

# ESMA's NINTH EXTRACT FROM ITS DATABASE OF ENFORCEMENT DECISIONS TAKEN BY EU NATIONAL ENFORCERS OF FINANCIAL INFORMATION (IFRS) INTERNATIONAL FINANCIAL REPORTING BULLETIN 2012/02



## Background

The European Securities and Markets Authority (ESMA) (previously called the Committee of European Securities Regulators) has, as a source of information to assist in the appropriate application of IFRSs, developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). EU National Enforcers monitor and review financial statements and consider whether they comply with IFRSs and other applicable reporting requirements, including applicable national law. The EECS is a forum in which all EU National Enforcers of financial information meet to exchange views and discuss experience of enforcement.

No decisions are taken at EECS, and decisions taken by EU National Enforcers are neither approved nor rejected. Relevant factors for each enforcement decision may include consideration of national law, the requirements of which may go beyond the requirements of accounting standards and interpretations. In consequence, when considering the cases that are publicly reported, careful consideration should be given to their individual circumstances.

ESMA regularly publishes extracts from its database, with the intention of informing market participants about which accounting treatments EU National Enforcers (the Enforcers), may consider as complying with IFRSs and thus contribute to a consistent application of IFRSs in the European Union. The published decisions generally include a description of the accounting treatment or presentation at issue, the decision taken by the Enforcer and a summary of the Enforcer's underlying rationale.

On 25 October 2010, ESMA published its ninth extract from the database. The full report can be found on the ESMA website at the following address: [http://www.esma.europa.eu/system/files/10\\_1151.pdf](http://www.esma.europa.eu/system/files/10_1151.pdf). Set out below is a summary of the conclusions reached, which are in the same order as they have been presented in the report.

The previous extracts published by ESMA are summarised in IFRBs 2007/06, 2008/07, 2008/17, 2009/04, 2010/05, 2010/06, 2010/07 and 2012/01.

## Transactions and related IFRSs covered by the extracts

1. Classification of financial liabilities (IAS 1)
2. Financial instruments – Hedge accounting (IAS 39)
3. Revenue recognition (IAS 18)
4. Intangible assets (IAS 38)
5. Impairment of non-financial assets (IAS 36)
6. Consolidation (IAS 27)
7. Share-based payment (IFRS 2)
8. Financial instruments – disclosure (IFRS 7)
9. Impairment of non-financial assets disclosure (IAS 36)

## STATUS

Final

## EFFECTIVE DATE

Immediate

## ACCOUNTING IMPACT

Additional guidance for the application of IFRSs.

## Summary of extracts

### 1. Classification of financial liabilities (IAS 1)

At 31 December 2008, the issuer had several long-term loans with different parties outstanding. All loans were subject to several covenants. Due to a sharp decline in sales, the issuer had breached all but one of the covenants.

According to the credit terms, a breach of a covenant entitled the lender to ask for immediate repayments of the amounts due. The issuer had already started negotiation in the last quarter of 2008 in order to obtain a letter waiving the covenants.

The issuer received a waiver letter in March 2009 and classified all of the debts whose covenants had been breached as non-current at 31 December 2008.

The enforcer found that the issuer's classification of debts as non-current liabilities did not comply with IAS 1 paragraph 74 (previously IAS 1 (2005) paragraph 65), and concluded that they should have been classified as current in the financial statements.

The above paragraph states that an entity that breaches a provision (a covenant) of a long term loan classifies the liability as current, even if the lender agreed after the reporting period (in this case March 2009) not to demand payment as consequence of the breach.

### 2. Financial Instruments – Hedge accounting (IAS 39)

The issuer had entered into interest rate swaps in order to hedge the variability of its future variable interest payments. The swaps qualified as cash flow hedges in accordance with IAS 39 paragraph 88 and were considered to be effective in 2007 and 2008.

At the end of November 2009 the issuer cancelled the hedging relationship and paid compensation comprising two amounts. One corresponding to the effective part of the hedge recognised in other comprehensive income and one for the balance corresponding to the non-effective part of the hedge over the period.

The issuer chose not to apply IAS 39 to the termination of the hedge accounting for the financial statements for the year ending 30 November 2009. The issuer argued that applying IAS 39 would conflict with the entity's objective of fairly presenting the financial performance. The issuer therefore departed from IAS 39 and recognised the entire payment in its income statement, arguing that this was permitted by IAS 1 paragraph 19.

The enforcer found that the treatment adopted by the issuer did not comply with IAS 39, paragraph 101 (a). The enforcer did not agree that the issuer could rely on IAS 1, paragraph 19 to support a departure from IAS 39 which requires the cumulative gain or loss on the hedging instrument to remain separately recognised in equity until the forecast transaction occurs.

The enforcer found that the issuer was not facing an "extremely rare circumstance" as referred to in IAS 1 paragraph 19.

IAS 39 paragraph 101 (a), requires that when a hedging instrument is terminated the entity discontinues prospectively the hedge accounting. The amount recognised in other comprehensive income remaining in equity until the forecasted transactions (the interest payments) occur.

Therefore, on termination of the swaps, the issuer should have recognised the cash payment against the fair value of the swaps recorded as debt. As a result there would have been no effect on profit and loss at the date when the swap was cancelled. The reclassification of the gain and loss accumulated in other comprehensive income would be reflected in the period during which the hedged cash flows will affect the income statement.

### 3. Revenue Recognition (IAS 18)

A football club entered into sponsorship contracts. They rendered services in return for the sponsorship earnings including access to web and e-mail based marketing, admission to matches, including the provision of meals and other events.

The issuer recognised all income at the date when the contract was signed for contracts that lasted less than 12 months. It did also not provide for the cost relating to the rendering of services in return for the sponsorship earnings.

The enforcer found that the issuer's revenue recognition policy did not comply with paragraph 20 of IAS 18 which requires income from services to be recognised by reference to the stage of completion of the transaction at the end of the reporting period.

The issuer argued that it only assumes limited obligations under the sponsorship contract. They referred to IAS 18, illustrative examples, paragraph 17 "if the fee entitles the member to services or publications to be provided during the membership period [...], it is recognised on a basis that reflects the timing, nature and value of the benefits provided".

The enforcer did not agree and found it more relevant to refer to IAS 18, illustrative examples, paragraph 15 which relates to "artistic performances, banquets and other special events". In this example, income should be recognised on the basis of "the extent to which services are performed at each event".

### 4. Intangible Assets (IAS 38)

The issuer operated in the art market, listing auction prices and indices. Between 1999 and 2004 it had developed a database of auction records. The database was accessible to users in exchange for an annual subscription and accounted for 95% of revenue of the issuer.

The database was not amortised, but was considered as an intangible asset with an indefinite useful life for the following reasons:

- There is no foreseeable limit to the period over which the database is expected to be used.
- There is no foreseeable risk of technical or commercial obsolescence. The data on the database is regularly updated to take into account current art auction records. The costs incurred on updating and maintaining the database are recognised in profit and loss.
- There are no legal constraints attaching to the data on the database and, consequently, there is no foreseeable limit to the issuer's control.

The carrying amount of the database did not change over the period of 2004 - 2008 as since completion in 2004 all expenses that related to maintenance and updates had been expensed. The database is considered a cash generating unit and is tested for impairment annually. No impairment had been booked against the database. The issuer had disclosed that the recoverable amount was value in use, determined by applying a discounted cash-flow methodology.

The enforcer accepted the issuer's accounting treatment as an intangible asset with an indefinite useful life.

The issuer recognised the database as an intangible asset at the date of transition to IFRS (opening balance sheet at 1 January 2004).

Analysing IAS 38 paragraph 90 the enforcer found the factors below that supported an indefinite useful life:

- The business model of the issuer is reliant on the existence of the database which generates 95% of its total revenue. Further, the database could be managed by another team.
- The database is maintained and updated on a regular basis. The data stored in the database contributes to the preparation of statistics available to the users of the database. The asset is a database not a piece of software and, therefore, the risk of either technical or commercial obsolescence is much lower.
- The level of expenditure required to maintain the database at its standard of performance and therefore to obtain expected future economic benefit seems to be reasonable as the database has been successfully running for the last 5 years (2004 to 2008).
- The issuer is the legal owner of the database, there are no legal constraints on the use of the database and, therefore, no foreseeable limit to the issuer's control over the database.

#### 5. Impairment of non-financial assets (IAS 36)

The issuer is a real estate investor and developer. At 31 December 2008, investments in retail (shopping) centres represented the main part of the company's total investments.

The acquisition of an investment property is usually realised through the acquisition of a 'shell' company which holds the property. The 'shell' is created to make use of local tax opportunities or to minimise taxes when the property is sold, such as corporation tax on any profit on disposal.

Operational shopping centres, as targeted by the issuer, are characterised by the presence of central management and contracts for operational services such as cleaning and maintenance. There are also leases with tenants. As a result of these arrangements, shopping centres can be individually managed as businesses by an owner. Both the issuer and the enforcer were of the opinion that the acquisition of the shell company qualifies as a business combination as defined in IFRS 3. The price paid by the issuer for acquiring 100% of the shares of the 'shell' company is generally calculated as the fair value of the real estate adjusted for any working capital, the fair value of long term liabilities and the deferred tax obligation. In this particular case, working capital and long term liabilities have no further relevance.

In the issuer's financial statements, investment properties acquired through business acquisitions are recognised at fair value at the date of the transaction. The difference between the fair value of the investment property and the cost of the investment property for tax purposes results in a deferred tax liability measured at nominal value in accordance with IFRS 3. Subsequently, the issuer applies the fair value model for investment properties.

The issuer did not disclose its accounting treatment for impairment testing of goodwill in its accounts but, when approached, provided the enforcer with additional information. Goodwill directly related to the deferred tax liability is only considered as impaired if the deferred tax liability is reduced below the amount at which it was first recognised. This reduction can be caused both by a reduction in the value of the real estate or a change in local tax regulations.

As long as the deferred tax liability is equal to, or larger than, the goodwill, no impairment is booked. If the deferred tax liability decreases to an amount lower than the identified goodwill, the issuer recognises the difference between the goodwill and the deferred tax liability as an impairment.

The issuer explained its accounting treatment by confirming that almost all of its goodwill is due to the deferred tax liability and that it is normal in the industry to account for goodwill in the way described.

The enforcer found that non-disclosure of both the methodology by which the recoverable amount of goodwill was determined and the assumptions underlying that methodology was in breach of the requirements of IAS 36, paragraph 134. This paragraph requires the issuer to state the basis on which recoverable amount has been determined and to disclose the key assumptions on which it is based. Furthermore the enforcer expected that the basis used to determine the recoverable amount should be fair value less costs to sell for the following reasons.

Goodwill recognised on the acquisition of an investment property through a business combination by real estate investment companies is normally a result of the fact that, in IFRS, deferred tax liabilities should be based on nominal rather than present value. IFRS recognises this inconsistency (IAS 36.BCZ86-89) and concludes that the principles of IAS 12 prevail.

The fair value of both the property and the deferred tax liability are normally reflected in the purchase price of the business combination. The difference between this purchase price and the amounts recognised according to IFRS 3, where deferred tax is calculated at nominal value, is recognised as goodwill in the acquirer's balance sheet.

In accordance with IAS 36.80, for impairment testing purposes, goodwill is allocated to each individual real estate investment identified as a cash-generating unit (CGU). Periodically, but at least annually, the recoverable amount of the CGU is compared with its carrying amount. If this comparison results in a negative amount, the impairment is first allocated to the goodwill. Any further difference is subsequently allocated against the value of the investment property, as required by IAS 36.104.

The recoverable amount is the higher of fair value less costs to sell and value in use. Value in use is a pre-tax valuation, as required by IAS 36.50 (b). Consequently, when the recoverable amount is based on value in use, any goodwill recognised should be written off directly on day one. Fair value less costs to sell is a post-tax valuation taking account of deferred tax. According to IAS 36.78, the deferred tax liability should be included in calculating the carrying amount of the CGU since the transaction price also includes the effect of the deferred tax and the purchaser assumes the tax risk.

On this basis, the enforcer concluded that the impairment testing of goodwill should be based on fair value less costs to sell rather than on the difference between the goodwill and the nominal value of the deferred tax liability as assessed by the issuer. The financial statements should disclose both that the determination of the book value of the CGU relating to the impairment testing of goodwill should take deferred tax into account and that the recoverable value should be based on fair value less costs to sell.

## 6. Consolidation (IAS 27)

The issuer sold 50% of its wholly-owned subsidiary A to a third party company B. The disposal was completed for reasons of industrial collaboration.

The issuer did not deconsolidate subsidiary A in its consolidated financial statements. It argued that the agreement that it had made with company B determined that the issuer would exercise general control over company A's operating and financial policies. The issuer had appointed three of the four members of the board of directors. However the agreement stipulated that the following decisions requested consent between the issuer and company B:

- Significant changes in company A's activities, acquisition or divestment of business entities
- Plans or budgets that deviate from the business plan
- Acquisitions, divestments or restructurings
- Accounting policies
- Distribution of dividends
- Agreements on financing or unusual guarantees
- Acquisition, leasing or divestment of assets with a value in excess of EUR 33 thousand
- Formation or change of material agreements such as distribution agreements with a term of 12 months
- Exclusive agreements
- Employment, change of employment terms or responsibilities or dismissal of senior employees
- Change of remuneration or other circumstances concerning related parties; and
- Other material or unusual business transactions

The enforcer required the issuer to deconsolidate company A as a subsidiary from its consolidated financial statements as it did not control the entity.

According to IAS 27 (2008) paragraph 13 control is presumed to exist when the parent owns more than half of the voting power in another entity. The paragraph also provides examples of situations where control exists despite the parent owning less than 50% of the voting power.

The issuer argued that its fact pattern met the definition in paragraph 13(b) "power to govern the financial and operating policies of the entity under a statute or an arrangement" and that it controlled company A.

The enforcer disagreed. It found that the significant restrictions in the agreement with regard to decisions to be made in the ordinary course of business indicated that the issuer did not control company A.

The enforcer was also of the view that the issuer was unable to utilise its majority at board level as consensus between the issuer and company B was required for all significant transactions.

## 7. Share-based payment (IFRS 2)

The issuer gave details of an employee benefit trust established by itself as part of its employee share based payment plan. The note stated that the scheme provided for the issue of shares to employees over three years ending 30 September 2008.

It also explained that the IFRS 2 charge was calculated by using the share price prevailing on 4 February 2005 as this was the date when substantially all terms and conditions were agreed by the parties.

The issuer clarified to the enforcer that the scheme involved the award of share options that vested after three year subject to certain service and performance related vesting conditions. The issuer had granted the options in three equal tranches in September 2005, 2006 and 2007. The total number of options issued was the same each year. The numbers allocated to individual employees however were established on an annual basis. In addition employees joining the entity in the second and third year were also eligible for awards.

The enforcer found that the issuer had applied an incorrect share price as it was not based on the grant date as determined by IFRS 2. The charge should have been determined based on the share price at the date when the different tranches were granted.

The "grant date" is defined in appendix A of IFRS 2. Appendix A states that the "grant date" is "the date ... when the entity and the counter party have a shared understanding of the terms and conditions of the arrangement". The enforcer was in the view that these conditions did not occur in February 2005 as the actual number of options to be granted and the specific performance conditions for individual employees were not agreed on at that point.

## 8. Financial Instruments – Disclosures (IFRS 7)

The issuer disclosed quantitative information about credit risk as required by IFRS 7 paragraph 34-36.

The notes only distinguished between loans measured at amortised cost and fair value. The characteristics of the issuer's loan portfolio however showed significant exposure towards real estate, to several large exposures and investment credits.

The auditor's opinion contained an emphasis of matter which drew attention to management's disclosure around the recognition and measurement of loans and collateral. Uncertainty about the measurement of loans and collateral was also highlighted in the long-form audit report that was addressed to the board of directors.

The enforcer found that the issuer's accounting policy did not comply with IFRS 7 paragraph 6 or IFRS 7 appendix B, application guidance B3. These paragraphs require financial instruments to be grouped into appropriate classes when providing the disclosures required by the standard.

The enforcer was of the opinion that the issuer did not disclose quantitative information as required by IFRS 7 as it did not provide any information about its exposure to credit risk relating to real estate, large exposures or investment credits.

## 9. Impairment of non-financial assets – disclosures (IAS 36)


An issuer explained in its consolidated financial statements that it had used a post-tax discount rate to calculate the value in use of its cash generating unit (CGU). However a pre-tax rate was disclosed.

The issuer had grossed-up the post-tax discount rate by an average tax rate in order to determine a pre-tax discount rate.

The enforcer found that a pre-tax discount rate should be disclosed and used for calculating the value in use when testing a CGU for impairment.

The issuer argued that discounting post-tax cash flows at a post-tax discount rate should, by definition, give the same result as discounting pre-tax cash flows at a pre-tax discount rate, and that this was supported by IAS 36 BCZ85.

The enforcer did not agree with the issuer. IAS 36, paragraphs 55 and appendix A, paragraph A20 specifically require the use of a pre-tax discount rate. Furthermore, IAS 36, BCZ84 concludes that value in use should be determined by using pre-tax cash flows and, hence, a pre-tax discount rate. IAS 36 BCZ85 merely illustrates the point that a post-tax discount rate grossed-up by a standard rate of tax is not always an appropriate pre-tax discount rate. In addition, the paragraph gives a worked example in which the 'real' pre-tax discount rate is determined by an iterative computation. This calculation should have been applied to determine the pre-tax discount rate that was disclosed in the financial statements.



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