

Beyond the GAAP

No 66 – April 2013

At a time when the American organisations are appointing new leaders to both the FASB and the SEC, the IASB is continuing its work, and expects to see an exceptional number of publications in 2013.

Key documents such as the second exposure draft on leases, or the exposure draft on insurance contracts, are due for publication before the end of June. The final standards on revenue recognition and hedge accounting should follow soon after.

In the meantime, *Beyond the GAAP* invites you to take a look at the IASB's proposals for the impairment of financial assets on the basis of expected losses. After the 2009 and 2011 publications, has the IASB finally arrived at a definitive model?

Happy reading!

Michel Barbet-Massin

Edouard Fossat

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Editors in chief:

Michel Barbet-Massin, Edouard Fossat

Columnists:

Vincent Guillard, Egle Mockaityte and Arnaud Verchère.

Contact us:

Laurence Warpelin
Head accounting standards
laurence.warpelin@mazars.ch
Tel. +41 21 310 49 03
www.mazars.com

Denise Wipf
Director
denise.wipf@mazars.ch
Tel. +41 44 384 93 75

News

New chairman to head the FASB

On 23 April 2013, the Trustees of the Financial Accounting Foundation, the FASB's supervisory body, named Russell G. Golden, one of the board's seven existing members, as chairman of the FASB with effect from 1 July 2013.

Following his appointment, Mr Golden said that he intended to:

- continue the work of his predecessor, Leslie F. Seidman;
- maintain high quality standards;
- put the interests of investors first; and
- never lose sight of the balance between costs and benefits.

New chairman to head the SEC

On 8 April 2013, the US Senate endorsed President Obama's decision to appoint Mary Jo White as the new head of the Securities and Exchange Commission, but its confirmation only allows her to complete the remainder of outgoing chairman Mary Schapiro's five-year term, which ends in June 2014. The Senate has made no comment on a longer-term appointment.

The appointment of this former federal attorney, a lawyer by training, suggests to some commentators that, throughout her term, the accent will be on the protection of investors and the strengthening of the regulatory framework, rather than on the adoption of IFRSs in the United States.

➤ The IASB publishes its proposed interim standard on rate-regulated activities

On 25 April 2013 the IASB published an Exposure Draft entitled 'Regulatory Deferral Accounts' proposing an interim standard on rate-regulated activities.

Pending a definitive standard, the IASB's objective with this interim standard is to:

- permit an entity that adopts IFRS to continue to use accounting policies accepted in its local jurisdiction for the recognition, measurement and impairment of regulatory deferral account balances;
- requires entities to present regulatory deferral account balances as separate line items in the statement of financial position and to present movements in those account balances as a separate line item in the statement of profit or loss and other comprehensive income;
- requires entities to provide disclosures on rate regulation and the associated risks resulting in the recognition of regulatory deferral account balances.

The closing date for comments on this exposure draft is 4 September 2013.

The exposure draft can be accessed on the IASB web site at:

http://www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Exposure-Draft-April-2013/Documents/ED_Regulatory-Deferral%20Account.pdf

- clarify the transitional arrangements for IFRS 10, stating that the first application date will be the commencement date of the reporting period for which the entity applies IFRS 10, and
- simplify the disclosures required, mainly by limiting the requirement to provide adjusted comparative information to the preceding comparative period only.

Like the consolidation package, these amendments are of mandatory application to current financial periods at 1 January 2014, a year later than was proposed in the standard published by the IASB. Early application is possible.

Commission Regulation (EU) 1254/2012 adopting these amendments and published in the Official Journal of the European Union on 5 April 2013 can be accessed at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:095:0009:0016:EN:PDF>

➤ ESMA: 13th extract from the database of enforcement

On 4 April 2013, ESMA (the European Securities and Markets Authority) published the 13th extract from its database of enforcement, containing ten decisions relating to the 2009, 2010 or 2011 accounts:

- IAS 39 – Recognition of financial expense on financial liabilities measured at amortised cost
- IAS 38 – Intangible assets with indefinite useful life
- IFRIC 12 – Presentation of revenue and expenses related to service concession arrangement
- IFRS 36 – Value in use calculation
- IAS 8 – Assessment of materiality of an error
- IAS 24 – Related party disclosures in interim financial statements
- IFRS 3 – Definition of a business
- IFRS 7 – Disclosures related to fair value of financial instruments
- IFRS 36 – Discount rate in value in use calculation
- IAS 16 – Residual value of property

This 13th extract from the ESMA database of enforcement can be consulted at:

<http://www.esma.europa.eu/system/files/2013-444.pdf>

European matters

➤ Europe endorses amendments to transitional arrangements for the standards on consolidation

On 4 June 2013, the European Commission endorsed the amendments to the transitional arrangements for IFRS 10, IFRS 11 and IFRS 12, published by the IASB on 28 June 2012.

Readers will recall that these amendments, presented in an earlier edition (see *Beyond the GAAP* May 2012):

European matters

➤ EFRAG, ANC and FRC publish an overview of feedback on the Disclosure Framework for the Notes

On 24 April 2013, EFRAG, the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC) published an overview of the key points made by respondents to the Discussion Paper 'Towards a Disclosure Framework for the Notes' published in July 2012 with a view to discussing ways of improving the quality and reducing the quantity of disclosures in the notes.

This overview can be consulted on the EFRAG site: <http://www.efrag.org/Front/n1-1143/Feedback-statement-on-the-Disclosure-Framework-Discussion-Paper.aspx>

Inter alia, the introduction of this new standard will mean that entities will no longer be able to present their share of income and expenses of these joint ventures in their statement of comprehensive income, which will affect the income statement (impact on revenue, impact on the operating profit).

To limit this impact, the ANC recommends to entities, where this method is considered relevant to their activities, to present their share of profit or loss in joint ventures which are consistent with the entity's activities, within the operating income:

- after an "Operating income" sub-total, and
- before a sub-total headed "Operating income after share in net profit of equity-consolidated entities".

The ANC further extends this recommendation to the share in net profit of associates which are also of an operational nature consistent with the group's activity.

The recommendation can be accessed on the ANC web site at:

http://www.autoritecomptable.fr/sections/textes_et_reponses_2/textes_adoptes_en_20/recommandations/recommandations_2013/view

France

➤ ANC recommendation on the presentation of the result of joint-ventures and associates accounted for using the equity method

On 4 April 2013 the French Autorité des Normes Comptables (ANC) published a recommendation on the presentation in the financial statements of the investor's share in the profit or loss of joint-ventures and associates accounting for using the equity method.

This recommendation follows the European Union's endorsement in December 2012 of the standard IFRS 11 – *Joint Arrangements*.

IFRS 11, to be applied no later than 1 January 2014, replaces IAS 31 – *Interests in Joint Ventures*, and significantly amends the accounting treatment of joint arrangements.

IFRS 11 removes the proportionate consolidation for joint arrangements classified as joint ventures, and makes the equity method mandatory for this type of arrangements.

A Closer Look

What is in the new draft standard on impairment of financial assets? (Phase 2 of IFRS 9)

In March 2013 the IASB published an exposure draft entitled "Financial Instruments: Expected Credit Losses". Comments may be submitted to the Board by 5 July 2013.

This document is part of phase 2 of the IFRS 9 project to replace the existing impairment rules under IAS 39. This is the third paper published by the Board, following an initial exposure draft in 2009 and a supplementary document published in 2011.

➤ Why this project, what instruments are concerned and which entities are involved?

This project constitutes the Board's response to criticisms of IAS 39, under which the rate of credit risk impairment was regarded as too late and too abrupt. Under IAS 39 an incurred loss has to be identified before the recognition of any impairment, which could give the impression that impairment losses are recognised in an inappropriate way ('too little, too late'). The IASB therefore proposes to abandon this 'incurred loss' approach in favour of one based on 'expected losses'. The IASB's proposal thus makes it possible for an entity to impair the assets earlier, even in part upon initial recognition, on the basis of expected losses.

This approach to impairment would apply to all financial assets that are debt instruments (loans, bonds, trade receivables etc.) not measured at fair value through profit or loss under IFRS 9. Irrevocable loan commitments and financial guarantees – unless measured at fair value through profit or loss – will also be in the scope of this approach.

Because of their financing and investment activities, financial institutions are among the entities most affected by these proposals. Manufacturing and service sector entities, while less concerned, will nevertheless follow this project with interest because of their portfolio of trade receivables.

➤ What are the main provisions of this exposure draft?

a) Impairment model with two distinct impairment measurement objectives

➤ General approach

The approach consists of spreading the recognition of impairment charge, the amount of which would cover the entity's expected credit risk losses, over the lifetime of the instrument.

Impairment will be recognised in two stages:

- on initial recognition of a financial asset, impairment is systematically recognised for expected losses due to events which could occur in the next twelve months (the "12-month expected losses");
- subsequently, should the credit risk deteriorate significantly, the initial impairment allowance is increased to cover all the expected losses (the "lifetime expected losses").

A practical way of illustrating these two stages of impairment is as follows:

Impairment = Probability of Default (PD expressed as a percentage) x Exposure At Default (EAD expressed in EUR for example) x Rate of Loss on the exposure Given Default (LGD expressed as a percentage)

- In the initial impairment allowance calculation (12-month expected losses), the PD factor reflects the probability of default during the next twelve months.
- In the impairment allowance calculation carried out in the event of subsequent significant deterioration in credit quality (lifetime expected losses), the PD factor reflects the probability of default over the residual life of the instrument.

Note that the impairment model is intended to be “symmetrical”: impairment can therefore be adjusted upwards and downwards as the credit quality of an instrument fluctuates. Similarly, a return to “12-month expected losses” is possible when the credit risk of an instrument for which lifetime losses have been estimated improves sufficiently.

All impairment allowance changes are recognised in profit or loss for the period.

When estimating expected losses, an entity must use the best available information, including historical data, information on current economic conditions or reasonable forecasts of future conditions and events. When several scenarios are possible, the expected losses for accounting purposes must correspond to the probability-weighted average of all the different expected loss scenarios, and not just to the most probable loss.

Furthermore, the losses thus determined must be discounted: impairments correspond to the present value of expected losses at the reporting date.

➤ **Events triggering the impairment allowance shift from “12 month expected losses” to “lifetime expected losses”**

The profit or loss impact of shifting from “12 month expected losses” to provisioning for “lifetime expected losses” may be very significant. The concept of credit risk deterioration is therefore critical in the new exposure draft.

The ED states that increased credit risk must be associated with an increase in the **probability of default** by the counterparty (and not simply an increase in the absolute amount of expected losses). This increase in credit risk occurs prior to a loss being incurred, as defined in the existing standard IAS 39. The threshold for “significant” deterioration is not quantified in the exposure draft. Preparers must therefore determine these thresholds in their internal impairment methodologies. This exercise will require the use of judgement.

The exposure draft sets nevertheless a ‘rebuttable presumption’ that a significant increase in credit risk has occurred when **payments are more than 30 days past due**.

The exposure draft also provides some examples of events and information which could be used to analyse the “significance” of credit deterioration. These include (but are not limited to) the following indicators:

- significant changes in market indicators of credit risk for a particular financial instrument or similar financial instruments with the same term (such as the credit spread, credit default swap prices for the same borrower, a decline in the fair value of the instrument below cost, etc.);
- an actual or expected significant downgrading in the borrower's credit rating by an external rating agency or on the internal rating scale;
- significant changes in internal price indicators of credit risk (this corresponds, for example, to situations where the credit spread that would result if the loan were to be newly issued to the same borrower at the reporting date is much higher than the contractual spread);

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- a significant downward trend in the operating results of the borrower (examples include declining revenues or margins, increasing operating risks, etc.);
- actual or expected adverse changes in the borrower's economic, financial, technological or regulatory environment;
- etc.

Note that, in order to facilitate the operational monitoring of changes in credit quality, the proposals introduce a **major simplification**: whatever the change in its credit risk since initial recognition, an instrument with low credit risk at the reporting date will be impaired on the basis of expected 12-month losses. The monitoring of credit risk evolution remains mandatory for other instruments.

The Board proposes to define the credit risk as 'low' if a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its obligations. Instruments with a rating equivalent to the external rating of 'investment grade' would be considered by the Board as having a low credit risk.

➤ Determination of impairment on a collective basis

When several financial instruments share common risk characteristics (such as the type or rating of the counterparty, the nature of the instrument, the sector or country concerned, the date of issue, etc.), the exposure draft allows assessing the changes in credit quality since their initial recognition on a collective basis. The characteristics on the basis of which the assets have been assigned to portfolios should, however, be indicative of the ability of their issuers to repay all of the amounts due to the entity. Further, any aggregations of financial instruments must be reviewed at each reporting date to ensure that the instruments still have shared risk characteristics, and may continue to be impaired on a collective basis. If an incurred loss (or a significant deterioration) occurs to one of the assets but not to the rest of the portfolio, the asset must be removed from the portfolio. Unless it can be allocated to another category 2 portfolio (i.e. one subject to the rule of impairment on the basis of lifetime expected losses), this asset should be impaired individually. Expected losses can also be determined on a collective basis.

b) Recognition of interest revenue

The exposure draft also proposes to amend the way in which interest revenue on impaired financial assets is accounted for, as follows:

- in most cases, interest revenue would continue to be calculated using the Effective Interest Rate (EIR) method as defined in IAS 39/IFRS 9, which would be applied to the gross amortised cost of the asset (i.e. before taking impairment allowance into account);
- However, where a credit loss has been incurred (in accordance with the existing IAS 39 definition), the EIR would be applied to the net amortised cost of the asset (i.e. after subtracting the impairment allowance from the gross carrying amount).

c) The three categories: a summary

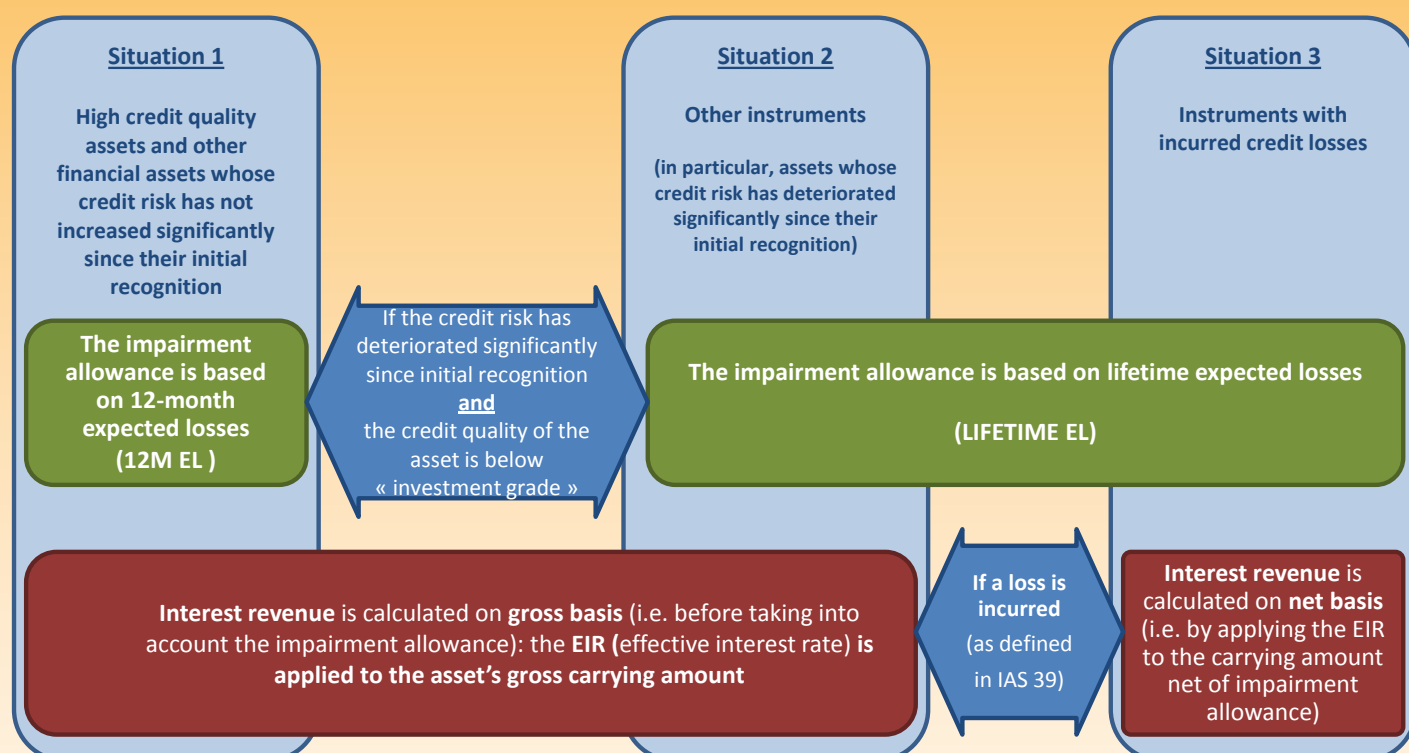
By combining the impairment model in paragraph a) with the recognition of interest revenue presented above, it is possible to arrive at three categories:

- From initial recognition, and provided that there is no significant deterioration in credit quality, impairment is equal to the 12-month expected loss, and interest revenue is calculated on the gross amortised cost;

A Closer Look

- In the event of significant deterioration in credit quality, but in the absence of any incurred loss (as defined in IAS 39), lifetime expected credit losses are recognized, but the interest revenue continues to be calculated on the gross amortised cost;
- Where there is an incurred loss, the impairment allowance covers the expected lifetime losses, and interest revenue is calculated on the basis of amortised cost net of expected losses.

This approach can be summarised in the following graphic.



➤ Special cases

a) A simplified approach for trade receivables and lease receivables

The draft standard on impairment proposes some operational relief for trade receivables and lease receivables (within the scope of standard IAS 17 Leases, or the standard which will replace it).

These proposals include:

- For 'short-term' trade receivables (those with no significant financing component in accordance with IAS 18 Revenue) impairment should be measured at an amount equal to lifetime expected credit losses. In practice, the 12-month loss and the lifetime loss would generally be the same for this type of asset where the lifetime is rarely longer than a year. Therefore, preparers do not need to track shifts between situations 1 and 2 (see the graphic above) for such instruments.

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- For 'long-term' trade receivables (those which include a significant financing component) entities would be free to opt:
 1. to apply the general approach described above (which entails monitoring the credit risk following initial recognition); or
 2. to systematically impair such instruments on the basis of lifetime expected losses, as for 'short-term' trade receivables.

This choice of accounting policy must be applied consistently to all 'long-term' trade receivables.

- For lease receivables, the same alternative is proposed as for trade receivables. Similarly, this choice of accounting policy will apply to all the lease receivables held.

Regardless of the impairment method chosen (simplified or general approach), the draft offers the option of using simplified methodologies of determining the amount of the impairment. For example, a provision matrix can be used for trade receivables. This matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1% if not past due, 3% if less than 90 days past due, 20% if 90–180 days past due, etc.). However, if the customer base were diverse, the entity would have to use appropriate provision rates to take account of the particularities of each sub-group of trade receivables. Naturally the entity would be required to demonstrate that these simplified methods are in line with the general principles of the approach.

b) A special model for assets that are credit-impaired on initial recognition

The exposure draft proposes a model which would only apply to assets that have objective evidence of impairment on initial recognition (for example, loan portfolios of the distressed assets activities of certain banks).

For these instruments:

- there would be no impairment at initial recognition;
- subsequently, the amount of impairment recorded on the balance sheet would correspond to changes in lifetime expected losses since initial recognition. Thus, the impairment allowance for such assets will be systematically different from the expected losses which would have been identified using the general approach;
- throughout the lifetime of the instrument, interest revenue would be calculated by applying a risk-adjusted EIR (i.e. taking account of future credit losses) to the net amortised cost (i.e. after deduction of the impairment allowance).

c) A special approach for modified loans

When an instrument is renegotiated (for example, if several due dates are deferred, or the contractual interest rate is amended) and that modification does not result in a derecognition, entities must assess if it is necessary to transfer the instrument to a different impairment category by comparing the asset's risk level on the reporting date (that is, taking into account the renegotiated characteristics) with its risk level at the time of initial recognition (as it was before renegotiation).

Further, the gross carrying amount of the asset (i.e. before taking account of impairment) should be adjusted to reflect the new contractual flows, and the difference between the previous gross carrying amount and the new gross carrying amount (generally obtained by discounting the new cash flows at the original EIR) will be recorded in profit or loss as a modification gain or loss.

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Where the modification of the contractual clauses is such that the asset must be derecognised and a new asset recognised, any deterioration in the credit risk of the renegotiated loan will be assessed by comparing its risk level on the reporting date with its risk level just after the renegotiation (i.e. the date of initial recognition of the 'new' instrument).

d) Loan commitments and financial guarantees

Given that loan commitments are undrawn amounts (and therefore not yet recorded as assets on the balance sheet), an entity should estimate expected credit losses consistently with its expectations that the loan commitment will be drawn down. Thus:

- For category 1 commitments (i.e. those for which the impairment amount is based on 12-month expected losses), impairment will only be recognized for these commitments (or portions thereof) which are likely to be drawn down in the next 12 months,
- For category 2 commitments (i.e. those for which the impairment amount is based on lifetime expected losses), impairment will only be recognized for these commitments (or portions thereof) which are likely to be drawn down over the remaining life of the loan commitment.

For financial guarantee where impairment is based on lifetime expected losses, the period to be taken into account is that during which the guarantee remains exposed to credit risk, and not the contractual maturity of the instrument which is being guaranteed.

e) Impairment of financial assets measured at fair value through other comprehensive income (FV-OCI)

Readers will remember that the draft amendment of Phase 1 of IFRS 9 (see Beyond the GAAP no 64, February 2013) reintroduces the Fair Value through Other Comprehensive Income category (FV-OCI) for assets that are debt instruments. These instruments will be presented in assets at their fair value, and changes in fair value from one period to another will be initially recognised in equity (the recyclable reserve Other Comprehensive Income).

In accordance with the new exposure draft on impairment (and in contrast to the provisions of the existing standard, IAS 39) credit risk impairment and interest revenue on the asset will be determined for these instruments in exactly the same way as for financial assets measured at amortised cost. Thus, identical profit or loss impacts should be recognised for two identical instruments bought at the same time, be they measured at amortised cost or at FV-OCI.

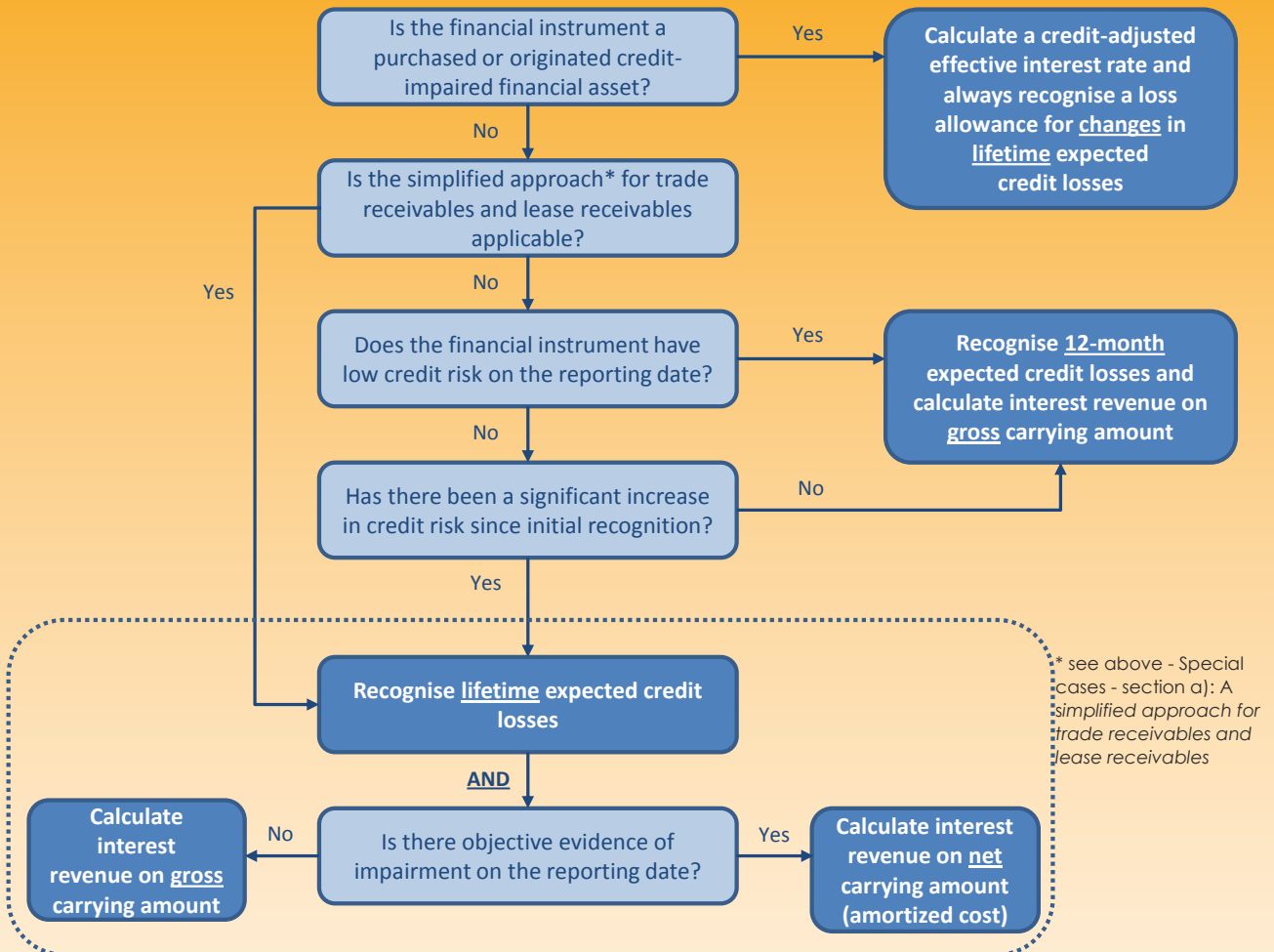
The impairment mechanism, however, would be different:

- For assets measured at amortised cost, the impairment charge would be recorded against a reduction of the amortised cost of the instrument,
- Whereas for an instrument measured at FV-OCI, the charge will be recorded against the recycling of an equivalent amount out of equity, without adjusting the carrying amount of the asset.

➤ Overview of the analysis to be conducted at each reporting date

The analysis to be conducted at each reporting date can be summarised in the following diagram.

A Closer Look



➤ Disclosures to be provided in the notes and transitional provisions

a) What is the impact on the notes to the financial statements?

The draft requires more extensive disclosures than those currently provided for impaired assets under IFRS 7. Additional disclosures will have to be provided about both the impairment allowances recognised in the balance sheet and the changes in the credit risk of financial instruments since their initial recognition.

b) Effective date and transition

As for the other phases of IFRS 9, the IASB proposes an effective date of 1 January 2015. In France, however, the application of the new text will be subject to its endorsement by the European Union.

The new impairment model would be applied retrospectively, i.e. each financial asset concerned will have to be classified to reflect the changes in its credit risk since initial recognition. However, when complete retrospective application is not feasible because of the cost of obtaining the information required to determine the classification (including information on initial credit quality), instruments may be impaired solely on the basis of their credit quality at each reporting date, without analysis of the change in credit risk. If this simplification is applied:

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- instruments with a low credit risk will be impaired on the basis of 12-month expected losses,
- and instruments of lesser quality will be impaired on the basis of lifetime expected losses,

until the date of derecognition of the instrument.

If, after the first application of the standard, the credit risk of an instrument – considered as low at the transition date – changes to such an extent that it becomes high (or the reverse), the determination of expected losses must be in line with the new absolute level of risk for this instrument (i.e. lifetime expected losses instead of 12-month expected losses, and vice versa).

The restatement of comparative periods (before the first application of the standard) is not required, but may be carried out if certain conditions are met. If the comparative periods are not restated, the impact of the first application – corresponding to the difference between the old and the new impairment allowance balance – will be accounted for in equity at the beginning of the annual reporting period in the course of which the standard is first applied.

A reconciliation between the impairment allowances recognised before and after the transition to IFRS 9 should also be provided. However, there will be no requirement to provide the carrying amounts of the instruments and the impairments allowances that would have been recognised for the transitional period under the previous approach in IAS 39.

➤ Is convergence with US GAAP certain?

It should be noted that the US standard setter, the FASB, published its draft standard on impairment at the end of 2012. If the two drafts are adopted in their current state, any short or medium-term convergence of the IFRS and US GAAP standards would be compromised. Unlike the IASB's proposed approach, which is based on two distinct impairment objectives depending on the extent of credit risk deterioration (12-month expected losses versus lifetime expected losses), the FASB proposes to base the impairment amount on lifetime expected losses all the time, including the date of initial recognition of the asset.

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Frequently asked questions

- Implementation of the transitional arrangements for IFRS 10, IFRS 11 and IFRS 12, published in June 2012;
- Recognition of a business combination under joint control;
- Impact on the recording date of a receivable of a commitment to purchase assumed by a third party, at a price agreed in advance, on the same asset;
- Recognition of a conditional put on non-controlling interests.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB

20 - 24 May 2013

17 - 21 June 2013

22 - 26 July 2013

Committee

14 - 15 May 2013

16 - 17 July 2013

10 - 11 September 2013

EFRAG

6 - 8 May 2013

12 - 14 June 2013

15 - 17 July 2013

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