

AMF recommendation 2007-23
Financial statements 2007

Reference texts: Article 223-1 of the AMF General Regulation

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1. Disclosures regarding a change in accounting policy

IAS 1 on the presentation of financial statements requires consistent presentation and classification for each period presented (paragraph 27); it also specifies that comparative information should be provided in respect of at least one previous period (paragraph 36). Any changes in accounting policy should be applied retrospectively (IAS 8.19), as if the new policy had always been applied.

Appendix I, paragraph 20.1 of Prospectus Regulation (EC) 809/2004 states that prospectuses should present historical financial information covering the latest three financial years (e.g. 2007, 2006 and 2005). Given that Article 28.1 of the Regulation allows the earliest financial period (in this case 2005) to be incorporated by reference, European regulators eventually decided that this could also apply to accounting policy changes. As a result, it would be acceptable for issuers to present only the two most recent financial periods under consistent presentation and classification rules, and not restate information relating to the earliest period (2005), if that year is incorporated by reference in the prospectus.

However, if an issuer chooses to present all three financial periods, it should ensure that the data are comparable, pursuant to the provisions of IAS 1 on consistency of presentation. The information relating to 2005 would therefore also need to be restated under the new policies adopted for the 2007 financial statements.

The AMF stresses that the same reasoning applies to registration documents and to corrections of accounting errors.

2. Disclosures regarding financial instruments

2.1. Financial instrument disclosures (IFRS 7)

IFRS 7 – *Financial Instruments: Disclosures*, was adopted by the European Union on 11 January 2006 and is effective for all accounting periods beginning on or after 1 January 2007. The aim of IFRS 7 is to provide a better description of the financial risks to which an entity is exposed and the ways in which they are managed. The new standard ushers in major changes for all issuers, not just credit institutions or insurance companies, although these entities are the most affected. For example, based on the balance sheets of CAC 40 companies, financial instruments represent on average:

- 96% of total assets and 86% of total liabilities of credit institutions; compared with
- 27% and 37%, respectively, for industrial and commercial companies.

Consequently, the more an entity uses financial instruments and is exposed to the associated risks, the more information it must disclose. Relatively few issuers in Europe chose to early-adopt IFRS 7 in their 2006 financial statements, probably because of the difficulty in implementing its requirements. The AMF therefore draws issuers' attention to the importance of producing high-quality information, particularly since mandatory application of IFRS 7 comes at a time of uncertainty in financial markets.

In sum, the new standard introduces some new disclosures and alters the way in which information will be presented.

2.1.1. New disclosure requirements

IFRS 7 modifies the scope of IAS 32 (*Financial instruments: disclosure and presentation*), which now addresses presentation issues only. The new standard introduces many new disclosures allowing users to

evaluate the significance of financial instruments for an entity's financial position and performance (paragraph 7).

Entities will be required to produce new, quantitative disclosures for financial instruments, in particular:

- the carrying amount of financial assets pledged as collateral for liabilities or contingent liabilities (IFRS 7.14);
- for cash flow hedges:
 - o for each line item in the income statement, the amount that was removed from equity and included in profit or loss for the period (IFRS 7.23d), and
 - o the ineffectiveness recognised in profit or loss that arises from cash flow hedges (IFRS 7.24b);
- for fair value hedges, gains or losses on the hedging instrument and on the hedged item attributable to the hedged risk (IFRS 7.24.a);
- for hedges of net investments in foreign operations, the ineffectiveness recognised in profit or loss (IFRS 7.24c);
- an analysis of the age of financial assets that are past due as at the reporting date but not impaired, and an analysis of impaired financial assets (IFRS 7.37);
- information regarding financial instruments which are not traded on an active market and whose fair value is determined using a valuation technique (method used, aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference) (IFRS 7.28).

The standard also introduces additional disclosures on accounting policies (IFRS 7.21), in particular:

- a description of the criteria used to determine impairment (IFRS 7.B5f);
- when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy applied to these financial assets (IFRS 7.B5g).

Lastly, new qualitative and quantitative disclosures are required to provide a better description of risk (particularly credit, liquidity and market risk) and how that risk is managed:

- qualitative disclosures (IFRS 7.33): for each type of risk, an entity must disclose (a) the exposures to risk and how they arise, (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk, and (c) any changes in (a) or (b) from the previous period;
- quantitative disclosures: an entity must disclose the extent of its exposure to risk arising from financial instruments, based on the information provided internally to key management personnel (paragraphs 34 to 42). These include:
 - o its exposure to each risk at the reporting date (IFRS 7.34), and in particular, summary quantitative data about all risks in line with the reports used by management to monitor exposures;
 - o credit risk, including the credit quality of financial assets (paragraph 36), an analysis of the age of financial assets that are past due as at the reporting date but not impaired (paragraph 37a), collateral and other credit enhancements obtained (paragraph 38, etc.);
 - o liquidity risk, including a maturity analysis for financial liabilities (paragraph 39);
 - o market risk, including a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date; and the methods and assumptions used in preparing the sensitivity analysis (paragraph 40). If the year-end exposure to market risk does not reflect the exposure during the year, the entity shall disclose that fact and the reason it believes the year-end exposure is unrepresentative (paragraph 42).

2.1.2. Presentation of information

2.1.2.1. Reference to a management commentary or another statement outside the financial statements

IFRS 7 offers the possibility of providing certain information outside the notes to the financial statements¹. This applies to the qualitative and quantitative disclosures referred to in paragraphs 31 to 42 on the nature and extent of risks arising from financial instruments and the management of these risks.

The AMF draws issuers' attention to the requirements to be met under IFRS 7.B6 when selecting this option:

- even when it is not included in the notes to the financial statements, the information must be available on the same terms and at the same time as the consolidated financial statements, and must be attached thereto. Failing this, the consolidated financial statements are incomplete;
- an explicit reference must be made to this audited information in the notes to the consolidated financial statements.

2.1.2.2. Presentation of information by class of financial instrument

Financial instruments with similar characteristics are to be grouped into classes. IFRS 7 states that certain disclosures should be provided by class of financial instrument (IFRS 7.6) and requires entities to provide sufficient information to permit reconciliation to the line items presented in the balance sheet (IFRS 7.7).

According to IFRS 7 (paragraphs B1 to B3 of Appendix B), classes of financial instruments:

- must be appropriate to the nature of the information disclosed;
- must take into account the characteristics of those financial instruments;
- are determined by the entity and are, thus, distinct from the categories of financial instruments specified in IAS 39;
- should at a minimum distinguish instruments measured at amortised cost from those measured at fair value and treat as a separate class or classes those financial instruments outside the scope of IFRS 7.

The AMF's review of 2006 financial statements found that it was often difficult to link balance sheet items to the financial instruments described in the notes. Accordingly, and because of the complexity of financial instruments, the AMF recommends that issuers provide precise information about how they apply these new obligations under IFRS 7.

2.1.3. Presentation of comparative information

As certain information required by IFRS 7 was already provided under IAS 30 and IAS 32, the preparation of prior-period comparatives for these disclosures should not pose any particular problems.

However, practical difficulties may arise when applying new disclosure requirements under IFRS 7 to prior reporting periods included as comparatives. When there are material difficulties in producing reliable information at a reasonable cost, IAS 8 requires the issuer to state which disclosures have not been made and why. The AMF nevertheless hopes that the use of this "impracticability" exception will be limited to certain clearly identified cases (such as new disclosures relating to financial year 2005, before IFRS 7 was published).

¹ IFRS 7.B6 suggests that this information could be included in a management commentary or risk report.

2.2. Identifying the liability and equity components of compound financial instruments such as convertible bonds (IAS 32)

This is a complex and sensitive area for issuers, in terms both of performance analysis and of reporting. Compound financial instruments often contain clauses that make it difficult to distinguish between these components and to measure the instruments upon initial recognition and at subsequent dates.

The AMF's review of 2006 financial statements revealed that the vast majority of entities holding compound financial instruments failed to provide a sufficiently detailed description of the analytical criteria and basis of measurement applied. The following information could help users better understand these instruments, where they are material:

- main characteristics;
- criteria used for recognising a liability/equity component or derivative (convertible bonds with variable exchange ratios or net cash settlement of the conversion option);
- the criteria, methods and assumptions applied to value the various components upon initial recognition in the balance sheet and at subsequent dates (for liability components and derivatives);
- the comparative data used to monitor assumptions from one period to the next.

The effects of the amendments to IAS 1, which were adopted by the European Union in January 2006, are discussed in section 6.2.

2.3. Financial instruments: recognition and measurement (IAS 39)

2.3.1. Terminology

In the financial statements for 2006, it is not unusual to find non-voting securities classified in the balance sheet under the categories used in French GAAP ("*titres de participation*", "*TIAP*", etc.), with the equivalent category under IFRS sometimes indicated in the notes. Because IFRS 7 requires, inter alia, that note disclosures of financial instruments be reconciled with the line items presented in the balance sheet, terminology should be harmonised.

2.3.2. Basis of measurement and impairment

Under IAS 39, the basis of measurement for financial instruments is the price quoted for the instrument on an active market, where available. This price should be taken into consideration even when the number of transactions is limited, unless the entity can demonstrate that they represent a forced sale. In this case, or when no active market for the instrument exists, fair value is determined using a valuation technique based on market inputs. IAS 39.48A requires issuers to show that the technique adopted has demonstrably provided reliable price estimates and would be commonly used by market participants to price a similar instrument. This requirement also applies to market inputs, including the illiquidity factor.

Regarding available-for-sale securities, very few issuers gave details of (i) the criteria used to assess impairment on these instruments, in particular interest rate derivatives with both individual and portfolio-based assessments of credit risk (IAS 39.59 (a)-(f)), (ii) the method applied in the event of a partial sale of securities (e.g. FIFO or another method), and (iii) securities measured at cost in the balance sheet, mainly unlisted securities for which no reliable measurement of fair value exists.

2.3.3. Presentation of the impacts of valuation adjustments on profit or loss and equity

Regarding available-for-sale securities and cash flow hedges, the AMF's review of 2006 financial statements found that issuers could improve their disclosures on the impact of transferring valuation adjustments previously carried in equity to profit or loss, as well as the information provided on hedge ineffectiveness. This is particularly important in view of the introduction of IFRS 7 (paragraphs 20 (a) (ii) and 23 (d)). Issuers should also be reminded that it would be useful to identify the impact of these financial instrument categories on equity (valuation adjustment on available-for-sale securities and the effective portion of cash flow hedges).

3. Share-based payment (IFRS 2)

The AMF conducted a wide-ranging review of the application of IFRS 2 (*Share-based payment*) by a sample of issuers² listed on Eurolist.

3.1. Presentation in the financial statements

In accordance with IFRS 2.50, issuers should disclose information that enables financial statement users to understand the effect of share-based payment transactions on profit or loss for the period and on the financial position.

3.1.1. Presentation in the income statement

The vast majority of companies in our sample reported expenses arising on share-based payment transactions within personnel costs. However, in certain cases the impact of share-based payment transactions on the income statement was not disclosed, and could not be determined from the personnel costs breakdown.

In some cases, share-based payment transactions were not included within personnel costs or 'current' operating profit (even though this indicator is presented on a separate line). Issuers using the CNC's recommendations³ concerning financial statement presentation should bear in mind the AMF recommendation 2006-22 regarding the distinction between 'current' operating profit (*résultat opérationnel courant*) and 'actual' operating profit (*résultat opérationnel*): only non-recurring items of particularly significant amounts should be reported on the lines between 'current' and 'actual' operating profit. The AMF had specified that "any items of the same nature that do not have the characteristics just mentioned are included in the current operating result. This will be the case for most [...] computed expenses of stock option plans [...]."

In accordance with IFRS 2.51 (a), the total expense recognised for the period, including separate disclosure of that portion of the total expense arising from transactions accounted for as equity-settled share-based payment transactions, should be included either in the income statement or in the notes. In practice, however, this distinction is not always made.

² Companies listed on the CAC 40 index together with the 20 next largest stocks.

³ Recommendation 2004 R 02 of 17 October 2004 applicable to industrial and commercial companies.

3.1.2. Measurement of share-based payment transactions

3.1.2.1. Measurement date

In the vast majority of cases reviewed, share-based payments concern employees, and the fair value of the related transactions is determined by reference to available market prices (taking into account the specific terms and conditions of the share plan). Fair value is assessed at the grant date, defined as “the date at which the entity and another party (including an employee) have a shared understanding of the terms and conditions of the arrangement”.

Our review found that issuers used a variety of terms to designate the measurement date including award date, grant date, date of approval by the board, and even date of the shareholders’ meeting (respectively, *date d’octroi*, *date d’attribution*, *date d’approbation par le conseil d’administration*, *date d’assemblée générale*). To improve comparability and provide users with relevant information, the AMF recommends adopting the terminology used in IFRS 2 (grant date, or ‘*date d’attribution*’) and clearly stating how the term is applied.

3.1.2.2. Assumptions used to assess the fair value of stock options awarded during the period

Paragraph 46 of IFRS 2 requires issuers to disclose information that enables financial statement users to understand how the fair value of equity instruments granted during the period was determined.

When equity instruments consist of share options, IFRS 2.47(a) requires disclosures regarding the model and main assumptions used. For share options granted during the period, issuers should disclose the weighted average fair value of the options at the measurement date (i.e. the grant date) and information on how that fair value was measured, including the option pricing model used and the inputs to that model (weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise).

For other equity instruments granted during the period, paragraph 47 requires issuers to disclose the number and weighted average fair value of those instruments at the measurement date, and information on how that fair value was measured.

A detailed analysis of the disclosures made for the different assumptions reveals a wide variety of practices:

- very few issuers gave details about the risk-free rate that they used;
- details were also lacking as regards expected dividends and reasons for early exercise;
- regarding the life of share plans, some companies adopted an estimated useful life, while others applied the contractual life of the plans. Details of the contractual life of these plans may be provided when describing their terms and conditions, but also as part of the disclosures indicating the assumptions used in measuring fair value (in a binomial model, for example). Issuers should therefore make a clear distinction between these two types of disclosure;
- when estimating expected volatility, some issuers used historical volatility, while others adopted a multi-criteria approach. In the latter case, issuers should make sure that they provide sufficiently detailed disclosures so that users can check that the criteria used are consistent with the requirements set out in IFRS 2.B22-B26 specifying the basis for estimating volatility.

When issuers have set up a number of different plans during the period or want to report on ongoing plans from previous years, they should consider preparing a summary statement to present the data required by paragraph 47.

Lastly, while the Black & Scholes model and binomial models (usually Cox Ross Rubinstein) were widely used, reference was also made to other pricing techniques such as Monte Carlo simulations. Since financial statement users are not necessarily familiar with these models – particularly in these early years

of IFRS adoption – we recommend that issuers provide a general explanation of the relevance of the models, having regard to the terms and conditions of their share plans.

3.1.2.3. Share plans with performance conditions

Paragraphs 19 to 21 of IFRS 2 concern share plans with performance conditions. A distinction is made between conditions that depend on market variables (e.g. share price appreciation) and conditions unrelated to the market (e.g. increase in the issuer's market share). Market conditions must be taken into account when fair value is measured initially. With non-market conditions, however, the only requirement is that the number of options be adjusted according to whether the performance criteria are met.

Around one-third of the companies from our sample operate plans with performance conditions. Among these, just over half apply performance targets unrelated to market conditions (revenue, operating margin, EBITDA margin, ROCE, etc.). In accordance with IFRS 2.45 (a), companies could usefully specify the indicators selected and the period set for meeting the performance targets.

For other plans, market-based performance conditions are an important factor in estimating the expense to be recognised under IFRS 2. In accordance with paragraph 45 (a), appropriate disclosures should be provided enabling users of financial statements to understand how fair value was determined where this is material.

In both cases, whenever performance conditions have been met, the explanatory notes should include information to this effect, in connection with paragraph 45 (b) (vii), which requires disclosure of the number and weighted average exercise price of the options exercisable at the end of the period. If, on the other hand, performance conditions are met gradually (for example by reference to predefined thresholds), the intermediate thresholds or criteria satisfied should be indicated.

3.2. Employee savings plans

3.2.1. Observations based on our 2006 review

On 21 December 2004, the French national accounting board (*Conseil National de la Comptabilité – CNC*), issued a press release addressing the treatment of employee savings plans (*Plan d'Épargne Entreprise*) under IFRS. These plans allow employees to subscribe a special issue of shares at below-market prices subject to a non-transferability period. The difficulty with PEEs is to determine whether the non-transferability condition impacts the expense to be recognised under IFRS 2.

The AMF noted widely diverging practices regarding PEEs in 2006 financial statements. While some issuers considered that the non-transferability inherent to the scheme should not lead to a reduction of the estimated expense, others applied a significant discount, sometimes as much as 20%, for this restriction.

3.2.2. Disclosures regarding PEEs

On 7 February 2007, the CNC issued a second press release providing a number of clarifications to its earlier statement. In this second release, the CNC underlined the need for issuers to provide extensive and precise disclosures enabling users to understand the way in which the financial statements were prepared.

We believe that this disclosure guidance could apply to other share-based payment schemes, particularly bonus share awards or PEEs that use leverage. In a leveraged PEE arrangement, employees make an investment equivalent, say, to one share and obtain a guarantee or partial protection for their initial outlay at maturity. They also capture some or all of the share price appreciation, multiplied by a coefficient (e.g. six times). Leverage is created by the issuer issuing a greater number of shares (at a discount) than those subscribed for (e.g. ten times more than the employee's investment). The issuer then transfers the discount on the shares to the institution responsible for structuring the transaction, in exchange for providing leverage. Participating employees benefit from the resulting multiplier effect.

All aspects of transactions carried out through leveraged PEEs that apply a multiplier to an initial investment should be described in detail (IFRS 2.44). Disclosures should also be made regarding the financing arrangements or guarantees, granted by the financial institution, that create the leverage and ensure proper completion of the transaction. In practice, the AMF's review found that at best, companies operating leveraged plans provided a general description of these schemes, but seldom explained how the plan's characteristics were taken into account in the pricing model. However, the need for these explanations appears to be confirmed by IFRS 2.46.

4. Related party disclosures (IAS 24)

IAS 24 requires certain related party disclosures to reflect the possibility that an entity's financial position may have been affected by the existence of related parties and by transactions with such parties. The AMF conducted a broad-ranging review of related party information provided by a sample of issuers⁴ listed on Eurolist, and identified a number of areas where disclosures could be improved.

4.1. Key management personnel

Key management personnel are classified as related parties by IAS 24. They are defined by paragraph 9 as "those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity".

The AMF's review of 2006 financial statements showed that "key management personnel" was given a wide variety of interpretations and generally defined too narrowly in comparison with the standard. In our sample, for instance, more than 35% of groups excluded directors from key management personnel, even though directors are explicitly included within the definition under IAS 24. Likewise, one-third of groups with a supervisory board considered that its members did not meet the definition of key management personnel. Different conclusions were also reached in the case of chief operating officers, senior management of subsidiaries and members of executive or other committees.

The large majority of groups (75%) either defined or provided sufficient details to enable users to understand which governing bodies are considered key management personnel. However, the various French terms used to refer to management ("*principaux dirigeants*", "*cadres dirigeants*", "*direction du groupe*", etc.) should be clarified.

We recommend that issuers clearly state in the notes which of their governing bodies or board committees they classify as "key management personnel" within the meaning of IAS 24.9. The definition should be consistent with the related disclosures in the other sections of the registration document or the annual report (e.g. presentations of the management team or executive committee, etc.).

4.2. Close family members

Under IAS 24.9, related parties include members close to the family of any individual which controls, jointly controls or has a significant influence over the issuer and any member of key management personnel. Close family members are rarely referred to by the major groups in our sample. However, issuers should bear in mind that the disclosures required by IAS 24 for close family members are generally considered to represent material information.

⁴ Companies listed on the CAC 40 index and the 20 next largest stocks.

4.3. Key shareholders

IAS 24.9 (a) defines a related party as any individual or entity that controls, jointly controls or exercises a significant influence over the issuer. In the case of listed companies whose capital may be spread among many investors, a shareholder with a very small equity interest can nevertheless exercise significant influence, and even control the company in specific cases. The application of IAS 24 therefore requires issuers to use their own judgement rather than rely on quantitative thresholds to identify key shareholders.

Specific disclosures are to be provided for entities falling within this category. These disclosures concern the nature of the related party relationship, as well as information about the transactions and balances outstanding at the reporting date, details of any guarantees given or received, and provisions for doubtful debts recognised in the period (paragraph 17).

In view of the above, IAS 24 requires issuers to disclose any specific circumstances resulting in significant influence or control. While a number of companies in our sample did disclose the fact that certain investors with an equity interest of less than 20% fell into the key shareholder category, the review found that other issuers supplied no information, even though at least one shareholder exercised significant influence or held more than 20% of the capital. The AMF therefore recommends analysing the substance of relations with shareholders in order to identify any related parties as defined by IAS 24.9(a).

4.4. Executive compensation

IAS 24.16 requires entities to disclose the compensation of key management personnel in total (rather than on an individual basis) for each of the following five categories: short-term employee benefits, post-employment benefits, other long-term benefits, termination benefits, and share-based payment. However, our review found that, in practice, this breakdown of total compensation was rarely provided.

The application of IAS 24.17 should prompt issuers to disclose, for each compensation category referred to in paragraph 16, the related balance sheet liabilities and off-balance sheet commitments (such as severance pay), as well as items reported on the face of the income statement. Our review of 2006 financial statements found that the information presented did not generally allow users to verify that all the required disclosures had been duly provided.

The AMF draws issuers' attention to the fact that disclosures in the financial statements and in the management report on the type of compensation (immediate or deferred) accruing to the parties covered by the two disclosure obligations (IAS 24 and management report) must be consistent. The regulator found that the commitments described in the management report were not always disclosed in the notes, particularly in the case of termination indemnities.

4.5. Nature of the relationship between parents, subsidiaries and other investees

There is room for improving disclosures concerning the relationship between a parent and its subsidiary or other investees. The AMF considers that a list of significant subsidiaries, showing the percentage of capital and voting rights held by the group, would help users understand the nature of the relationship between the parent and its subsidiaries (IAS 24.12). This information could be grouped with the disclosures made under IAS 27 on consolidation (for example, a description of the nature of control when the controlling entity holds less than 50% of the subsidiary's voting rights).

We found that issuers typically provided a description of the impacts of related party transactions on the income statement and balance sheet⁵, but often failed to give information on the terms and conditions of these transactions, on commitments given and received and on the impact of doubtful debts arising from related parties (IAS 24.17).

⁵ Issuers are reminded that in consolidation, transactions with fully consolidated subsidiaries are eliminated in their entirety, while certain transactions with proportionally consolidated or equity-accounted companies are presented.

Issuers should bear in mind that IAS 24.18 requires disclosures to be made separately for each type of investment (joint ventures, associates, etc.). However, we found that this was rarely the case in practice, which meant that the information provided was of limited interest to users.

4.6. Common board members

Only a minority of the groups in our sample identified entities with board members in common with the issuer as a related party.

Under IAS 24.9(f), an entity with board members in common with the issuer should only be considered as a related party when that board member controls, jointly controls, significantly influences or holds significant voting power over the entity. This is rarely the case with major issuers.

Issuers should however bear in mind that the notion of “board members” (“*dirigeants*”) encompasses not only the chairman of the board of directors but all parties defined in paragraphs 9(d) and 9(e) of IAS 24. Further, in view of the requirement to report on related party transactions⁶ (information which is not published in the registration document or with the financial statements), the AMF reminds issuers that the information provided under these two disclosure obligations must be consistent, and that the information provided in the financial statements must comply with the level of detail required by IAS 24.18.

When an entity is classified as a related party because it has a board member in common with the issuer holding significant voting power, a description of the criteria used to assess the relationship may be helpful.

4.7. Materiality

In addition to the aforementioned obligations, IAS 24 states that certain transactions are to be disclosed if they are with a related party, such as participation in a defined-benefit plan which spreads the associated risks among the group’s entities, settlements of liabilities on behalf of another party, provision of guarantees and transfers of research and development (IAS 24.20).

We observed that issuers often failed to provide these related party disclosures on the grounds that the impact of these transactions on the financial statements was not material. Paragraph 11 of IAS 1 defines material information as information that could influence the economic decisions of users taken on the basis of the financial statements. In assessing related party transactions under IAS 24, qualitative considerations should prevail over a quantitative approach:

- “The profit or loss and financial position of an entity may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the entity with other parties.” (IAS 24.7);
- “A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.” (IAS 24.9).

These principles are designed to take into account the specific ways in which related party relationships can influence an entity’s financial position. Consequently, although we understand that issuers may wish to be selective in their related party reporting, for example by defining a materiality threshold, a number of precautions should be taken:

- materiality thresholds should be adapted to the type of transaction concerned, particularly in the case of disclosures concerning transactions with individuals;

⁶ Statutory auditor’s report on agreements which the issuer has directly or indirectly entered into with a member of management (CEO, COO, director), an investor holding at least 10% of its voting rights or the investor’s ultimate controlling party, other than on an arm’s length basis (Art. L 225-38 and 39 of the French Commercial Code).



- items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of the related party transactions on the financial statements of the entity (IAS 24.22);
- entities should ensure that transactions involving non-material amounts which disclosure is necessary to ensure a good understanding of the financial statements are presented appropriately in the notes. This could be the case, for example, with commitments given to a joint venture to partner its development, if the joint venture's development would be a key factor in increasing the group's market value. It may also apply to transactions carried out at no consideration involving goods or services whose fair value is significantly higher.

5. Impairment of assets (IAS 36)

Because intangible assets account for a sizeable percentage of equity, impairment is a critical issue. At the end of 2006, intangible assets owned by CAC 40 industrial and commercial companies represented a substantial 77% of equity, compared with 81% one year earlier.

IAS 36 defines the recoverable amount of an asset as the higher of its fair value less costs to sell and its value in use (paragraph 18). Value in use is the present value of the future cash flows expected to be derived from the asset. The standard identifies a "fair value hierarchy", specifying the order of preference that must be applied in fair value calculations:

- the best evidence of an asset's fair value less costs to sell is a price in a binding sale agreement (IAS 36.25);
- if there is no binding sale agreement but the asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal (IAS 36.26);
- if there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available, by reference to recent transactions for similar assets (IAS 36.27).

IAS 36.27 states that if the first two methods are impractical, reference should be made to the "best information available" to reflect the amount that an entity could obtain taking into consideration "the outcome of recent transactions for similar assets within the same industry" (analogical methods). In practice, it may be difficult to obtain detailed information and identify listed/unlisted companies or transactions that can be usefully compared with the asset or group of assets to be valued. For a meaningful comparison, the share price must be relevant, the transactions selected sufficiently recent to ensure that the economic climate has not significantly changed, and the peer sample should include entities operating in the same industry, with a similar scale and profitability profile as the issuer.

As a result, a discounted cash flow method may be more appropriate to estimate fair value. However, issuers should ensure that this type of method is applied correctly. For example, business plans drawn up by management which factor in increases in capacity and future restructuring measures (excluded from calculations of value in use under IAS 36) should not be considered unless issuers are confident that these projections are consistent with those that would be applied by the market. If this is the case:

- the process used to develop the business plan should be known and deemed to be appropriate for calculating fair value, based on the issuer's ability to forecast cash flows accurately in the past;
- issuers should have enough evidence to justify the forecasts in the business plan. In particular, comparable transactions should be selected, possibly based on less stringent criteria than in the analogical methods referred to above (industry studies, analysts' reports, etc.). This would allow issuers to show that the forecasts are in line with the market (capacity increases and future restructuring measures based on analysts' expectations, revenue growth, profitability targets, etc.). The relationship between the results obtained and the comparable transactions used should be explained, along with any variation;
- issuers should also conduct analyses of sensitivity to the main forecasts and assumptions underlying the calculation (IAS 1.120).

If cash flow projections are used, issuers should disclose this fact in the notes to the financial statements, and explain the reason for this choice. Any changes to key past assumptions should also be disclosed, along with the sources of information used. Sensitivity analyses should be provided where appropriate (IAS 36.134 (f) and IAS 1.120).

6. Presentation of financial statements (IAS 1)

6.1. Information provided for the first-time application of IFRS

For the transition to IFRS in 2005, IFRS 1 provided a number of options, notably concerning business combinations, recognition of actuarial gains and losses arising on employee benefit obligations, and use of a revalued amount as deemed cost for property plant and equipment. The first financial statements prepared under IFRS included detailed disclosures allowing users to assess the impact of these options compared with the policies applied under previous GAAP. However, certain options have an impact over more than one period.

The AMF's review of 2006 financial statements found that certain issuers no longer provided information about the options taken at the time of transition to IFRS, even though the disclosure would certainly help users understand the financial statements. In accordance with paragraph 108 of IAS 1, the AMF draws issuers' attention to the need for ongoing disclosures about the options taken upon first-time adoption which continue to have a significant impact on the financial statements.

6.2. IAS 1 amendments: Capital disclosures

The IAS 1 amendments were adopted by the European Union on 11 January 2006 and are effective for financial periods beginning on or after 1 January 2007.

The revised standard is designed to provide users of financial statements with additional information on the issuer's objectives, policies and processes for managing capital. Entities are required to provide both qualitative and quantitative information in the notes to the financial statements, in particular (IAS 1.124 B):

- a description of what the entity manages as capital: some entities include certain financial liabilities (e.g. subordinated debt) as equity, while others consider that certain equity components (such as those related to cash flow hedges or financial instruments with a step-up clause) do not classify as equity;
- quantitative data summarising what the entity manages as capital;
- a description of any external restrictions affecting the entity's capital (for example, arising from regulatory requirements);
- an indication of whether the entity has complied with any capital requirements and if it has not complied, the consequences of such non-compliance.

The AMF notes that these new disclosures for 2007 must be based on information reported internally to management.

6.3. Materiality principle

All requirements under IFRS only apply if the resulting information is material. In accordance with IAS 1.31, applying the materiality concept means that a specific disclosure requirement need not be satisfied if the information is not material. To avoid over-burdening their financial reports, issuers should look to ensure a healthy balance between their obligations under the standards and the relevance of the resulting information.

7. Cash flow statements (IAS 7)

7.1. Line of profit or loss used under the indirect method

IAS 7.18 provides that cash flows from operating activities may be reported using either the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed, or the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature. Although entities are encouraged to report operating cash flows under the direct method, it is rarely used in practice, mainly because it requires substantial modifications to data and/or systems.

Use of the indirect method under IAS 7 requires entities to adjust profit or loss for the effects of transactions of a non-cash nature, but does not specify which line of profit or loss should be adjusted. In the illustrative example provided in the Appendix to IAS 7, the first line in the cash flow statement is profit before taxation, while IAS 7.20 states that profit should be adjusted for the effects of minority interest.

The definition of profit applied by CAC 40 companies differs widely in practice, with the most commonly used terms being consolidated net profit, net attributable profit, pre-tax profit, net profit from continuing operations, pre-tax profit of consolidated subsidiaries, operating profit and gross operating profit (respectively, *résultat net consolidé*, *résultat net part du groupe*, *résultat avant impôt*, *résultat net des activités poursuivies*, *résultat avant impôt des sociétés intégrées*, *résultat opérationnel* and *excédent brut d'exploitation*). As some of these terms are not defined by the standards, issuers are encouraged to provide a precise definition of the terminology applied in the notes to the financial statements. This will allow users, at a minimum, to understand how the indicator was computed based on the nearest profit indicator presented in the published income statement.

7.2. Cash and cash equivalents

7.2.1. The AFTE/AFG position

On 8 March 2006, the French association of corporate treasurers (*Association Française des Trésoriers d'Entreprise* – AFTE) and the French asset management association (*Association Française de la Gestion Financière* – AFG) put forward a number of criteria for analysing which collective investment schemes could be reported within cash and cash equivalents⁷. Their analysis identified two major categories of funds, which entails very different additional control procedures. Euro-denominated money market funds classified in the AMF's *Monétaire Euro* fund category, are automatically considered to meet the definition of cash and cash equivalents under IAS 7. This definition is provided in IAS 7.6 and states that cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. No other money market funds are automatically classified as cash and cash equivalents. As a result, issuers should perform an in-depth analysis to determine whether these other funds fall within the cash and cash equivalents category, for example if they present low historical volatility or have largely stable net asset values.

The recent turmoil on the financial markets should prompt investors and statutory auditors to verify that these accounting classifications are still appropriate. Issuers are advised to review the performance of funds automatically classified as cash equivalents over 2007 to confirm that the risk of changes in value remains insignificant. The analysis of other money market funds based on the four criteria in IAS 7 should also be updated, paying particular attention to the risk of changes in value, historical volatility, prospective sensitivity, and the availability of net asset values (e.g. daily or weekly) in 2007. Instruments that fail to meet any of these criteria should not be reported within cash and cash equivalents in the 2007 financial statements.

⁷ AMF position 2011-13

7.2.2. Other disclosures

In accordance with IAS 7.45, an issuer must disclose the components of cash and cash equivalents and present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

The effect of any change in the policy for determining components of cash and cash equivalents, for example a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, is reported in accordance with IAS 8 (IAS 7.47).

8. Employee benefits (IAS 19)

8.1. Impacts of the option allowing actuarial gains and losses to be carried in equity.

IAS 1 on the presentation of financial statements includes specific requirements applicable to the statement of changes in equity.

IAS 1.96 states that an entity should present a statement of changes in equity showing:

- (a) profit or loss for the period;
- (b) each item of income and expense for the period that, as required by other standards or by interpretations, is recognised directly in equity, and the total of these items;
- (c) total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest; and
- (d) for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with IAS 8.

In accordance with IAS 1.97, an entity should also present, either on the face of the statement of changes in equity or in the notes:

- (a) the amounts of transactions with equity holders acting in their capacity as equity holders, showing separately distributions to equity holders;
- (b) the balance of retained earnings (i.e. accumulated profit or loss) at the beginning of the period and at the balance sheet date, and the changes during the period; and
- (c) a reconciliation between the carrying amount of each class of contributed equity and each reserve at the beginning and the end of the period, separately disclosing each change.

Following the amendments made to IAS 1 to reflect the new provisions of IAS 19 published in December 2004, the statement of changes in equity can be presented in two different ways:

- as a statement of recognised income and expense, with transactions involving equity holders presented in the notes;
- or as a statement of changes in equity, showing total income and expense recognised in the period and transactions with equity holders.

Under IAS 19.93B, issuers that choose to recognise actuarial gains and losses in equity must present those gains and losses in a "statement of recognised income and expense", which will only include those items referred to in IAS 1.96. Entities may not then present actuarial differences in either the statement of changes in equity prepared under the columnar format in accordance with IAS 1.101, or in any other format showing the items referred to in IAS 1.97.

We found that the groups opting to recognise actuarial gains and losses outside the income statement did not always comply with IFRS. Some issuers presented two complete statements of changes, even though the standard asks for only one statement to be chosen, while others published a single statement by aggregating income and expense with transactions involving equity holders. Furthermore, the total amount of income and expense recognised during the period was not always disclosed, contrary to the requirements of IAS 1.

8.2. Disclosures regarding experience adjustments

Issuers should be careful when reporting amounts for experience adjustments relating to the current year and previous years. The effects of differences between actuarial assumptions and what has actually occurred should be presented in accordance with IAS 19.120 A p (ii,) and result in an adjustment to plan assets and liabilities. Experience adjustments provide users of financial statements with a useful indication about the quality of the estimates made.

8.3. Disclosures concerning plan assets

IAS 19.120 A (j) requires, for each major category of plan assets (including, but not limited to, equity instruments, debt instruments, property, and all other financial assets), disclosures about the percentage that each constitutes of the fair value of total plan assets held.

The AMF reminds issuers of the importance of providing the appropriate level of disclosure for these assets (and for the “other assets” category in particular), to allow users to assess the degree of risk associated with the plan (IAS 19. BC 85 A (b)).

9. Business combinations and consolidation

Business combinations as dealt with by IFRS 3 continue to be the focus of numerous discussions between issuers and the securities regulator.

9.1. Failure to recognise or disclose contingent liabilities

According to paragraph 36 of IFRS 3, acquirers must allocate the cost of a business combination to the acquiree’s identifiable assets, liabilities and contingent liabilities. When the combination represents a major acquisition for the issuer, the acquirer should ensure that all contingent liabilities have been identified. The AMF noted that issuers sometimes failed to describe the type of contingent liabilities recognised, even though the material nature of the liabilities may require more extensive disclosures for users.

9.2. Use of provisional values

In recognising a business combination, acquirers should determine the fair value of the assets, liabilities and contingent liabilities of the acquiree. Because not all of this information may be available at the acquisition date, IFRS 3.62 allows entities to account for the combination using provisional values, which may subsequently be adjusted within 12 months of transaction. If the initial accounting is modified after the balance sheet date of the year in which the combination took place, IFRS 3 provides that comparative information may be presented as if the final accounting had been completed from the acquisition date (IFRS 3.62 (iii)). For this reason, paragraph 69 of the standard requires issuers to disclose in the notes to the financial statements that the initial accounting for the business combination was determined only provisionally and to explain why this is the case.

We noted that in practice, these disclosures were not always provided. The AMF wishes to draw issuers’ attention to the significant efforts to be made in order to provide explicit information on business combinations accounted for using provisional values. Where no such disclosures are made, users may consider the provisional estimates as final, which would mean that any subsequent adjustments would have to be accounted for as a change in accounting policy or correction of an error in accordance with IAS 8.

9.3. Determining the fair value of the price paid

IFRS 3.24 states that the acquirer should measure the cost of a business combination as the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree.

The AMF wishes to draw issuers' attention to the fact that all aspects of the transaction should be taken into account when determining the fair value of the consideration provided in exchange for control. Accordingly, when the seller helps to finance the business combination, issuers should consider whether the terms of conditions of the financing arrangement are compatible with market conditions. Financing granted under extremely favourable terms for the issuer may effectively represent a discount to the sale price; if this is the case, issuers should consider whether to adjust the fair value of the price paid for the combination and, hence, the residual goodwill.

9.4. Problems encountered in applying IAS 28

In terms of disclosures concerning investments in associates, the AMF would like to see more issuers providing summarised information for the assets, liabilities, revenues and profit or loss of these investments (IAS 28.37.b).

Issuers should be reminded that the level of disclosure adopted for investments in associates should be determined in light of the materiality of the investment for the reporting entity.

10. Main IFRIC rejections

10.1. CESR / *BusinessEurope* / FEE statement on the main IFRIC rejection notes

Before taking requests for interpretation onto its agenda, IFRIC examines them in light of the four criteria in its foundation constitution. A request can be rejected if one of the following criteria is met:

- existing standards are clear enough to allow the issue to be addressed without the need for interpretation; this may also be the case if there are no divergent practices regarding the matter in question;
- the issue is included in the IASB's work plan and will be dealt with in the short or medium term by a new standard or a draft amendment to an existing standard;
- the issue is so complex that IFRIC is unlikely to be able to produce an interpretation within a reasonable timeframe;
- divergent practices exist, but the issue is too specific for IFRIC to address.

Because IFRIC publishes rejection notes, it is highly instructive to analyse the interpretation requests that were rejected on the grounds of adequate existing standards or the unlikelihood of divergent practices. Even though the notes that accompany IFRIC decisions are not part of the "applicable sources" listed in IAS 8.11, they can offer valuable insights for the proper application of IFRS.

CESR, *BusinessEurope*⁸ and FEE (Fédération des Experts Comptables Européens) discussed the status of these rejection notes at end-2006 and reached a consensus on various issues, including the following:

- Although they are not officially part of IFRS, IFRIC rejection notes are an important source of guidance, especially during the current transitional period, to help users apply IFRS correctly and uniformly;

⁸ *BusinessEurope* is the former Industries de la Communauté Européenne (UNICE).

- Since IFRIC rejection notes often provide clarification of the standards, issuers are expected to pay close attention to them when determining their accounting policies. In the case of a change in a previous accounting treatment following the issue of an IFRIC rejection note, an issuer should apply IAS 8 and provide proper and sufficient disclosure of the reasons for the change, having regard to the particular facts and circumstances of the individual case, including reference to the IFRIC rejection note. In most cases, there is no need to specify whether the consequence of a rejection note, i.e. a retrospective change to previously presented information, is a change in accounting policy or an error correction. (Sample wording was provided for this purpose.) If an issuer decides to continue applying an accounting policy that appears to be inconsistent with an IFRIC rejection note, the burden of proof is on the issuer to explain why the accounting policy concerned is nevertheless appropriate.

Although these views may change in future, the AMF considers that the consensus still applies to 2007 financial statements.

10.2. Main rejections in 2007

The AMF is drawing attention to some of the IFRIC rejection notes issued in 2007. In particular, where matters of concern to them are submitted to the IASB for clarification, issuers should clearly describe the position they have adopted pending an amendment to the standard.

10.2.1. Issues put out to consultation in an Exposure Draft of Annual Improvements or addressed in another IASB project

10.2.1.1. January 2007: IAS 39 - Instruments indexed to an entity's own revenue or EBITDA

The IFRIC was asked to provide guidance on whether a contract indexed to the revenue of an issuer or to its earnings before interest, tax, depreciation and amortisation (EBITDA) is (or might contain) a derivative. According to IAS 39.9, a derivative is, inter alia, a financial instrument or a contract whose value changes in response to a variable "provided in the case of a non-financial variable that the variable is not specific to a party to the contract".

This issue raises two questions:

- Does the above exclusion apply only to insurance contracts?
- Does EBITDA or revenue represent a financial or non-financial variable?

The IFRIC finally decided not to take this item onto its agenda but to refer it to the IASB, with the recommendation that IAS 39 be amended to stipulate that the exclusion applies only to insurance contracts.

10.2.1.2. May 2007: IAS 16 – Sale of assets held for rental

IFRIC declined to provide an interpretation of the accounting treatment of asset sales following a rental period (e.g. where a carmaker rents vehicles for a period of time before selling them second-hand). IFRIC noted a degree of interpretational divergence as regards this issue. It recalled that, under normal circumstances, IAS 16 and IFRS 5 prohibit the recognition of revenue when a previously rented asset is sold, but it acknowledged that, in limited circumstances, reporting revenue might be consistent with IAS 18 (if the amount is recognised gross on the "sales" or "revenues" line rather than net on an "other revenues" line). IFRIC decided to raise this issue with the Board.

10.2.1.3. May 2007: IAS 1 - Current / non current presentation

At present, paragraphs 51 to 62 of IAS 1 require a distinction between current and non current items on the balance sheet. The IFRIC decided not to take this issue onto its agenda, while recommending to the Board that paragraph 62 be amended to make it clear that classifying financial assets and liabilities as

"held for trading" does not necessarily imply that they have to be classified as current assets or liabilities. This amendment would apply to derivatives not designated as hedging instruments, that have a maturity of more than one year and that will have to be shown on the balance sheet as non-current items.

10.2.1.4. July 2007: IFRS 5 - Plan to sell the controlling interest in a subsidiary

The issue submitted to the IFRIC concerned the partial sale of a subsidiary, with the seller retaining a residual interest. What triggers classification of the subsidiary's assets and liabilities as held for sale? How should the remaining non-controlling equity investment be measured?

IFRIC decided not to add this issue to its agenda. The majority opinion was that the loss of control subsequent to the sale was sufficient to meet the definition of a "disposal group". However, it asked the Board to clarify this point in IFRS 5.

10.2.1.5. September 2007: IFRS 5 - Disclosures

Do the disclosure requirements of IFRS 5 supersede the requirements of the other standards as regards non-current assets (or disposal groups) classified as held for sale?

The IFRIC concluded that this issue could be resolved by amending the standard rather than by issuing an interpretation. However, reporting its analysis, it said the requested clarification should confirm that the IFRS 5 requirements take precedence over those of other standards, although additional disclosures may be necessary to comply with the general requirements of IAS 1.

10.2.2. Rejections confirmed by the IASB

10.2.2.1. March 2007: IAS 17- Sale and leasebacks with repurchase agreements

Addressing the question of whether an asset can be derecognised in the event of a sale and leaseback with a repurchase agreement, the IFRIC decided that the first issue to analyse was how to treat the sale and leaseback transaction. The appropriate framework for that analysis is provided by IAS 17 and two interpretations: SIC-27 and IFRIC 4. If the analysis concludes that the transaction does not convey a right of use, then IAS 17 does not apply and the transaction comes under IAS 18.

10.2.3. March 2007: IAS 36 - Identifying cash-generating units in the retail industry

The IFRIC confirmed that paragraphs 6 and 68 of IAS 36 require cash-generating units (CGUs) to be identified on the basis of independent cash inflows rather than independent net cash flows (although some may prefer to use this concept where costs are shared by several CGUs in a corporate group). The IFRIC considered that, because the standard was very clear on how to analyse this issue, there was little likelihood that practices would diverge.