No matter who you are, the sovereign debt crisis cannot have escaped your notice, having become a regular feature in the daily press and the focus of attention around the globe. News from the accounting world does not always command the same interest! However, the IASB is making progress with its work, laying the groundwork today for the accounting standards of tomorrow.

One key outcome of October’s redeliberations on the impairment section of the Financial Instruments project is that the IASB announced another shift in the impairment of financial assets. The same goes for the lessor section of the Leases project, with this month’s redeliberations suggesting a new accounting model.

Enjoy your reading!

Michel Barbet-Massin
Edouard Fossat

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### News

**IASB Work Plan**

The IASB updated its work plan on 31 October.

In particular, it should be noted that the publication dates for some projects have been confirmed, and in some cases slightly altered:

- **Financial Instruments – Impairment**: the new exposure draft has been confirmed, and is now scheduled for the first half of 2012;

- **Macro hedge accounting**: the exposure draft is scheduled for the first half of 2012.

It should also be noted that two post-implementation reviews are now officially inscribed in the IASB’s work plan:

- **IFRS 8 Operating Segments**: this project, begun in 2011, should be completed next year;

- **IFRS 3 Business Combinations**: the post-implementation review will start in 2012.

The IASB’s new work plan, as updated on 31 October 2011, can be accessed via the link below:


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Revenue recognition: more disclosures required in interim financial statements

In the run-up to the publication of a new exposure draft on revenue recognition (published on 14 November 2011), the IASB and the FASB this month discussed the disclosures required on this subject in interim financial statements.

They decided to amend IAS 34 to stipulate that the following disclosures should be made in an interim financial report, if they are material:

- a disaggregation of revenue;
- a tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period;
- a maturity analysis of remaining performance obligations;
- information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability, for the current reporting period;
- a tabular reconciliation of the movements of the assets recognised from the costs incurred in a contract (the costs of obtaining the contract and the costs incurred in the process of fulfilling a contract).

These new disclosures need to be viewed in the context of the joint redeliberations of May 2011 on the disclosures required under the future standard on revenue recognition at the end of the annual period (see Beyond the GAAP No. 45 – May 2011).

Proposed amendments to IFRS 1: government loans with a below-market rate of interest

On 20 October 2011, the IASB published an exposure draft (ED/2011/15 Government Loans) which proposes an amendment to IFRS 1 pertaining to government loans with below-market rate of interest. The comment period is open until 5 January 2012.

As a reminder, government loans with a below-market rate of interest have to be recognised initially at fair value and the impact of the difference with the market rate has to be recognised as a government grant, since the amendment to IAS 20 introduced in May 2008 as part of the Improvements project.

October’s exposure draft proposes introducing a new exception to the retrospective application of IFRSs by a first-time adopter.

Thus, a first-time adopter would be required to apply IAS 20 prospectively to loans with a below-market rate of interest entered into on or after the date of transition to IFRSs.

Loans entered into before the date of transition to IFRSs would therefore not need to be adjusted, unless the information required for the adjustment was available at the time of initially accounting for that loan.

Impairment of financial assets (Phase II of IFRS 9) – latest deliberations

In the previous issue, we sketched out the broad principles developed by the Boards in 2009, 2010 and at the start of 2011, summarised the most recent decisions, and then introduced the key points of the new “three-bucket expected loss approach”, as they then appeared.

However, the Impairment of Financial Assets project saw another U-turn in October. Read on for more details.

**IASB and FASB go back to original plan: the relative credit risk model**

Having opted for the relative credit risk model in July, and rejected this model in favour of the absolute credit risk model at the following meeting, the IASB and FASB have changed their minds yet again and have once again announced that they will develop an expected loss model based on a relative model.

As a reminder, the relative model involves initially classifying all debt instruments in bucket 1 and subsequently transferring them to bucket 2 or 3 if their credit risk deteriorates. In contrast, the absolute model involves classifying assets into one of the three buckets in line with the entity’s assessment of the corresponding credit risk at a given point in time. Thus, under the absolute model, the least risky financial assets would be assigned to bucket 1 and the most risky assets to bucket 3, even if they had only just been acquired.

The IASB and FASB are aware that there may be operational difficulties in collecting data on changes in credit risk over time given the current configuration of credit risk management systems, which are generally based on credit risk information at a point in time; historic data on expected losses are not always retained by entities preparing financial statements.

However, following recent discussions with stakeholders, the two Boards seem to have concluded that these operational difficulties are preferable to the major weakness of the absolute model: the recognition of potentially large day-1 losses for loans which have high risk levels from their origination date.

**Criteria for transfers between buckets yet to be defined**

Readers will remember that, under the new three-bucket expected loss approach, the amount of impairment to be recognised for an asset depends on which bucket it is allocated to, and is determined on the basis of:

- losses expected over a relatively short time period (12 or 24 months) for assets in bucket 1; or
- losses expected over the total remaining lifetime of the assets, for those in buckets 2 and 3.

Thus, it is essential to define the boundaries between the buckets. The IASB and FASB have asked their staffs to develop principles for the transfer of assets from bucket 1 to buckets 2 or 3, and to identify the indicators which would signal a need to recognise the total expected losses.

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1 For more details on these models, see the study published in last September’s issue (Beyond the GAAP No. 48)
Greater need for disclosures in the notes to ensure comparability

The Boards also emphasised the importance of disclosing information on credit risk management in the notes to the financial statements.

Under the relative credit risk model, there is a risk that two entities could assign the same asset to different categories (and thus have very different impairment level) depending on whether they acquired the asset at the origination date or at a later date at which its credit risk had already deteriorated.

Additional disclosures are therefore likely to be required in the notes in order to support the expected loss approach and ensure comparability between entities.

Next steps

In order to give the staffs time to develop proposals on these new working priorities, the next deliberations on Impairment of Financial Assets (Phase II of IFRS 9/Impairment) have been postponed by one month to December 2011. Beyond the GAAP will keep you fully up-to-date on these future discussions.
In August 2010, the FASB and IASB jointly published a draft standard on leases. Before publishing the final standard, the Boards decided to rework various sections in response to the many comment letters received.

The tentative decisions taken since January 2011 have significantly changed the exposure draft, and the Boards therefore announced on 21 July of this year that they would publish a new exposure draft in the first half of 2012.

In the run-up to this new draft, deliberations have continued during October and early November. They addressed the following issues:

- The “receivable and residual” approach;
- Presentation requirements for lessors;
- Transition requirements;
- Lessor disclosures.

**Lessor accounting model: the “receivable and residual” approach**

**Exemption from the “receivable and residual” approach**

The Boards decided that the “receivable and residual” approach shall not apply to leases of investment property.

In the absence of any further clarification, it would appear that this provisional decision applies both to investment property measured at fair value (which lay outside the scope of the draft standard from the outset) and to investment property measured at cost.

For these contracts, the lessor shall recognise the leased asset on its balance sheet and recognise revenue over the lease term (similar to the approach used for operating leases under IAS 17).

**Details of the “receivable and residual” approach**

The Boards once again discussed the “receivable and residual” approach and made additional clarifications and modifications to the proposals put forward last July.

At the start of the contract, the lessor shall recognise:

- A receivable for the present value of the lease payments, discounted using the rate that the lessor charges the lessee, and revenue accordingly;
- A net residual asset, resulting from the derecognition of part of the leased asset with a corresponding expense.

The lessor shall not recognise any increase in net assets at the commencement of the contract: the net residual asset shall be measured at the outset as the difference between the net carrying amount of the leased asset just before the start of the contract, and the lease receivable calculated as described above.

This net residual asset shall be composed of two elements:

- A gross residual asset, equivalent to the estimated residual value of the asset at the end of the lease term, discounted using the rate that the lessor charges the lessee;
- A deferred profit, equivalent to the difference between the net residual asset and the gross residual asset.

The gross residual asset and the deferred profit shall be presented together as a net residual asset in the balance sheet.
Subsequently:

- The receivable shall be measured using the effective interest rate method. This receivable will generate interest income;
- The gross residual asset shall be “capitalised” to the residual value at the end of the lease term as estimated at first recognition date, using the rate that the lessor charges the lessee. Thus, the gross residual asset will generate interest income over the lifetime of the lease;
- The deferred profit may not be recognised in profit or loss until the residual asset is sold or re-leased.

Under this new approach, lease income is mainly interest income, recognised over the lifetime of the contract (with the exception of the deferred profit, component of the net residual asset, which is not recognised until the end of the contract).

Thus, in contrast to the Boards’ thinking in July, there is no longer any distinction between:

- leases where profit on the right-of-use asset transferred to the lessee is reasonably assured;
- leases where profit on the right-of-use asset transferred to the lessee is not reasonably assured.

Readers will remember that last July’s deliberations1 favoured different models for recognising lease income (immediately or over the lifetime of the contract) depending on whether or not the profit related to the transfer of the “right of use” to the lessee was reasonably assured.

Variable lease payments

Previously the Boards decided that variable lease payments based on the usage or the performance of the underlying asset shall not be taken into account when measuring the receivable, contrary to contingent payments that depend on an index or a rate.

The Boards hold that variable lease payments based on performance or usage of the underlying asset are de facto included in the valuation of the residual asset, as they are not recognised as part of the lease receivable.

Thus the Boards analysed the effect that the receipt of those variable payments may have on the valuation of the residual asset.

In the absence of any further clarification from the two Boards, we understand from the IASB staff working papers that these discussions only relate, a priori, to substantive variable lease payments. It would appear that this mean variable lease payments which form a significant proportion of the asset’s returns, i.e. the lessor is relying on the variable lease payments just as much as on the fixed lease payments for the expected returns. In other words, this covers situations where the rate that the lessor charges the lessee takes into account the estimation of those variable lease payments.

In view of the above, the Boards have made the following decisions:

- If the rate that the lessor charges the lessee does not take account of estimated variable lease payments of this type, the residual asset shall not be adjusted.
- In contrast, if the rate that the lessor charges the lessee does take account of estimated variable lease payments of this type, the residual asset shall be adjusted by derecognising a portion of the residual asset as an expense at the time when the variable lease payments are recognised in profit or loss. This adjustment is made on the basis of the expected variable lease payments.

In other words, no adjustment is made to the residual asset for any difference between the expected and actual variable lease payments.

As there are many grey areas here, it will be necessary to pay particular attention to the wording of the exposure draft on the subject (always assuming that the Boards do not change their minds again prior to publication).

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1 For more details on last July’s redeliberations, see the study published in the July-August 2011 issue (Beyond the GAAP No. 47)
Further details on the lease receivable (i.e. the right to receive lease payments)

The Boards stated that the lease receivable should not be measured at fair value, even if all or part of the receivable is held for sale.

The lessor shall apply the principles of IFRS 9 (IAS 39) to determine whether or not the receivable may be derecognised.

For lease receivables which include option elements or variable lease payments that are not transferred, the portion of the receivable to be derecognised shall be measured on the basis of the fair value of the receivable, excluding option elements and variable lease payments that are not transferred.

Finally, the lessor shall apply the disclosure requirements in IFRS 7 for transferred lease receivables.

**Presentation requirements for lessors**

On the subject of presentation in the statement of comprehensive income, the two Boards provisionally decided that:

- The accretion of the gross residual asset shall be presented as interest income;
- The amortisation of initial direct costs shall be presented as an offset to interest income;
- Lease income and lease expense may be presented either in separate line items or in a single line item, whichever best reflects the lessor’s business model. If the lessor decides to present them in a single line item, the amount of income and the amount of expense should be disclosed in the notes, referencing the line item of the comprehensive income statement in which these amounts are presented.

**Requirements for initial application**

At the October meeting, the Boards provisionally decided that the future standard would be first applied as described below. The Boards may also decide to permit the option of fully retrospective application.

**For lessors**

For finance leases existing at the beginning of the first comparative period presented, the lessor will not be required to adjust the net carrying amount of the assets relating to these contracts.

In contrast, for operating leases existing at the beginning of the first comparative period presented, the lessor must:

- Recognise a receivable equivalent to the present value of the remaining lease payments, discounted at the rate charged in the lease that was determined at the start of the contract. This receivable shall be adjusted if necessary to take account of any impairment;
- Recognise a residual asset using the “receivable and residual” approach, based on the information available at the beginning of the first comparative period presented, rather than the information available at the start of the contract;
- Derecognise the underlying asset: if lease payments are uneven over the lifetime of the contract, the entity shall adjust the portion of the asset to be derecognised at the beginning of the first comparative period presented, taking account of prepaid or deferred lease payments.

**For lessees**

For finance leases existing at the beginning of the first comparative period presented, the lessee will not be required to adjust the lease assets and lease liabilities, but shall reclassify them respectively as “right-of-use assets” and “liabilities to make lease payments”.
For operating contracts existing at the beginning of the first comparative period presented, the lessee must:

- Recognise a liability equivalent to the present value of the remaining lease payments; the discount rate shall correspond to the lessee’s incremental borrowing rate at the transition date for each portfolio of leases with similar characteristics;
- Recognise a “right-of-use” asset, calculated on the basis of the value of the liability at the start of the contract and taking account of the time elapsed since then.
- Recognise in retained earnings any difference between the right-of-use asset and the liability to make lease payments at the transition date.

Sale and leaseback transition requirements (for sellers/lessees)

Sale and leaseback transactions which were completed before the effective date will be subject to the following transition requirements:

- If the leaseback was classified as a finance lease, no adjustment is required.
- If the leaseback was classified as an operating lease: the seller/lessee must re-evaluate the terms of the sale contract with reference to the criteria for transfer of control of the asset, as set out in the revenue recognition standard. If the contract meets the criteria, the seller/lessee should measure and recognise lease assets and lease liabilities using the same initial application rules as for operating leases (cf. Requirements for initial application for lessees, above). Any gain or loss resulting from this contract should be recognised in retained earnings at the transition date.

Simplification measures

In order to make initial application of the future standard easier, the Boards will allow entities (both lessees and lessors) to apply the following simplification measures:

- An entity is not required to evaluate initial direct costs for existing contracts that began before the effective date;
- An entity will be permitted to use the information available at the transition date, rather than having to use the original information available at the time.

If entities decide to apply either of these simplification measures, they should disclose this in the notes.

Disclosures to be made in the notes by lessors

Entities which use the “receivable and residual” approach must disclose the following items in the notes:

- A table showing all the items recognised in the statement of comprehensive income over the period, disaggregating:
  - The profit recognised at the start of the contract, split into the revenue and the cost of sales;
  - Interest income from the receivable;
  - Interest income from the residual asset;
  - Variable lease payments; and
  - Income from short-term leases.
- The criteria for determining variable lease payments;
- Whether or not there are options for renewal and/or early termination of the contract, and the characteristics of these options;
- A qualitative description of purchase options granted and details of the level of the entity’s exposure to these options;
A reconciliation of the opening and closing balance for elements of profit and loss, i.e. the receivable and the residual asset;

A maturity analysis of lease receivables, including their undiscounted amount. As a minimum, this analysis should include the amounts receivable in each of the next five years and the aggregated amount receivable thereafter;

Information on the way in which the entity manages its exposure to the risks associated with the leased asset: the risk management strategy, any residual value guarantees, etc.

However, entities are not required to disclose the following information:

- The initial direct costs incurred over the period;
- The weighted average of the various rates used to calculate the amount of the receivable (i.e. the right to receive lease payments); and
- The fair value of the receivable or the residual asset.

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- Assessing when debt factoring permits derecognition
- Accounting for share options in a consolidated subsidiary.

Events/publications

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.ffl.fr, +33 (0)1 44 01 39 99.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

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