IASB’s publications rarely speed up so intensely as during this month! After the discussion papers on financial instruments, the Annual Improvements project is partly achieved. Two other subjects addressed by the IFRIC are already under the international spotlight: hedges of a net investment in a foreign operation and real estate sales. Beyond the GAAP’s May issue presents the latest news on these subjects in the run-up to the publication of the definitive interpretations.

Happy reading!

Michel Barbet-Massin   Jean-Louis Lebrun

### Highlights

- **European matters**
- **IFRS news**

### A Closer Look

- Hedges of a Net Investment in a Foreign Operation: how will the forthcoming IFRIC interpretation clarify the situation?

- D21 – Real Estate Sales: IFRIC members reached a consensus!

### Events and FAQ

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**Publication of Annual Improvements to IFRSs**

On 22 May 2008, the IASB published a collection of amendments to IFRSs, in order to improve consistency and integrate certain IFRIC decisions.

We present a summary of the major changes below.

**Cost of an investment in the separate financial statements**

An amendment to IFRS 1 – *First-time Adoption of IFRSs* and IAS 27 – *Consolidated and Separate Financial Statements* was also published on 22 May 2008. The amendment addresses the measurement, at the parent company level, of the cost of investments in subsidiaries, jointly-controlled entities and associates on first-time adoption of IFRSs. The amendment also clarifies measurement conditions of the cost of an investment in the parent’s separate financial statements.

Basically, retrospective measurement of the cost of the investment is no longer required. The IFRS deemed cost of an investment in the separate financial statements may be either:

- the carrying amount of the investment under previous accounting principles; or
- the fair value at the date of transition.

The standard is effective for annual periods beginning on or after 1 January 2009.
European impact study on the implementation of the revised IAS 23 – Borrowing Costs

The European Commission published its conclusions on the impact study(1) for the revised IAS 23 on 5 May 2008. The new standard, published in March 2007, requires the capitalisation of financial costs as part of the cost of qualifying assets financed through borrowing.

The conclusions can be summarised as follows:

- The respondents to the study are in favour of the new standard;
- The removal of the option of recognition as an expense increases the comparability of financial statements;
- Capitalisation of borrowing costs is more in line with the conceptual framework;
- The impact of the new standard is expected to be limited as a majority of companies have already adopted the capitalisation method for borrowing costs;
- Implementation costs are mainly related to the revised standard’s first time application and are therefore not recurring;
- A new study will be carried out after the new standard has been in force for two years.

Following this study, the Commission recommends that Europe should adopt the revised IAS 23 standard, as the benefits resulting from its application are believed to outweigh the implementation costs.

The Commission is expected to reach a conclusion on adoption at the end of 2008. If the vote is positive, the new standard will apply for annual periods beginning on or after 1 January 2009.

The transition provisions require prospective application, without any impact on the opening equity of the first annual period presented.

(1) the European adoption process for the standards and interpretations published by the IASB now includes an impact study in order to determine the cost/benefit ratio of the application of the new text.

Emissions trading schemes

After the withdrawal of IFRIC 3 in 2005 and a long period of review, the IASB decided in May 2008 to develop a standard defining the conditions for the recognition of emissions trading schemes, energy certificates and other similar regimes.

Major issues raised at the time of the elaboration of IFRIC 3 will be revised: among these, the recognition agenda in the income statement of the impact of these regimes and other similar regimes. This project is expected to be carried out in conjunction with the FASB.

Revenue recognition

As part of the work related to the forthcoming discussion paper, the staff presented a draft chapter at the May session, addressing the measurement of commercial contracts. Following this presentation, the majority of the IASB members voted for the “customer consideration” measurement approach.

The draft discussion paper proposes two measurement approaches:

- Measurement of the contract’s rights and performance obligations at fair value. This fair value would be determined by reference to the exit price obtained by the entity in the case of transfer of the performance obligations to a market player;
- Measurement of the performance obligations at the contract price, with a proportion of this contract price allocated to each individual obligation relating to an identifiable product or service.

However, a majority of the Board members favour remeasurement of certain performance obligations (such as the stand-ready obligations). No information is currently available on the cases in which remeasurement would be required or the basis on which it would be carried out.
Annual improvements process

The Board decided to review the general process for the preparation of exposure drafts presenting the annual improvement amendments, in order to facilitate public understanding of the issues.

In future versions, each improvement will be published on the IASB’s website as soon as it is approved, in the form of a near-final draft. The final deliberations will take place in June, the exposure draft being expected in August.

The definitive changes will be published in May of the following year, with an effective date on 1 January of the year n+2. In addition, the amendments will be classified by category, in order to highlight the amendments which have an impact on current accounting practice.

Exposure draft on the revision of IAS 33 – Earnings per Share

The Board has taken its final decisions prior to the publication of this exposure draft, expected before the summer.

Beyond the GAAP will keep you informed on major changes as soon as the draft is published.

Improvements to IFRSs - year 2008

The IASB published an update to the IFRS standards on May 22. The document comprises two parts: one covering amendments resulting in accounting changes, and the other covering editorial changes with no impact on accounting.

It should be noted that some amendments, which address more complex issues than simply improving consistency of IFRSs, were withdrawn from this year’s update. Indeed, criticisms were expressed in response to the invitation to comment. These subjects will be addressed and published separately.

However, a number of the expected changes were confirmed, including:

- IFRS 5 and plan to sell the controlling interest in a subsidiary: 100% of the subsidiary’s assets and liabilities must be classified as held for sale on the face of the balance sheet, and as a discontinued operation in the income statement, if applicable.
- IAS 1 and current/non-current classification: derivatives which are not held for trading purposes (excluding financial guarantee contracts and effective hedging instruments) must be classified as current or non-current.
- IAS 10 and dividends: dividends authorised by the shareholders’ meeting after the closing of accounts are note provided for at the balance sheet date.
- IAS 16 and sale of assets previously held for rental: if it is part of the entity’s ordinary activity, the sale proceeds are recognised as revenue from ordinary activities and all the related flows are classified as operating activities within the cash flow statement.
- IAS 19: plan amendments and reduction in existing benefits. The amendment clarifies the distinction between negative past service costs and reduction in existing benefits.
- IAS 20 and loans from government at a below-market rate: the loan now has to be measured at fair value and the impact of the difference with the market rate must be recognised as a grant.
IAS 36 and recoverable amounts of cash-generating units: when the recoverable amount is based on fair value, the latter being determined by discounted cash flow projections, the standard requires the provision of the following additional information:
- The period over which management has projected cash flows;
- The growth rate used to extrapolate cash flow projections;
- The discount rate applied.

IAS 38 and advertising and promotional activities: the expenditure on advertising and promotion must be recognised as an expense when the entity has access to the goods or when it receives the services, even if it is not expected to use them.

IAS 40 and property under construction: investment property under construction falls within the scope of IAS 40 and must be measured at fair value if this option is adopted.

First-time adoption constraints (date and prospective or retrospective application) are provided for each standard. The amendment to IFRS 5, in particular, has to be applied in conjunction with the revised IAS 27.

However, generally speaking, the amendments are applicable for annual periods beginning on or after 1 January 2009, with early application permitted.

Conceptual framework: latest IASB publications

Two documents relating to the changes in the conceptual framework were published on 29 May, as part of the convergence process between IFRSs and US GAAPs:
- An exposure draft describing the objectives, characteristics and constraints of financial reporting as a useful basis for decisions;
- A discussion paper, setting out the latest views on
  - The reporting entity concept (single entity and group);
  - The distinction between the parent company approach and the group reporting approach;
  - The control concept (taking into account latent control and options over voting rights).

These two documents are open to comment until 29 September 2008.
In the March 2008 issue of Doctr’in (renamed Beyond the GAAP), we presented the latest discussions in progress at the IFRIC on D22 - hedges of a net investment in a foreign operation. The IFRIC members approved the latest amendments to this document at their May meeting and Beyond the GAAP provides you with an update on the forthcoming interpretation.

A definitive consensus was reached, without the need for a further invitation to comment. The draft interpretation will be submitted to the IASB at the June meeting. If approved, the final interpretation is expected to be published in the course of the month, with effective application for annual periods beginning on or after 1st October 2008 (early application is encouraged).

**Background**

According to IAS 21 - *The Effects of Changes in Foreign Exchange Rates*, a net investment in a foreign operation is the amount of the reporting entity’s interest in the net assets of that operation. This investment can take the form of a subsidiary, a joint venture or an associate company. It can be held directly or indirectly by a parent company through its subsidiaries.

Foreign exchange differences generated by a net investment in a foreign operation must be recognised as a distinct component of equity. These cumulative foreign exchange differences are reclassified to profit or loss at the date of exit from the net investment in a foreign operation, i.e. in the case of disposal of the consolidated share.

To protect themselves from variations in foreign exchange rates (foreign exchange risk), groups can hedge their net investments in foreign operations. The effective portion of the hedge is recognised in equity. It offsets the foreign exchange differences that are generated by the net investment in a foreign operation. Like foreign exchange differences, the effective portion of the hedge is reclassified to profit or loss on disposal of the investment. The ineffective portion of the hedge is systematically recognised in profit or loss.

**Scope of the draft interpretation**

This draft interpretation is applicable to any entity holding a net investment in a foreign operation and wishing to hedge the foreign exchange risk through hedging operations that are subject to hedge accounting under IAS 39.
Clarifications provided by the draft interpretation

The forthcoming interpretation will clarify the type of risks that qualify as hedged risks in the hedge of a net investment in a foreign operation, and provide guidance on how to determine the amount of the hedge.

- The text does not allow the use of hedge accounting for foreign exchange differences resulting from the differences between the functional currency of the foreign operation and the presentation currency of the parent entity’s consolidated financial statements. The hedged risk can be any foreign exchange risk arising from the variations between the functional currency of the foreign operation and the functional currency of the parent company or of any intermediate parent company within the group.

Example:

Parent Company P
Functional currency: EUR
Presentation currency: CHF

Subsidiary A
Functional currency: JPY

Subsidiary B
Functional currency: GBP

Subsidiary C
Functional currency: USD

P can hedge its net investment in each of its subsidiaries A, B and C by designating the foreign exchange risk between their respective functional currencies (JPY, GBP and USD) and the Euro (the functional currency of P) as a hedged risk.

In addition, subsidiary B can hedge its net investment in C by designating the foreign exchange risk between its own functional currency (GBP) and the functional currency of C (USD) as a hedged risk.

However, it is not possible to use hedge accounting under IAS 39 to hedge the foreign exchange risk resulting from the exchange differences between the currency used for the presentation of the consolidated accounts (CHF) and the respective functional currencies of subsidiaries A, B and C (JPY, GBP and USD).
The hedged item can be an amount of net assets equal to or less than the carrying amount of the net investment in a foreign operation. A net investment in a foreign operation can be hedged only once for any given risk. When several hedges are implemented within a group, it is necessary to make sure that the same risk is not hedged twice.

Example:

- **Parent Company P**
  - Functional currency: EUR
  - Presentation currency: CHF
  
  ![Diagram](Image)

- **Subsidiary A**
  - Functional currency: JPY
  - Net assets of 500m¥

- **Subsidiary B**
  - Functional currency: GBP
  - Net assets of 300m£

- **Subsidiary C**
  - Functional currency: USD
  - Net assets of 200m$

If P decides to hedge its EUR/USD exposure resulting from its net investment in subsidiary C, it can do so by designating the 200m$ loan held by subsidiary A as the hedging instrument, as the nominal amount is equivalent to the net situation of subsidiary C.

If P decides to hedge its EUR/USD and EUR/GBP exposures, it can do so by designating the 200m$ loan held by subsidiary A as the hedging instrument for the net investment in subsidiary C. In addition, P will have to issue another loan whose nominal amount must not exceed 194m£ (300m£-106m£) to hedge its exposure to foreign exchange risk in subsidiary B. Indeed, while the EUR/GBP risk is different from the EUR/USD risk, P has already hedged 100% of subsidiary C’s equity through the USD loan held by subsidiary A. Therefore, it is not permitted to hedge subsidiary C’s equity in GBP equivalent (106m£) through a EUR/GBP hedge, as the GBP/USD risk would be hedged twice for subsidiary C at P level.
The draft interpretation also stipulates where, within a group, the hedging instruments designed to hedge the foreign exchange risk of net investments in a foreign operation can be held in order to fall within the scope of hedge accounting.

- The hedging instrument can be held by any entity within the group, excluding the foreign operation which itself is being hedged, as long as the requirements of IAS 39.88 are satisfied (designation and documentation formalised at inception, demonstration of the effectiveness of the hedge, etc.).

- The assessment of hedge effectiveness is not affected by the hedging instrument being or not a derivative instrument, or by the method of consolidation (direct method or step-by-step method).

**Example:**

Note: the example refers to the above diagram.

The hedging of the EUR/USD risk at P level could be done either by designating the 200m$ loan held by subsidiary A as the hedging instrument, or by designating a forward sale of 200m$ (carried out by P, A or B), for example.

Subsidiary B can not hedge its GBP/USD exposure by designating the 200m$ loan held by entity A as the hedging instrument, as this loan is held outside the sub-group composed of B and its subsidiary C.

Finally, the draft interpretation explains how an entity must determine the amounts to be reclassified from equity to profit or loss, relating to both the hedging and the hedged instruments, on disposal (or liquidation) of the net investment in a foreign operation.

- The gain or loss on the hedging instrument relating to the effective portion of the hedge that was recognised in equity has to be recognised as profit or loss on disposal of the foreign operation, in line with IAS 39.102.

- It is necessary to identify the portion of the “foreign currency translation reserve”, included in the parent company’s equity, that relates to cumulative foreign exchange differences linked to the foreign operation disposed of by the parent company. This amount also has to be reclassified as profit or loss on disposal of the foreign operation. It may be determined either using the direct method of consolidation or the step-by-step method (the amount of the foreign currency translation reserve relating to the foreign operation may differ according to the consolidation method used).

**Transitional provisions**

Entities will be able to choose between prospective and retrospective application. In addition, if a hedging instrument had been designated in a hedge relationship and the hedge no longer meets the conditions for hedge accounting under the new interpretation, the entity shall apply IAS 39.91 to discontinue prospectively that hedge accounting.
Conclusion

This document was rather welcomed in the invitation to comment in October 2007. The major comments related to practical difficulties resulting from the possibility offered under the draft interpretation for a parent company to hedge its net investment in a foreign operation by holding the hedging instrument in any entity within the group (excluding the hedged operation itself). Indeed, when the functional currency of the entity holding the hedging instrument is different from both the functional currency of the parent company wishing to hedge its investment and the functional currency of the foreign operation, it seems difficult to demonstrate the effectiveness of the hedge. This possibility goes beyond what is permitted under FAS 133 in US GAAP. The IFRIC has overturned these criticisms and decided to stick to the initial consensus.

Indeed, in its additional deliberations, the IFRIC attempted to demonstrate that the method of consolidation adopted by groups (either direct or step-by-step) is irrelevant when assessing the effectiveness of a hedge, even if the amounts recognised are different. The IFRIC also wanted to provide additional guidance on the consequences of disposal of an investment in a foreign operation.

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Progress was made towards completion of the IFRIC’s work on the recognition of real estate sales! Several months of research and discussions were necessary to reach a consensus, which now seems established. The task was not easy as real estate sales and therefore their recognition are significantly affected by local legal specificities. In some countries, contracts may have the characteristics of a sale of real estate before construction is complete.

Identification of the characteristics of the agreement

The IFRIC draft interpretation assumes that the entity analysed the sale agreement in detail. This analysis should focus on the following issues:

- Can the agreement be analysed as a whole or does it need to be split into separate components, e.g. the sale of land and the sale of the real estate?
- Is the buyer able to specify the major structural elements of the construction?
- Does the seller provide a service or the delivery of goods?
- If the agreement is an agreement for the sale of goods, does the seller transfer the risks and rewards as construction progresses?

These issues have been addressed by the interpretation committee and must be used to identify the accounting treatment applicable to each agreement.

Is the sale of land a separate transaction?

This question is crucial as it determines the timescale over which the entity must recognise the margin from the land. In most cases, this distinction is covered by IAS 18 – Revenue, which requires the recognition criteria to be applied to separately identifiable components of a transaction in certain situations.

In practice, this means that transactions in which the sale of land could have been carried out separately from the construction component have to be isolated. In the case of a sale by units, the buyer acquires an indivisible portion of the occupied ground. In this specific case, the sale of land can obviously not be separated from the real estate sale. Therefore, the contract is an inseparable whole.

However, the issue remains in the case of selling an estate of individual houses. Each transaction relates to a single construction and a single plot of land. Separate accounting for the sale of land would entail revenue recognition at the date of signature of the off-plan sale agreement. It should be noted that the current practice of a number of promoters involves recognition of the margin on the sale of land as construction progresses.
Is the buyer able to specify the structural elements of the construction?

This issue has fuelled the debate for a number of months. The answer to this question will determine which accounting standard is applicable. If the client is able to specify the structural elements of the project, the transaction meets the criteria for a construction contract as mentioned in IAS 11 – Construction Contracts. As a consequence, the promoter’s margin is recognised using the percentage of completion method. This standard requires a large amount of information to be provided in the notes to the financial statements.

What does “specify the structural elements” mean? Following a lot of debate, the IFRIC appears to confirm that the buyer’s specifications must be related to the structural elements of the project. The colour of the tiling in the bathroom is not a structural specification as intended by the IFRIC. Examples of structural specifications would be participation in architectural choices, overall design, selection of projects or contractors, etc.

When the client is unable to specify the structural elements, the contract must be recognised under the provisions of IAS 8 – Revenue.

Rendering services or selling goods?

Those who are familiar with IAS 18 will already understand the consequences of the answer: rendering a service requires the recognition of margin under the percentage of completion method. On the other hand, selling goods requires recognition upon completion. The spectre of the completed contract method led a number of promoters to express fierce criticism when the exposure draft was published. They failed to appreciate the ingenuity of the IFRIC members and staff.

The IFRIC’s consensus goes far beyond a simple distinction between rendering services and selling goods, and introduces a key concept: the sale of goods may be recognised on a continuous basis. The percentage of completion method would therefore be applied to a sale of goods if the agreement transfers the control and the risks/rewards to the buyer as construction progresses. In the opposite case, obviously, the sale would be recognised upon completion.

The example of off-plan contracts provides for the transfer of legal ownership as construction progresses. The client may provide the building as a guarantee while it is under construction. While the analysis of the transfer of risks and rewards in the case of off-plan contracts still needs to be formalised, the specificities of such contracts seem to have been taken into account by the IFRIC beyond the initial hopes of the industry.

Disclosures and effective date

The IFRIC plans to ask entities applying the “continuous” sale method to provide part of the information required by IAS 11 on construction contracts. However, some of this information – often seen as difficult to provide by entities issuing financial statements – is not required. This is the case for the “due to customers” and “due from customers” information required under IAS 11.42-44.

The IFRIC plans to make this interpretation applicable for annual periods beginning on or after 1 January 2009. The consensus from the IFRIC is expected to be submitted to the IASB at the June Board meeting. The publication of the definitive interpretation is expected by end-June or the beginning of July.
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, France.

Frequently asked questions

- Methods for the recognition of a non-competition indemnity in the interim accounts;
- Recognition and measurement of hotels methods at first-time application of IFRS standards: which fair value?
- Should a firm buying commitment signed during an annual period, and leading to the control after the balance sheet date, be considered as a derivative to be recognised in the period?
- Accounting treatment of an issuance of OBSAAR convertible bonds;
- Accounting treatment of a free share grant;
- What are the sale proceeds which have to be recognised in the case of a contribution of shares of subsidiaries, remunerated as shares providing a significant influence?
- How should an acquired entity’s finance leases be treated in the case of a business combination?
- Should the direct costs related to the acquisition of a subsidiary be incorporated into the cost of the business combination gross or net of tax?

Upcoming meetings of the IASB, IFRIC and EFRAG

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