

# Beyond the GAAP

N°24 – June 2009

## Editorial

Derecognition: the first phase in the replacement of IAS 39. The IASB has begun by examining securitisation and other transfers of financial assets. Its decision to focus on derecognition before the recognition and measurement of financial assets is undoubtedly related to the financial crisis and the resultant pressure brought to bear on the Board from all sides. In this issue of Beyond the GAAP, we outline the key principles of the exposure draft. In their current state, the proposals would result in the derecognition of many financing transactions carried out by banks (repos). Meanwhile, transfers of trade receivables would rarely result in derecognition. Such an outcome will doubtless provoke a lot of debate.

Happy reading!

Michel Barbet-Massin

Jean-Louis Lebrun

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#### Editors-in-Chief:

Michel Barbet-Massin, Jean-Louis Lebrun

#### Columnists:

Françoise Flores, Vincent Guillard, Pascal Jauffret,  
Sébastien Landry, Arnaud Verchère, Mathieu Vincent.

#### Contact us:

Mazars  
Exaltis, 61, rue Henri Régnault  
92 075 – La Défense – France  
Tel: +33 (0)1 49 97 60 00  
[www.mazars.com](http://www.mazars.com)

## News

### IASCF publishes annual report

The IASCF published its 2008 annual report on 19 June 2009. The report comprises a comprehensive account of the activities of the IASCF and the IASB, as well as the organisation's audited financial statements.

The annual report is available on the IASB's website:  
<http://www.iasb.org/Home.htm>

### IASCF Constitution Review

The IASCF recently announced dates for three round-table discussions relating to the second phase of its Constitution Review:

- London, 9 September 2009
- New York, 6 October 2009
- Tokyo, 21 October 2009.

These round-table discussions will allow the IASB to identify other points of view in addition to those expressed during the comment period, which closed on 31 March 2009



M A Z A R S

## European matters

### ➤ IFRIC 15: next steps?

Interpretation IFRIC 15 – Agreements for the Construction of Real Estate has been approved by the EFRAG and the ARC and is awaiting adoption by the European Union. This interpretation, as issued by the IASB, will be effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted (eg for interim financial reports as at 30 June 2009), as this Interpretation clarifies existing and applicable Standards and is not contrary to any existing Interpretations.

IFRIC 15 clarifies the definition of a construction contract and the articulation between IAS 11 and IAS 18 and provides guidance on how to account for revenue when the agreement for the construction of real estate is in the scope of IAS 18.

To meet the definition of a construction contract in accordance with IAS 11, the customer must have the ability to specify the major structural elements of the design of the real estate. The Interpretation may have a significant impact as it is potentially applicable by analogy to areas other than agreements for the construction of real estate.

When the contract does not meet the definition of a construction contract under IAS 11, revenue should be recognised in accordance with IAS 18:

- By reference to the stage of completion in the case of a contract for rendering services (when the entity is not required to supply construction materials),
- Upon completion in the case of a sale of goods when the transfer of control and the significant risks and rewards only occurs on delivery (main source of divergence),
- And finally, by reference to the stage of completion in the case of a sale of goods when the transfer of control and the significant risks and rewards is made as construction progresses.

The agreement for the construction of real estate may also include a sale of land. In this case, an entity applying IFRIC 15 would recognise revenue and a margin from the sale of land when control and the significant risks and rewards of the land transfer to the buyer, regardless of the transfer of the construction itself.

The application of IFRIC 15 may significantly affect entities in the construction industry.

For more details on IFRIC 15, please refer to the May 08 issue of Beyond the GAAP.

### ➤ Adoption of IFRS 3 and IAS 27

The European Commission has just adopted IFRS 3R and IAS 27R (published in the 12 June 2009 issue of the Official Journal of the European Union), without changing the effective date.

The revised standards are thus effective for financial periods starting on or after 1 July 2009.

Early application is permitted, provided that both IFRS 3R and IAS 27R are applied simultaneously.

For more details on IFRS 3 R and IAS 27 R, please refer to the January 08 and March 08 issues of Beyond the GAAP.

## IFRS news

### ➤ IASB proposal on management commentary

On 23 June 2009, the IASB published an exposure draft (ED) on a proposed good practice framework for the preparation and presentation of management commentary, in response to demand from both preparers and users of financial statements.

Management commentary, which accompanies the financial statements, provides an opportunity to explain the entity's financial position, past performance and cash flows, and to present its future objectives and the strategies which will be used to achieve them.

The IASB's proposals are based on international best practice for management commentary. Use of the good practice guide is optional, but it should help to improve the consistency and comparability of management commentary.

The exposure draft is open for comment until 1 March 2010 and is available from:

<http://www.iasb.org/NR/rdonlyres/53DC9B3B-34A5-400F-B4B5-4F2FF24F231E/0/EDManagementCommentary.pdf>

### ➤ Expected loss model

On 25 June 2009, the IASB published a request for information on the feasibility of an expected loss model for the impairment of financial assets.

This is part of the comprehensive review of IAS 39 (for which the IASB published an updated timetable in May 2009). The replacement is expected to be completed in 2010.

One of its key stages is the publication of an exposure draft on impairment of financial assets (expected in October 2009).

The IASB is seeking input on practical issues which would arise if this impairment model were adopted.

The Request for Information is open for comment until 1 September 2009.

### ➤ Credit risk

On 18 June 2009, the IASB published a discussion paper on the role of credit risk in liability measurement.

This document is accompanied by a working paper prepared for the IASB by its staff, which presents the most common arguments for and against incorporating credit risk in liability measurement.

The IASB notes that the issue of 'own credit risk' has implications beyond liability measurement. In particular, it has significance for projects such as accounting for financial instruments, insurance, fair value measurement and provisions, contingent liabilities and contingent assets.

The purpose of this request for comments is, therefore, to generate a debate on one of the major issues in fair value accounting.

The document, which is open for comment until 1 September 2009, is available from the following address:

<http://www.iasb.org/NR/rdonlyres/9F2A5CC2-71F8-43FF-A2F9-7947B3A61662/0/DDCreditRisk.pdf>

## ➤ Amendments to IFRS 2

On 18 June 2009, the IASB published several amendments to IFRS 2 – *Share-based Payment*.

These amendments aim to clarify the accounting treatment to be used for group cash-settled share-based payment transactions.

It focuses particularly on arrangements in which a subsidiary receives goods or services from its parent company or another entity in the group.

The amendments clarify how a subsidiary should account for these transactions in its own financial statements.

The amended version clearly stipulates that the subsidiary which receives the goods or services should account for them no matter which entity in the group settles the transaction, and no matter how the transaction is settled (shares or cash).

In other words, the goods or services must be measured from the entity's own point of view. The amount recognised by the entity is not necessarily the same as that recognised by the group.

The term 'group' has the same meaning as in IAS 27 – *Consolidated and Separate Financial Statements*. 'Group' in this sense refers only to a parent and its subsidiaries.

The amendments to IFRS 2 also incorporate guidance that was previously included in the interpretations IFRIC 8 – *Scope of IFRS 2* and IFRIC 11 – *IFRS 2 – Group and Treasury Share Transactions*. The IASB has therefore withdrawn these two interpretations.

The amendments are effective for annual periods starting on or after 1 January 2010 and must be applied retrospectively. Early application is permitted.

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## IAS 36 – Impairment of Assets: Points to note at 30 June 2009

The objective of IAS 36 is to ensure that assets (notably goodwill, and tangible and intangible assets) are carried at a fair value which does not exceed their recoverable amount.

In an economic and financial environment which is still unsettled, the 30 June 2009 closing of accounts seems an appropriate time to look at the issue of impairment tests, as required by IAS 36.

Beyond the GAAP will assist you by highlighting the main points to note at 30 June 2009.

### ➤ Are entities required to carry out impairment testing as of 30 June 2009?

Under IAS 36, an entity must assess at each reporting date whether there is any indication of impairment. If there is, the entity must carry out an impairment test.

IAS 34.B36 requires entities to use the same criteria to test for impairment and reversal of impairment in both the annual financial statements and the interim financial statements. This does not mean that an entity must necessarily carry out a detailed calculation of impairment for each interim period.

However, at the end of each interim period the entity must assess whether any significant indicators of impairment have arisen since the end of the last annual period, in order to determine whether such a calculation is required.

Entities are not therefore automatically required to carry out impairment testing as of 30 June 2009. However, it is obligatory if there is any indication of impairment.

### ➤ What indicators should be considered?

The most likely indicators of impairment in the current economic conditions are as follows:

- The entity fails to achieve revenue, business plan or budget forecasts;
- The carrying amount of net assets exceeds the entity's market capitalisation.

If an entity's market capitalisation was already lower than its net assets as of 31 December 2008, and has not changed significantly since, the entity does not need to carry out an impairment test at 30 June 2009, as long as this element was taken into account in the impairment test at the end of the 2008 reporting period and there are no further indications of impairment as of 30 June 2009.

## ➤ Can an entity re-use a calculation made in a preceding period of the recoverable amount of a CGU?

An entity can re-use the most recent detailed calculation of the recoverable amount of a CGU made in a preceding period, as long as all the following criteria are met:

- There has been no significant change in the assets and liabilities making up the CGU since the most recent calculation of the recoverable amount;
- The most recent calculation of the recoverable amount resulted in an amount which substantially exceeded the carrying amount of the unit; and
- Based on an analysis of events that have taken place and circumstances that have changed since the most recent calculation of the recoverable amount, it is very unlikely that a current determination of the recoverable amount would be less than the current carrying amount of the unit.

Therefore, it is possible to re-use calculations from 31 December 2008 at 30 June 2009 if the conditions above are met.

If the entity is required to carry out an impairment test at 30 June 2009 (i.e. if there is an indication of impairment) and the calculations from 31 December 2008 cannot be re-used, the business plans used to calculate the recoverable amount should be updated and approved by the management as of 30 June 2009.

## ➤ How might the allocation of goodwill for impairment testing be affected by IFRS 8?

Goodwill acquired in a business combination should be allocated, from the acquisition date, to each of the CGUs or groups of CGUs likely to benefit from the synergies of the business combination.

Each CGU or group of CGUs to which the goodwill is so allocated:

- Must represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
- Must not be larger than an operating segment determined in accordance with IFRS 8.

The implementation of IFRS 8 may lead entities to change their reporting structure, thus requiring them to change the allocation of goodwill for impairment testing. IFRS 8 provides an opportunity for entities to reorganise their CGUs. However, it is unlikely that the implementation of IFRS 8 will lead entities to reduce their number of CGUs.

Changes to the reporting structure may require entities to recognise potential additional impairment losses for goodwill.

## ➤ Should the impact of changes to the reporting structure under IFRS 8 be calculated (and recognised) retrospectively?

*A priori*, yes. However, it is impossible to rewrite business plans for previous periods in line with the new reporting structure in order to carry out new impairment tests. In view of this, prospective application is permissible.

## ➤ What effect does the amendment to IAS 36 have on the allocation of goodwill to CGUs or groups of CGUs?

The IASB published an amendment to IAS 36 in April 2009. The amendment stipulates that each CGU or group of CGUs to which goodwill is allocated must not be larger than an operating segment prior to aggregation.

IFRS 8 permits entities to aggregate operating segments that have similar economic characteristics in order to reduce the number of segments disclosed, in comparison with the number of segments individually reviewed by the chief operating decision maker.

As a result, groups which allocate goodwill to segments as disclosed in the note on segment reporting (i.e. after aggregation) may in the future have to make further changes to the amounts recognised for impairment losses for goodwill.

Although this amendment is not mandatory until 1 January 2010 (prospective application), it might be sensible to anticipate its consequences from 2009. This amendment does not contradict IAS 36; rather, it provides clarifications which are necessary to ensure consistent practice.

## ➤ Can an entity reverse an impairment loss recognised for goodwill in an interim period?

IFRIC 10 indicates that an entity must not reverse an impairment loss recognised for goodwill in a previous interim period. The term 'interim period' includes quarterly and half-yearly financial statements.

Thus, impairment losses recognised for goodwill at 31 March or 30 June 2009 are permanent and cannot be reversed at 31 December 2009 or subsequently.

## Exposure draft – Derecognition of financial assets: rethinking the principles of derecognition?

On 31 March 2009, the IASB published an exposure draft on the rules for derecognition of financial assets and liabilities, as part of the review of IAS 39 and IFRS 7.

This exposure draft is the result of a joint project launched by the IASB and the FASB in April 2005. Its aim is to improve and “potentially” bring to convergence the derecognition requirements in IAS 39 – *Financial Instruments: Recognition and Measurement*, and FASB Statement No. 140 – *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140).

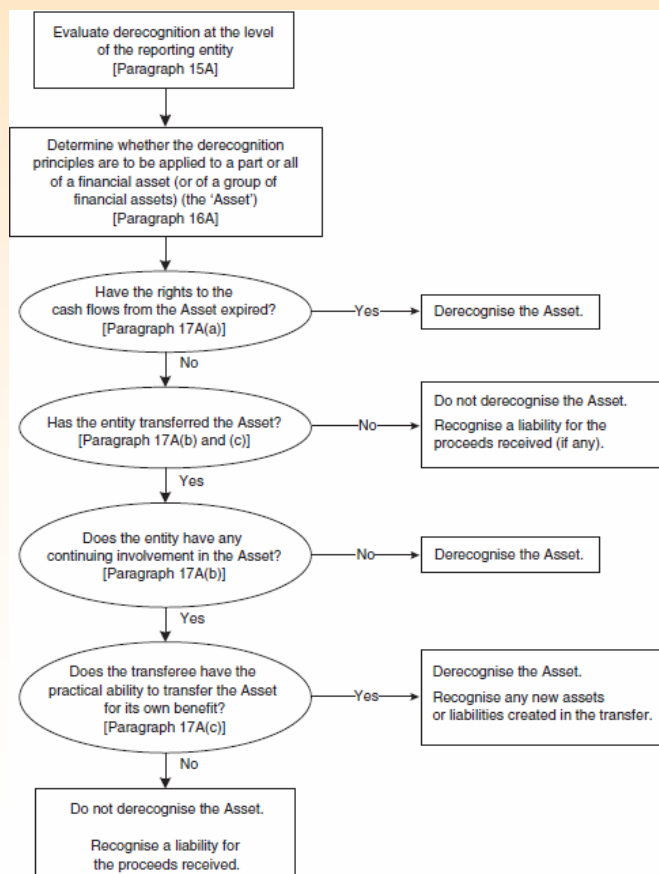
Like the review of IAS 39, this project has been significantly accelerated in view of the global financial crisis and the resultant pressure from governments.

The main criticism of the current approach is that it is extremely complicated to put into practice. The Board has identified internal inconsistency as the main drawback. The current approach is actually based on two different analytic criteria: ‘risks and rewards’ and ‘control’. Moreover, it often runs into complex issues around how to quantify the risks and rewards transferred.

The proposed new approach is intended to be simpler. Beyond the GAAP here presents the main points.

### ➔ Key points of the proposed approach

The evaluation proposed in the exposure draft is based around a decision tree, as in the current standard.



## ➤ A stage-by-stage approach to the evaluation

### Stage 1: Determine the scope of the evaluation

- The evaluation is carried out at the level of the reporting entity

As in the current approach, the entity must first set the bounds of the reporting entity. In particular, all ad hoc entities must be consolidated prior to evaluating the item for derecognition. With this in mind, close attention should be paid to coherence with ED 10 - *Consolidation*<sup>1</sup>.

- Determine whether the evaluation is to be applied to all or part of a financial asset

This stage of the evaluation is almost identical<sup>2</sup> to its equivalent in the current approach. The evaluation may only apply to part of an asset (or group of assets) if this part comprises specifically identified cash flows or a strictly proportionate share of the cash flows from the asset (or group of assets) as a whole. In all other cases, the asset to be evaluated is the entire asset.

### Stage 2: Have the rights to the cash flows from the asset expired?

If yes, the asset should naturally be derecognised. If no, we continue with the evaluation.

### Stage 3: Has the entity transferred the asset?

Under the proposed approach, the definition of 'transfer' is somewhat broader than under the current approach. A transaction shall be treated as a transfer if the entity passes some or all of the cash flows or other economic benefits underlying an asset to another party. The definition of a 'transfer' is not related to the legal form of the transaction. Thus, an obligation to repay a loan, using only the proceeds generated by a specified asset in which the lender holds a security interest, may qualify as a transfer.

If no transfer is deemed to have occurred, the entity shall recognise a liability for the proceeds received.

If a transfer is deemed to have occurred, we continue with the evaluation.

### Stage 4: Does the entity have any continuing involvement in the asset?

An entity is deemed to have no continuing involvement in the asset if it neither retains any of the contractual rights or obligations inherent in the asset nor acquires any new contractual rights or obligations relating to the asset.

If the entity does not have any continuing involvement in the transferred asset, the asset is derecognised. Alternatively, if the entity does have a continuing involvement in the asset, we continue with the evaluation.

<sup>1</sup> Both exposure drafts propose an approach based around the concept of 'control'. However, the definition of 'control' does not seem to be entirely consistent across the two documents.

<sup>2</sup> Except that the concept of a group of 'similar' assets no longer exists

## **Stage 5: Does the transferee have the practical ability to transfer the asset for its own benefit?**

This will often be the deciding factor: the transfer of control. The exposure draft proposes that the entity shall be deemed to have transferred the control of an asset when the transferee is able, in its turn, to freely dispose of the asset. The evaluation must therefore be conducted from the point of view of the transferee.

A transfer of control is deemed to have occurred if the transferee is in a position to transfer the asset to a third party unilaterally, without having to impose additional restrictions on that transfer.

The transferee must actually have this ability. Therefore, a call option retained by the transferor is not an obstacle to the transfer of control of the asset if the asset is traded on an active, liquid market. If the transferor exercises the call option, the transferee will have no difficulty in delivering the asset even if it has been sold, because a similar fungible asset can be purchased on the market. However, a similar situation involving an illiquid, non-fungible asset would mean a transfer of control had not taken place.

If a transfer of control is deemed to have taken place, the asset is derecognised. On the other hand, if a transfer of control is not deemed to have taken place, the asset remains on the balance sheet and a liability is recognised for the proceeds of the transfer.

## **➤ Overview of the main changes from the current approach**

### **Much simpler**

The proposed approach is much simpler.

In contrast with the current approach, the evaluation approach proposed in the exposure draft has a binary outcome: either the asset (or part of the asset) is fully derecognised, or it is not derecognised at all. The 'partial derecognition' option has been abandoned.

The 'risks and rewards' criterion is now much less significant; instead, the evaluation focuses on control. This means that entities no longer need to attempt to quantify the risks and rewards, which is almost unavoidable under the current approach when evaluating either risks and rewards or continued involvement.

### **Clarification needed on practical issues**

For example, we feel the two following issues need further discussion:

- The term 'transfer' needs to be clarified. The exposure draft notes that the new definition of 'transfer' is broader than the current 'transfer of contractual rights to cash flows'. In addition, it states that the proposed approach does not include pass-through arrangements. However, it is not easy to identify when a transfer is deemed to have occurred.
- Evaluating transfer of control from the point of view of the transferee poses some practical difficulties. Will the transferor be in a position to assess the transferee's actual ability to freely dispose of the asset<sup>3</sup>?

<sup>3</sup> The first stage of the decision tree stipulates that the evaluation is carried out at the level of the reporting entity (after consolidation). Thus, the transferee must be an entity which is not controlled by the transferor. The transferor will therefore have difficulty in assessing its actual ability to dispose of the asset.

## A controversial decision

The IASB believes that the internal inconsistency of the current approach accounts for a significant proportion of the difficulties in implementing it. To make it simpler, the exposure draft proposes a significant reduction in the weighting of the 'risks and rewards' aspect in the evaluation. Instead, the focus is on control.

This decision will certainly cause widespread debate, as it could lead to changes in accounting treatment. The approach proposed in the exposure draft would make it theoretically possible to derecognise an asset even if the entity has retained all the associated risks and rewards.

## ➤ Big changes in the treatment of certain transactions

The proposed approach is frequently likely to lead to the derecognition of assets traded on a liquid, active market. On the other hand, derecognition of assets which are not traded on a liquid, active market is likely to be rarer. To illustrate this point, Beyond the GAAP will take you through two practical examples:

### Example 1: Sale of a previously-owned stock with a two-year fixed price repurchase agreement.

- Evaluation under the current approach:

The stock is not derecognised; rather, the transaction is treated as collateralized financing. Under the current approach, the transferor is deemed to retain virtually all the risks and rewards, and must therefore retain the asset on its balance sheet.

- Evaluation under the proposed approach:

The stock is derecognised and the transaction is treated as a transfer. A forward contract derivative is recognised. As the stock is publicly traded, the transferee has the ability to dispose freely of the asset without having to obtain the consent of the transferor; as a result, a transfer of control has taken place and the asset is derecognised.

### Example 2: Securitisation of trade receivables, involving the transfer of a significant proportion of the associated risks and rewards.

- Evaluation under the current approach:

*A priori*, trade receivables are partially or fully derecognised, depending on the proportion of risks and rewards retained.

- Evaluation under the proposed approach:

As the transferor has a continuing involvement via the risks and rewards retained, it must assess the transferee's ability to freely dispose of the receivables. As there is no active, liquid market for this type of instrument, and since in practice this type of arrangement usually stipulates that the transferor will reclaim the receivables in the case of litigation, it is difficult to argue that control has been transferred. As a result, it is highly likely that the receivables will remain on the balance sheet.

## ➤ Other aspects of the exposure draft

The exposure draft does not propose any significant changes to the accounting treatment of transactions which do not result in the removal of an asset from the balance sheet. Such transactions will continue to be recognised as guaranteed financing.

The exposure draft also addresses the derecognition of financial liabilities. *A priori*, no significant changes are expected in this area.

The amount of information to be provided in the notes on transactions deemed to be 'transfers' is expected to increase significantly.

Finally, the section on transitional requirements proposes prospective application from a yet-to-be-determined date.

## ➤ Alternative approach using fair value

The exposure draft also presents an alternative approach supported by a minority of the Board members (5 out of 14). Beyond the GAAP summarises the main points.

### Key elements of the alternative approach

The evaluation starts by identifying a transfer, using a definition similar<sup>4</sup> to that proposed in the exposure draft.

Where a transfer is deemed to have occurred, the alternative approach asks two questions:

- Has the transferor retained access, for its own benefit, to all of the cash flows or other economic benefits of the transferred asset?  
AND
- Has the transferor retained the ability to restrict others' access to these economic benefits?

If the answer to both questions is yes, the asset is not derecognised.

If the answer to either of the two questions is no, the entire asset is derecognised. In this case, the residual rights and obligations associated with the transferred asset and retained by the transferor would be recognised at fair value in the balance sheet.

### Significant predicted effects

The alternative approach looks very simple. However, it is likely that there would be difficulties in implementation. In particular, it could prove very difficult to measure the fair value of the rights and obligations retained.

Adopting this alternative approach would lead to very significant changes in accounting treatment, compared with the current approach. The 'all or nothing' logic of this approach would lead entities to recycle the entirety of latent capital gains or losses on AFS assets, even if only a portion of the cash flows were transferred.

Finally, it should be noted that this approach is another step towards fair value: each time that part of an asset is transferred, the asset is derecognised and the parts retained are *de facto* revalued at their fair value.

<sup>4</sup> The alternative approach defines a transfer as a situation in which cash flows or economic benefits are passed to another party, whereas the exposure draft approach only mentions economic benefits.

Therefore, the alternative approach seems to make derecognition easier, while increasing the use of fair value.

⇒ **Summary table (a simplified analysis\* by our experts)**

| Elements of the evaluation                  |                     | Result of evaluation for each approach |                     |                      |
|---|---------------------|--|---------------------|----------------------|
| Proportion of risks and rewards transferred | Transfer of control | Current standards                      | Exposure draft      | Alternative approach |
| 100%  | Yes                 | Total derecognition                    | Total derecognition | Total derecognition  |
| 100%  | No                  | Total derecognition                    | Total derecognition | Total derecognition  |
| 75%   | Yes                 | Total derecognition                    | Total derecognition | Total derecognition  |
| 75%   | No                  | Partial derecognition                  | No derecognition    | Total derecognition  |
| 25%   | Yes                 | Total derecognition                    | Total derecognition | Total derecognition  |
| 25%   | No                  | Partial derecognition                  | No derecognition    | Total derecognition  |
| 0%  | Yes                 | No derecognition                       | Total derecognition | Total derecognition  |
| 0%  | No                  | No derecognition                       | No derecognition    | No derecognition     |

(\*) It is assumed that transactions are similar in all respects, and that the definitions of 'control' and 'risks and rewards' are identical for all three approaches.

⇒ **Comment period**

The exposure draft is open for comment until 31 July 2009.

# Events and FAQ

## Events/publications

### Seminars on "Current developments in IFRS"

Mazars' Technical Department in Paris will host a number of seminars throughout 2009 dedicated to current developments in IFRS. These seminars are organised by Francis Lefèbvre Formation. Sessions will be held on 25 September and 18 December 2009.

Registration forms can be obtained from Francis Lefèbvre Formation, 13-15 rue Viète, 75017 Paris.

### 2009 closure of accounts

Save the date! Forthcoming seminars devoted to the 2009 closure of accounts, organised by the Mazars' Technical Department in Paris are:

- French accounting principles: two sessions in Paris (Friday 20 November and Thursday 7 January) and one in Lyon (17 November);
- IFRS: A single session in Paris on 21 October.

Registration forms should be sent to Francis Lefebvre Formation – [www.flf.fr](http://www.flf.fr), +33 (0)1 44 01 39 99.

## Frequently asked questions

### IFRS standards

- Accounting treatment of perpetual convertible bonds;
- Capitalisation of borrowing costs on general borrowings;
- Initial application of IFRS 8;
- Concession contracts: financial asset model, intangible asset model or mixed model?;
- Hedging a structured loan using a combination of instruments;
- Accounting treatment and hedging of commodity swaps;
- Accounting treatment for disqualified hedging relationships and re-designation of non-zero fair value derivatives.

## Upcoming meetings of the IASB, IFRIC and EFRAG

### IASB

20 - 24 July 2009  
14 - 18 September 2009  
19 - 23 October 2009

### IFRIC

9 - 10 July 2009  
3 - 4 September 2009  
5 - 6 November 2009

### EFRAG

8 - 10 July 2009  
1 - 3 September 2009  
8 - 9 October 2009

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