

Beyond the GAAP

MAZARS' NEWSLETTER ON ACCOUNTING
STANDARDS

CONTENTS

Highlights

IFRS highlights page 2

A Closer Look

Exposure draft on presentation of
financial statements: a detailed look at
three major proposals page 3

Events and FAQ page 6

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EDITORIAL

Following the announcement of the first results for 2019 in February, companies that have not yet closed their accounts need to consider the potential implications of the current coronavirus epidemic for the disclosures required in the notes on events after the reporting period in accordance with IAS 10, as some market regulators have just recalled.

The full economic and accounting repercussions of this new (health) crisis are not yet known, but meanwhile, the IBOR reform of benchmark rates – a result of the previous (financial) crisis in 2008 and the manipulation of interest rates by certain banks – will soon come into effect. Against this background, the IASB is continuing its work on amending IFRSs (Phase 2 of the project) to clarify the accounting treatment to be used for modifications to benchmark rates as a result of the reform. In this issue of Beyond the GAAP, we update our readers on the tentative decisions made by the IASB in preparation for amending standards.

Enjoy your reading!

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IFRS highlights

IBOR reform – Phase 2: summary of ongoing IASB discussions

In the third quarter of 2019, the IASB began discussions on Phase 2 of the IBOR reform project, which involves replacing old interest rate benchmarks with new ones.

This month, the Board completed its discussions on the topics that could potentially involve amendments to current IFRSs. The IASB's main proposals are currently as follows:

- any changes to the interest rate benchmark of a financial instrument shall fall within the scope of Phase 2 if they are:
 - required as a direct consequence of IBOR reform; and
 - done on an economically equivalent basis;
- IFRS 9 and IAS 39 shall be amended to state that modifications to a financial instrument as a result of IBOR reform shall be reflected through a prospective recalculation of the effective interest rate, rather than as an adjustment to profit or loss;
- IFRS 9 and IAS 39 shall be amended to make the hedge accounting eligibility criteria less stringent, as follows:
 - changes to a hedging relationship or hedge documentation to reflect IBOR reform shall not require the entity to discontinue the hedging relationship (e.g. changes to the description of the hedging instruments, the risk or the hedged item, or changes in the method used to measure hedge effectiveness);
 - if hedge effectiveness is measured retrospectively under IAS 39, the cumulative fair value changes of the hedging instrument and the hedged item shall be reset to zero at the date when the exceptions permitted by the Phase 1 amendments cease to apply;
 - if modifications are made to instruments that are part of a group of hedged items, the Board proposes that the entity should create two sub-groups of hedged items (for the old and new interest rate benchmarks) and should perform the proportionality test separately for each sub-group;
- IFRS 16 shall be amended to state that modifications required as a direct consequence of IBOR reform shall be treated as remeasurements of the lease liability (as in IFRS 16.42(b) and IFRS 16.43);
- IFRS 7 shall be amended to help users of financial statements to understand the nature and extent of risks arising from IBOR reform, by requiring the following disclosures:
 - a description of how the entity is managing the IBOR transition for the various rates involved;

- the carrying amount of affected financial assets and financial liabilities, including the nominal amount of hedging derivatives, disaggregated by significant interest rate benchmark;
 - for each significant interest rate benchmark, an explanation of how the entity determined the base rate and relevant adjustments to assess whether the modifications fell within the scope of the Phase 2 amendments;
 - the impacts of IBOR reform on the entity's risk management strategy;
- A temporary exception to the "separately identifiable" criterion for non-contractually specified risk components shall be introduced, permitting entities to conclude that the criterion is met, if and only if:
 - the entity reasonably expects that the new benchmark rate will become a separately identifiable component within twelve months of its designation as a risk component; and
 - the component can be reliably measured from the date it is designated as a risk component.

The IASB's proposed amendments would be mandatory for financial periods commencing on or after 1 January 2021, with early application permitted. They would be applicable retrospectively. In practice, retrospective application would permit entities to reinstate hedging relationships that were discontinued as a result of IBOR reform during a prior period before publication of the amendments.

An exposure draft bringing together the IASB's recent (but still tentative) decisions is currently scheduled for April 2020. We will look at the content of this document in a detailed study in a future issue of Beyond the GAAP, together with the IASB's other proposals to date, which are less significant and thus omitted from this brief summary.

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A Closer Look

Exposure draft on presentation of financial statements: a detailed look at three major proposals

In the December 2019 issue of Beyond the GAAP (no. 139), we presented an overview of the major new innovations proposed in the General Presentation and Disclosures exposure draft, which will eventually replace IAS 1 (in 2024 at the earliest).

In this issue, we will go into more detail on some of the major proposals in the draft standard:

1. Categories in the statement of profit or loss: the importance of identifying the entity's "main business activities"
2. Investments in equity-accounted entities: proposed changes to presentation in the primary financial statements and how to distinguish between "integral" and "non-integral" entities
3. Presentation of operating expenses by nature or function: the "mixed" approach will no longer be permitted

For reference, EFRAG's comment letter is already available here:

<http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520Draft%2520Comment%2520Letter%2520on%2520Primary%2520Financial%2520Statements.pdf>

Finally, readers are reminded that the comment period for the exposure draft is open until 30 June 2020.

1. Categories in the statement of profit or loss: the importance of identifying the entity's "main business activities"

As already noted in our previous issue of Beyond the GAAP, the exposure draft proposes four categories (i.e. operating, integral associates and joint ventures, investing, and financing) and would require income and expenses to be classified in the statement of profit or loss based on the definitions of these categories.

The "operating" category would include items that are not classified in any of the other categories, or in income tax or discontinued operations. This is thus the "default" category.

However, the exposure draft states that this category shall include income and expenses from the entity's "main business activities", without defining this term. There is only a brief note in the application guidance stating that if, under IFRS 8, an entity reports a segment that constitutes a single business activity, this may indicate that this activity is a main business activity.

This approach would allow an entity to adapt the presentation of income and expenses across the various categories depending on the nature of its business activities. Thus, although some income and expenses might meet the definitions of "investing" or "financing" income and expenses, the exposure draft explicitly states that:

- income and expenses from investments shall be classified in the "operating" category if, in the course of its main business activities, the entity invests in assets that generate returns individually and largely independently of other resources held by the entity. For example, this would apply to a real estate investment company, an investment entity as defined in IFRS 10, or an insurance company;
- some income and expenses that would normally fall within the "financing" category shall be classified in the "operating" category if:

- the entity provides financing to its customers as a main business activity (as is the case for banks or lessors offering finance leases). It should be noted that in this case, the entity may make an accounting policy election to classify outside the "financing" category either: a) only the income and expenses from financing activities, and from cash and cash equivalents, that relate to the provision of financing to customers; or b) all income and expenses from financing activities and from cash and cash equivalents. The Board is providing this choice as some companies might experience practical difficulties in allocating cash flows in the statement of profit or loss;
- the income and expenses relate to the cash and cash equivalents of an entity that, in the course of its main business activities, invests in financial assets that generate a return individually and largely independently of other resources held by the entity (in which case the income and expenses related to these investments are classified in the "operating" category). This would be the case for e.g. insurance companies;
- the entity recognises income and expenses on liabilities arising from issued investment contracts with participation features that fall within the scope of IFRS 9;
- the entity recognises insurance finance income and expenses in profit or loss under IFRS 17.

Applying these principles requires the use of judgement. The application guidance also notes that an entity may have more than one main business activity, giving the example of a car manufacturer that also offers financing to its customers. In this case, the entity has both a manufacturing main business activity and a customer-finance main business activity.

2. Investments in equity-accounted entities: proposed changes to presentation in the primary financial statements and how to distinguish between “integral” and “non-integral” entities

a) Proposed changes to presentation in the primary financial statements

Readers will remember that the share of profit or loss from equity-accounted investments that are part of the main business (“Share of profit or loss of integral associates and joint ventures”) would be presented below operating profit as defined by the IASB. An additional subtotal would then be required to aggregate these two line items, before presentation of income and expenses to be presented within the “investing” category. The share of profit or loss from other equity-accounted investments (“Share of profit or loss of non-integral associates and joint ventures”) would be presented in profit or loss before financing and tax, in the “investing” category.

The application guidance states that income and expenses from integral associates and joint ventures shall include:

- the share of profit or loss of integral associates and joint ventures;
- impairment losses and reversals of impairment losses on integral associates and joint ventures;
- gains or losses on disposals of integral associates and joint ventures.

It should be noted that the same distinction should be made in the statement of other comprehensive income, where an entity would be required to present line items, in each category of the comprehensive income statement, for the following:

- the share of other comprehensive income of integral associates and joint ventures accounted for using the equity method;
- the share of other comprehensive income of non-integral associates and joint ventures accounted for using the equity method.

In the statement of financial position, an entity would be required to present separate line items for investments in integral associates and joint ventures, and investments in non-integral associates and joint ventures.

In the statement of cash flows, cash inflows and outflows arising from investments in associates and joint ventures should be presented within investing cash flows (using the classification scheme set out in IAS 7, which is different from the classification proposed in the exposure draft for the

statement of profit or loss), with integral and non-integral investments presented separately. This would require amendments to IAS 7 consequential to the publication of the new standard on the presentation of financial statements.

b) How to distinguish between “integral” and “non-integral” entities

Integral associates and joint ventures are defined as companies accounted for using the equity method that are integral to the main business activities of an entity and hence that do not generate a return individually and largely independently of the other assets of the entity. Non-integral entities are de facto those that do generate a return individually and largely independently of the other assets of the entity.

The principles for differentiating between integral and non-integral entities will be included in IFRS 12, amended by the future IFRS on the presentation of financial statements. All relevant facts and circumstances would need to be taken into account when making the distinction. A significant interdependency between an entity and an associate or joint venture would indicate that the associate or joint venture is integral to the main business activities of the entity. IFRS 12 would include indicators of significant interdependency between an entity and an associate or joint venture:

- the entity has integrated lines of business with the associate or joint venture;
- the entity shares a name or brand with the associate or joint venture, such that externally it may appear that the entity and the associate or joint venture are a single company (even if the reporting entity has other, separate businesses);
- the entity has a supplier or customer relationship with the associate or joint venture that it would have difficulty replacing without significant business disruption.


Distinguishing between integral and non-integral entities would thus require the use of judgement, potentially to a significant degree.

The classification would not be set in stone but could only be changed in the event of a change in the relationship between the entity and the associate or joint venture.

3. Presentation of operating expenses by nature or function: the “mixed” approach will no longer be permitted

Readers are reminded that the draft new standard does not propose changing the presentation of operating expenses in profit or loss by nature or function: entities already have this choice. However, the proposed application guidance lists a range of factors to be taken into account when assessing which method would provide the most useful information for the entity concerned (e.g. customary practices in the sector).

Moreover, although the IASB does not explicitly state that one method is preferable to the other, it should be noted that entities presenting their operating expenses by function would be required to present a breakdown of expenses by nature in a separate note to the financial statements. Readers will remember that the current IAS 1 simply requires entities to provide, at a minimum, additional information on the nature of expenses, including depreciation and



amortisation and employee benefits expenses. The IASB has already faced strong opposition from companies on this point. Information on the nature of all expenses may not necessarily be readily available and may not be deemed relevant by management. The IASB is hoping to receive more feedback on the costs and benefits of this proposal through the comments process, although it must be said that the Board currently seems fairly convinced of the utility of this information, a position which is strongly supported by analysts (as the information would be helpful in forecasting future operating expenses and would link profit or loss more closely with the cash flow statement).

The new standard would also provide an important “clarification” to IAS 1 by explicitly prohibiting entities from using a combination of the nature of expense method and the function of expense method (the so-called “mixed” approach).

However, the proposed standard also includes an exception to this principle, as it requires entities to present, as a minimum, the line items specified in the draft standard in the

statement of profit or loss, whatever method of analysis of expenses is used. In practice, this means that a company that has elected to present expenses by function would be required, despite the prohibition, to separately present some expenses by nature in the statement of profit or loss, such as impairment losses on trade receivables accounted for in accordance with IFRS 9.

Moreover, it should be noted that the prohibition on “mixed” presentation of operating expenses would necessarily constrain an entity’s choice of how to present information on (for example) restructurings or litigation settlements, when circumstances would require a separate presentation (cf. IAS 1.98 which is reproduced in full in paragraph B15 of the exposure draft of the new standard). It follows that, if an entity has elected to present operating charges by function, separate presentation of any of these items of income or expenses would only be possible by means of specific disclosures in the notes to the financial statements. In other words, separate presentation in profit or loss would be prohibited.

Key points to remember

- Following the publication of an initial study in the December 2019 issue of *Beyond the GAAP*, we decided to focus in more detail on three major proposals of the exposure draft, given the significant implications of this project for the presentation of financial statements. These proposals are as follows:
 - Categories in the statement of profit or loss: the definition of the “operating” category would permit an entity to adapt the classification of income and expenses in profit or loss depending on the nature of its “main business activities”, although the draft standard does not give any explicit guidance to define this concept precisely. All entities will need to make (potentially significant) use of judgement when carrying out this classification, in order to determine whether a particular item falls into the “investing” category, the “financing” category, or the default “operating” category.
 - Investments in equity-accounted entities: preparers will be required to distinguish between “integral” and “non-integral” entities, based on an assessment of the level of interdependency between the issuing entity and the associate or joint venture. This distinction has particular significance for the presentation in profit or loss, as the share of profit or loss of integral associates and joint ventures should be presented separately, immediately below operating profit as defined by the IASB, with a subtotal then required to aggregate these two line items. The share of profit or loss of non-integral associates and joint ventures would be presented in the “investing” category.
 - Presentation of operating expenses by nature or function: the draft standard would explicitly prohibit entities from using a combination of the nature of expense method and the function of expense method (the so-called “mixed” approach). Moreover, entities presenting expenses by function would be required to present detailed disclosures of expenses by nature in the notes to the financial statements, beyond what is currently required by IAS 1.

Publication

Alternative Performance Measures: how have the practices of large European corporates evolved?

Building on our previous studies on this topic, Mazars has analysed the use of Alternative Performance Measures (“APMs”) by a sample of issuers in their financial reporting for 2017 and 2018. We also look at the future changes proposed by the IASB as part of the Primary Financial Statement Project (see our study in this issue), and what this will mean for corporates.

The study can be downloaded from our website [mazars.com](https://www.mazars.com)

Frequently asked questions

IFRSs

- Impact of share-based payments with performance conditions on the calculation of diluted earnings per share
- Accounting for a trademark licence contract
- Correct accounting treatment for partial disposal of a business
- Securitisation and deconsolidation of receivables
- Accounting for a commercial incentive relating to energy efficiency certificates

UPCOMING MEETINGS OF THE IASB, IFRS INTERPRETATIONS COMMITTEE AND EFRAG

IFRS		EFRAG	
IASB	Committee	Board	TEG
16-20 March	29 April	17 March	25-26 March
20-24 April	16-17 June	21 April	16 April
18-22 May	15-16 September	26 May	6-7 May

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