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Beyond the GAAP

Mazars' newsletter on accounting standards

Contents

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Editorial

In our January 2014 issue, we highlighted the ongoing differences of opinion between the IASB and the FASB as they tried to finalise the standard on financial instruments. After years of work on the joint standard, they seem unable to reach a consensus on either phase 1 (classification and measurement) or phase 2 (impairment).

This month, yet another flagship project for IFRS/US GAAP convergence is seeing the prospect of a joint standard slipping away. At their joint meeting in March 2014, the FASB and IASB each opted for a different approach to lease accounting for lessees.
Many observers are hoping that these differences of opinion will lead the IASB to revise its approach, or indeed to abandon this widely unpopular project.

Happy reading!

Michel Barbet-Massin Edouard Fossat

IFRS

IFRS IC confirms that accounting treatment of joint arrangements should be based on legal and contractual analysis of the parties' rights and obligations

In March 2014, the IFRS Interpretations Committee continued its discussions of implementation issues with regard to the application of the requirements of IFRS 11 *Joint Arrangements.*

As a reminder, the IFRS IC has tentatively clarified in January 2014 that:

- the classification of a joint arrangement depends on rights to the assets and obligations for the liabilities of the parties to the arrangement;
- rights and obligations, by nature, are enforceable;
- the assessment of "other facts and circumstances" should be focused on whether those "other facts and circumstances" create enforceable rights to the assets and obligations for the liabilities.

For more details, see Beyond the GAAP No. 74, January 2014.

In March 2014, the IFRS IC discussed how and why "other facts and circumstances" might create rights and obligations that result in a joint arrangement being classified as a joint operation.

The IFRS IC noted that the purpose of assessing "other facts and circumstances" is to consider whether the substance of the joint arrangement gives the parties rights to the assets and obligations for the liabilities. Some members of the IFRS IC described this as a "substance over form" approach. In our opinion, this implies an analysis of the substance of the legal and regulatory environment in which the joint arrangement is operating, and of the contractual agreements relating to the joint arrangement (including the commercial contracts concluded between the parties and the joint arrangement).

The IFRS IC, when considering the concept of "substance over form", observed that in order for "other facts and circumstances" to result in the parties having obligations for the liabilities of a joint arrangement, it is necessary to demonstrate that cash cascades from the parties through **legal or contractual obligations** to ensure the settlement of the liabilities of the joint arrangement **on a continuous basis.** The IFRS IC therefore thought that the parties' intention to support the joint arrangement was insufficient to establish obligations for the liabilities of the joint arrangement.

However, the IFRS IC noted that the concept of "substance over form" may not be consistently understood or applied in practice (i.e. does it mean economic substance or legal substance?). Consequently, the IFRS IC decided to consult the IASB on this matter before progressing this issue further. We will be sure to keep you updated as the debate continues.

Recognition of "other net asset changes" in an associate or joint venture

In November 2012, the IASB published a draft amendment to IAS 28, with the aim of clarifying how an investor should account for their share of other net asset changes in an associate or joint venture (with 'other' in this case meaning other than the profit or loss of the associate or joint venture, other comprehensive income and the dividends paid by the associate or joint venture).

In the draft, the IASB proposed that the investor should recognise its share of other net asset changes in equity. In the event of loss of significant influence, the amounts recognised in equity should then be reclassified to profit or loss (see Beyond the GAAP No. 61, November 2012).

The comment letters received were quite negative. In July 2013, the Interpretations Committee resubmitted its original proposals, namely to treat reductions in an investor's percentage interest as partial sales and increases in percentage interest as incremental purchases (see Beyond the GAAP No. 69, July-August 2013).

However, in December 2013, the IASB stated that none of the proposed approaches were without their problems, and decided to finalise its proposals. It acknowledged that this was only a short-term solution to put an end to the diverse practices until the Board could look again at the principles of the equity method.

Finally, at its March 2014 meeting, the IASB decided that it was not necessary to re-expose the draft amendment and that it would become mandatory for financial periods starting on or after 1 January 2016. It did not mention at this stage the possibility of early application of the amendment.

The publication of the final amendment to IAS 28 is scheduled for the second quarter of 2014.

Bearer plants – amendment finalised

In June 2013 the IASB published a draft amendment to IAS 41 – *Agriculture*, with a view to including bearer plants within the scope of IAS 16 – *Property, Plant and Equipment.* Under the draft amendment, bearer plants would be recognised using either the cost model or the revaluation model (but not at fair value less costs to sell).

At its meeting on 21 March 2014, the IASB examined the points raised in the comment letters and confirmed the provisions of the draft amendment, notably:

- the revaluation model as set out in IAS 16 may be applied to bearer plants;
- no specific disclosures on bearer plants will be required in the notes under IAS 16.

The final amendment is now scheduled for the second quarter of 2014.

IAS 12: recognition of deferred tax assets for unrealised losses

At its March 2014 meeting, the Interpretations Committee decided to recommend to the IASB a narrow scope amendment to IAS 12 which would clarify the accounting treatment of deferred tax assets for unrealised losses on debt instruments measured at fair value, in accordance with IAS 39 or IFRS 9.

The amendment would primarily consist of an example illustrating the following aspects of application of the principles of IAS 12:

- An unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference, even if the holder of the instrument expects to recover its carrying amount by holding it to maturity and receiving all the contractual cash flows and if the loss is not tax-deductible until realised.
- An entity assesses the use of deductible temporary differences related to unrealised losses on debt instruments measured at fair value in combination with other deductible temporary differences.
- When assessing the likelihood that future taxable profit will be available, an entity assumes that it will recover an asset for more than its carrying amount, provided that this is probable.
- Future taxable profit excludes tax deductions represented by these deductible temporary differences (i.e. tax deductions resulting from the reversal of these deductible temporary differences).
- The example should illustrate the situation where all three sources of future taxable profit are available (i.e. reversal of deductible temporary differences, future taxable profit and tax planning opportunities) but are not sufficient to allow recognition of deferred tax assets for all of the deductible temporary differences.
- The example should explain how an entity shall determine the amounts to be recognised in OCI and in profit or loss, when the entity cannot recognise all deferred tax assets due to insufficient future taxable profit.

The proposed amendment to IAS 12 and the illustrative example will be presented at a future meeting of the IASB.

IASB work plan

At the end of its March meeting, the IASB updated its work plan. A key point was the announcement of an exposure draft on the revisions to the Conceptual Framework, to be published in the fourth quarter of 2014.
It should also be noted that the work plan is not up-to-date with the publication of the exposure draft entitled *"Disclosure Initiative – Proposed amendments to IAS 1"*, which took place on 25th March (for more details on this exposure draft, see above).

The IASB's work plan can be viewed on the IASB's website at the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx

Amendment to IAS 1 on rules for current or non-current classification of liabilities

In March 2014, the IASB continued its discussions on the provisions of IAS 1 relating to the current or non-current classification of liabilities in the statement of financial position.

Readers will remember that the IASB published a proposed amendment to IAS 1 as part of its *Annual Improvements* process in May 2012. The draft proposal suggested that the decision to classify a liability as current or non-current should be linked to the provisions for derecognition of financial liabilities under IAS 39. This proposal was dropped following comments received in the written consultation process.

The IASB relaunched the project in March 2013 in the form of a proposed limited amendment to IAS 1. The purpose of this amendment was to develop a comprehensive guidance on the classification of liabilities in the statement of financial position.

The following provisional decisions were made at the March 2014 meeting of the IASB:

- A liability shall be classified as non-current only if a right to defer the settlement of the liability for at least 12 months exists at the closing date.
- In the case of refinancing of a liability, as we understand it, a liability may only be classified as non-current if the loan contract specifies a right to defer the settlement of the liability for at least 12 months after the closing date. As we understand it, this right could result either from an existing clause in the original loan contract, or from an amendment to the original contract agreed before the closing date (i.e. as part of a renegotiation of the terms of the original loan contract with the original lender). Thus, in practice, a refinancing agreement made before the closing date with a different lender should not, in our understanding, affect the classification of the liability (i.e. the liability would still be classified as a current liability if the original loan contract specified that the liability should be settled within 12 months of the closing date).
- The amendment does not make any clarifications on how post-balance-sheet events should be taken into account in the classification of liabilities.

An exposure draft on this limited amendment to IAS 1 is scheduled for the third quarter of 2014. Beyond the GAAP will make sure to keep you fully updated on any proposed changes relating to the classification of liabilities as current or non-current in the statement of financial position.

IASB publishes exposure draft of limited amendments to IAS 1

On 25 March 2014, the IASB published an exposure draft entitled *"Disclosure Initiative – Proposed amendments to IAS 1"*, which is open for comment until 23 July 2014. This publication forms part of a wider project on disclosures in the notes to IFRS financial statements.

Readers will remember that many respondents to the 2011 consultation on the IASB's agenda asked the IASB to review the disclosure requirements in existing IFRS and to explore ways to improve disclosures.

In December 2012, the IASB therefore decided to add a broad-scope project on disclosures to its work plan, in addition to its current work on the Conceptual Framework. The *Disclosure Initiative* project was launched in 2013 and will take the form of several limited-scope projects aimed at improving the quality of disclosures in the notes.

The recent publication is one of these limited-scope projects. The exposure draft only relates to IAS 1 – *Presentation of Financial Statements*, and its purpose is to clarify that entities can use their judgement in the presentation of financial statements. The proposed amendments:

- Clarify the materiality requirement in IAS 1.
- Clarify that specific line items in the statement(s) of profit or loss and other comprehensive income and the statement of financial position can be disaggregated.
- Add requirements for how an entity should present subtotals in the statement(s) of profit or loss and other comprehensive income and the statement of financial position.
- Clarify that entities have flexibility as to the order in which they present the notes, but also emphasise that understandability and comparability should be considered by an entity when deciding that order.
- Remove potentially unhelpful guidance in IAS 1 for identifying a significant accounting policy.

The exposure draft can be accessed on the IASB's website via the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/Amendments-to-IAS-1/ED-March-2014/Pages/Exposure-Draft-and-Comment-letters.aspx

European matters

EC sets out accounting measures for long-term financing of the European economy

On 25 March 2013, the European Commission adopted the Green Paper on the financing of the European economy and started a three-month public consultation to open up a debate on how to increase the availability of long-term financing and kick-start sustainable long-term growth.

A year later, on 27 March 2014, the Commission submitted its planned measures for achieving these goals to the European Parliament and the Council. Unsurprisingly, some of these measures relate to accounting standards. In particular, it should be noted that fair value accounting was heavily criticised on the grounds that it introduces volatility into financial statements and encourages short-term behaviour.

Therefore, the Commission has made the following announcements in the accounting standards section:

- as part of the adoption process for IFRS 9, it will examine whether the use of fair value is appropriate, particularly for long-term investing business models;
- it will invite the IASB to give due consideration to the consequences of all its decisions for investors' investment horizons, both in particular relevant projects and in the development of the Conceptual Framework. In this context, the Commission emphasised that particular attention should be paid to reintroducing the concept of prudence;
- over the course of 2014, it will study the appropriateness of the adoption criteria, taking particular account of Europe's long-term financing needs;
- it will launch a consultation in 2014 to investigate i) the need for a simplified accounting standard for the consolidated financial statements of listed SMEs, and ii) the usefulness of a complete separate accounting standard for unlisted SMEs, to complement the Accounting Directive.

For more details, see the full document:

http://ec.europa.eu/internal_market/finances/docs/financing-growth/long-term/140327-communication_en.pdf

A Closer Look

IASB splits with FASB on Leases standard

At a joint meeting on 18 and 19 March 2014, the IASB and FASB began redeliberations on their proposed joint standard on leases. A second exposure draft on the subject was published on 13 May 2013 (see Beyond the GAAP No. 67, May 2013).

During the session, the Boards discussed the following topics:

- Lease classification;
- Lessee accounting model;
- Lessor accounting model;
- Lessee small-ticket leases;
- Lease term;
- Short-term leases.

Since the comment period closed in September 2013, the two Boards have been discussing ways of simplifying the accounting treatment of leases (particularly at their January meeting) but thus far without reaching a decision. The March meeting therefore marks a turning point in the progress of the project, as for the first time decisions have been made which change the model proposed in the May 2013 exposure draft.

1. What are the new classification criteria?

As a reminder, the 2013 exposure draft distinguished between:

- Type A leases, in which the lessee consumes more than an insignificant part of the leased asset;
- Type B leases, in which the lessee consumes an insignificant part of the leased asset.

The 2013 exposure draft also includes a presumption that the contract falls into one of the two categories depending on whether or not it is property. Leases of assets other than property (equipment, vehicles, etc.) are presumed to be Type A leases, while property leases are presumed to be Type B.

These classification criteria were harshly criticised by stakeholders and were discussed again at the March meeting. The Boards decided that criteria should be similar to those used under IAS 17 to distinguish between operating leases and finance leases:

- the classification would depend on whether the contract was effectively a financing arrangement or a sale, rather than an operating lease; and
- the distinction would be made on the basis of whether almost all of the risks and rewards incidental to ownership of the underlying asset had been transferred to the lessee.

Using these criteria, contracts would be classified as follows:

- most contracts currently classified as operating leases would be Type B; and
- most contracts currently classified as finance leases would be Type A.

2. Lessee accounting model

The two Boards were unable to reach an agreement on the lessee accounting model at this meeting. They therefore decided that they would each have their own accounting model.

What is the IASB's model?

At the meeting, the IASB decided that there would be a single approach for lessee accounting, and that a lessee would account for all leases as type A leases.

Under this single approach, all leases would result in separate recognition of amortisation of the right of use and interest on the lease liability. As a result, it would no longer be necessary to distinguish between Type A and Type B.

This decision by the IASB is rather surprising, given that:

- *the IASB distinguishes between two types of leases and seems to be planning on retaining two accounting models for lessors;*
- *many commenters challenged the idea that all leases are effectively a purchase on credit, and suggested that the definition of a lease should be revisited.*

What is the FASB's model?

In contrast to the IASB, the FASB decided to retain a dual approach for lessee accounting:

- for Type A leases, the model would involve separate recognition of amortisation of the right of use and interest on the lease liability;
- for Type B leases, the model would involve recognition of a single lease expense.

Readers will recollect that both the models described above involve recognition of an asset and a liability at the outset. They differ only in terms of recognition of leases expenses:

- *for Type A leases, the total lease expense is recognised at a decreasing rate over the lifetime of the contract, as for a finance lease (amortisation and financial interest);*
- *for Type B leases, the total lease expense is recognised on a straight-line basis over the lifetime of the contract.*

Thus, the FASB has decided to retain the accounting models proposed in the May 2013 exposure draft. However, given the decisions made on the distinction between Type A leases and Type B leases, the scope of each model has been significantly altered.

3. Lessor accounting model

At the meeting, the two Boards agreed that:

- two accounting models should be retained;
- classification as Type A or Type B would depend on whether almost all of the risks and rewards incidental to ownership of the underlying asset had been transferred to the lessee (IAS 17 criterion) rather than the nature of the underlying asset (whether or not it is property); and
- for Type A leases, the complex receivable and residual model should be abandoned in favour of a model similar to that currently used for finance leases.

By modifying the criteria for distinguishing between types of lease, and by abandoning the receivable and residual model, the two Boards are therefore reintroducing principles similar to IAS 17 (i.e. the distinction between operating leases and finance leases using the same criteria).

However, the two Boards differed on the rules for revenue recognition for Type A leases. In contrast to the IASB, the FASB concluded that the lessor may not recognise a profit at lease inception.

4. Small-ticket leases for lessees

At the meeting, the two Boards discussed the possibility of introducing simplified requirements for small-ticket leases, mainly in responses to criticisms from some commenters on the complexity of implementing the model proposed in the 2013 exposure draft.

After agreeing that there was no need to introduce a materiality threshold, the Boards differed on whether or not lessees should be given a recognition and measurement exemption for small-ticket leases. The IASB decided to introduce this exemption (for lessees only), while the FASB decided not to.

Finally, it should be noted that the Boards decided to allow both lessors and lessees to apply the lease guidance at a portfolio level (e.g. fleet of vehicles or photocopiers).

5. Determining the lease term

Readers will remember that the lease term was defined in the 2013 exposure draft as the non-cancellable period during which the lessee has the right to use the leased asset. The term includes periods covered by an option to extend or terminate the lease if the lessee has a strong economic incentive to extend or not to terminate it.

Following their redeliberations, the Boards decided that:

- an entity should consider all relevant factors that create an economic incentive to exercise an option or not;
- options should be taken into account if it is "reasonably certain" that the lessee will exercise them;
- the concept of "reasonably certain" is a high threshold, similar to "reasonably assured" under US GAAP;
- purchase options should be treated in the same way as renewal options.

Finally, the two Boards decided that:

- the lessee should only reassess the lease term on the occurrence of a triggering event or significant change in the circumstances under their control;
- the lessor should never reassess the lease term.

6. Short-term lease exemption for lessees

The 2013 exposure draft included an option under which lessees were exempt from recognising short-term leases. 'Short-term' referred in this case to contracts of no more than 12 months, including renewal options.

At the meeting, the two Boards decided to retain the exemption, but made changes to its scope, bringing the rules on determining the length of short-term leases into line with the general rules on lease term.

A lease is therefore a short-term lease if it is no more than 12 months, including renewal options for which there is a strong **economic incentive**.

By changing the definition of a short-term lease in this way, the Boards have increased the number of contracts which could fall within the scope of the exemption.

7. What can we learn from these first redeliberations?

These are only the first decisions in this phase of redeliberations, which could still drag on for months. In this first stage, the Boards have:

- adopted criteria for lease classification similar to those used under IAS 17 to distinguish between operating leases and finance leases;
- retained a balance sheet approach for lessees, under which all leases give rise to recognition of a lease liability and a right-of-use asset;
- abandoned the complex receivable and residual approach for lessors, and ultimately decided to reintroduce lease recognition principles similar to those used under IAS 17 (which distinguishes between operating leases and finance leases using the same criteria);

- made decisions which tend towards simplification :
    - a less stringent definition of short-term contracts;
    - introduction of a portfolio-level approach; and
    - in the case of the IASB only, introduction of an exemption for small-ticket leases for lessees.

These first decisions show that the two Boards have chosen to ignore some of the criticisms levelled at their project, particularly regarding the principle in the project that a lessee should systematically recognise an asset and a liability for all leases. Nor have the Boards paid attention to criticisms of the conceptual weakness of their model, which is particularly evident in the inconsistencies between lessor and lessee accounting.

Finally, the two Boards have now publicly stated their differences of opinion regarding certain structural aspects of lease accounting, notably the lessee accounting model. These initial disagreements make one wonder whether this shared project will ever actually result in a joint standard.

Although the schedule for redeliberations has not yet been announced, one can hope that at future meetings, the Boards will revisit the definition of a lease (in particular what distinguishes a lease from a service contract or any other executory contract).

A Closer Look

ESMA seeks to circumscribe use of financial indicators

In October 2005, the CESR (Committee of European Securities Regulators) published Recommendation CESR/05-178b on Alternative Performance Measures (APMs). These are financial measures used by issuers in their financial reporting which are not defined in accounting standards (e.g. EBITDA, free cash flow, net debt, etc.).

Eight years later, the CESR's successor, ESMA (European Securities and Markets Authority) wants to update and strengthen the principles of the 2005 Recommendation. ESMA has recently published draft guidelines on the subject, with a view to making the new principles on APMs mandatory at the European level. In contrast to "recommendations", ESMA's "guidelines" would be mandatory for all issuers. National regulators would be responsible for ensuring compliance within their jurisdictions.

ESMA's goal is not to prohibit the use of APMs, but to further circumscribe their use. It is particularly keen to ensure that these performance measures are clearly defined and that they are appropriate and useful for decision-making by users of financial statements. ESMA therefore feels it is necessary to standardise the use of these measures.

The comment period for the draft guidelines runs until 14 May 2014. ESMA is planning to publish its final document by the end of 2014.

1. What is the scope of the guidelines?

ESMA's guidelines would apply to all listed companies which use APMs in their public documents. However, the guidelines would not apply to prospectuses, with the exception of financial statements included or referred to in the prospectus. The guidelines would thus primarily apply to financial statements, annual reports, press releases and so on.

The guidelines would cover all financial measures used by issuers in their financial reporting, such as measures which are adjusted from the aggregate figures used in the financial statements, and aggregate measures used in the financial statements which are not defined under IFRS.

2. What do the guidelines say?

In its draft guidelines, ESMA is planning to require listed companies to:

- provide definitions of the APMs used;
- provide reconciliations of these APMs to the aggregate figures used in the IFRS financial statements;
- explain why they use these APMs and how they are useful and relevant.

In addition, listed companies must use APMs consistently over time.

Finally, ESMA suggests that listed companies should present APMs less prominently than the aggregate figures used in the IFRS financial statements.

Definitions

The issuer must define the financial measure, its components and its basis of calculation (particularly the hypotheses and assumptions used in calculations).

A list of the definitions of all APMs must be provided in any public document which mentions an APM.

The APM should have a meaningful name. Issuers may not use terms which refer to measures defined under IFRS, if the APM differs from the IFRS definition.

Reconciliation

Each APM must be accompanied by a reconciliation to the aggregate figure used in the IFRS financial statements and an explanation of the calculations used in the adjustment. However, this is not required if the APM is an aggregate measure presented in the financial statements and the components are directly readable in the same document. In addition, comparative disclosures must be presented.

Justification

The company must explain why it has used an APM and how it is relevant to users of the financial statements.

The APMs used must be consistent and comparable over time. If an issuer decides to redefine or stop using an APM then an explanation must be provided.

Prominence of figures from IFRS financial statements

However relevant APMs are felt to be for users of financial statements, they should be presented less prominently than the aggregate amounts used in the IFRS financial statements. In other words, they should only be used as supporting information.

ESMA's draft guidelines are available on ESMA's website via the following link:
http://www.esma.europa.eu/content/ESMA-Guidelines-Alternative-Performance-Measures

Events & FAQ

Frequently asked questions

IFRS

- Share-based payments with vesting condition, performance condition and liquidity clause conditional on a sale.
- First-time application of the new standards on consolidation: is it necessary to adjust the remeasurement recognised using the proportionate consolidation method when an associate became a joint venture?
- Determination of goodwill associated with an operation that is disposed of and that is part of a larger CGU
- Accounting treatment for CatBonds (Catastrophe Bonds).
- Accounting for internal gains and write-offs under IFRS 5.
- Post-balance sheet event ("fake CEO" scam).

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB	Committee	EFRAG
22 - 25 April 2014	13 - 14 May 2014	7 - 9 May 2014
19 - 23 May 2014	15 – 16 July 2014	11 - 13 June 2014
13 - 20 June 014	16 - 17 September 2014	14 - 16 July 2014