at fair value in the parent’s consolidated financial statements.

An exposure draft without unanimous support

The draft presented by the IASB has been the subject of debate even within the Board, since three members voted against. The EFRAG has already expressed its support for the principle of fair value measurement, and for the criteria defining an investment entity, but still has reservations about re-consolidation of subsidiaries of an investment entity by the ultimate parent.

The comment period runs until 5 January 2012.
A sovereign debt crisis now provides the background to the joint deliberations of the IASB and the FASB on the development of a model for the impairment of financial assets of the debt instrument type.

The Impairment project, the second phase in the replacement of IAS 39, has undergone many changes since the first plenary work sessions in 2009. In all, three models have been designed and then abandoned. A single guiding principle seems to have been maintained throughout these three years of discussion: the desire to move away from IAS 39’s ‘incurred loss’ model in favour of an ‘expected loss’ model which would make it possible to recognise debt losses in advance.

Deliberations in recent weeks have focused on a new approach known as the ‘the three-bucket expected loss approach’. As we write, the document on this new model is expected to be published at the end of 2011 or during 2012.

After retracing the main principles developed in the documents published by the Boards in 2009, 2010 and early 2011, Beyond the GAAP will set out the latest decisions, and try to identify the problematic aspects of this new approach.

The original proposals of each Board (2009 and 2010 exposure drafts)

The financial crisis of 2008 exposed the limits of the existing IAS 39 model, based on an ‘incurred loss’ approach requiring the identification of a loss event before any impairment can be recorded in profit or loss, and this led the two Boards to propose developing an ‘expected loss’ approach instead.

The guiding principle of the draft published by the IASB in November 2009 was the recognition of the cost of credit risk (i.e. the losses associated with the issuer’s counterparty risk) symmetrically with the recognition of the interest margin in profit or loss ('matching').

Therefore, the IASB proposed to spread out the recognition of expected losses due to the credit risk over the lifetime of the financial asset, by including them in the effective interest rate (EIR). This approach automatically led to the recognition of income net of expected credit losses.

The main aim of the FASB draft published in May 2010 was to ensure that the total impairment allowance was sufficient to cover future losses under all circumstances. This translated into the recognition in profit or loss, at origination, of all losses expected to occur over the remaining lifetime of a financial asset (“day-one loss”).

The joint proposal of January 2011 (supplementary document)

After receiving the opinions expressed in the comment letters and by the Expert Advisory Panel, the boards published a supplementary document in January 2011 aiming to reconcile, at least in part, the objectives of the original proposals of each board, particularly in respect of ‘open’ loan portfolios.

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1 For more details of these approaches, see Beyond the GAAP No 42 – February 2011
2 An ‘open’ loan portfolio may contain all new generations of loans granted, in contrast to ‘closed’ portfolios which only contain a single generation of loans.
Unlike the IASB’s initial model, this joint approach is based on the principle of ‘decoupling’, i.e. the principle of a separate recognition of interest income (calculated in accordance with the EIR method) and credit losses.

This document introduces the distinction between the “good book” (portfolios of healthy assets) and the “bad book” (portfolios of doubtful assets requiring special monitoring). This distinction depends on the internal organisation of risk management. It is therefore entity-specific.

The diagram below presents the rules for accounting for future credit losses as proposed in the supplement, for each book. NB: impairment methods inspired by the FASB’s original proposals are highlighted in red; those which are closer to the IASB’s original model are highlighted in green.

**Impairment of financial assets – towards a new model, the “three-bucket expected loss approach”?**

Following outreach activities on the good book/bad book model, the boards decided in May 2011 to bring about some change in their model. So far no draft text has been published, but the tentative decisions taken appear to maintain the idea of several different impairment methods depending on the category to which the financial asset belongs. This approach would be based on three asset categories (“buckets”) rather than two, and would retain the expected loss approach, hence its name: the “three-bucket expected loss approach”.

Based on the tentative decisions taken over the last four months, the broad outline of this new expected loss impairment model is as follows.

**a. Criteria for assigning financial assets to buckets**

The initial and subsequent assignment of assets to one of three buckets will reflect the entity’s assessment of the credit risk inherent in the asset (for example, on the basis of the internal rating of the counterparty risk).

Thus all assets with a similar risk profile will be allocated to the same portfolio, and will follow the same impairment rules regardless of the date they were granted or the past performance of their credit risk. The least risky financial assets will be classified in bucket 1 and the most risky ones - in bucket 3.

The subsequent deterioration of the credit risk of an asset initially classified in bucket 1 beyond a certain level will trigger the transfer of the asset or group of assets to bucket 2 or even bucket 3. Were the credit risk to improve, transfer back to a less risky bucket would also be possible.

This model is known by the IASB staff as the “**absolute credit risk model**”, since it is founded solely on the credit risk analysis of the asset at the reporting date, without considering the evolution of the risk over time.
b. Methods of accounting for future losses per bucket

Assets assigned to Bucket 1:

- impairment will be determined on a portfolio basis;
- from origination, the total amount of impairment to be recognised will correspond to the losses expected **over the next twelve or twenty four months** (the exact loss-horizon should be specified later);
- the impact on the profit and loss account at each reporting date will be equal to the difference between the impairment allowance already recognised, and the losses expected to occur in the next 12 or 24 months (i.e. variation of the impairment allowance from one period to another).

In comparison with the treatment originally set out in the supplementary document for “good book” assets, this approach keeps only the floor mechanism inherited from the FASB approach.

Assets assigned to Bucket 2:

- impairment will, again, be determined on a portfolio basis;
- from origination, the total amount of impairment to be recognised will correspond to the losses expected **over the total remaining lifetime of the financial assets**;
- in the event of changes in future loss expectations, the total amount of impairment will be adjusted and the adjustment recognised in profit or loss.

This approach is very similar to the proposals set forward for “bad book” assets in the previous model.

Finally, for assets assigned to Bucket 3:

- impairment will be calculated in the same way as for bucket 2, but it
- will be determined on an individual basis.

c. Schematic presentation of the new model (on the basis of decisions taken at the time of writing)
**Assumptions**

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<thead>
<tr>
<th>Example 1:</th>
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<tbody>
<tr>
<td>1a) Origination/ acquisition of a &quot;healthy&quot; financial asset as of year-end N</td>
<td>N+1</td>
<td>N+2</td>
<td>N+3</td>
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<tr>
<td>Loss expectations as of year-end N:</td>
<td>5</td>
<td>5</td>
<td>5</td>
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<tr>
<td>Loss horizon for bucket 1 = 12 months</td>
<td>15</td>
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**Classification and impacts**

<table>
<thead>
<tr>
<th>Bucket 1</th>
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<tbody>
<tr>
<td>Initial P&amp;L impact (end of N): -5€</td>
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<tr>
<td>Impairment amount = losses expected to occur in the next 12 months</td>
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<table>
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<tr>
<th>Example 2:</th>
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<tr>
<td>2) Origination/ acquisition of a &quot;riskier&quot; financial asset as of year-end N</td>
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<tr>
<td>Loss expectations as of year-end N:</td>
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<td>Loss expectations as of year-end N+1:</td>
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<tr>
<th>Bucket 2</th>
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<tr>
<td>Initial P&amp;L impact (end of N): -25€</td>
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<tr>
<td>Impairment amount = expected remaining lifetime losses</td>
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Note: the financial asset corresponds to a portfolio of loans measured at amortised cost.
a. Recognition of a loss at origination: a weakness of the absolute risk model?

The recognition of all or part of expected losses at the date of initial recognition of financial assets would result in the recognition of “day-one losses”).

This impact in profit or loss, which may be considerable in some situations, would take no account of the remuneration received for this credit risk. Therefore, even a loan priced so as to have a high margin could lead to the recognition of a day-one loss.

This could have several potentially adverse consequences. For example:

- An entity would automatically bring about a deterioration in its profit and loss account by deciding to increase the amount of loans granted.
- Conversely, a sale of loans whose initial pricing was right at a market price close to par would automatically require the recognition of a gain through the reversal of the impairment allowance initially recognised.

From a more conceptual point of view, the recognition of a day-one loss at origination contradicts a key principle of standards applicable to financial instruments (IAS 39 and the future IFRS 9), namely the initial recognition on the statement of financial position of all financial assets and liabilities at their fair value.

These aspects constitute the main weakness of the absolute credit risk model described above.

Some IASB members have therefore proposed an alternative approach of classification, the “relative credit risk model”.

This “relative” approach recommends initially classifying all financial assets in bucket 1 and subsequently transferring them to buckets 2 and 3 in the event of a deterioration in credit quality.

However, the Board decided not to proceed with this relative approach and develop the “absolute risk” model instead, believing that the latter approach was more consistent with credit risk management practices and that existing risk management systems were not capable of gathering and storing information on the evolution of credit risk over time.

b. The importance of the definition of buckets

This approach lends great significance to the definition of the boundaries between the buckets applied by each entity.

Thus, the total amount of impairment allowance accounted for an asset classified by an entity in bucket 1 (Example 1a) will be potentially different from that accounted for an asset with the same future loss estimate but classified by another entity in bucket 2.

Likewise, this definition of boundaries will be crucial in the event of changes in the quality of an asset.

When an asset migrates from bucket 1 to bucket 2 or 3, the difference between the impairment amount determined by the ‘losses over next 12 or 24 months’ approach and by the ‘losses over remaining lifetime’ method would be recognised immediately in profit or loss (Example 1b).

The definition of the credit quality threshold at which an asset must be transferred from one category to another will therefore be critical, in particular to ensure the comparability across entities.

Finally, this definition will be the more important the longer the residual maturity of the asset and the more the expected losses are positioned towards the end of lifetime of the instrument.

What are the next steps?

The IASB and the FASB will next address the following areas:

- Definition of the criteria for the transfer of assets to bucket 2 or 3 in conjunction with the methodology for measuring the degree of deterioration of credit risk.
The treatment of the special case of loans acquired on the secondary market, in the light of the absolute risk model.

Analysis of the case of entities for which the origination of assets of lower credit quality is the norm: how should we handle the consequences of classifying these assets directly in bucket 2 under the absolute credit risk model?

Beyond the GAAP will keep you informed of these future discussions which should result in the publication of a new document before the end of the first half 2012.
In August 2010, the FASB and the IASB jointly published a draft standard on Leases. The very many comment letters received in response to this draft have led the Boards to re-address various aspects before the final publication of the standard.

The tentative decisions taken since January 2011 have so fundamentally altered the first version of the draft that on July 2011 the Boards announced the publication of a new exposure draft.

While awaiting publication (expected in the first half of 2012, according to the IASB work plan as updated at 30 September 2011) deliberations are continuing, and new tentative decisions have been taken during September on:

- Scope
- Lessor accounting
- Lessor presentation

**SCOPE**

The Boards tentatively decided not to provide a scope exclusion from the leases standard for assets often treated as inventory and that are associated with the leasing of another underlying asset (e.g. parts of a larger leased asset).

**Lessor accounting model**

In our previous edition (see Beyond the GAAP no 47 – July August 2011), we presented the lessor accounting approach finally agreed by the two Boards, namely a single accounting model based on a receivable and a residual asset.

In this approach, the lessor recognises, at the commencement of the lease:

- a lease receivable at the present value of lease payments and revenue accordingly;
- a residual asset resulting from the derecognition of a part of the leased asset and an expense corresponding to the cost of sale of the derecognised portion of the leased asset.

This month, the Boards have issued some clarifications regarding the recognition of the receivable (the right to receive lease payments):

- the right to receive lease payments should be measured subsequently using the effective interest rate method;
- the lessor should refer to existing financial instruments guidance (IAS 39) to assess impairment;
- a lessor should recognise immediately in profit or loss changes in the right to receive lease payments due to reassessments of variable lease payments that depend on an index or a rate;
- it will not be possible to measure this receivable at fair value.

The Boards instructed the staff to analyse further whether there should be a requirement to measure the right to receive lease payments at fair value if that right were held for sale. The question remains open at this stage.

For the residual asset, the Boards have clarified that:

- the lessor should refer to IAS 36 to determine whether the residual asset should be impaired;
- revaluation of the residual asset should be prohibited.
Finally, the Boards discussed how the lessor should account for residual value guarantees. They tentatively decided that:

Unlike lessees, who only take account of the residual value guarantees which they grant the lessor, lessors will take into account the residual value guarantees they obtain on the leased asset regardless of the source of the guarantee (i.e. the lessee or a third party).

The amount which the lessor expects to receive under the residual value guarantee can only be recognised at the end of the lease. However the lessor must consider these guarantees when determining whether the residual asset is impaired.

**Lessor presentation**

On the statement of financial position, lessors will have the choice of presenting the lease receivable and the residual asset:

- on two separate lines,
- or on a single line entitled ‘lease assets’. In this instance entities must disclose the amount of the lease receivable and of the residual asset in their notes to the financial statements.

In the statement of cash flows, a lessor should classify the cash inflows from a lease as ‘operating activities’.
Seminars on “Current developments in IFRS”
The last seminar of 2011 dedicated to current developments in IFRS, organised by Francis Lefebvre Formation, will be held on 9 December 2011. To register, please contact Francis Lefèbvre Formation – www.flf.fr, +33 (0)1 44 01 39 99.

2011 Annual accounts Days
Mazars’ Doctrine team will lead a number of seminars on 2011 annual accounts:
- French accounting principles: two sessions in Paris (18 November and 13 December) and one session in Lyons (15 November);
- IFRS: one single session in Paris on 18 October.
To register, please contact Francis Lefèbvre Formation – www.flf.fr, +33 (0)1 44 01 39 99.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

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