

Beyond the GAAP

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Editorial

Will IFRS be the next victim of the current crisis? By now, the due process of the international standard setter is already overwhelmed. The turmoil led the IASB, EFRAG and the European Commission to adopt and publish an amendment to IAS 39 in less than one week. This high speed standard setting gave the European Commission an idea. The EC listed the topics that it wants resolved with the closure in 2008. This list was mailed to the IASB for action! The EC is waiting for an answer.

Happy reading!

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News

Using judgement in determining the fair value

The IASB published on 31 October a document prepared by the staff and accompanying the report of the Expert Advisory Panel (see below).

This document summarizes different stages of determining fair value when markets are illiquid: use of quotations, use of quotations from brokers, forced transactions...

Fair value measurement when markets are illiquid

The Expert Advisory Panel created by the IASB published its report on determining fair value when markets are illiquid.

The experts in valuation propose practical solutions to determine fair value in current markets.

This report has not been approved by the IASB and is not an IFRS standard. It is practical application guidance.

The report is available on the IASB website (www.iasb.org)



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IFRS news

➤ Debt/Equity

The comment letters on the project "Financial Instruments with Characteristics of Equity" have highlighted eight different possible approaches. The IASB and FASB decided to develop their future standard based on the principles of the "perpetual" and "basic ownership" approaches.

These two approaches use a positive definition of equity. A "perpetual" instrument has no unwinding clause. It entitles the holder to a share of the net assets on liquidation.

A "basic ownership" instrument is the most subordinated instrument that entitles the holder to a share of the entity's net assets.

The two Boards have not ruled out the possibility of drafting exceptions to the principles that will be finally adopted.

➤ Derecognition

The IASB and FASB decided to prepare the exposure draft for a standard dedicated to derecognition of assets and liabilities.

Initial discussions focused on the outflow of balance sheet assets. The principle to be developed will be based on the definition of an asset. When an instrument no longer satisfies the definition of an asset it will be derecognised. While it seems simple, the exposure draft should assess at what point in time and under which circumstances an entity loses control of the asset. The specific provisions to be applied to liabilities are yet to be analysed.

The exposure draft is to be published in the first half of 2009.

➤ Discussion paper on the presentation of financial statements

As part of their joint project, the IASB and FASB published a discussion paper on 16 October 2008 on the presentation of financial statements. The project is named "Preliminary Views on Financial Statement Presentation".

The project aims at creating an organisational standard to ensure that financial statements clearly present the entity's financial situation. It focuses on the way assets, liabilities, revenues, expenses, cash flows and related information are presented in the financial statements. Recognition and measurement issues are not addressed in this discussion paper.

For the Boards, the financial statements must satisfy a dual objective.

- cohesiveness: this will be achieved when the reader will be able to easily establish a link between the elements making up the financial information; and
- disaggregation: this will be achieved when elements that respond differently to economic events are presented separately.

Comments are welcome until 14 April 2009.

A Closer Look

Financial crisis: what are the potential impacts on the accounts?

Some people believe that the current crisis is a matter for banks and insurance companies. For others, the impacts of the crisis are limited to financial instruments. What a mistake! BEYOND THE GAAP highlights potential impacts for banks, insurance companies and also for industrial and service companies.

➤ Cash situation and liquidity

The current lack of liquidity can have devastating effects for all groups from all sectors. If all groups are not currently facing a difficult situation, the presentation of liquidity and net cash situation will be, no doubt, a key issue for the 2008 financial communication. The assessment of the liquidity and cash at hand can be complex:

- The analysis must include confirmed lines of credit and "stress" scenarios (i.e. line of credit confirmed but not tapped into and then cancelled by the bank...)
- Some loan contracts include covenants or the identification of trigger events. The identification of these clauses can be complicated specifically in groups including foreign subsidiaries that have a strong financial autonomy. Moreover, it is essential to monitor compliance with these terms over time.
- The high volatility of the market must lead preparers and auditors to pay special attention to instruments classified as "cash equivalents". On the top of that, structured financial instruments must be analysed on a case-by-case basis. The sensitivity of some instruments may be challenged in 2008 given the proven volatility of markets. These instruments (structured EMTN) may have been classified as cash equivalent in 2007 when the volatility was lower than in 2008.

➤ Fair value of financial instruments and impairment

Estimating fair value

IAS 39 specifies that quotation is the best estimate for fair value of an instrument quoted in an active market. Thus, blue chips (CAC 40, Eurostoxx 50, FTSE 100...) should be measured using only the quotation.

The current crisis has increasingly highlighted the difficulties in estimating fair value when markets become illiquid. Several guidelines were recently issued to estimate fair value in such circumstances:

- On October 31st, the Expert Advisory Panel and the IASB staff published a document proposing a methodology for estimating fair value. This document is available on the IASB website (www.iasb.org).
- The SEC and FASB have proposed concrete measures for the application of FAS 157 when markets become illiquid.

Although these texts do not have an official character (i.e. the Expert Advisory Panel's document will not be approved by the IASB), they constitute a basis for discussion.

Impairment of AFS financial assets

The impairment of AFS financial assets requires that an entity defines its objective evidence of potential loss.

As far as equity instruments are concerned (i.e. shares), IAS 39 specifies that a prolonged or severe decline in a security's fair value constitutes an objective indicator of loss in value. There is not, at this stage, any market position regarding the interpretation of the criteria "prolonged or severe". In any event, losses in value on securities relating to shareholders' equity cannot be recovered. These losses are therefore permanent, including for interim cut-offs.

Concerning debt instruments, indications of loss in value are based solely on the assessment of the credit risk. Trends in benchmark rates (Euribor, Libor...) do not constitute in itself an appropriate indication of loss in value.

In any case, the loss in value recorded in the income statement equals the difference between the change in fair value and the acquisition cost of the security. Hence there is no longer any fair value variation included in equity at the date of recording the loss in value.

Reclassification of Trading/ AFS/HTM securities/ Loans and receivables

A recent amendment to IAS 39 allows, under certain conditions, securities in the "Trading" or "AFS" category to be reclassified in the "HTM" or "Loans" category. These reclassifications concern neither derivatives nor securities which have benefited from the "fair value option".

Some entities use the HTM – Held To Maturity category. The "tainting"¹ principle automatically applies if the transfer is not expressly provided for under IAS 39.9.

¹The "tainting" principle imposes the obligatory declassification of the entire HTM portfolio and forbids the use of this category for 2 years.

➤ Long-term assets and employee benefits

The impacts of the financial crisis include impairment of long-term assets and employee benefits..

Impairment of long-term assets

The scale of the financial crisis requires business plans to be considered carefully. Impairment tests must be carried out at least once a year and more often if there is an indication of loss in value. Profit warnings constitute indications of loss in value amongst others. It is possible – and often desirable – to carry out these tests before working on the accounts as of December 31st.

The discount rates used for the discounting of future cash flows must be assessed carefully given market conditions. Reference to the rate of private companies' bond issues is not necessarily relevant given the current activity of the money market.

Employee benefits

Three parameters require special attention:

- The discount rate. Many actuaries consider classic benchmark discount rates as non-relevant for discounting employee benefits obligation (for example, the IBOX Corporate index). The low money market liquidity requires reflection on the parameters to be used in such circumstances.
- Plan assets may also be impacted by the current financial crisis. The decline in value of portfolios may create unfunded obligations. Similarly, the expected return of plan assets is likely to be revised downwards compared with to previous forecasts. Remember: changes in these parameters constitute actuarial gains or losses.
- Finally, it may be useful to consider the depositary risk and the availability of plan assets. Some investments have been entrusted to institutions that are protected by law. The availability of plan assets in short or medium term can be challenged.

Long-term provisions: dismantling or restoring obligations

The calculation of these provisions is particularly sensitive to the discount rate used. Like corporate commitments or impairment of long-term assets, the low money market liquidity requires in-depth analysis on the parameters to be used in such circumstances.

Beyond the GAAP

Find out all the latest news on international accounting standards in Mazars IFRS newsletter

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Financial assets can now be reclassified!

How fast can the IASB set standards? Nearly as quick as a bat of an eyelid. Consider the amendment to IAS 39 recently issued. This amendment was requested by European members of the G8 meeting at the Elysee Palace in Paris on 4 October. The IASB published the text on 13 October. The European Commission published the regulation adopting the text in Europe on 15 October. BEYOND THE GAAP gives you the key elements of this unconventional amendment.

➤ Why was this amendment necessary?

The European members of the G8 asked the IASB and FASB to ensure that the rules for the reclassification of financial assets are the same in both sets. This concern at the highest level is justified by the fact that US GAAP has for a long time allowed the reclassification of financial assets in rare circumstances. This possibility did not exist under IFRS, even in rare or exceptional cases.

It is the different treatment of reclassifications between the two reference systems which prompted European members of the G8 to request the harmonisation of accounting principles.

In addition to this political request, it was necessary to amend the principles as investment intentions may have changed as a result of the current crisis. Some securities initially identified as speculative may have seen their investment horizon altered by the lack of market liquidity or a sharp deterioration in value. Under these circumstances, the purpose for holding the security may have changed from short-term arbitrage to a more long-term basis. Prior to the amendment published in October, such a change in investment intention was not translated in the IFRS accounts by a reclassification of the security.

Remember that international accounting standards provide for the specific accounting treatment of each securities classification. The accounting category – and the reclassification possibilities – is therefore of vital importance: some categories are assessed at fair value and others at cost.

➤ What are the authorised reclassifications?

The amendment published by the IASB in October 2008 enables certain financial instruments in the “Trading” or “Available for Sale” category to be reclassified to the “Loan and Receivables” or “Held to Maturity” categories.

These reclassifications are allowed under certain conditions:

- Derivative instruments may, under no circumstances, be reclassified. The amendment published by the Board therefore has no impact on these financial instruments.
- Financial instruments accounted for under the “fair value option” are not concerned by the amendment.
- The amendment shall be applied in rare situations. The IASB has already indicated that the current crisis is a rare situation.

The table below summarises the reclassification possibilities offered by the amendment published by the IASB in October 2008.

	US GAAP	IAS 39 Amendments
Reclassification apart from the "Trading" category in rare circumstances	Authorised	Authorised
Reclassification to the "Loans" category if there is the intention and capacity to hold assets in the future (loans) or until maturity (debt securities)	Authorised	Authorised
Reclassification of derivative instruments	Unauthorised	Unauthorised
Reclassification apart from the fair value option	Unauthorised	Unauthorised

Whatever the situation may be, the cost of entry into the destination category is equal to the fair value at the reclassification date. For debt securities, the effective interest rate is calculated on the basis of the new cost as defined above, taking into account the entity's future flows forecasts. In the event of a revision of future flows receivable, it is the effective interest rate that is modified, as an exception to the general rule.

It is important to emphasise that the IASB has specified new initial application conditions:

- If the date of the reclassification decision is before 1 November, the reclassification can be retroactive to 1 July 2008.
- After 1 November, reclassifications are made on the date of the reclassification decision.

Finally, discussions were held for several hours in order to establish whether the securities to be reclassified had to meet the conditions required by the destination category on the reclassification date or on the initial acquisition date. The consensus that seems to be emerging is an assessment of compliance with the conditions on the reclassification date.

➤ What information is to be provided?

Contrary to the provisions of US GAAP (FAS 115 and FAS 65) which does not provide for the provision of any specific information in the case of reclassification, the amendment to IAS 39 specifies particular information.

This information includes the identification of exceptional circumstances, reclassified amounts, the fair value variations of instruments reclassified during the existing or previous period, etc.

Although the IASB published this amendment in no time, it is important to emphasise that the due process was not complied with. Due to the emergency, the IASB did not publish any exposure draft. Neither did the EFRAG. As the standard setter already demonstrated its velocity, some may wish to take advantage of this brand new feature. The EC calls for additional changes before the end of the year!

The EC calls for additional changes to IAS 39

The amendment to IAS 39 issued in October is not enough. So say the European Commission. The EC sent a letter to the IASB (27 October 2008) in order to provoke additional debate on three items. These items are critical according to the EC and must be dealt with before year-end.

➤ Extension of the possibility for reclassification to financial instruments assessed at the fair value option

Up until now, this category was used to reduce measurement or recognition inconsistencies between a financial asset and liability. However, strong market volatility has called into question market values and valuation models. The European Commission therefore proposes amending IAS 39 in order to extend the reclassification of financial instruments at the fair value option to other categories of financial asset.

➤ Treatment of credit derivatives embedded in synthetic securitisation transactions

IAS 39 and FAS 133 have different approaches as far as embedded credit derivatives are concerned. On the one hand IAS 39 AG30 (h) states that embedded credit derivative should be bifurcated. On the other hand FAS 133 states that they should not. This difference appears clearly when it comes to synthetic CDOs (Collateralised Debt Obligations).

➤ Impairment of available for sale assets

- In case of a debt instrument, the impairment loss equals to the difference between the acquisition cost and the recoverable value. This amount includes both the credit risk and the market risk, especially in the case of illiquid markets. To ensure that only the credit risk justifies the impairment loss, the European Commission would like the applicable method to be identical to that used for the "held to maturity" and "loans and receivables" categories (book value – recoverable value).
- In case of an equity instruments, IAS 39 states impairment charges shall not be reversed in subsequent periods. The European Commission wishes to allow the reversal of impairment losses on equity instruments, as is the case for debt instruments.

Exposure draft for the improvement of information on financial instruments

As we announced it in our October issue, the IASB issued its exposure draft *Improving disclosures about financial instruments*. This publication forms part of the IASB response to the crisis as it has accelerated several projects. The IASB proposes to amend IFRS 7 in order to improve the financial information on:

- the different levels of fair value used for the valuation of financial instruments;
- the illiquidity risk

➤ Information on fair value

Fair value can be estimated in different ways. Inspired essentially by SFAS 157, the IASB proposes to distinguish three levels in the calculation of fair value, depending on whether fair value is based on external data. For the IASB, fair value can be:

- 1st level: prices listed on an active market;
- 2nd level: measurement methods based on observable parameters;
- 3rd level: measurement methods whose main parameters are non-observable.

Based on these levels, issuers would be asked to provide information on the way the fair value has been calculated, not only for financial instruments booked at fair value but also for financial instruments valued at cost or amortised cost and whose fair value is provided in an appendix.

In addition and in order to provide improved financial information, the IASB recommends a new presentation for financial instruments booked at fair value. It involves breaking down fair value by level for each category of instrument (AFS, FVTPL). A reconciliation statement between opening and closing amounts would complete the financial information for instruments at fair value based on level 3 (measurement methods based on non-observable parameters).

Finally, in the event of movement from one level to another, the ED provides for a reconciliation statement to be included in the financial statements. The entity must justify the reasons that prompted it to carry out such movements.

➤ Information on the illiquidity risk

The ED states that financial information relating to the illiquidity risk is required for financial liabilities where settlement results in the outflow of cash or another financial asset.

The IASB proposes to introduce the obligation to provide an analysis on the maturity of derivative and non-derivative financial liabilities. This analysis would be based on the way according which the entity manages the illiquidity risk associated with these financial instruments.

Finally, the ED is an opportunity for the IASB to strengthen the link between quantitative and qualitative information on the illiquidity risk.

Comments can be submitted to the IASB until 15 December 2008.

Events and FAQ

Events - Hungary

Conference on tax law changes 2009

Mazars is organising a conference on tax law changes and their application on 8 December 2008 with special attention to corporate income tax, personal income tax, contributions and the rules of tax procedure.

The language of this event will be Hungarian.

For further details and an application form please follow this link:

<http://www.mazars.hu/newsroom/adokonferencia.html>

Frequently asked questions

- Derecognition of cereal swaps;
- Recognition of a hedging swap with a cancellation option exercisable by the seller;
- Effect of a shareholder pact in an acquisition operation;
- Recognition of "Carried interest" retroceded to the manager's employees;
- Derecognition of receivables transferred under a factoring contract;
- Recognition of variations in interest percentages in an affiliated company;
- Recognition of deferred taxes on equity write-downs.

Upcoming meetings of the IASB, IFRIC and EFRAG

IASB

17 - 21 November 2008

15 - 19 December 2008

19 - 23 January 2009

IFRIC

6 - 7 November 2008

8 - 9 January 2009

5 - 6 March 2009

EFRAG

12 - 14 November 2008

10 - 12 December 2008

21 - 23 January 2009

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