AN UPDATE ON INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs)

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Opening Comment

International Financial Reporting Standards (the "IFRSs") have been criticized by some on the Paris Market, including the President of the Autorité des Normes Comptables (the French accounting standards setter - ANC) and a representative from KPMG France, as illustrated by several press articles published about IFRSs. In this unusual context, mostly related to our country from my standpoint, I would like to respond to some of the recurrent criticisms against the international standards. A listed corporation leader, a director, who report in accordance with IFRSs, a creditor, a portfolio manager, an individual shareholder, or an employee (who is possibly also a shareholder) are legitimately interested in accounting developments in France. They have a right – and a moral obligation –to learn more and to benefit from the direct insight of someone[1]1 involved in setting the IFRSs.

Sometimes, these criticisms are voiced by commentators who have a limited knowledge of accounting issues, and this memorandum will hopefully fill them in. I have thus opted to approach the subject from a technical perspective, without entering into unnecessary detail, as there is a need to set the record straight about the content of IFRSs in order to hold a constructive debate.

Some other criticisms come from accounting professionals. In many cases, their statements either show that they misunderstand aspects of IFRSs, or are pursuing their own agenda. Indeed I understand the G20 is still pressing the IASB to work intensively in order to create a single set of high-quality global accounting standard, and the Ministers confirmed to the European Commission, during the ECOFIN Summit of November 13, 2012, that they would not revise the 2002 decision adopting IFRSs. Accordingly, some position statements inconsistent with these objectives, endorsed at the highest levels, including by the French Republic, raise a serious concern and affect the credibility of our country in international fora, mostly in standards-setting circles. The IFRSs, which legally are European Regulations once endorsed, are part of French law for French listed entities; the implementation of this Act is reviewed by their statutory auditors, under the supervision of the Autorité des Marchés Financiers (AMF), and it is sanctioned if necessary by the enforcement arm of the AMF. An issuer wishing to comply with legal requirements cannot therefore fail to be disturbed by a hostile attitude shown, apparently as a matter of principle, by the ANC's leadership.

For the reader's convenience, I wrote this memorandum to respond to the ten criticisms which appear to me as the most frequently voiced in France. With all respect to the reader, some responses may partially overlap, due to an interaction between some of the problems. Finally, I have deliberately limited the scope of this memorandum to the technical issues, still recognizing that important issues have to be considered about the ways and means to reach the objectives assigned to the IASB and its American counterpart body, the FASB, and stated as follows at the conclusion of the G20 2008 Summit in Washington[2]:

[1] Readers may think that I am not independent of the IASB, and therefore, that I am not objective in my assessments. Be that as it may, I will let them compare my arguments with those put forward by the critics, and then possibly ask for third party expert opinions in order to make their own assessments. What matters to me is to be able to make as much information available as possible to set the record straight and refocus the debate. As for my independence, I do not represent any interest group, I am not related to anyone outside the IFRS Foundation, and I am not financially interested in the success of the IFRS Project. I receive only a fixed salary reflecting the market conditions for an accounting professional.

[2] http://canadainternational.gc.ca/g20/summit-sommet/g20/declaration_111508.aspx?lang=eng&view=d

"Strengthening Transparency and Accountability:

- The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
- Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.
- The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
- Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
- Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
- With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities."

This 2008 statement is still current: the G20 did not change at all their accounting recommendations. The reader will find, on the Web site of the IFRS Foundation[3], a regularly updated document detailing the actions taken by the IASB in response to the G20 Report ("Declaration on Strengthening the Financial System"), published on April 2, 2009 at the conclusion of the London Summit. To a large extent, the additions and amendments brought to IFRSs since 2009 meet the roadmap as set by the G20. However, our world is constantly changing. New economic problems surface periodically, requiring a review of the standards. No accounting authoritative framework can ever be considered as complete or "finished". The same applies to IFRSs. Some major projects are still to be completed, partly because it a complicated task to ensuring both convergence with the American standards and a consideration of the requirements of the world's economies, to which international standards apply. I am therefore not denying that some problems still have to be solved, and that IFRSs are still open to improvement. However, absolute stability of the set of standards, as called for by some, is desirable but unachievable.

Let us realistically review what exists today, and assess the progress made in the past ten years. More than 100 jurisdictions require or permit the application of IFRSs for financial reporting. Two thirds of the G20 countries have adopted IFRSs. Those who still have not (USA, Japan, India…) allow foreign issuers to use IFRSs to access their domestic capital markets. Japan and India allow their listed entities to state their financial information under IFRSs. Approximately half of the Fortune Magazine Global 500 companies use IFRSs, and their number is growing each year.

Matters related to the private law authority status of the IASB, to the governance of the IFRS Foundation and of the IASB's Board, and those concerning the relations between the IASB and the regional or national accounting standard setters, are the prerogatives of the Trustees of the Foundation, and I will leave it to Michel PRADA, the French Trustee and also Chairman of the Board of Trustees, to respond any question. I would note though that the governance of the IFRS Foundation is overseen and was reviewed in early 2012 by the Monitoring Board[4], consisting of the major global market regulators.

[3] http://www.ifrs.org/Alerts/Governance/Documents/Response-to-G20-conclusions-October-2011.pdf
[4] http://www.iosco.org/monitoring_board

RESPONSES TO TEN FREQUENT CRITICISMS CONCERNING IFRSs

We will review the ten following assertions, which we believe are unsubstantiated or overstated by the French commentators (and possibly also by some in other jurisdictions):

- IFRSs implement "fair value" widely (page 9)
- The purpose of IFRSs is to reflect the aggregate financial value of an entity (page 11)
- IFRSs deny the concept of accounting prudence (page 12)
- IFRSs give precedence to economic reality over legal form (page 14)
- With IFRS financial statements, business leaders are confused (page 15)
- IFRSs do not reflect the "business model" (page 17)
- Treatment of business combinations is an aberration (page 19)
- Financial instruments will soon be stated at "full fair value", which will increase the volatility of earnings (page 21)
- "Fair value" is always defined as a "market value", even when markets are not liquid
- (page 23)
- IFRSs create an accounting volatility not reflecting economic reality (page 24)

WARNING

The opinions expressed in this memorandum are the personal views of the author. These should not be understood as the official views of the IASB or of its members.

EXECUTIVE SUMMARY

- **IFRSs implement "fair value" widely**

IFRSs do not require, nor does the IASB plan that they will require, that all assets and liabilities be stated at fair value. The IASB has clearly confirmed a preference for a mixed system of measurements at fair value and measurements at depreciated historical cost, based on the business model of the entity and on the probability of realising the asset and liability-related cash flows through operations or transfers. The same is true for the classification and measurement of financial instruments. A "mixed model" has been in use since 1989 under IAS 39: it will be maintained under the new IFRS 9.

- **The purpose of IFRSs is to reflect the aggregate financial value of an entity**

The (limited) use, under IFRSs, of an accounting measurement of certain assets and liabilities at fair value is often mistaken for a so-called desire to reflect, in the book shareholders' equity, the aggregate financial value of an entity. Moreover, as IFRSs do not allow to recognize, in the balance sheet the intangible assets generated internally by business operations, any attempt to state the aggregate value of the business would fail. A business entity would be accounted for as a whole at its market value only when it is acquired and consolidated by another entity.

- **IFRSs deny the concept of accounting prudence**

Transactions and economic events should be reflected in the financial statements in an unbiased manner, without emphasizing a "principle of prudence" which would actually consist in introducing a systematic negative bias of measurement and in setting up hidden reserves, understating the earnings for a period, and then overstating the earnings for a subsequent period. The role of IFRSs is not to act as a prudential or as an economic control instrument, beyond ensuring financial transparency, which is a condition for the proper operation of markets. However, prudence remains very significantly incorporated in the various IFRSs, which are, in many areas, more prudent than the French standards.

- **IFRSs give precedence to economic reality over legal form**

The standards do not deny the significance of an entity's legal environment, including how the courts may interpret commercial transactions such as contracts with customers. IFRSs are based on principles and must adapt to an international environment which cannot take into account all the characteristics of national laws. These standards focus on the analysis of the economic reality of commitments, so as to provide a complete and relevant vision of the risks and benefits of the entity, sometimes extending beyond the legal form of a transaction.

- **With IFRS financial statements, business leaders are confused**

The scope of the IASB's standard-setting work covers information reported periodically by publicly-traded entities about their financial situation and financial performance. The IFRS Conceptual Framework identifies the main audiences for financial reporting (external capital providers, i.e. the shareholders and the creditors) and the type of business decisions this information must support. More generally, this Framework considers external users who do not have access to internal data: financial information is thus useful to customers, suppliers and employees. It is not therefore information to be used primarily by companies' management, who have free access to information derived from internal management reporting. The prudential regulators require the filing of specific reports based on their needs. Tax authorities are not interested in consolidated statements. The determination of taxable income and

dividends is still linked to the individual statements, generally prepared in accordance with the national accounting rules.

It is however fair to say that all these concurrent accounting, prudential and tax reference standard sets are a complicating factor; however the IASB should not be blamed for this situation.

- **IFRSs do not reflect the business model**

Some business leaders criticize the Conceptual Framework for allegedly focusing on a "balance sheet-based" approach and not reflecting correctly the business model or the operational reality of business entities. Does the Framework really require measuring financial performance as being equal to the change in the net financial position between two successive balance sheets? This is both true and false. True as in double-entry accounting, the aggregate performance is affected by the changes in value of the assets and liabilities stated in the balance sheet. But this is also false, as a change in the net asset value will not always be reflected in the net income for the period. The recently-initiated revision of the Conceptual Framework will also focus on a review of the role of the business model in financial information reporting, while preserving a balance with the objective of inter-company comparability. IFRS 8 on segment reporting is strongly oriented toward the business model as it requires the reporting of performance information on the various business segments "through the eyes of management".

- **Treatment of business combinations is an aberration**

The international accounting rules (IFRS 3) and the French accounting rules (CRC 99-02) are practically equivalent: these require that the identifiable assets and liabilities of a corporation be stated in the consolidated balance sheet at fair value at the time of their acquisition. The difference between the net value of the identifiable assets and liabilities and the fair value of the consideration given (the purchase price) is *goodwill.* Goodwill shall be written down if the expected results do not materialize.

- **Financial instruments will soon be stated at "*full fair value*", which will increase the volatility of earnings**

The IASB decided to maintain a mixed model for the measurement of financial assets. Therefore, conventional bank assets (loans and other receivables) and the bond investment portfolios held to maturity, which comprise the majority of the balance sheet of a bank, are still stated at amortized cost. The financial liabilities (deposits, interbank financing, and borrowings) are still stated at historical cost, subject to a fair value option in a very limited number of cases. On the other hand, the derivative instruments (swaps, options, etc.) are still valued, as under IAS 39, at market value since these generally do not have an entry cost and as only their market value is likely to reflect fairly the financial risk for the contracting business entity. The hedge accounting mechanisms neutralize the volatility induced by the mark-to-market value of the derivative instruments, provided these mechanisms are used as part of a hedging strategy.

- "**Fair value" is always defined as a "market value", even when markets are not liquid**

Released as a response to the questions which were raised during the 2008 financial crisis in a context of illiquid markets, IFRS 13 describes the fair value concept and how to implement it. As it applies when another IFRS requires (or permits) the application of the fair value concept, this standard does not extend the scope of fair value in accounting. Fair value is not always identical to market value, even though priority must always be given to observable data why using a mathematical model to estimate fair value.

- **IFRSs create an accounting volatility not reflecting economic reality**

For the IASB, it is not appropriate to hide, or to artificially mitigate, the volatility of income when this reflects the actual economic conditions. To state clearly the financial position of a business entity, the financial statements must emphasize the business aspects generating, or subject to, volatility. Lessons learned from volatility depend on the strategy (and the self-control) of the players (business leaders and financial statements users), and on the prudential rules for the financial intermediaries. The accounting information is only one ingredient in the decision-making process.

DETAILED RESPONSES

Criticism 1: IFRSs would implement a generalised notion of "fair value"

IFRSs certainly use the fair value concept and present value[5] more frequently than continental European accounting frameworks or other frameworks inspired by them (for example in Japan). However, contrary to what some assert, it is not, by far, an "all fair value" system.

The IASB, as did the preceding IASC, clearly confirmed a preference for a mixed system of measurements at fair value and measurements at depreciated historical cost, based on the "business model" of the entity and on the probability of realising the asset and liability-related cash flows through operations or transfers.

The fair value is stated either directly in the financial statements – and affects the performance measurement and the accounting net position – or in the notes, to improve the disclosure of risks and of value that may be realisable. I will be discussing later IFRS 13, a standard developed to solve the problems in the application of the fair value concept in some market situations (effective on January 1, 2013 in the European Union).

IFRSs do not require, nor are they planned to require, that all assets and liabilities are valued at fair value. The balance sheet of an industrial or commercial business entity mostly includes items stated at depreciated historical cost, except in the rare cases of entities developing through external growth, who must record their acquired assets and liabilities at fair value on the acquisition date. This is actually also a requirement of the French regulations on consolidated accounts (CRC 99-02 and 07).

Unless otherwise duly justified, inventories and fixed assets are stated in the balance sheet at their depreciated historical cost. Indeed, IAS 36 does not allow a fair value recording of tangible assets (plants, machines, transportation equipment, etc.) when recognizing profits. **However, a revaluation through equity is allowed provided it is carried out regularly**: for all intents and purposes, this amounts to a statutory re-statement which would be implemented more frequently than under French standards. In addition, IAS 40 allows – on an optional basis – **to state investment properties at fair value** with corresponding changes in earnings: this better reflects the business model of some real estate corporations who regularly rebalance their real estate portfolios. However, the historical cost basis is still a regularly-selected method for entities holding investment properties. (And by the way, a head office is not an investment building…)

Finally, IAS 38 **allows** the measurement of **intangible assets at fair value, with corresponding changes in earnings, but only if there is an *active market***, and thus a reliable valuation, for these assets (for example, a taxi license). Generally a trademark or a patent does not meet this condition. **The same is true for the valuation of financial instruments.** A "mixed model" has been in use since 1989 under IAS 39: it will be maintained under the new IFRS 9. I will present below the content of this draft standard. The truth is that the balance sheet of a commercial bank prepared in accordance with IFRSs consists mostly of items stated at historical cost, net of loan loss provisions and depreciation: fixed assets, customers' deposits, term accounts, interbank financing, loans and receivables, and bond investment portfolios held to maturity.

[5] Present value is the discounted value of a future-term asset or liability, updated to take into account the time value of money.

Structured or complex financial assets generating cash flows which do not depend only on capital and on contractual interest representing the time value of money and credit risk, should definitely be recorded at fair value in the income statement. Embedding in these assets some derivative instruments or leverage clauses substantially alters future cash flows, and historical cost would not reflect the resulting risks.

The same applies to assets held in trading portfolios, which is logical– and undisputed – as these are held only with a view to being sold in a relatively short term.

The specific case of **derivative financial instruments** (swaps, options, future contracts) is worth mentioning: as most of these contracts do not have a cost when signed, their historical cost is not relevant and obviously useless to measure the extent of the commitments undertaken. A market value measurement with matching changes in the income statement is therefore needed to reflect the risks. This certainly generates some volatility. However IAS 39 (and then IFRS9) contains "hedge accounting" provisions which neutralise this volatility when the use of derivative instruments is part of a hedging strategy and provided its effectiveness can be demonstrated.

Liabilities, except for derivative financial instruments, are recorded at historical cost. Borrowings, trade accounts payable, customers' deposits, taxes and employee-related payables, accruals are stated at historical cost. Stating at current value a liability with a remote settlement date, to reflect the time value of money, should not be mistaken for a fair value measurement.

A **"fair value" option** is available for financial liabilities, to be used only when some inconsistency should be avoided in the valuation of a liability backed by a financial asset itself stated at fair value. In practice, only banks make a limited use of this option for their market transactions.

The suggestion of a "full fair value" approach is thus, in France, a persistent urban legend. Fair value is one accounting measurement method among others (amortised historical cost, replacement cost, revalued historical cost, etc.). The accounting standard setter must select the measurement method providing the most useful information to the account readers, considering the information users and their needs. Accuracy (measurement precision) is not necessarily more important than relevance of information: a good assessment, though approximate, of present value will often be deemed more useful, by a capital provider, than a historical cost which is "mathematically accurate" but provides obsolete information, to evaluate future cash flows and risks. We remind readers that financial statements prepared in accordance with IFRSs have a reporting objective, and that dividend distribution is still based on the accounting income of the individual (separate) parent company financial statements based on French accounting standards (which, by the way, also need valuations in many areas: provisions, depreciation and amortization, etc.).

<u>Criticism 2: The purpose of IFRSs is to reflect the aggregate financial value of an entity</u>

It has even been suggested that the IASB requires business entities to record their assets at a “scrap value”, even though they do not wish or need to divest their assets.

The (limited, as explained above) use, under IFRSs, of an accounting measurement of assets and liabilities at fair value is often mistaken for a so-called desire to reflect, in the book shareholders’ equity, the aggregate financial value of an entity.

This interpretation is wrong, as the IFRS Conceptual Framework clearly states: “General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity”. To the IASB, it is clear that the purpose of IFRS financial statements is not to disclose the aggregate resale value of the entity, even though much of the identifiable assets and liabilities would be recorded at fair value. The sole objective is to help users to assess the future cash flows generated from operations, which can then be compared with future investment requirements in order to determine the available cash flow to be assigned to a return on investment or to a debt repayment.

Moreover as IFRSs do not allow an entity to recognize in the balance sheet intangible assets generated internally by business operations, any attempt to state the aggregate value of the business would fail.

An entity is to be reported as a whole at market value only when it is acquired by another entity and consolidated in the accounts of the latter. Identifiable assets and liabilities, which partly account for the purchase price, are assumed by the acquiring entity at their fair value, and the difference (often material) with the purchase price is the goodwill. The accounting rule is identical in the French standards.

Finally the obligation to record impairments when the recoverable amount becomes lower than depreciated historical cost is mirrored in all modern sets of accounting standard: IAS 36 is not fundamentally different from the effective French standards. These provisions result from the implementation of the prudence principle and have nothing to do with some “scrap value” approach, because they are not based on a business discontinuance assumption. On the contrary, the impairment test takes into account the long term business forecasts of the operational unit under review. The IFRS statements are prepared on the basis of a going concern assumption.

Criticism 3: IFRSs negate the concept of accounting prudence

An effective altimeter shall be calibrated in a neutral manner, and should not include inertia mechanisms hiding altitude variations. Similarly, as regards financial information reporting, transactions and economic events shall be recorded in the statements in an unbiased manner, without emphasizing a "principle of prudence" which would actually consist in introducing a systematic negative bias of measurement and in setting up hidden reserves.

Understating the assets or overstating the liabilities during an accounting period often leads to a distortion in the actual business performance, not only over the related period, but also in a future period: this is inconsistent with an unbiased reporting objective and with the principle of fair and equal treatment of the present and future shareholders. This has been strongly condemned by the stock exchange authorities in many countries, and furthermore, I believe this is contrary to the true and fair view principle as stated in the 4th and the 7th European Union Directives.

The IFRS Conceptual Framework, a guide adopted and followed by the standard setter when drafting new standards, has therefore deleted the **explicit** reference to prudence as a fundamental principle, since the IASB determined, as did its predecessor the IASC, that the use of this principle could result in abusive accounting practices.

The IASB has made the assumption that the users of the financial information are sufficiently knowledgeable on economic issues to respond in a rational way to expansion or contraction phases, without the need to implement for them a "prudential filter", generally and for the financial statements of all entities. However, the prudential regulators of financial intermediaries (mainly banks and insurance companies), while using the financial information reported to them, may wish to implement supplemental "prudential filters", in addition to setting liquidity and capital ratios, in order to *influence the behaviour* of the banks or the insurance companies and to ensure a sufficient level of equity capital to withstand economic depressions. These intermediaries do carry on their balance sheets some risks "on behalf of third-parties" requiring specific supervision and some special precautions.

This should not be a strictly accounting concern. The role of IFRSs is not to act as an economic control instrument, beyond ensuring financial transparency, which is a condition for the proper operation of markets and a key component of financial stability.

However, prudence remains very significantly incorporated into the various IFRS.
As an example, IAS 36 ('*Impairment of assets*') requires an impairment provision so that an asset will not be carried at a value higher than the recoverable amount (i.e. the transfer value or the value in use, whichever is higher); IAS 39 on financial instruments is being revised so that provisions for credit risks (on loans and other receivables) be stated more prospectively, based on expected losses (the *'Expected loss model'*) rather than incurred losses.

For liabilities, the principles are identical to the French standards, and the decision tree is exactly the same: a debt shall be recorded as soon as an event occurs or immediately when a condition exists at the balance sheet date, and a future cash outflow becomes probable, although a disbursement may be in the distant future (for example, provisions for product warranties or for industrial site restoration

commitments). The provisions carried in accordance with IAS 37 reflect all the risks arising up to the financial statements preparation date, if a subsequent disbursement is probable ("*more likely than not*").

It may be noted that IFRSs are in some areas more prudent than French or other standards. Some examples are as follows:

- Recording provisions for pension liabilities is required (IAS 19), while it is not allowed in the Plan comptable général (General Chart of Accounts) and it is only a "preferred method" in the CRC Regulations concerning consolidated accounts.
- The IFRS treatment of derivative financial instruments transactions is more prudent, as it states requirements for effectiveness and transactional documentation before accepting that a transaction can be considered, in accounting terms, as a hedging rather than a speculative transaction.
- The consolidation of financial risk-bearing special purpose entities is more stringent under IFRSs than in many other frameworks (including the USA standards, until recent amendments adopted by the FASB).
- The draft standard for leases, which would require a lessee to report as a liability its irrevocable commitments to pay rentals is also, in my opinion, another example.

Certainly under French standards, "buffer" provisions have historically been permitted or required: FRBG (i.e. Funds for General Banking Risks) for banks, general risks provisions for industrial business entities, and equalization reserves for insurance companies. However all projects since 1999 to modernise the French standards for the consolidated accounts deleted these provisions as a source of non-transparency in accounting. The "accounting buffers" have now been replaced with "prudential buffers", not included in the accounting but taken into account in determining the statutory capital (Basel 1 and 2; Solvency 2).

Finally, as another sign of prudence in IFRSs, some business economic resources of an entity are not recognized as assets as there is too much uncertainty in their valuation (e. g. internally generated intangible assets).

<u>Criticism 4: IFRSs give precedence to economic reality over legal form</u>

The standards do not deny the significance of an entity's legal environment, including how the courts may interpret commercial transactions such as contracts with customers. For example, one of the requirements for recording revenue arising from a contract with a customer is that there must be a real agreement between the parties and that this agreement is enforceable by the relevant authorities.

Nevertheless, IFRSs are based on a conceptual framework establishing their independence from the legal system. Any suggestion that a source for any accounting standard can be found systematically in the law is clearly unworkable in an international framework**.** Consequently IFRSs focus on the analysis of the economic and financial reality of commitments, so as to provide a complete and relevant vision of the risks and benefits of the entity. Sometimes IFRSs may look beyond the legal form (i.e. the label) of a transaction. A financial liability labeled as a " lease" might thus be treated as an asset purchase on credit; a commitment made to employees and materializing after they leave will be treated as a present liability; a sale with extensive rights of return may be treated as a consignment transaction; a securitisation or a REPO transaction without any transfer of credit or market risks will be treated as a financing transaction backed by receivables…

The accounting treatment of subsequent events (IAS 10) also shows that the Standards require a sophisticated legal analysis to make cut-off decisions when it comes to allocating expenditures to the appropriate financial years.

Let us illustrate this with the example of lay-off plans, which are unfortunately too common.

The management of a business entity decides to reduce the workforce of a plant and implements a lay-off initiative on economic grounds; this occurs between the balance sheet date and the date on which the accounts are approved by the Board of directors. Should we accrue the costs at year-end? A "prudent" accountant will be tempted to do so (cf. the Renault Vilwoorde factory closing case in1996). An accountant using IFRSs should also consider whether the implementation conditions were adequately specified and reported to employees so as to create for the entity a "constructive obligation" on the date of the balance sheet. Failing that, this event will not be accrued at year-end, but rather identified in the notes to financial statements, as information on subsequent events.

Criticism 5: With IFRS financial statements, business leaders are confused

We should first recall that the scope of the IASB's standard-setting work covers information reported periodically by publicly-traded entities about their financial situation and financial performance. The standards do not cover the many other areas (societal and environmental responsibility, salary and human resources policy, corporate governance, etc.) which could interest employees and governments, nor the timely information also useful to investors (in accordance with the "Transparency Directive" on ongoing market disclosure).

The determination of taxable income and dividends is still associated with individual (parent company separate statements) accounts, generally established using national accounting rules, although in practice, listed entities strive to follow a dividend-payment policy based on the consolidated net income determined as per IFRSs.

A prudential supervisor has its own requirements and adds "filters" when determining statutory capital or liquidity ratios.

It is correct to say that all these concurrent accounting, tax and prudential standard sets are a complicating factor; the IASB should not be blamed for this situation.

Similarly, should we blame only the IASB for the increased reporting requirements on all sorts of subjects, a key factor accounting for the higher volume of annual reports? There is ample evidence that a significant factor in the increased volume of annual reports is the inflation in non-financial information.

Under European law, the financial statements are supplemented by the management report, whose standardization is beyond the scope of the IASB's work. The primary role of this report is to explain and comment on the content of the financial statements, and it is an excellent communication vehicle for commenting on performance, including in connection with segment information (IFRS 8).

To establish consistent financial reporting standards, **it is helpful to first define the objectives of these standards, and the qualitative characteristics of useful reporting. This is the rationale for the IFRS Conceptual Framework**, originally published in1989 and currently under review. This framework identifies the main audiences for financial reporting (external capital providers, i. e. the shareholders and the creditors) and the type of business decisions this information must support. More generally, this framework considers the external readers who do not have access to internal information: financial reporting is thus useful to customers and suppliers, and also to employees in the many countries where no specific information is available to the employee representatives.

Therefore this information is not designed primarily for management internal use, it is not directly related to tax purposes, nor is it a basis for national statistics or prudential control. In fact business leaders have access to as much information as they want from internal management reporting. Prudential regulators require specific reports tailored to their needs. Tax authorities are generally not interested in consolidated accounts.

It should be noted however that many aspects of IFRSs were developed in order to avoid a separation

between the internal steering instruments and published financial statements. Consequently the income statement presentation does not focus on classification of expenses by nature, and segment information must be in line with the entity's organizational structure. The release in France of a standard structure for the presentation of financial statements in keeping with our traditions met the wishes of many listed corporate groups, who were eager to provide easy comparisons with their competitors. It was a useful addition to the guidance published by IASB (IAS 1).

Obviously it is desirable to align the published performance measures with the internal measures, and not to encourage the use of performance indicators separate from the accounting information audited by statutory auditors. However defining what belongs in profit and loss for a period and what should be reported as other changes in an entity's net assets is a permanent challenge. IASB Standards already reflect some transactions and events in the profit and loss account and others in "other comprehensive income".

As part of the Conceptual Framework review, discussions are underway to ensure greater coherence between standards in this respect and to detail the respective information contents for these two levels of analysis. It will be appropriate to also define in a more rational way the conditions under which a change in value recorded in other comprehensive income will be reclassified to the profit and loss account, for example when the value is "crystallised" through a transfer or a settlement.

The IASB is well aware that the IAS 1 dealing with the presentation of financial statements, a standard inherited from the IASB's predecessor, needs some tidying up. An initial draft standard on the presentation of financial statements , released in 2006, had to be set aside, as it might have been too ambitious. However this will have to be addressed again.

The Board has already initiated a short and medium-term action plan to resolve the sensitive issue of the excessive amount of notes to consolidated accounts (the so-called *"disclosure overload"*). This may require amendments to standards, but above all, changes in the behaviour of those preparing financial statements, as well as the statutory auditors, and the market regulators: the preparation of notes to financial statements should no longer be considered solely as a compliance exercise, the materiality concept should be better used, and the notes should not be crowded with irrelevant information or immaterial amounts.

Generally, international investors, and market authorities as well, are satisfied with the quality of the financial statements prepared in accordance with IFRSs, to such an extent that since 2007, the US SEC, so concerned with investor protection, has recognised the quality of IFRSs as being equivalent to American standards and authorised their use for foreign corporations listed in the USA. Similarly neither ESMA[6] nor the AMF have expressed concern on the relevance of information available to markets through IFRS financial statements.

[6] European Securities Markets Authority

Criticism 6: IFRSs do not reflect the "business model"

Some business leaders criticize the IFRS Conceptual Framework for allegedly focusing more on a "balance sheet-based" approach and less on the "flow-based" transactions reporting. Hence, they argue that it does not reflect correctly the business model or the operational reality of business entities.

Does the Framework really require measuring the financial performance of a business as being equal to the change in the net financial position between two successive balance sheets?

This is both true and false. True as the Framework mostly defines the attributes of an asset (a positive economic resource for the entity) or a liability (a negative economic resource) and captures income or an expense based on the variation in accounting value of an asset or a liability. Consequently, consistent with double-entry accounting, the **aggregate financial performance** is affected by the changes in value of the assets and liabilities recognized in the balance sheet.

But this is also false, as **a change in the net asset book value will not always be reflected in the accounting net income for the period**.

On one hand, the transactions between the entity and its shareholders (dividends or share redemptions, share issuance or stock option issuance) directly affect the components of equity . But beyond this, it should be noted that the IASB is increasingly using a specific component of financial statements, i.e. *Other Comprehensive Income* (OCI) to record the counterpart entry for the changes in a balance sheet value. The recent amendment of IAS 19 on pension liabilities, to record as OCI the restated current value of the liability, IFRS 9 allowing to record as OCI the changes in the value of a share portfolio, or the Draft IFRS 4 concerning insurance liabilities are examples of this.

It is possible to discuss the meaning of the balance presented at the end of the OCI schedule in terms of understanding the business performance during the period under review, and the draft standard "Presentation of Financial Statements" now on hold did nothing to address the question. But as mentioned above, the IASB will soon reconsider the issue. I do not believe the Board intends to return to an earlier idea of combining in a single financial statement the Profit and Loss statement and the Other Comprehensive Income statement. **The net income will remain as a very important performance indicator.**

There has been a significant development for the past few years, as the **business model concept has been increasingly present** in IFRSs, whether it relates to the classification of financial instruments held, the optional valuation of investment properties at fair value or amortised cost, the difference between inventories and fixed assets, and finally, the flexibility available to entities when selecting the structure of their financial statements emphasizing the performance data deemed to be the most relevant. The recently-initiated revision of the Conceptual Framework will also focus on a more fundamental review of the business model in financial reporting, while preserving a balance with the objective of inter-company comparability.

IFRS 8 on segment information is strongly oriented toward the business model as it requires the reporting of performance information on the various business segments "through the eyes of management", i.e. aligning external disclosure with the indicators used in steering the business.

However a business model should not be mistaken for *intent-based accounting*. The management's intentions regarding an asset may change with current business opportunities, which is not unusual. If all assets were stated at fair value, this would be irrelevant from an accounting perspective. However, given that IFRSs provide a mixed measurement model (historical cost/fair value), **allowing discretionary modifications to the accounting classification and to the measurement method of an asset according to current intentions would provide ample scope for much abuse.** An asset stated at fair value, could be reclassified into the amortized cost class when the market price might decrease, to avoid recording losses. An asset stated at historical cost could be reclassified into a fair value class based on the need to recognize potential value increases. This is why the IASB uses carefully the business model concept: a business model is an observable method of managing an asset class (for example bank loans held to maturity in a balance sheet as opposed to a systematic policy of entering into securitizations); it can be observed, changes only in specific circumstances and this change is appropriately disclosed. "*Cookie jar accounting*"[7] or income "smoothing" practices are not acceptable.

[7] The term "cookie jar accounting" was used by Arthur LEVITT, former Chairman of the US SEC, to describe a policy of smoothing the accounting income of successive periods, through provisions and reversals of economically unsubstantiated accounting provisions.

Criticism 7: Treatment of business combinations is an aberration

In business acquisition transactions ("business combinations"), the international accounting rules (the IFRS 3 and its American counterpart SFAS 141) and the French accounting rules (CRC 99-02) are practically equivalent: these require that the identifiable assets and liabilities of the acquired corporation are stated in the consolidated balance sheet at fair value on the acquisition date. The difference between the net value of the identifiable assets and liabilities and the fair value of the consideration given (i. e. the purchase price) is *goodwill.* Goodwill must be written down (recognising what is called "impairment") only if the expected results do not materialize. **The acquisition of a business entity is the only event in its corporate life which results in recording all the identifiable assets and liabilities at fair value.** In a cash transaction, the price paid is the amount of cash transferred. In a takeover paid through an exchange of shares issued by the purchaser or held by him (for example equity securities of a subsidiary), price paid is the fair value of the consideration, generally based on the quoted market price before the transaction.

A prolonged debate took place in the years around 2000 about the accounting treatment of goodwill: was it appropriate to "get rid of it" immediately and charge it to equity or charge it to expenses? Should it be written down only during times of economic stress, or amortised systematically over time, recording a straight-line charge in the income statement? If so, over which period should it be done, in order to maintain an inter-company comparability? Until then in the USA, rules provided for a fixed amortisation period of up to 40 years, while in Europe, this period could vary from 5 to 20 years…

An immediate charge to expenses or as a reduction of equity was discarded in 2002, considering that the payment for goodwill is not a "gift" to the shareholders who sold the target entity (except in very rare cases where transactions are made under unusual conditions). The "pooling of interests" method (available as an option for an acquisition in exchange for shares) was thus discontinued. The ability to use this method ("méthode dérogatoire") still exists in the French consolidation standards.

The straight-line amortisation of goodwill, although it has (according to some) the benefit of gradually reducing the residual amount in the balance sheet, would not avoid the need for a regular impairment test to make sure the carrying amount of goodwill is not higher than its recoverable amount. Thus, systematic amortisation would not solve the impairment problem, especially when a long period is selected for amortisation. And what would be the economic justification for a rapid amortisation of the cost of an investment when the return will materialise only over a long period in many cases? Finally, why should we amortise systematically the cost of an investment with an undeterminable life, when the value of this investment may actually increase?

Consequently, the FASB and IASB have decided that goodwill should not be amortised, but would be subject, at the end of each accounting period, to an *impairment* test comparing the accounting value with the economic value (defined as the discounted amount of future cash flows over a forecast horizon specific to the business entity, increased by a residual value). If the difference is negative, an impairment is recognized in the income statement. French Accounting Regulations CRC 99-02 and CRC 99-07 were aligned with international standards.

Another decision was made by the IASB in a recent amendment of the standard: fees and commissions paid to intermediaries in an acquisition are no longer considered as part of the cost of the acquired business, but rather as an expense incurred by the acquiring company: therefore there would be no justification for adding these to the price paid (i.e. the value of the consideration to the former

shareholders of the target entity) and thus for mechanically increasing the goodwill. Many financial executives, after an initial negative response to this decision, which would decrease the earnings of their entities in the case of growth by acqusition, subsequently told me that they felt it is “sounder” to record those fees and commissions as expenses, for what they really are, rather than burying them in goodwill.

Finally, I should point out that the standards released by the IASB since 2005 are subject, three years after their effective date, to a “post-implementation” review, to make sure the outcome of reporting under the standard actually meets, based on experience, the objectives set by the IASB. IFRS 3 will then be subject to such a review, starting in mid-2013.

Criticism 8: Financial instruments will soon be stated at "*full fair value*", which will increase the volatility of earnings

In the preparatory work[8] for IFRS 9 (released at the end of 2009, to be implemented from early 2015, in order to replace IAS 39), using fair value more widely in measuring financial instruments was mentioned only as a **theoretical possibility** to simplify to the extreme the reporting of financial assets and liabilities. From the outset, the IASB was well aware that this suggestion would not generate much support, even though some organisations representing investors (for example, the CFA Institute) supported this alternative. The IASB soon decided, as did the American standard setter, to **maintain a mixed model for measuring financial assets. Financial liabilities will still be stated at historical cost**, subject to a **fair value option** in a very limited number of cases.

Derivative instruments (swaps, options, etc.) are still stated, as currently under IAS39, at market value since these generally do not have an entry cost and as only their market value is likely to reflect fairly the financial risk for the entity. But the IASB maintained, and even improved, the hedge accounting mechanisms set up to neutralise the volatility induced by the "mark-to-market" value of the derivative instruments, provided these mechanisms are used as part of a hedging strategy.

For **financial assets**, amortised historical cost is still the applicable accounting model for assets which are issued, or acquired, in order to recover the capital and contractual interest though cash receipts over time. **The "conventional" bank assets (loans and other receivables) and the bond investment portfolios held to maturity, being the majority of the balance sheet of a bank, are still classified and stated at historical cost**, provided the institution intends to keep them.

Structured or complex financial assets, generating cash flows which do not depend only on capital and contractual interest representing the time value of money and credit risk, are stated at fair value, with changes in fair value reported in the income statement. Indeed, a comparison with future cash flows, which is necessary to determine the possible impairment allowances, cannot be based on capital and interest as the cash flows are significantly changed by the derivative instruments embedded in the contracts.

However the IASB also proposes, in the exposure draft released in late 2012, to create a third accounting classification to be stated at "fair value through OCI" in order to remove an important difference with the proposed American standards and to reflect the interaction between the reporting of financial instruments held by insurance companies and the measurement proposed for their insurance liabilities. For the banks and the insurance companies as well, this classification would include the bond portfolios held either to collect the cash flows or as "liquidity reserves". The proposed classification of financial assets is therefore truly a matter of **reflecting the business model of an entity, while providing two types of useful information**: the fair value of instruments in the balance sheet, and the interest income and loan loss provisions in the income statement. The accounting link between the two sets of information would be provided by Other Comprehensive Income (OCI).

It is important to remember now that **the prudential treatment in terms of statutory capital is not part of the responsibility or the jurisdiction of the IASB.**

Finally, convergence between IFRS and US GAAP for financial instruments, and streamlining those standards, are one of the priorities assigned to the standard setters by successive G20 summits, and are still current issues.

[8] Discussion Paper released in 2008.

Criticism 9: "Fair value" is always defined as a "market value", even when markets are not liquid

Released as a response to the questions raised during the 2008 financial crisis in a context of illiquid markets, **IFRS 13** describes precisely the fair value concept and how to implement it. Because it applies when another IFRS requires (or permits) the application of the fair value concept, **this standard does not extend at all the scope of fair value in accounting**.

Fair value is not always identical to market value, even though priority must always be given to observable data why using a mathematical model to estimate fair value**.** Fair value is defined as the price which would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants, at the measurement date. It is thus an exit price. The valuation technique to be used depends on each context, and three approaches are possible: income-based, market-based, or cost-based.

For financial instruments, fair value is thus a market price, either observed when trading activity is available, or estimated from economic data. The standard does not prescribe the models used for this purpose. When the market transaction volume decreases so significantly that the observed value no longer reflects the price which would result from a transaction concluded under normal terms and conditions, a more detailed review of this transaction is required, and the price may need to be adjusted.

For a non-financial asset, a measurement of fair value shall reflect the capacity, by the participants to a possible transaction, of generating economic benefits using this asset in optimal conditions ("highest and best use"). These conditions must be:

- Physically possible, considering the features of the asset to be included in the price determination (for example the location of a property);
- legally permissible (a land in an area suitable for building does not have the same value as land in an area not qualified for a building permit);
- financially feasible, considering the future costs required to complete the project.

This optimal use is valued from the perspective of a player independent of the entity even if it intends to use the asset in a different way. However the standard assumes that the current use is the optimal use, except when there are indications (the market price or another factor) that a different use by another player would maximise the value of this asset. A possible example could be an industrial building to be reconverted as a residential building.

IAS 36 dealing with provisions for non-financial asset impairments defines **recoverable amount as the higher of value in use and the possible transfer value** (fair value determined in accordance with IFRS13) minus the sale costs.

Criticism 10: IFRSs create an accounting volatility not reflecting economic reality

For the IASB, it is not appropriate to hide, or to artificially mitigate, the volatility of income when this reflects the actual economic conditions. The financial statement users must see clearly this volatility in order to fully understand the financial situation of an entity. The financial statements must emphasize the business aspects generating, or subject to, volatility, showing how the various components of the financial performance of an entity are significant to evaluate the amount, timing and degree of uncertainty of future cash flows. A systematic use of historic cost could actually have adverse effects, hiding the extent of risks incurred and obscuring the reality of economic cycles. This is why investors and financial market regulators generally support[9] the use of fair value for financial instruments, at least for those held for sale.

Lessons learned from volatility depend on the strategy (and the self-control) of the players (business leaders and financial statement users), and on the prudential rules for financial intermediaries. The accounting information is only one ingredient in the decision-making processes, and it is not fair to blame the thermometer for the fever and for the decisions made to address the situation.

The "Financial Crisis Advisory Group" set up by the IASB and its counterpart body, the FASB, to review the accounting issues arising from the financial crisis released very clear conclusions on the subject in July 2009[10]:

"Although effective financial reporting provides indispensable rigor and transparency to the market, investors, analysts, regulators and others cannot rely exclusively on the information it provides. All users should recognize the limitations of financial reporting: it provides only a snapshot in time of economic performance and cannot provide perfect insight into the effects of macro-economic developments. Financial reporting is also dependent on the generation of reliable data by well-functioning markets that have proper infrastructure, and the use by financial institutions and other business entities of proper processes for price verification and other aspects of the valuation of assets and liabilities"

"Proponents of fair value accounting do not deny that indeed mark-to-market accounting shows the fluctuations of the market, but they maintain that these cycles are a fact of life and that the use of fair value accounting does not exacerbate these cycles. Moreover, they argue that fair value accounting standards provided "early warning" signals by revealing the market's discomfort with inflated asset values. In their view, this contributed to a more timely recognition of problems and mitigation of the crisis.

Whatever the final outcome of the debate over fair value accounting, it is unlikely that, on balance, accounting standards led to an understatement of the value of financial assets. While the crisis may have led to some understatement of the value of mark-to-market assets, it is important to recognize that, in most countries, a majority of bank assets are still valued at historic cost using the amortized cost basis. Those assets are not marked to market and are not adjusted for market liquidity. By now it seems clear that the overall value of these assets has not been understated – but overstated. The

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[9] Appendix 2 includes a list of research papers and reports published on the subject.

[10] http://www.ifrs.org/The-organisation/Advisory-bodies/FCAG/Pages/Areas-within-the-Financial-Crisis-Advisory-Group- scope.aspx

incurred loss model for loan loss provisioning and difficulties in applying the model – in particular, identifying appropriate trigger points for loss recognition – in many instances has delayed the recognition of losses on loan portfolios. (The results of the US stress tests seem to bear this out.) Moreover, the off-balance sheet standards, and the way they were applied, may have obscured losses associated with securitizations and other complex structured products. Thus, the overall effect of the current mixed attribute model by which assets of financial institutions have been measured, coupled with the obscurity of off balance sheet exposures, has probably been to understate the losses that were embedded in the system."

APPENDIX 1

WHO WE ARE AND WHAT WE DO[11]

Since 2001, almost 120 countries have required or permitted the use of IFRSs. All remaining major economies have established time lines to converge with or adopt IFRSs in a near future, as attest the schedules prepared for this purpose. In 2002, the European Union decided that IFRSs, approved individually further to a decision of the Commission[12], should be used in the preparation of the consolidated statements of publicly-held corporations and for entities whose equity securities (shares or bonds) can be traded on a regulated market. The extension of this requirement, for the preparation of individual statements or for the application to some other categories of companies is an option available to the EUMember Countries.

The IFRS Foundation is a not-for-profit private sector body raising funds to support the operations of the IASB as part of their functions as an independent accounting standard-setter.

Our objective
To develop a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles.

How do we do this?
• An independent standard-setting board (IASB), overseen by a geographically and professionally diverse body of trustees, publicly accountable to an independent Monitoring Board of public capital market authorities (IOSCO, US SEC, Japan FSA, European Commission)

• Supported by an external IFRS Advisory Council and an IFRS Interpretations Committee to offer guidance where divergence in practice occur

• A thorough, open, participatory and transparent due process

• Engagement with investors, regulators, business leaders and the global accountancy profession at every stage of the process

• A guaranteed collaboration with the worldwide standard-setting community

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[11] http://www.ifrs.org/The-organisation/Documents/WhoWeAre_French_2012.pdf
[12] http://ec.europa.eu/internal_market/accounting/legal_framework/regulations_adopting_ias/index_en.htm

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ANNEX 2 - IFRSS, FAIR VALUE AND FINANCIAL CRISIS: SOME PUBLIC REPORT REFERENCES

US SEC, Report to the American Congress: "Congressionnally-mandated Study says "Improve, do not suspend, Fair Value Accounting Standards" – See Press Release # 2008-07 (December 30, 2008)

http://www.sec.gov/news/studies/2008/marktomarket123008.pdf

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"The Fair Value Controversy: Ignoring the Real Issue", (EDHEC Business school, November 2008, a study written by Escaffre, Foulquier and Touron)

"EU Implementation of IFRS and the Fair Value Directive - a report for the European Commission", (ICAEW, October 2007); see particularly pages 12 and 13 of the Executive Summary

http://www.icaew.com/en/technical/financial-reporting/ifrs/articles/ifrs-one-year-on-icaew-assesses-implementation

"Market Turmoil and Accounting Impact: 10 key questions" - FitchRatings Credit Policy, a special report (October 29, 2007)

UBS Investment Research, "Don't blame fair value accounting"- UBS Global Equity research, a report by David Bianco – (March 17, 2008)

Presentation by Mr Andrew Haldane, Executive Director for Financial Stability, Bank of England (March 2010)

http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech427.pdf

Rapport sur la crise financière, Mission confiée par le Président de la République, September 2008, Report of the Working Group led by Mr. René Ricol (see particularly pages 58 -62)

http://www.ladocumentationfrancaise.fr/var/storage/rapports-publics/084000587/0000.pdf

Overview of Progress in the Implementation of the G20 - Recommendations for Strengthening Financial Stability Report of the Financial Stability Board to G20 Leaders
http://www.financialstabilityboard.org/publications/r_111104gg.pdf