

Beyond the GAAP

Mazars' newsletter on accounting standards



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Editorial

In publishing the definitive version of the hedging provisions of IFRS 9, *Financial instruments*, the IASB had already taken a major step towards revising the accounting treatment of entities' risk management activities.

The publication in April of the Discussion Paper on macro-hedging represents new progress in this area. The IASB proposes to extend the scope of hedge accounting to dynamic risk management as it is practiced by financial institutions in their asset/liability management.

While its examples tend to be drawn from interest rate risk management in financial institutions, the Discussion Paper also addresses the issues faced by industrial and service entities. The IASB invites stakeholders to submit practical examples of risk management to which an accounting approach to macro hedging would be relevant.

In this edition, *Beyond the GAAP* introduces the essence of this paper in 20 Q&A.

Happy reading!

Michel Barbet-Massin Edouard Fossat

IFRS

IASB considers IFRS IC recommendations on IFRS 2

Last February, the IASB began to examine the IFRS Interpretation Committee's recommendations for amendments to IFRS 2, and decided that this standard would be amended to specify the accounting treatment of the following two subjects:

- Accounting for cash-settled share-based payment transactions that include a performance condition;
- Share-based payments settled net of tax withholdings.

During the April 2014 meeting, the IASB continued to examine these recommendations for IFRS 2 in respect of the two remaining topics:

- Share-based payments in which the manner of settlement is contingent on future events controlled by neither the entity nor the counterparty;
- Modification of the term and conditions of a share-based payment transaction from cash-settled to equity-settled.

In the first case, the IASB rejected the proposed change, mainly on the grounds that this amendment, under which the share-based payment transaction should be classified as either cash-settled or equity-settled in its entirety, depending on which settlement method is probable, would introduce a distinction between a liability and equity that would be inconsistent with the requirements in IAS 32.

In the second case, IASB tentatively decided to add guidance to IFRS 2 to clarify that:

- the share-based payment transaction would be measured by reference to the modification date fair value of the equity instruments;
- the liability recognised in respect of the original cash-settled share-based payment should be derecognised at the time of the modification and the equity-settled share-based payment should be recognised to the extent that the services have been rendered up to the modification date; and
- the difference between the carrying amount of the liability and the amount recognised in equity at the modification date should be recorded in profit or loss immediately.

Finally, the IASB took the opportunity to set the transitional arrangements for all the narrow-scope amendments to IFRS 2. It tentatively decided that the proposed amendments to IFRS 2 should be applied on a prospective basis, but that an entity should be permitted to apply them retrospectively, if it has the information necessary to do so.

Leases: further redeliberations

At a joint session held on 23 April 2014, the FASB and the IASB continued to redeliberate the proposals in the draft standard on leases, which was the subject of a second exposure draft on 13 May 2013.

During this session, the two Boards discussed simplifying and clarifying their draft standard in the following areas:

- lease modifications and contract combinations;
- variable lease payments
- in-substance fixed payments; and
- discount rate.

Beyond the GAAP will present a detailed account of the decisions taken at this meeting once all the two Boards' redeliberations are sufficiently advanced.

IASB clarifies the accounting for acquisitions of interests in joint operations

The IASB has just published amendments to the standard IFRS 11 – Joint Arrangements. Readers will remember that IFRS 11 establishes principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (ie joint arrangements). IFRS 11 classifies joint arrangements into two types:

- joint ventures, which are consolidated by the joint venturers using the equity method;
- joint operations, where the joint operators account for their share of the assets, liabilities, revenue and expenses.

The amendments now published by the IASB clarify the accounting for the acquisition of an interest in a joint operation that constitutes a business (as defined in IFRS 3 – *Business combinations*). The amendments state that the principles on business combinations accounting in IFRS 3, and other IFRSs, should be applied to these transactions as long as they do not conflict with the guidance in IFRS 10.

We will present these amendments in more detail in a future edition.

European matters

ESMA: 15th extract from the database of enforcement

On 9 April, ESMA, the European Securities and Markets Authority, published the 15th extract from its database of enforcement, containing 10 decisions taken by European regulators on the following topics:

- Classification of contingent consideration based on continuing employment (FRS 3)
- Allocation of goodwill on sale of an operation (IAS 36)
- Sale of single licenses presented as discontinued operations (IFRS 5)
- Identification of a CGU (IAS 36)
- Determination of the fair value of land (IAS 40)
- Change of presentation of the share in the profit or loss of associates and joint ventures accounted for using the equity method (IAS 1, IAS 8, IFRS 11)
- Cost of listing (IAS 32)
- Conditions for hedge accounting (IAS 39)
- Hedging of the presentation currency (IAS 39)
- Minimum funding requirements (IAS 19)

This 15th extract from the ESMA database of enforcement can be consulted at:

<http://www.esma.europa.eu/news/ESMA-publishes-15th-extract-EECS-enforcement-decisions?t=326&o=home>

EFRAG publishes the results of a study on proposals to simplify the Leases exposure draft.

On 14 April 2014, EFRAG published its report presenting the results of a survey conducted in February 2014, in conjunction with the French, German, Italian and British standard setters (ANC, ASCG, FRC and OIC), on the simplifications to the draft standard on leases currently under redeliberations by the Boards.

The purpose of this survey was to collect the views of European users regarding possible simplifications of the lessee accounting model set out in the May 2013 exposure draft, and to assess the usefulness and workability of the changes proposed by the IASB staff.

This report is accessible on the EFRAG site at: http://www.efrag.org/files/EFRAG%20public%20letters/Leases/EFRAG_limited_survey_on_the_simplifications_to_E_D_Lease.pdf

Finalising the EFRAG reforms

In the wake of the Maystadt report, the European Union has launched a reform of EFRAG, the European Financial Reporting Advisory Group. It is expected that:

- The governance of EFRAG will be transformed and the model which has been in place since the body was founded will be abandoned. Responsibility for defining EFRAG's positions and executive responsibility, excluding day to day management, will be entrusted to a Board composed of representatives from national standard setters and the private sector. The appointment of the president of the Board, nominated by the European Commission, will have to be approved by Finance Ministers and the European Parliament. The Board will aim to seek a consensus in its work. The technical expert group (EFRAG TEG) will continue its technical work, but will have an advisory role vis-à-vis the Board. These new governance for EFRAG should come into effect during the third quarter of 2014.
- EFRAG's role will be strengthened: the presence of the main European stakeholders on its Board will enhance its legitimacy as the voice of Europe in international accounting debates. EFRAG continues to be responsible for the technical evaluation of IFRSs. However, in future it will also be asked to determine whether these standards are compatible with the European public interest. Accordingly, EFRAG will have to ensure that IFRSs do not obstruct economic growth and financial stability. In other words, EFRAG will issue opinions on all the criteria of the European regulation on the endorsement of IFRS.

Financing of EFRAG by the European Union has been confirmed for a period of three years, until the end of 2016, when the European Parliament will assess the results of the current reforms.

More information on the EFRAG site:

<http://www.efrag.org/Front/n1-1307/EFRAG-INSIDER---First-quarter-2014.aspx>

A Closer Look

Accounting for dynamic risk management (macro hedging): the essence of the project in 20 Q&A

On 17 April 2014 the IASB published a Discussion Paper entitled *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*. In this study, Beyond the GAAP offers an introduction to this paper and the subjects it tackles in 20 Q&A.

1. What is the Discussion Paper (DP) about?

Risk management is a crucial matter for businesses, with a degree of formalisation and organisation that varies from one entity to another, depending on its size and sector. In the financial sector it frequently, though not always, involves the use of derivative instruments.

IFRS 9 offers an accounting model for hedging operations based on derivative instruments. But these provisions are not always appropriate to dynamic risk management activities.

The object of this DP is to present a possible approach that would reflect the dynamic risk management of entities for accounting purposes.

2. What entities are concerned?

Traditionally, dynamic risk management (currently known as macro-hedging) is associated with asset/liability management in financial institutions (banks and insurance entities), to manage the interest rate risk. So, not unnaturally, the majority of the examples in the DP relate to this activity.

Nonetheless, the approach in this Discussion Paper is not intended to address the problems of a single sector, nor to be confined to financial risks. In practice, corporate entities are very likely to be affected by these proposals

when managing their foreign exchange rate risk, or their commodity price risk for example.

This Discussion Paper therefore concerns any entity involved in the dynamic management of one or more risks, whether financial or otherwise.

3. How do these proposals interact with IFRS 9?

The existing IAS 39 covers both general hedge accounting requirements and provisions specific to portfolio hedge of interest rate risk (which was designed more specifically for asset/liability management in financial institutions).

In IFRS 9, the Board took a different path; this standard only offers general provisions for hedge accounting. The provisions in this Discussion Paper are therefore intended to result in an IFRS distinct from but complementary to IFRS 9, which will replace the IAS 39 rules on portfolio hedge of interest rate risk.

4. What are the main principles?

The Board's proposal rests on the following principles:

- The hedging instrument is revalued at fair value and subsequent change in value are recorded in profit or loss for the period;

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- Managed risk exposure is also revalued at fair value, but only for the risk that is being managed. Adjustments in the fair value of this component are recorded in profit or loss for the period;
- These two revaluation mechanisms presented above will have a net effect in profit or loss. Any mismatch in exposure risk management will automatically be reflected in the profit or loss accounts of the period.

This approach thus principally involves remeasuring the hedged item, and is intended to be applied to groups of instruments, hence its name: the Portfolio Revaluation Approach (PRA).

5. Does the PRA amount to “full fair value”? What is the difference between it and fair value hedging under IAS 39 and IFRS 9?

Although it relies on the concept of remeasurement, the PRA is not a “full fair value” approach, because the at-risk exposure is only revalued for the risk that is managed.

The PRA is also unlike fair value hedging insofar as it requires no one-for-one link between the hedging instrument and the hedged item. The absence of this link makes it possible to take account of dynamic management, for example on an open portfolio of instruments (a portfolio to or from which instruments are regularly added and removed). Finally, it takes better account of certain common practices in dynamic risk management (see below).

6. Will this new approach be mandatory?

The question of whether this new approach will be of mandatory application if an entity engages in dynamic risk management is one of the questions asked by the Board in this Discussion Paper. No decision has yet been reached.

7. Will the proposed model be appropriate to all types of dynamic risk management?

The proposed model is based on the principle of revaluing the hedged risk. It is therefore more appropriate to an approach consistent with fair value management rather than cash flow management. It is probable that some management methods will fit this PRA approach more naturally than others.

The Board encourages commentators to inform it of any risk management model likely to be correctly reflected by the proposed approach.

The call for comments is also an opportunity to notify the Board of any dynamic risk management practices that could not be properly reflected by the PRA, so that it can develop a supplementary model if appropriate.

8. How should the revaluation of the hedged item be carried out?

The revaluation is carried out using standard methodologies for calculating discounted values.

The cash flows to be taken into account will be defined in a manner consistent with the designation of the managed risk and could take account of different adjustment factors, such as behavioural assumptions.

Discount rates will take account of the levels at the valuation date. The choice of discounting curve depends on the risk managed. The DP envisages the use of different curves (funding curve, benchmark curve, curve used for determining customer prices, etc.).

9. Will the scope of the PRA be managed risks or hedged risks?

This is one of the questions asked by the Discussion Paper. Both approaches are considered and submitted for comments:

- Revaluing the whole managed exposure. In this scenario, a position which is managed but not hedged will be revalued and will impact the profit and loss accounts. This is at first sight a simpler method to apply, but would introduce volatility.
- Revaluing only the managed and hedged exposure. In this scenario the unhedged risk would continue to be valued in accordance with the general provisions. The main limit of this approach is the need to distinguish between the hedged and unhedged parts of the managed exposure; only the hedged part will be revalued.

10. Does the PRA take account of risk limits set by entities in the risk management policies?

Entities frequently define risk limits below which they take no risk reduction measures; the enterprise only intervenes when the risk exceeds the predefined limit.

The question of whether the PRA must take account of the risk limits set by entities remains open, and assumes inter alia that the Board will choose to define the scope of the PRA as the totality of the managed rather than covered exposures (cf. the previous question).

If the Board opts to adhere to the entity’s risk management policy, the PRA will not be applied while a position remains below the risk manager’s limits (i.e. the exposure will not be revalued).

This option nevertheless raises questions of comparability. As risk limits can vary from one entity to another, the same degree of exposure could be treated differently from an accounting point of view. Though it takes no clear position on this subject, the Board notes that it has identified a number of disadvantages in taking account of these risk limits.

11. Will internal derivatives used in risk management be recognised?

The Discussion Paper proposes that the use of internal derivatives should be recognised in the PRA.

Let's take the example of the asset/liability management department in a bank which wants to hedge an exposure using a derivative. To do so it contacts one of the bank's trader to set up an internal operation. The trader may decide not to hedge the position externally. The value of the contract results in a gain for the asset/ liability management of 10 and a loss for the trading department of -10. Within the group this transaction has no theoretical impact and IAS 39 does not recognise hedging relationship relying on internal derivatives that are not externalized

The Discussion Paper proposes to recognise the result of both activities in P&L for the period, recording the gain of 10 for risk management (which will be offset by the revaluation in accordance with the PRA), and a loss of -10 for trading.

12. Will the PRA take account of transactions that have not yet been contracted?

This subject is raised by the Discussion Paper. Some entities include transactions that have not yet been contracted in their risk management, such as advertised offers of lending at fixed interest rates (for which no contractual basis yet exists). Including transactions of this type ('pipeline transactions') in the PRA would reflect risk management but would raise a number of conceptual issues. In particular, as the PRA leads to a revaluation of exposures, taking account of flows not yet contracted could conflict with the definition of an asset in the IASB conceptual framework.

13. Will the PRA take account of behavioural approaches?

The risk management of some entities models future cash flows with reference to behavioural assumptions. The simplest example to understand is that of a prepayment option on a loan. A bank often uses estimates to determine the extent to which its loans will be early repaid. The Board invites comments on the question of whether to take these behavioural factors into account in the PRA. Likewise, the accounting impact of changes in past assumptions of customer behaviour is also open to further study (should they be recognised in profit or loss?).

14. Will the PRA be able to take account of the economic maturity of demand deposits collected by the banks?

This is a very sensitive issue, because it is fundamental to the Board's objective of reflecting the real substance of the banks' risk management. The Board devotes a section to

this subject in its Discussion Paper and indicates its intention to take account of this economic profile, while also noting that it has identified some difficulties of application.

The paper also addresses the issue of 'sub-Libor' exposures.

15. The macro hedging used by European banks depended on a bottom layer approach limiting the impact on profit or loss where the bank remained under-hedged. Does the PRA adopt this approach?

This is one of the questions asked by the Discussion Paper, which reaches no decision on the subject but highlights some operational problems of taking such an approach in a PRA. The main difficulty consists in the need to identify, within the managed risk position, those exposures which make up the 'bottom layer' so that they can be revalued as the managed risk. The Board notes that this distinction between the managed and hedged part of the exposure and the part that is managed but not hedged could raise operational difficulties.

16. Will the PRA take account of an equity book model in interest rate risk management?

Some entities, in particular banks, model their equity as instruments with an interest rate risk profile and include them in their overall risk management. The inclusion or otherwise of the EBM in the PRA is another question raised in the DP.

17. Will there be an impact on the presentation of the statement of financial position and the income statement?

Yes, probably.

In the case of the statement of financial position, the Discussion Paper considers three alternatives for the presentation of revaluation adjustments of the managed risks:

- Line-by-line remeasurement;
- Presentation of the effects of revaluation adjustments on one line for assets and another for liabilities; and
- Presentation of the net revaluation adjustment in a single line item, in assets or liabilities as appropriate.

In the case of the income statement, and setting aside the case of internal derivatives mentioned above, two approaches are considered:

- Presenting the activity's performance without taking account of risk management, and then presenting on two distinct lines the net impact of risk management instruments (accrued interest on a swap, for example) and the impact of revaluations due to the PRA (change in clean price on hedging instruments and hedged items

representing the current estimate of future mismatch); or

- Presenting performance in terms of the risk management target (on the assumption that this has worked perfectly), then presenting on a separate line the difference between the actual and targeted performance of risk management, showing how successful it has been.

18. Are there new requirements for disclosures?

Yes, the Discussion Paper identifies four areas:

- Qualitative information on the objectives and policies for dynamic risk management;
- Qualitative and quantitative information on the risk position;
- Application of the PRA; and
- Quantitative and qualitative information on the impact of dynamic risk management on the current and future performance of an entity.

19. The majority of examples come from interest rate risk management in the banking industry. Does the DP also put forward approaches for other risk types and other business sectors?

The Board has devoted many years to understanding the management of interest rate risks in the banks. This is why most of the illustrations in the Discussion Paper are drawn from this area.

However, the Board has no desire to limit its approach to interest rate risk management in the banking sector. The Discussion Paper also mentions the question of managing foreign exchange rate and commodity risks.

Some risk management practices in corporate entities will already be correctly handled by the general hedge accounting provisions in IRFS 9. For the rest, the PRA may provide a solution, and the Board invites entities to submit any examples of risk management which are likely to be correctly addressed by the PRA.

Nonetheless the PRA is unlikely to provide a universal solution, insofar as it depends on revaluing the exposure. This principle is not really compatible, for example, with taking account of probable future transactions, the revaluation of which may not fulfil the definition of an accounting asset under IFRSs.

However, leaving aside the PRA model, the Discussion Paper may be an excellent opportunity for entities, in whatever business sector, to report the existence of dynamic risk management practices to the Board in order to raise awareness and develop its reflections.

20. What are the next steps ?

Comments on this discussion paper should be submitted to the Board by 17 October 2014. The Board will announce how it intends to pursue this project on the basis of the responses obtained.

Events & FAQ

Frequently asked questions

IFRS

- Impact of credit insurance on the securitisation of a trade receivable.
- Agent/principal issue in revenue recognition.
- Acquisition of a property partly used for administrative purposes and partly leased (investment property or PPE).
- Impact of a law introducing a new tax passed after the closure of the financial year.
- Consolidation by a management company of a real-estate fund.
- Consequence of the fragmentation of property rights on the consolidation, and determination of the non-controlling interest in the entity.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB

22 - 25 April 2014
19 - 23 May 2014
13 - 20 June 2014

Committee

13 - 14 May 2014
15 - 16 July 2014
16 - 17 September 2014

EFRAG

7 - 9 May 2014
11 - 13 June 2014
14 - 16 July 2014

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