

AMF Recommendation 2013-19 2013 Financial statements

References: AMF General Regulation, Article 223-1

It is not within the remit of the AMF to set or interpret international accounting standards, a role performed solely by the International Accounting Standards Board (IASB) and the international standards interpretations committee¹. However, before the close of each annual accounting period, the AMF, like the European Securities and Markets Authority (ESMA) and other European regulators, seeks to identify the most salient subjects in a given context. In so doing, it alerts listed companies and statutory auditors to these issues, thereby contributing to the disclosure of high-quality information. With respect to the most important topics, users must be able to understand issuers' accounting treatments and judgements.

ESMA has published its priorities for 2013 financial statements. The topics addressed were deemed important at European level, so the AMF has approved the wording and hence recommends that companies consult this document.

ESMA has also published a report on the comparability of the financial statements of 40 financial institutions in Europe, which financial institutions may find useful. The AMF has also sought to draw attention to topics relating to the new standards on consolidation, which can be adopted early for the 2013 financial statements, and to items presented under taxes, which investment analysts particularly need to understand in the current environment.

Many concerns have been raised about the volume of information included in annual financial reports and registration documents. Various bodies, including the IASB, have sought to address this issue, and regulators are involved in the ongoing discussions. The AMF notes that the response to this problem, which is not simply a routine compliance exercise, is to refocus accounting information on factors that are specific to the company and relevant to understanding its financial position and the risks it incurs.

Many of the following recommendations call on issuers to provide descriptions or explanations in the notes to the financial statements. As regards specific aspects of the standards, the topics addressed will not be applicable to all issuers. Furthermore, the degree of detail in the disclosures will also have to be adjusted to the relative importance of the subject addressed in order to emphasise the relevant information.

¹ IFRS IC

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1. Relevance and specific nature of financial note disclosures

[The IASB is currently working to make note disclosures clearer, emphasising relevance rather than volume. Market regulators are involved in these efforts at the European and international levels. ESMA also addresses this issue in its 2013 priorities.]

In recent years, the AMF has called several times on companies to prioritise the relevance of the information they present in the notes and to underscore key topics. These recommendations remain entirely valid.

In December 2012 the French accounting standards-setter *Autorité des normes comptables* (ANC) also stressed that, to be relevant, the information disclosed in financial statement notes should be company-specific and that the materiality principle should apply (ANC Recommendation 2012-01).

IAS 1 – *Presentation of Financial Statements* states in paragraph 31 that not all the information required by a standard has to be presented in the notes if it is not material. This supports the view that the notes must be adapted to the specific nature of the reporting entity and the environment in which it is operating as of the reporting date.

The AMF is aware of the difficulties involved in preparing notes relating to items that fit and are relevant to the entity's specific circumstances and its environment. This is a lengthy and complex exercise that should be set in train at the earliest possible stage.

Recommendation

The AMF encourages companies to increase senior management's involvement in preparing financial statement notes in order to underscore the importance of this project.

It may also be useful to present the draft notes relating to the key events and main topics of the period both to senior management and to the audit committee.

Pursuant to IAS 1, the notes to the financial statements include a summary of:

- the significant accounting policies relevant to an understanding of the financial statements (IAS 1.117) and the major judgements management has made in applying these accounting policies (IAS 1.122),
- the assumptions about major sources of uncertainty (IAS 1.125) and the extent to which carrying amounts are sensitive to these assumptions (IAS 1.129).

As such, note disclosures concerning the method used for recognition of revenue (specifically, operative events) and financial instruments are sometimes uninformative since they are not well-suited to the business sector or market environment.

Recommendation

The AMF encourages companies to specify in the summary of accounting policies how these policies will be applied and the key judgements made to determine how major transactions are recognised.

It is also important to ensure that the items disclosed each year are still relevant, in particular the major sources of uncertainty and the sensitivity analyses that have been selected.

1.1. Results of operations: a performance indicator

Investors and investment analysts have stressed their need to understand how a company's past performance was achieved in order to better assess its future performance. In its 2009 and 2010 recommendations, the AMF addressed topics relating to the presentation of the income statement. The AMF notes that results of operations is a subtotal used by the majority of companies to present their performance. The IFRS do not, however, define this subtotal, although IAS 1.85 cites the benefit of

presenting relevant subtotals and IAS 1.BC56 notes that the results of operations must be representative of all business usually regarded as “operating” activities.

While certain items are clearly included in operating activity (depreciation and amortisation, goodwill impairment, restructuring costs, acquisition-related costs), some of the options available under the standards – or, occasionally, the absence of specific guidance – compels companies to make a choice as to presentation. This is the case, in particular, for net interest on a defined benefit asset(liability), which can be disclosed under results of operations or interest income. Given the judgement required to determine which items are included in the operating subtotal, investors are anxious that the definition of the subtotal's components presented on the income statement be precise and stable over time.

Recommendation

The AMF recommends that results of operations be clearly defined by specifying the component parts. Regarding the choice of presentation, it is important that the definition be consistent over time and that any changes be justified and supported by quantified data so that users can assess its impact on performance during the relevant annual period.

Concerning implementation of IFRS 11 - *Joint Arrangements*, which requires that joint ventures be accounted for using the equity method, some companies are concerned about the classification of the contribution of associates on the income statement.

The AMF specified in its 2011 recommendations that the presentation of the share of profit or loss of associates can be included in a subtotal representing operating activities, but only in specific situations analysed on an ongoing basis. In addition, a change in presentation would have to fulfil the conditions of IAS 8.14.

In April 2013, the ANC published recommendation 2013-01 on the presentation of the share of profit or loss of associates and joint ventures. This recommendation stipulates that, for associates and joint ventures whose “operational nature is the extension of the activity of the group”, the share of these companies' net profit or loss can be presented after the “Operating results” subtotal and before the “Operating results after the share of net profit or loss of associates and joint ventures” subtotal. This recommendation suggests a presentation highlighting the composition of the subtotals.

Recommendation

When associates are considered to be the extension of a group's operating activities, it is important that the choice of presentation should not distort the ratios calculated by users based on the income statement subtotal presenting the group's operating activity. Additionally, the headings used should clearly specify that associates and joint ventures have been taken into account.

2. New standards applicable in 2013

[The AMF draws market participants' attention to several important new requirements relating to two new standards applicable in 2013: IFRS 13 – Fair Value Measurement and revised IAS 19 – Employee Benefits. ESMA also addresses these two topics in its 2013 priorities.]

2.1. IFRS 13 – Fair Value Measurement

IFRS 13 – *Fair Value Measurement* applies on a forward-looking basis to annual periods beginning on or after 1 January 2013.

The standard's measurement principles apply to all items for which a fair value is calculated, including financial instruments, investment properties, and assets and liabilities remeasured in a business combination.

In its Appendix B, which lists many of the factors to be taken into account, IFRS 13 provides a methodology for assessing whether a market is active and it clarifies the criteria to be analysed when determining whether a valuation should be categorised Level 2 or Level 3.

2.1.1. Non-performance risk

IFRS 13 explicitly states that fair-value measurement of financial instruments, including derivatives and debts remeasured in a business combination, should account for the counterparty default risk and, for liabilities, the entity's own credit risk (IFRS 13.42).

If the instrument is an asset, its value is adjusted to account specifically for the counterparty credit risk (commonly called the Credit Value Adjustment, CVA); conversely, if the instrument is a liability, its value is adjusted to recognise, among others, the company's own credit risk (Debit Value Adjustment, DVA).

Paragraph 67 of the standard states that relevant observable inputs must be used to determine fair value, meaning that market parameters have to be analysed.

Recommendation

The AMF asks companies to specify in the financial statement notes the methodology used to calculate these adjustments for non-performance risks and to clearly state the accounting impacts when material.

2.1.2. Blockage factor and unit of account

IFRS 13.69 states that the characteristics of the asset or liability taken into account by market participants in a transaction (hence those that have to be used under the standard when calculating fair value) may include control premiums or non-controlling interest discounts. This same paragraph then states that "a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account in the IFRS that requires or permits the fair value measurement".

Thus, in the case of a subsidiary, joint venture or associate, does the unit of account consist of each share taken individually or the holding as a whole? This issue may arise in particular when performing an impairment test for a listed company under IAS 36. It may also arise when an issuer acquires control of a company in which it held available-for-sale financial instruments or over which it had significant influence, and then has to remeasure its prior holding.

The IASB, when asked about this issue, acknowledged in March 2013 that the standards were unclear and needed to be amended.

Recommendation

The AMF calls on companies facing this issue to present and explain in the notes the unit of account used for subsidiaries, joint ventures and associates. The approach used should moreover be applied on a consistent and ongoing basis.

2.1.3. Information to be disclosed in the notes

The information disclosed in the notes must fulfil the objectives detailed in the standard. This involves, in particular, understanding the "valuation techniques and inputs used" to determine the fair values and, for recurring measurements made using significant unobservable inputs, the effect of these measurements on profit or loss or other comprehensive income for the period (IFRS 13.91).

The AMF reminds companies to verify that the information they present in the notes meets these objectives.

The higher the degree of judgement required to determine fair value level (levels 2 and 3), the more stringent the requirements on the information to be disclosed in the financial statement notes.

Recommendation

It is important for companies to specify the type of analysis they perform to determine the level of fair value for material, sensitive items.

In particular, for an investment property valuation performed by an expert using market data, the company should consider the extent of the expert's restatements to determine whether the fair value level is Level 2 or Level 3.

For assets and liabilities recognised at fair value and categorised within Level 3, IFRS 13.93(d) requires quantitative information on the significant unobservable inputs used, and IFRS 13.93(h)(i) calls for qualitative information on the sensitivity of the fair value to changes in significant unobservable inputs, if they could have a significant impact. In addition, for financial instruments recognised at fair value and categorised within Level 3, IFRS 13.93(h)(ii) requires quantitative information on sensitivity.

Recommendation

A significant amount of information is required for Level 3 valuations to assist readers in understanding the impacts of the valuation techniques used. The AMF recommends adapting the degree of granularity to the relevant nature, characteristics and risks.

2.2. Employee benefits: several impacts related to application of revised IAS 19

Revised IAS 19 applies to annual periods beginning on or after 1 January 2013. Aside from the changes made to the accounting treatment for post-employment benefit plans (eliminating the "corridor" approach, calculating the yield on assets by applying the discount rate used to value obligations, and recognising past service costs immediately), the standard has changed the information to be disclosed in the notes.

The note disclosure should enable readers to understand (IAS 19.135):

- the characteristics of the defined benefit plans and the risks associated with them,
- the amounts recognised,
- the potential impact of the defined benefit plans on the amount, timing and uncertainty of future cash flows.

Recommendation

As defined benefit plans can be complex and their characteristics may vary significantly from country to country, the AMF recommends that companies be particularly forthcoming in presenting these significant plans and their impacts on the financial statements.

It will be recalled that the objective of the notes is help readers understand the key characteristics of significant plans and the related risks, which may not necessarily be best reflected in tabular format.

Under IAS 19.138, an entity is required to assess whether all or some disclosures should be disaggregated to distinguish plans with materially different risks. As applicable, the company must consider the most relevant way to reflect these different risks (e.g. by geographic region, type of plan, minimum funding obligation).

Similarly, paragraph 142 requires that companies disaggregate the fair value of plan assets into classes that distinguish the nature and risks of those assets.

Recommendation

The AMF calls on companies to determine the most relevant method and the level of granularity required to present the levels of risk associated with the different plans and the related assets.

The standard also requires disclosure of the sensitivity to key assumptions (IAS 19.145(a)).

Recommendation

In most cases, the discount rate will be one of these key assumptions. Entities should also consider the key nature of other assumptions, based on the characteristics of the plans and the local environment (wage increases, staff turnover, and so on), for which a sensitivity analysis should also be presented.

When the obligations are especially significant, the impact of defined benefit plans on future cash flows is of particular interest to investors. Companies are thus invited to disclose, inter alia, the duration of the obligation and information on the timing of benefit payments (IAS 19.147(c)). **This schedule may prove useful when disbursements are not expected to be consistent over time or result from an obligation establishing a minimum funding level.**

3. Follow-up on topics discussed in previous AMF recommendations

[The AMF draws attention to the IFRS IC's conclusions on the concept of high-quality bonds used to determine the discount rate for employee benefits.]

3.1. Discount rate for pension obligations

The discount rate for pension obligations must be determined with reference to yields on corporate bonds considered to be high quality pursuant to IAS 19.83. Although the standard does not define this concept, the practice generally adopted by companies has been based on AA and AAA credit ratings.

In 2012, owing to the extent of rating downgrades, the IFRS IC was asked about the conditions under which the practice could potentially be modified.

The AMF and ESMA had, in their recommendations at the end of 2012, asked companies not to modify their practices pending clarification by the IFRS IC.

In July 2013, the IFRS IC published a draft decision rejecting the request for clarification on the grounds that the provisions in the standard were sufficient. This text is based on paragraphs 84 and 85, which stipulate that the discount rate must reflect the time value of money, but not the risks (actuarial, investment and credit risk) to which these creditors are exposed.

This draft rejection also states that:

- The concept of a top-quality bond is absolute as the term used is “high-quality corporate bonds” and not “the highest-quality”;
- The method used to determine the rate should not be amended as long as the market in high-quality corporate bonds remains deep;
- The notes must include information, where material, on the method used to determine the rate (IAS 1.122), the rate used and the sensitivity of the provision to a rate change (IAS 19.144-145).

The IASB also clarified that the depth of the market must be assessed at the level of the currency area, not the country.

In relation to the above, the AMF notes that companies should not change their current practices, since there is a deep market within the euro area.

Paragraph 86 of the standard states that the discount rate for longer maturities can be determined by extrapolating interest rates observed on the market for shorter maturities.

4. **Taxation**

[Taxation is of particular interest to investors and analysts. The AMF has conducted a study of the information disclosed on current and deferred taxes by companies included in the benchmark CAC 40 index.]

4.1. **Reconciliation between tax expense or income and accounting profit**

4.1.1. Disclosure

The standard requires that the reconciliation between the amount of tax and the accounting profit be disclosed as an amount or as a rate (IAS 12.81(c)).

Recommendation

When the reconciliation is based on tax rates, the AMF encourages companies to disclose the amount of pre-tax IFRS accounting profit in the same place to make it easier for readers to identify the amounts in question.

4.1.2. Chosen tax rate

Most companies disclose the reconciliation between the amount of tax and accounting profit using the domestic tax rate in the country in which the entity is domiciled.

In France, companies with revenues exceeding €250 million have been subject to an additional tax of 2.77%² since 2011 and before the potential impact of the 2014 Budget Act. Some companies present this additional tax in the tax rate and thus use a rate of 36.1%, while others present a tax rate that excludes the additional contribution (i.e. 34.43%), but the impact of this additional contribution is not directly visible in the reconciliation items.

Recommendation

The AMF believes it is important for readers to understand the items included in the rate used to prepare the reconciliation between tax income (expense) and accounting profit.

4.1.3. Explanation of the main impacts

IAS 12.85 suggests disclosing the relationship between the amount of tax and the accounting profit using either the tax rate in the country in which the entity is domiciled or the rate resulting from application of the tax rates for each country.

When the first method is used, one of the major reconciliation items is the effect of the differences between the tax rate in the country where the parent group is domiciled and the rates in other countries where the group has operations.

In the vast majority of cases, this amount is presented separately in the proof of tax, but no explanation is provided.

Recommendation

The AMF encourages companies to provide details for the line showing the impact of rate differentials when these amounts are significant.

One example that may be relevant would be to specify, for the top contributing countries, the effective tax rate applicable to the company in these countries or the tax differential compared with the rate of group's parent company.

The AMF's study also shows that the headings for the items presented in the reconciliation are sometimes confusing and difficult for financial statement users to understand³. Thus, when reading proofs of tax, it is not always easy to understand, for example, the effect of tax loss carryforwards that were not previously recognised.

² That is, a 3.3% social solidarity contribution and a 5% additional contribution based on a tax rate of 33.33%

³ For example, dividends or impacts of tax provisions

Recommendation

The reconciliation between tax income (expense) and accounting profit is a complex exercise. The AMF therefore calls on companies to use clear headings and to explain in summary terms the meaning of the various significant reconciliation items.

4.2. Deferred tax assets and liabilities

In its 2009 and 2012 recommendations, the AMF focused on the analysis to be performed and information to be disclosed in the notes with respect to deferred tax assets on tax loss carryforwards. The AMF calls on the companies concerned to refer to these prior recommendations.

IAS 12.81(g)(ii) requires disclosure of the amount of deferred tax recognised in profit or loss for each type of temporary difference if this amount does not directly reflect the variation, for a given type, between the amount of deferred tax recognised on the beginning balance sheet and that recognised at the end of the period. This is the case, for example, with business combinations, which give rise to the recognition of deferred tax with no impact on profit or loss.

Some companies' notes include a table that presents, for each type of temporary difference, the amounts of deferred tax recognised at the beginning and end of the period, as well as changes by type (e.g., impact on profit or loss, other comprehensive income, equity, changes in scope, exchange rate differentials).

When it is necessary to explain deferred tax flows (for example, in the event of a significant business combination), this method of presentation effectively meets users' need to understand the changes in deferred tax.

4.3. Classification of certain specific items

4.3.1. The 3% tax on dividends

The August 2012 Budget Act established an additional contribution when cash dividends are distributed. The accounting treatment for the tax on dividends was clarified by the IASB in 2000 and then again in 2012. Paragraph 35A of IAS 32 states that the tax relating to distributions to holders of an equity instrument and the tax relating to the transaction costs of an equity transaction must be accounted for in accordance with IAS 12 - *Income Taxes*. IAS 12 in turn specifies that the tax consequences of dividends are recognised in profit or loss for the period during which the distribution decision was made (IAS 12.52B), when the payout concerns past earnings.

The IFRSs therefore clearly state that the additional contribution must be recognised in profit or loss.

4.3.2. Tax credit for competitiveness and employment (*Crédit d'impôt pour la Compétitivité et l'Emploi, CICE*)

The CICE⁴ took effect on 1 January 2013.

Under IFRS, this tax credit can be presented as a deduction from the payroll expenses to which it relates or under other income. The choice will depend mainly on which accounting presentation options were previously used under IAS 20.

Recommendation

When the amounts are significant, it is useful to specify in the financial statements the amount of the CICE and in which account it is recognised.

⁴ Tax credit of 4% based on compensation of up to 2.5 times the minimum wage; the rate will be increased to 6% as from 1 January 2014. The tax credit is repaid, if it has not been deducted, after three years.

5. Standards on consolidation (IFRS 10, 11, 12)

[The AMF draws companies' attention to certain provisions in these standards, although for most companies they will not apply until 2014, as the consolidation scope is key to preparing consolidated financial statements. The AMF also notes that the IFRS IC has received specific questions on IFRS 11 which have not yet been put onto the meeting agenda.]

The standards on consolidation (IFRS 10 - *Consolidated Financial Statements*, IFRS 11 - *Joint Arrangements* and IFRS 12 - *Disclosure of Interests in Other Entities*) apply retrospectively, with a few specific exceptions, for annual periods beginning on or after 1 January 2013. They were adopted by the European Union and shall apply mandatorily as from 1 January 2014 at the latest; early adoption is permitted.

5.1. Analysis of control

IFRS 10 introduces changes (how to account for call options, for example) and clarifications (de facto control, in particular) in the analysis of control.

IFRS 10.7 stipulates that control arises from power over the investee, exposure to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the investor's returns.

While the principles are set out succinctly in the standard, they are followed by detailed application guidance comprising numerous examples and indicators describing factors that may or may not grant power to the investor. This has visibly increased the number of criteria to be analysed.

It would be premature to determine that control does or does not exist based on a single paragraph taken out of context, or on the basis of any similarity to an example, without considering the other points of analysis described earlier in the application guidance.

Recommendation

Against this backdrop, even when the situation bears some resemblance to certain aspects of the application guidance, it is critical to follow the chain of reasoning and to ensure that all the relevant facts have been considered before determining whether control exists.

IFRS 10.11 also states that, since power arises from rights, it can be straightforward to determine who holds power over an investee, particularly when power results from voting rights.

For example, in the specific case of de facto control, paragraphs B44-B45 state that, if it is clear that the investor does or does not have control after analysing the factors listed in paragraph B42(a)-(c), it is not necessary to continue the analysis and to analyse other facts and circumstances.

In the case of joint arrangements, according to IFRS 11.14 the distinction between joint venture and joint operation depends on the rights and obligations of the parties. For a joint arrangement to meet the definition of joint operation, the parties must have both rights to the assets relating to the joint arrangement and obligations for the liabilities. (IFRS 11.15).

IFRS 11.17 states that rights and obligations are assessed by considering the legal form and the contractual arrangement and, when relevant, other facts and circumstances only when they give rise to direct rights and obligations.

In May 2011, the IASB published its responses to frequently asked questions on IFRS 11. This document states in particular that similar operations carried out through different structures can be accounted for differently according to IFRS 11 if the parties' rights to the assets relating to the joint arrangement and their obligations for its liabilities are different.

5.2. Significant changes resulting from the first-time adoption of IFRS 10, 11 and 12

Recommendation

When an analysis under the new provisions of IFRS 10 results in a conclusion that differs from prior analyses as to the existence of control over investees which, singly or together, make a significant contribution to the consolidated financial statements, issuers must explain clearly in the notes the specific relevant factors that led them to reconsider their relationships with these investees.

For example, if, owing to the clarification of the concept of de facto control, application of IFRS 10 results in the first-time consolidation of investees that had previously been equity-accounted, it is helpful to explain which investee-specific factors had a decisive impact on the analysis.

At the end of 2012, the AMF had already highlighted in its recommendations the information required under IAS 8 - *Accounting Policies, Changes in Accounting Estimates and Errors* regarding standards that were issued but are not yet effective (qualitative and quantitative information about any significant impact expected).

The AMF notes that it is important to disclose in the 2013 financial statements the information required under IAS 8 regarding the expected impacts of IFRS 10 and IFRS 11.

Investors will have to compare these financial statements with those published by companies that applied these new consolidation principles in 2013.

5.3. IFRS 12 – Disclosure of Interests in Other Entities

5.3.1. Judgements used in analysing control

IFRS 12 (paragraphs 7 to 9) highlights the importance of disclosing the significant assumptions and judgements on which the analysis of control is based.

Recommendation

For significant cases involving complex analyses, the AMF recommends explaining in the notes the factors used to determine control, to enable the reader to better understand the specificities of the relationship between the investor and the investee in question.

5.3.2. First-time adoption of IFRS 12

IAS 34.15 states that the information included in the interim financial report shall provide an understanding of the changes in the financial position and performance since the end of the annual reporting period.

The AMF notes that IAS 34.16A requires that the nature and effect of changes in accounting policies be specified in the interim financial report.

Recommendation

When the impacts related to the first-time adoption of IFRS 10 and/or IFRS 11 are significant, the AMF invites companies to consider the relevance of presenting, starting with the condensed interim financial statements, some of the information required under IFRS 12 that may be helpful to understanding the financial performance and the change in financial position.

5.3.3. Prioritisation of information

IFRS 12 requires a significant amount of information on a group's different interests while highlighting, in paragraph 4, the need for issuers to present this information in the most relevant and legible manner possible.

Recommendation

Given the extent of the advance preparations required to provide high-quality information that can be used by readers, the AMF encourages issuers to begin their data collection and analysis work as soon as possible.

5.3.4. Information on non-controlling interests

Some of the new requirements introduced in this standard raise in particular the issue of the degree to which information is aggregated. The objective is to present disclosures that are specific enough to be relevant but do not needlessly burden the notes.

For example, the standard requires separate and detailed information on subsidiaries in which the non-controlling interests are material. Assessing this materiality is therefore of particular importance. As the standard's basis for conclusions states (IFRS 12.BC21-29), users of financial statements have requested this specific information because it provides an understanding of the share of a subsidiary's profit or loss and cash flow that is attributable to the non-controlling interest.

Recommendation

To meet this objective, the AMF recommends assessing the relevance and granularity of the information to be presented based on specific situations involving non-controlling interests. The information that can be taken into account includes aspects such as the existence of significant cash balances, the proportion that these interests represent in the subtotals used by the group (profit or loss, cash flow, assets, liabilities), and the existence of sub-groups.