Edito

Will the United States adopt the IFRS standards in 2013? There is no official answer yet, and bets are open. Anyway, for sure both the IASB and the FASB have recently accelerated the process of convergence: two new US IFRIC members were appointed and an updated joint work plan is presented in this issue of “Beyond the GAAP”. Standard setters’ focus on this objective may slow down or even delay significant work such as the Insurance project, due to a lack of resources.

Happy reading!

Michel Barbet-Massin   Jean-Louis Lebrun

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News

Towards a quicker adoption of IFRS standards in Europe

Europe has recently changed its IFRS standards endorsement process, in order to accelerate the adoption of international standards and interpretations. The European Commission will use the “regulatory procedure with scrutiny”, together with faster coordination between the Parliament, Council, Regulation Committee and Commission.

From 12 to 14 members at the IFRIC board

In November 2007, the IASB’s Foundation announced plans to enlarge the Interpretation Committee. Two members were nominated in April 2008:

➢ Margaret M. Smyth,
➢ Scott Taub,

Both are American. Mr Taub is the former head of accountancy affairs at the SEC.
The IASCF to review its constitution

The IASB’s foundation announced the launch of a consultation process regarding the review of its constitution. Two subjects have already been identified as priorities:

- Governance rules;
- The Board of the IASB.

A publication will be exposed later in May covering both subjects and calling for comments. This publication will probably propose the creation of a Monitoring Group to which the foundation’s Trustees will report. The Monitoring Group would be empowered to:

- Nominate the trustees;
- Evaluate the procedures used by the Trustees to nominate the members of the Board of the IASB;
- Review the strategy of the IASB and its efficiency. The Monitoring Group could give an opinion on the standard setter’s working agenda, without having powers to amend it;
- Ensure that the IASB procedures are respected.

The potential members of the Monitoring Group could be:

- The Chief Executive of the International Monetary Fund,
- The Chairman of the Emerging Markets Committee of the IOSCO,
- The Chairman of the Technical Committee of the IOSCO,
- The Chairman of the Japanese Regulator (Japan Financial Services Agency),
- The Chairman of the SEC,
- The Chairman of the World Bank,
- The designated representative of the European Commission.

Reducing the complexity of IAS 32 and IAS 39

As already announced as early as last March, the IASB has published a discussion paper proposing amendments to the standards, with a view to reducing the complexity of financial instruments’ accounting treatments. This document could lead to amendments to the existing standards.

The IASB identified non-negotiable parameters in its search for solutions:

- Commentators’ proposals shall not entail a reduction of the use of fair value below the levels set in existing standards;
- Proposed changes should ideally increase the relevance and understanding of financial information.

The IASB’s approach consists of three stages:

- The IASB believes that a large part of the complexity of the accounting for financial instruments lies in the numerous accounting and measurement methods (fair value vs amortised cost, five categories of financial assets etc.). The IASB therefore proposes to reduce the number of categories.
In the long term, the IASB plans to use one single method to account for and measure financial instruments. Against this background, the international standard setter considers that fair value is the best possible method.

In the medium term, the use of fair value for all financial instruments raises issues which can not be resolved quickly. The IASB proposes several possible changes which might provide a short/medium term solution: maintain mixed methods (fair value and cost), widen the fair value option, change the hedging rules etc.

However, the discussion paper does not address the scope of financial instruments to which the new principles would be applied, or the difficulties of fair value measurement.

Comments on this analysis shall be submitted by September 19, 2008. Note that this project is being carried out with the US accounting body, the FASB. It has published for comments a document based on the IASB’s discussion paper; comments shall also be submitted by September 19, 2008.

Draft Interpretation D24 – Customer contributions

The period for comments on the Draft Interpretation D24 – Customer contributions (see our January 2008 newsletter) ended on April 25, 2008. The draft interpretation deals with contributions by a customer, either in cash or in the form of an item of property, plant and equipment.

Mazars backs this draft interpretation and highlights the need for implementation guidance for the various situations that fall under this issue.

However, we have expressed the following general reservations:

- The scope of the interpretation is far too wide and may interfere with service concession arrangements (IFRIC 12) and government grants (IAS 20);
- We believe that a single accounting treatment for all situations covered by the interpretation is not realistic. However, it would be useful to provide guidance as to how entities could use their judgment and choose the most appropriate treatment for the various transactions.

Update of the IASB-FASB Convergence road map

Given that the United States may have the groups use IFRSs from 2013, the IASB and the FASB have started to update their joint working programme. The objective is to focus resources on primary projects which could be finalised by 2011. This decision directly impacts the scope of the revisions in process and entails the rejection of all highly controversial issues. In addition, the IASB proposes to call a temporary halt to the review of standards between 2011 and 2015. This update significantly alters standards’ prospects for changes during this period.

The major items are:

- Revenue recognition: the discussion paper will be published and discussed as expected, with the presentation of two methods of measurement.
- Fair value measurement: the expected standard should be mostly based on SFAS 157, and should also include the definition of an entry price.
- Consolidation: a high priority project under the current financial crisis, which should be developed based on the current IASB’s work in progress.
- Derecognition: again, a high priority project in the light of the current financial crisis. The issue is a tough one, and the initial efforts of the staff are to be reviewed and finalised.
- Presentation of financial statements: the project will be continued, but refocused on its initial objective, which is the presentation of information in primary financial statements. In addition, controversial subjects are expected to be avoided; the net result would thus be maintained, as well as the recycling of items accounted for in equity.
- Employee benefits: following the discussion paper, the standard should be revised with a view to eliminate the corridor and the measurement of assets on the basis of the expected return. The evaluation of defined contribution plans with a guaranteed return, proposed in the discussion paper, will be adopted only if comments are positive; otherwise, it will be abandoned.
Leases: the scope of the project would be reduced, with a focus on one main objective: recording all the lessee’s liabilities in the balance sheet. Current operating leases would be accounted for as finance leases, the counterparty of the liability being the acquired right of use. The lessor’s accounting treatment would not be affected.

These decisions will naturally affect the IASB’s work programme. As such, the Insurance project could be delayed, while the review of IAS 27 – Provisions - will definitely be finalised.

The works on emission rights and on business combinations under joint control, launched by the IASB last December, will be continued only if sufficient resources are available.

Revenue recognition

The Board approved the first chapters of the discussion paper on the major characteristics applicable whatever the measurement model: need for a contract, definition of a performance obligation, conditions for satisfying a performance obligation.

The proposed model currently allows revenue to be recognised both by reference to the stage of completion and upon achievement.


In February, the Board’s decisions seemed in favour of the assessment of non financial liabilities at fair value, through, if needs be, the measurement of a transfer value, even if such a transfer is only hypothetical.

This decision was apparently challenged during April’s Board session, but the recommended basis for assessment was not defined or formalised. Significant differences of opinion were expressed on the relevance of the recognition of a margin, beyond the margin for risks and uncertainties.

Consolidation

Due to the financial crisis, the Board decided to accelerate the draft revision of IAS 27 – Consolidation – and SIC 12 - Special Purpose Entities. The Board decided to prepare an exposure draft directly, instead of the planned discussion paper.

The staff proposed a two-pronged approach:

- Characterise the model of control that enables to assess whether consolidation is required;
- Define the information to be provided for in the notes to the accounts, in addition to the current requirements, in order to make sure that all relevant information on non-consolidated entities are included;
- Fill out the current notes to the accounts specific to subsidiaries, in order to provide a comprehensive overview of all the restrictions that may impair controlled assets and liabilities.

Recognition of joint ventures

The debate stimulated by the comments received, two-thirds of which were negative, was very lively. However, the Board confirmed the principle of eliminating proportionate consolidation, and will focus future works on:

- New contacts with companies in order to understand the practical difficulties that were widely reported,
- Contacts with user groups the elimination of proportionate consolidation would leave unsatisfied, in order to understand the information needed.
Study of restatements in the United States between 1997 and 2006: an area for European companies to consider?

In April 2008, the US Treasury Department published a study of the reasons for and impact of restatements by US listed companies between 1997 and 2006. While the study was carried out on companies publishing their accounts under US GAAP, European companies subject to IFRSs may learn from the study’s results as the two set of standards are converging.

The study focuses exclusively on the impact of the correction of errors in financial statements. Attention is to be paid to:

- A drastic increase in financial restatements was reported to the SEC: from 90 in 1997 to 1,577 for the single year 2006;
- A negative market reaction to these corrections;
- A decline in restatements associated with fraud or revenue recognition issues;
- An increase in restatements associated with non-recurring events, non-operating expenses and reclassifications.

In addition to traditional issues associated with revenue (20% of the restatements) and with the recognition of operating expenses (23% of restatements), the study highlights the complexity and practical difficulties presented by a number of accounting standards, in the following areas in particular:

- Accounting for and measurement of debt instruments (19% of restatements);
- Accounting for acquisitions, mergers, disposals and reorganisations (17% of restatements);
- Share-based payments (12% of restatements);
- Income tax (9% of restatements).

This list is - not surprisingly - similar to the list of issues faced by companies publishing their accounts under IFRSs.

The international accounting body’s intention to simplify several standards, as demonstrated by the IASB’s recently published discussion paper “Reducing Complexity in reporting financial instruments”, sounds like a response to these observations.

The study is available on the website of the US Treasury Department:
IAS 33 on earnings per share must be applied by listed companies and companies in the process of an IPO. It requires companies to provide, on the face of the income statement, the basic and diluted earnings per share.

While those concepts may seem quite simple – the basic earnings per share is the net result divided by the actual number of shares, and the diluted earnings per share is the adjusted net result divided by the potential number of shares – their practical application is often complex.

**Basic earnings per share**

While the determination of the basic earnings per share may be very simple for most companies, the following items require specific attention:

- The basic earnings per share must correspond to the result attributable to ordinary shares, adjusted for any preferential dividend. Companies with different classes of shares must adjust the result to only keep the result attributable to ordinary equity holders;
- The number of shares to take into account is the weighted average number of shares outstanding during the period. This implies that:
  - Treasury shares must be excluded from the calculation, and
  - Shares issued during the period and treasury shares bought or sold must be taken into account only for the period of the year where they were effectively outstanding.

**Diluted earnings per share**

The determination of the diluted earnings per share is based on the calculation of the basic earnings per share, with the following changes related to the instruments issued by the company that provide deferred access to equity (potential ordinary shares, under the terminology of IAS 33, resulting from instruments such as convertible bonds or reimbursable convertible bonds, and warrants):

- Adjustment to the numerator (result): exclusion of expenses that would not have been incurred had the dilutive potential ordinary shares already been issued. For example, net of tax interest charges related to convertible bonds must be excluded from the result, as if the bonds were converted on the first day of the period;
- Adjustment of the denominator (number of shares): addition of the weighted average number of dilutive potential ordinary shares to the weighted average number of outstanding shares. A dilutive instrument issued in a previous period is deemed converted on the first day of the period. However, an instrument issued during the period will be taken into account on a pro rata basis.

Only **dilutive** potential ordinary shares shall be taken into account, excluding those with an anti-dilutive effect. Shares considered as anti-dilutive are:

- Potential ordinary shares resulting in an increase of the earnings per share, and
- Potential ordinary shares resulting from warrants or call options whose exercise price is higher than the share average price over the period.
In addition, the dilutive or anti-dilutive nature of an instrument on the earnings per share is measured after taking into account the impact of most dilutive instruments. Instruments that may result in potential ordinary shares must be ranked from the most dilutive to the less dilutive before determining, step by step, their dilutive nature as regards earning per share.

**Accounting treatment for warrants and call options**

As noted above, warrants and call options are considered dilutive only when their exercise price is lower than the share average price over the period. Warrants may therefore be anti-dilutive one period and be excluded from the diluted earnings per share, while being dilutive the following year due to a rise in the share price.

When warrants issued by the entity are dilutive under IAS 33, it does not mean that the total number of shares to be issued in the case of exercise of those warrants should be added to the denominator.

The overall exercise of the warrants must be analysed as:

- An issuance of shares at the average price of the period, and
- An issuance of bonus shares.

Shares purchased at the average price of the period are neither dilutive nor anti-dilutive, and they are not taken into account in the calculation of the diluted earnings per share. Only bonus shares will be integrated in the calculation.

**Example:**

A company issued 100 warrants, each bearing the right to purchase one share at a price of 60. The average share price over the period is 75. The overall exercise of the warrants results in a cash inflow of 6,000, accounting for 80 shares at a price of 75. The number of dilutive bonus shares to be added to the denominator for the calculation of the diluted earnings per share is 20.

**The specific case of share-based payments**

In the case of share-based payments paid with entity’s equity instruments, the analysis is the same as for warrants. The only difference lies in the determination of the exercise price: for share-based payments, a “full” exercise price must be determined, taking into account the fair value of services due from the relevant employee (assessed at the first day of the period or at the date of attribution of the share-based payment if occurring during the period).

The fair value of services due from the relevant employee corresponds to the remaining expense to be accounted for over the residual vesting period, in line with IFRS 2.

**Example:**

On January 1st, 20X1, the company granted its employees 100 options, each bearing a right to purchase one share at a price of 60. The vesting period is set at 4 years. The average share price over the year is 75. The unit value of the option at the date of January 1st, 20X1 is 20.

In order to calculate the earnings per share on December 31, 20X1, the “complete” exercise price of the option is 80 (exercise price of 60 plus 20, which is the fair value of the services due over the vesting period). The price is higher than the average stock price over the year (75).

Options are therefore anti-dilutive, and will not be integrated into the calculation of the diluted earnings per share.
In order to calculate the earnings per share in the following year, the dilutive nature of the options must be reviewed, taking into account the revaluation of the complete exercise price and the average share price over 20X2. The average share price over 20X2 is 85.

The complete exercise price of the option at the date of January 1st, 20X2 is 75 (exercise price of 60, plus the IFRS 2 expense to be accounted for over the residual vesting period: 15). The options are therefore dilutive. The overall exercise of the options results in a total exercise price of 7,500, corresponding to 88 shares at a price of 85. The number of dilutive "bonus shares" to be added to the denominator for the calculation of the diluted earnings per share is thus 12.

In September 2005, the IASB launched a project for the amendment of IAS 33, in parallel to a similar project undertaken by the FASB. This project should result in the publication of an exposure draft in the first half of 2008. However, no date has yet been set for the publication of the revised standard.

In the meantime, companies must continue to calculate the basic and diluted earnings per share under the provisions of current IAS 33.

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In November 2006, the IASB published IFRIC 11 on group and treasury share transactions. This interpretation, applicable for periods from March 1st, 2007 (but only from March 1st, 2008 under the European rule adopting the interpretation: see our February 2008 newsletter), covers the accounting of stock option plans in the IFRS statutory accounts of a subsidiary or the consolidated accounts of a sub-group, when:

- The subsidiary’s (or sub-group) employees are granted rights to equity instruments of the subsidiary or the parent company by the parent company, or
- The subsidiary’s (or sub-group) employees are granted rights to equity instruments of the parent company by the subsidiary.

IFRIC 11 states that these various transactions in the statutory accounts of the subsidiary, or in the sub-group consolidated accounts, are share-based payments within the scope of IFRS 2. The consequences are as follows:

- An expense must be recognised in the accounts of the subsidiary or the sub-group, insofar as the employees provide services to this subsidiary or sub-group;
- When the share-based payment is granted by the parent company, these transactions are qualified as equity-settled, as the subsidiary or sub-group has no obligation to provide cash or another asset. As a consequence, the benefit granted is accounted for on the basis of fair value at the grant date, without later revaluation.
- When the share-based payment is granted by the subsidiary and relates to shares of the parent company, it is said to be cash-settled, as the subsidiary or the sub-group has the obligation to provide the shares that are not its own equity instruments but the equity instruments of an entity outside the group (the parent company). There therefore exists an obligation to provide financial assets associated with a liability. As a consequence, the benefit to be recognised is revalued up to the date on which the instruments are redeemed to the employee, on the basis of the fair value of the underlying shares.

In this second case, the description of the share-based payment differs depending on the level of recognition: either the subsidiary/sub-group or the consolidated accounts of the parent company.

IFRIC 11 clarifies the scope of application of IFRS 2 and the treatment of these specific situations.

However, it only covers share-based payments where the employee obtains equity instruments. It does not cover transactions where the parent company grants employees of the subsidiary (or of the sub-group) a cash payment based on the value of the shares of the parent company or the subsidiary.

In order to clarify the accounting treatment applicable to this type of share-based payments, the IASB published proposed amendments to IFRS 2 and IFRIC 11 in December 2007. The proposals aim:

- to make it clear that these transactions at the level of the subsidiary or the sub-group do qualify as share-based payments within the scope of IFRS 2, and
- to indicate which accounting rules should be applied to these transactions in the statutory accounts of the subsidiary or the consolidated accounts of the sub-group whose employees are granted the payments.
The IASB’s draft applies the following principles:

- These transactions fall within the scope of IFRS 2, and must result in the recognition of an expense in the accounts of the subsidiary (or the sub-group).
- As the employee will receive a cash payment, these transactions must be considered as cash-settled. The expense recognised by the subsidiary or the sub-group will be adjusted to the cash amount paid by the parent company to the employees. The analysis is therefore the same whether the transaction takes place within the subsidiary or in the parent company’s consolidated accounts.
- However, these transactions do not incur any obligation for the subsidiary or the sub-group to carry out a cash outflow for the benefit of employees. Despite being regarded as cash-settled, the expense will be recognised as the counterparty to an increase in the equity of the subsidiary or the sub-group.
- These transactions, like those covered by current IFRIC 11, may generate rebilling agreements between the parent company and the relevant subsidiary. Neither IFRS 2 nor IFRIC 11 is expected to cover these rebilling agreements. They should be analysed separately from the share-based payment transactions with which they are associated.

The effective date of these two amendments is not mentioned in the IASB draft.

These proposed amendments are welcome, as they enable to eliminate any doubt as to the standard applicable to this type of transactions; and they clearly establish the need to recognise an expense in the accounts of the subsidiary or the sub-group when its employees receive share-based remuneration.

However, several issues remain, regarding:

- whether there is sufficient clarification of the scope of IFRS 2. Is it possible that other ways of structuring transactions might lead to a need for additional amendments to IFRS 2?
- whether the principles adopted are consistent with those of IFRS 2 or IFRIC 11: is the revaluation of cash-settled plans justified by the fact that the employee eventually receives cash, or by the fact that the entity bears a liability which must be measured at fair value?

After three years of implementation of IFRS 2, two interpretations (IFRIC 8 and IFRIC 11) and several pending issues (those addressed in the draft amendment, but also the recognition of corporate savings plans, for example), it may be time for the IASB to redefine the principles and the definitions for share-based payments and to carry out a revision of IFRS 2.
Events and FAQ

Events / publications

IMA France conferences

On May 21, 2008, Mazars partner Isabelle Sapet will hold a conference at IMA France, Paris, to present feedback on the experience of the first-time application of IFRS 7 on financial instruments disclosures.

You can register for this event on the IMA France website (www.ima-france.com).

Seminars on “Current developments in IFRS”

Mazars’ Technical Department will host a number of seminars throughout 2008 dedicated to current developments in IFRS. These seminars, organised by Francis Lefèbvre Formation, will be held on 20 June, 26 September and 19 December 2008.

A one-day seminar dedicated to the preparation of accounts will also be held at the end of 2008 with Francis Lefèbvre Formation.

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

Frequently asked questions

- Parties linked to a securitisation vehicle and recognition of a loan transferring back the result of the vehicle;
- Method of consolidation for a company held at more than 50% where several decisions must be taken unanimously by the board of directors;
- Presentation of comparative information and consolidation method to be adopted for a business combination under joint control;
- Scope of consolidation for a venture capital organisation;
- First time application of the IAS 1 amendment on equity disclosures;
- Does a disposal “without recourse” automatically result in the de-recognition of the receivables?
- Acquisition of a real estate company with warehouses: business combination or purchase of assets?

Upcoming meetings of the IASB, IFRIC and EFRAG

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