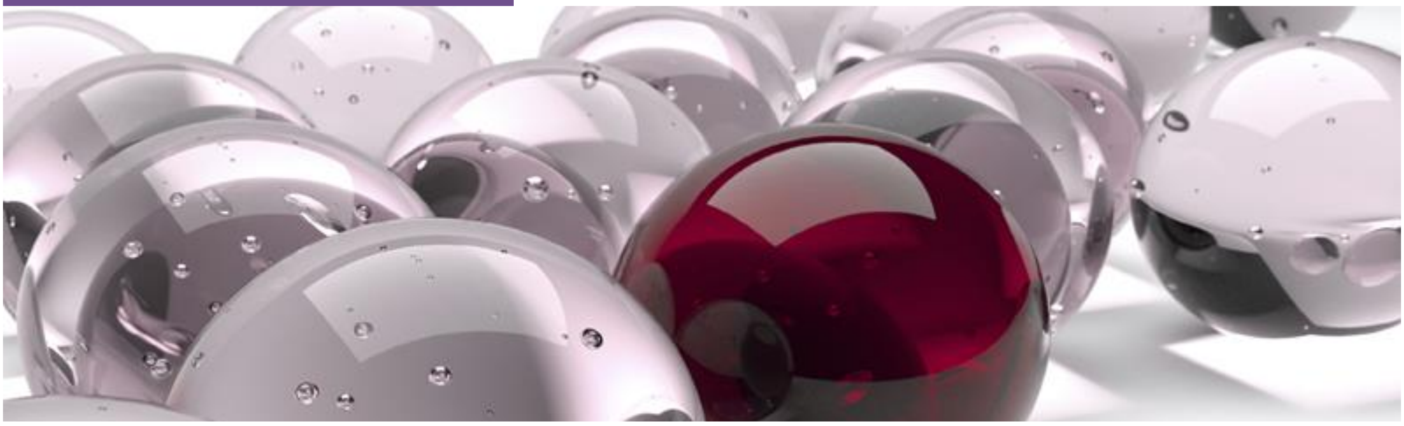
Beyond the GAAP

Mazars' newsletter on accounting standards

NEWSLETTER / No.104– October 2016



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Editorial

Improving the effectiveness of financial reporting is one of the IASB's key focal areas for the coming years. Four projects fall under the theme of "Better communication", including the Disclosure Initiative and a research project on the format of primary financial statements.

ESMA's recommendations for 2016 financial statements echo this project, with a strong focus on the need for consistency between the performance measures used in the financial statements and those used in other financial communications. In the wake of ESMA's *Guidelines on Alternative Performance Measures* coming into effect, the regulator also encourages issuers to ensure that APMs used are useful and relevant.

The regulator also discusses the issue of sub-totals that are not required under IFRSs. It emphasises that labels must be clear and accurately reflect the items grouped under that sub-total. The underlying data should be consistent with the principles of IFRSs, notably the principle of faithful representation. There are plenty of issues here that could usefully be included in the IASB's research project on the format of financial statements.

Enjoy your reading!

Michel Barbet-Massin Edouard Fossat

European Highlights

IFRS 16: EFRAG publishes Preliminary Consultation Document on endorsement advice

On 12 October 2016, EFRAG published for comment a Preliminary Consultation Document on the endorsement of IFRS 16 – *Leases*.

This is a new addition to EFRAG's due process. EFRAG has been asked by the European Commission to carry out supplementary analysis to assess whether IFRS 16 is conducive to the European Public Good, in addition to assessing whether the standard meets the regular criteria of true and fair view, relevance, reliability, comparability and understandability.

EFRAG is also continuing to work on the following topics in order to complete its assessment:

- The impact of IFRS 16 on European SMEs;
- Additional outreach with users of financial statements;
- An economic study it has commissioned on the effects of the standard.

These analyses will also allow EFRAG to reach a conclusion on the cost/benefit trade-off of applying the new standard.

Once it has completed these analyses, EFRAG will publish a complete draft endorsement advice for further consultation.

The due process has been modified so that a decision can be reached in time for issuers to early apply IFRS 16 if they wish to do so, on the same date that IFRS 15 becomes mandatory (i.e. from 1 January 2018). Readers will remember that IFRS 16 becomes mandatory for financial periods commencing on or after 1 January 2019, subject to adoption by the European Union.

The Preliminary Consultation Document is open for comment until 8 December 2016.

The Preliminary Consultation Document and some of the analyses that have already been carried out are available via the following link:
http://www.efrag.org/News/Project-253/EFRAG-requests-comments-on-its-Preliminary-Consultation-Document-regarding-the-endorsement-of-IFRS-16-Leases.

Basel Committee studies prudential impact of IFRS 9 on banking sector

On 11 October of this year, the Basel Committee on Banking Supervision published a double consultation on managing the impact of provisioning on regulatory capital. This is in preparation for the effective date of IFRS 9 – *Financial Instruments* on 1 January 2018 (except for insurance companies).

Readers will remember that IFRS 9 will involve earlier recognition of credit losses, requiring the use of expected credit loss (ECL) models rather than incurred loss models as used under IAS 39. This new approach applies to all financial assets measured in the balance sheet at amortised cost or fair value through OCI, as well as to commitments to lend money and financial guarantees.

Although it now appears that the impact will be less significant than initially thought, some credit institutions could see a substantial negative impact on their net book value, and thus on prudential capital, at the transition date.

For such cases, the Basel Committee makes the following prudential recommendations:

- In the short term, phase the impact in gradually over a transition period to be determined (three to five years)
- In the medium to long term, review the current prudential approach. Possibilities include the alignment of EL/provisions approaches used internally for standard portfolios, and the removal of the add-back of excess provisions to Tier 2 capital.

For more information, see the following documents:
https://www.bis.org/bcbs/publ/d385.htm
https://www.bis.org/bcbs/publ/d386.htm

European Highlights

EU adopts IFRS 15

On 29 October 2016, the European Union published Commission Regulation 2016/1905 of 22 September 2016 in the OJEU. This Regulation adopts IFRS 15 – *Revenue from Contracts with Customers*, which was published by the IASB in May 2014.

The standard becomes mandatory for financial periods commencing on or after 1 January 2018. Early application is permitted.

The Regulation as published in the OJEU can be found here: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016R1905.](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016R1905)

IFRS Highlights

IASB reveals work plan for next five years

On 2 November 2016, the IASB published its feedback statement on the work plan consultation that it launched in 2015.

In addition to completing existing projects and maintaining the current framework, the IASB's work plan for 2017 to 2021 will focus on better communication.

We will take a more detailed look at the new work plan in the November issue of Beyond the GAAP.

The IASB's feedback statement is available here: http://www.ifrs.org/Current-Projects/IASB-Projects/IASB-agenda-consultation/2015-agenda-consultation/Documents/2016-Feedback-Statement.pdf

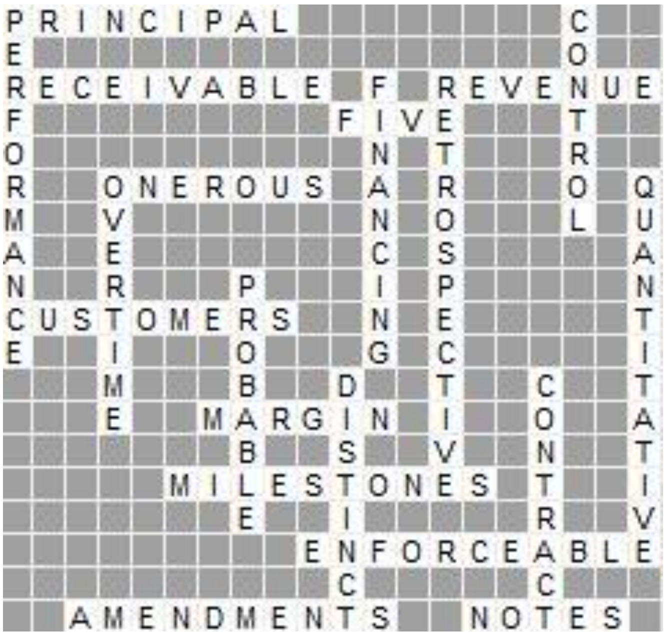
Sue Lloyd appointed vice-chair of IASB

On 18 October 2016, the Trustees of the IFRS Foundation announced the appointment of Sue Lloyd as vice-chair of the IASB. Her term expires on 31 December 2018. She replaces Mr Ian Mackintosh, whose term expired on 30 June 2016.

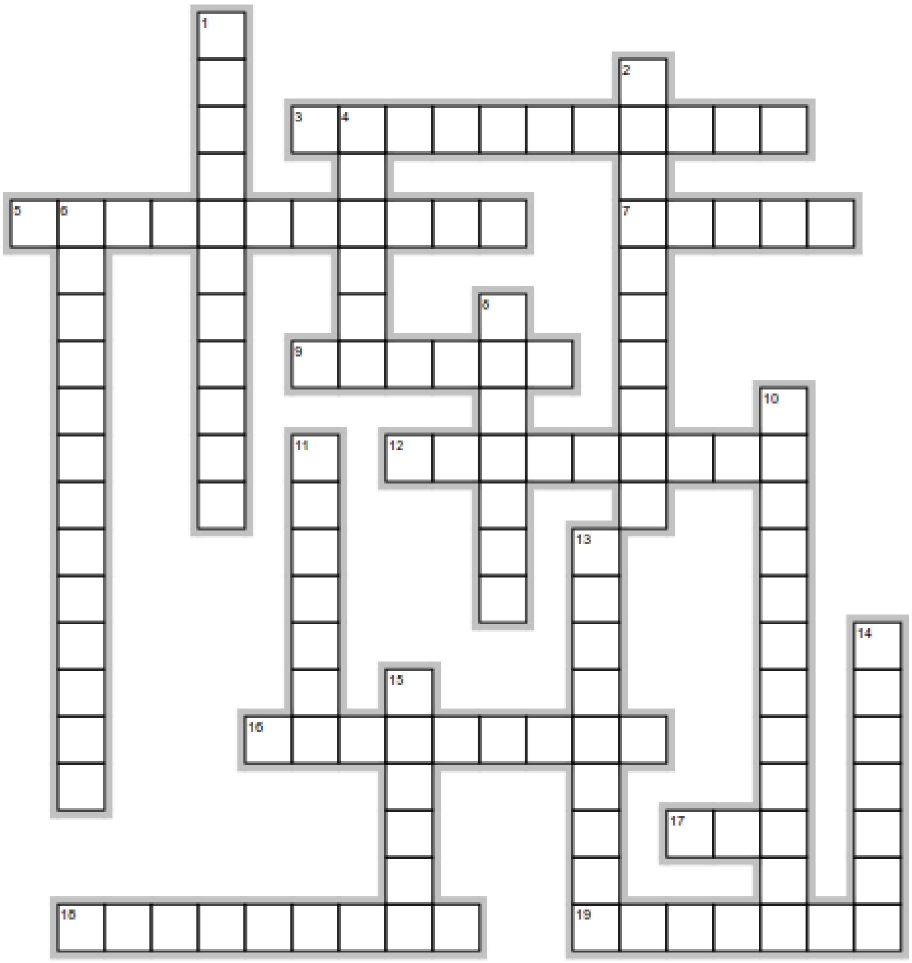
Sue Lloyd has been a Board member since 2014 and has been employed by the IFRS Foundation since 2009, as Director of Capital Markets and Senior Director of Technical Activities.

The press release is available here: http://www.ifrs.org/Alerts/Governance/Pages/Sue-Lloyd-appointed-as-Vice-Chair-of-the-International-Accounting-Standards-Board.aspx

Crossword: last month's solution



Crossword: The finer points of payments to employees!



Down:

1. Type of analysis that an entity must disclose for each significant actuarial assumption
2. For goods or services received or acquired, this impacts how the plan is accounted for
4. Type of information that an entity should disclose regarding benefits provided by defined benefit plans
6. For longer maturities, qualification of the discount rate estimation technique from the yield curve
8. Another term for "paid"
10. Change in the timing of expense recognition in the event that an equity-settled plan is terminated
11. Their cost related to the past is recognised immediately as an expense
13. Qualification of the unit credit method used to measure defined benefit plan obligations
14. This version of IAS 19 was published in June 2011
15. Type of conditions that are taken into account when measuring the fair value of shares or share options

Across:

3. Term that applies to both equity and music
5. Employee benefits paid as compensation for termination of employment
7. The number of types of share-based payment transactions covered by IFRS 2
9. Term for an employee who subscribes to a plan
12. Value at which options granted are measured if their fair value cannot be measured reliably
16. Part of the vesting period over which a change made to an equity-settled plan that increases the fair value of the instruments granted is made
17. Actuarial gains and losses on defined benefit plans are recognised here
18. One of the actuarial assumptions used to estimate post-employment benefits
19. Type of contribution or benefit post-employment benefit plan

A Closer Look

What are ESMA's priorities for 2016 financial statements?

ESMA published its recommendations for 2016 financial statements on 28 October 2016, drawing issuers' attention to the following topics:

- presentation of financial performance;
- the impact of the UK referendum decision to leave the European Union;
- the impact of the new standards that will be implemented over the coming years;
- Financial instruments: distinction between equity instruments and financial liabilities.

These topics were selected following the recent introduction of new rules on Alternative Performance Measures (APMs), which have raised questions.

Beyond the GAAP presents the key points to be taken into account in the 2016 financial statements.

ESMA's recommendations are available via the following link: https://www.esma.europa.eu/sites/default/files/library/esma-2016-1528_european_common_enforcement_priorities_for_2016.pdf

1) Presentation of financial performance

ESMA identified presentation of financial performance as a key topic. This was primarily due to the fact that ESMA's *Guidelines on Alternative Performance Measures* came into effect in July 2016, but also because the IASB has emphasised that one of its priorities for the coming years is to increase the effectiveness of communication in financial statements (which includes performance).

1.1 Presentation of information not specifically required by IFRSs

The regulator reminds issuers that while IFRSs permit the inclusion of additional information in the financial statements even if it is not required, this information must comply with the general principles set out in IAS 1, notably the principle of faithful representation.

ESMA recommends that, if entities present non-sector-specific measures of performance that are not required or defined under IFRSs, they should ensure that:

- the measures are based on principles that comply with IFRSs;
- the measures are relevant;
- the measures are reconciled to the primary financial statements.

1.2 Line items, headings and sub-totals

Presentation of financial statements was identified as a key topic following the implementation of the amendment to IAS 1 with effect from 1 January 2016. This amendment emphasises that materiality is key when deciding how to present sub-totals in the primary financial statements.

In addition to the aforementioned amendment to IAS 1, this topic was also felt to be important as it is not always clear how certain material items should be classified in the financial statements. ESMA gives the examples of net costs relating to employee benefit obligations (i.e. should the full cost be presented in operating profit or loss, or should it be broken down into operating and finance elements?) and impairment of equity-accounted investments.

ESMA also encourages companies to disclose their judgements in the notes, in cases where IFRSs do not stipulate the appropriate presentation of material items in the statement of comprehensive income.

Issuers are also reminded that all operating income and expenses should be included in the sub-total for 'operating profit', even though operating profit is not defined under IAS 1. In particular, ESMA states that it agrees with the IASB that:

- it is inappropriate to exclude items such as business combination impacts and depreciation of assets, even if it has been common practice in the sector;
- items that have affected past periods and/or expected to affect future periods can rarely be labelled or presented as non-recurring items such as most of the restructuring costs or impairment losses.

Issuers are therefore encouraged to ensure that the 'operating profit' sub-total in the statement of comprehensive income includes all items of an operating nature, notably business combination impacts, depreciation of assets and inventory write-downs, and restructuring costs.

As regards current and non-current items, companies are encouraged to:

- clearly define the criteria used to distinguish between current and non-current items;

- be careful when classifying an item of profit or loss as non-recurring, ensuring that it is both non-recurring and material. Issuers should take particular care to present adequate disclosures in the notes on the breakdown of all items classified as non-recurring over the period.

Finally, ESMA emphasises that it is important for all the financial statements to be readable:

In order to improve the readability of the primary financial statements, issuers should:

- ensure that details are provided in the notes on all material line items that are separately presented, and that cross-references to the notes are provided in the financial statements;
- not reduce the understandability of financial statements by adding immaterial information or by aggregating material items that have a different nature or function.

1.3 Segment information and performance

The regulator reminds issuers that IFRS 8 defines an operating segment as a component of an entity whose operating results are regularly reviewed by the entity's chief operating decision-maker. As a result, the sub-totals presented in the primary financial statements may differ from those presented in segment information.

The standard permits aggregation of segments, subject to certain criteria. ESMA reminds issuers that if segments are aggregated, they must provide a description of the judgements made by management in applying the aggregation criteria.

The regulator recommends that entities should:

- ensure consistency and standardisation of the measures presented in the segment information in financial statements and those presented in other financial communications (e.g. press releases on results, management reports, etc.). The measures must be consistent in terms of both how segments are reported (activity vs. geographical area) and the nature of measures used;
- avoid presenting, in the financial statements, measures based on principles that do not comply with IFRSs and that are presented to the chief operating decision-maker without a breakdown by segment.

1.4 Statement of profit or loss and other comprehensive income for the period

The regulator recommends that entities should:

- provide additional disclosures in the notes if specific line items in OCI are material, allowing readers to understand the source and composition of these amounts;
- present a breakdown of OCI by nature if the accumulated OCI is material, in addition to presenting an analysis of OCI in the statement of changes in equity.

1.5 Earnings per share

Earnings per share is a performance measure that is commonly used to assess and compare companies' performance.

As regards earnings per share, ESMA recommends that:

- entities should present information on instruments that are currently antidilutive but that could dilute earnings per share in the future, as this information is important for shareholders;
- earnings per share based on aggregates other than those required by IAS 33 should not be presented on the face of the statement of other comprehensive income, but rather in the notes.

1.6 Alternative Performance Measures

ESMA's *Guidelines on Alternative Performance Measures* set out requirements for entities that use APMs in publications other than the financial statements.

Entities are required to define these APMs, reconcile them to the financial statements, give them meaningful labels, and not give them more prominence than the sub-totals presented in the financial statements.

Following the implementation of the new guidelines (which became mandatory in July 2016), the regulator has taken the opportunity to draw issuers' attention to this topic.

Thus, entities are encouraged to ensure that APMs used in their financial communications are relevant and useful.

2) The impact of the UK referendum decision to leave the European Union

The UK's vote to leave the European Union has ushered in a period of uncertainty. In this context, it is unsurprising that the regulator has made some recommendations to entities to help them answer analysts' and investors' questions as to how this decision may affect the entities' activities and future performance.

Companies that have significant activities, operations and/or investments in the UK are encouraged to do the following:

- In their financial reporting: present and explain their exposure, the actual and potential impacts of the Leave vote (whether financial, operational and/or strategic), and the way in which management intends to manage the risks;

- In their financial statements: explain and present the impact of the Leave vote on the assumptions used in the valuation of assets and liabilities, and provide details of sensitivity analyses used in these valuations (exchange rates, growth rate, discount rate, etc.);
- Re-issue, expand or amend previous communications;
- In the event of high volatility in the pound, reconsider the methods used to calculate exchange differences, in particular considering whether it is necessary to change the periods used to calculate average exchange rates to ensure they are appropriate and accurately reflect the fluctuations in the exchange rate. This is particularly necessary when significant operations are involved.

3) New standards

The next few years will see the implementation of new standards on revenue recognition (2018), financial instruments (2018) and leases (2019), which are expected to have major consequences for financial statements.

In this context, ESMA has published specific recommendations on the implementation of the standards and the disclosures to be made to users of financial statements on the impact of the transition to IFRS 15 and IFRS 9.

These recommendations emphasise the importance of making an early start on the preparations for first-time adoption of the standards, and of paying attention to all relevant communications (amendments, possible clarifications from the IFRS Interpretations Committee, and discussions within the IASB's Transition Resource Groups). They also stipulate that the regulator expects to see progressively more detail in financial reporting on the impacts of the new standards as the effective date approaches. As far as is possible, the 2017 interim financial statements should provide some indication of the magnitude of the expected impacts.

In the 2016 annual financial statements, entities are encouraged to provide detailed qualitative information on the progress of preparations, key issues identified and a qualitative indication of the expected magnitude of the impacts of these standards on the financial statements. The regulator expects companies to take account of these recommendations when preparing their 2016 financial statements.

With reference to IFRS 16 – which will have a significant impact on the accounting treatment of leases – the regulator encourages companies with material leases to provide additional qualitative and quantitative disclosures in the notes, as soon as they are able, to help users of the financial statements to assess the potential impacts of the new standard.

4) Classification of financial instruments into equity instruments and financial liabilities

ESMA draws issuers' attention to the fact that distinguishing between equity instruments and financial liabilities requires significant use of judgement. It also points out that there have been several cases referred to the IFRS IC, which have shown that IFRSs do not provide clear guidance. ESMA also takes the time to remind issuers that:

- the general principle for distinguishing between liabilities and equity is whether the entity has an unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation;
- if it does not have such an unconditional right to avoid payment, the instrument is classified as a liability;
- economic compulsion (when an entity has an economic incentive, but not a contractual obligation, to settle in cash) does not in itself create a liability.

ESMA therefore recommends that issuers should present disclosures on financial instruments accounted for as equity that have characteristics that create an economic compulsion to make payments.

Still on the same topic, ESMA also draws issuers' attention to the additional complexity created when entities settle obligations with their own equity instruments:

- depending on whether the "fixed-for-fixed" criterion is met, the contract may qualify as equity, financial assets or financial liabilities;
- the IFRS IC itself has recognised that diversity in practice may exist regarding the application of the fixed-for-fixed criterion.

ESMA points out that the IFRS IC has sometimes had difficulty in reaching a consensus on the accounting treatment of certain instruments due to a lack of clarity in the standard.

In this context, ESMA recommends that issuers should be transparent in their disclosure of the characteristics of the instrument (par value, interest and any step-up clauses, coupon payment terms, triggering events for payments, key contract dates, conversion or call and put options).

Finally, ESMA highlights that IFRS 7 requires issuers to present disclosures of embedded derivatives if they have issued a financial instrument that contains both a liability component and an equity component, and the instrument has multiple embedded derivatives whose values are interdependent (e.g. an issued convertible debt).

ESMA states that issuers are encouraged, where relevant, to present additional line items in the statement of financial position or the statement of other comprehensive income if the amounts related to the financial instrument are material. In addition, it will be easier for readers to identify items if the presentation disaggregates related flows in the statement of cash flows, and the distribution to holders of instruments classified as equity (in addition to dividends on ordinary shares) is stated in the notes.

Events and FAQ

Frequently asked questions

IFRS

- Exclusion of a subsidiary held for sale from the scope of consolidation.
- The correct accounting treatment for a business takeover consultancy mandate.
- Monetisation of deferred tax assets.
- Increase in percentage interest, resulting in a need to carry out a new PPA.
- Impact of negative interest rates on liabilities and hedging instruments.

Upcoming meetings of the IASB, the IFRS Interpretations Committee and EFRAG

IFRS		EFRAG	
IASB	Committee	Board	TEG
12-16 December		13 December	24 November
16-20 January		12 January	19-20 December
20-24 February		7 February	25-27 January

The drafting of the present issue was completed on 23 November 2016