

ESMA's ELEVENTH EXTRACT FROM ITS DATABASE OF ENFORCEMENT DECISIONS TAKEN BY EU NATIONAL ENFORCERS OF FINANCIAL INFORMATION (IFRS) INTERNATIONAL FINANCIAL REPORTING BULLETIN 2012/04



Background

The European Securities and Markets Authority (ESMA) 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 16 August 2011, ESMA published its eleventh 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/2011_265.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, 2012/01, 2012/02 and 2012/03.

Transactions and related IFRSs covered by the extracts

1. Determination of fair value less costs to sell (IFRS 5)
2. Classification of subsidiary held for sale (IFRS 5)
3. Impairment of financial assets (IAS 39)
4. Aggregation of operating segments (IFRS 8)
5. Distribution of non-cash assets to shareholders (IAS 39, IFRIC 17)
6. Investment properties (IAS 40)
7. Disclosure on financial instruments (IFRS 7, IAS 1)
8. Presentation of fair value changes in the Profit and Loss account (IAS 1)
9. Financial instruments – Disclosure (IFRS 7)

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

Additional guidance for the application of IFRSs.

Summary of extracts

1. Determination of fair value less costs to sell (IFRS 5)

The issuer decided to sell one of its loss making business divisions. The decision to sell for an amount of CU 2 million was announced in December 2009 and approved by the extraordinary meeting in the first quarter of 2010. It was agreed to defer payment of the CU 2 million until 31 December 2013.

The division was presented as a disposal group in the 2009 financial statements in accordance with IFRS 5 paragraph 6.

The deal included three expense items closely related to the sale of the division:

- a) Possible loss relating to a receivable; the item related to the agreement between the seller and the buyer according to which the seller would refund the buyer in the event that the specific receivable was not collected by the buyer from a customer;
- b) An expense relating to the discounting of the long term receivable on the fixed amount of the sale price of the disposal group;
- c) A provision relating to the expected transaction costs (legal advice, lawyer fees, etc.).

The issuer recognised the related expenses as part of its discontinued operations but presented the resulting provision in its statement of financial position as provisions of the continuing operations.

The enforcer was of the opinion that the three items did not qualify as provisions of the continuing operations of the issuer and, for that reason, could not be presented as such in the issuer's statement of financial position.

The enforcer based its decision on the following considerations

- a) Possible loss relating to a receivable: According to IFRS 5, paragraph 18, the carrying amounts of all the assets and liabilities in a disposal group are to be measured in accordance with applicable IFRSs, immediately before the initial classification of the disposal group as held for sale. Therefore, the receivable from the customer should have been tested for impairment immediately before classification of the division as held for sale and the resulting loss would have been recognised against the net carrying amount of the disposal group at initial classification as held for sale. Moreover, since the sales contract stipulated that the seller would refund the buyer in the event that the receivable was not collected, the expected sales price of the disposal group should have been adjusted to take into account the potential refund.
- b) The expense relating to the discounting effect: The "fair value less costs to sell" of the disposal group should have incorporated the effect of discounting given that payment was deferred until 2013.
- c) The provision on transaction costs: The expected transaction costs were to be considered as an additional cost of the transaction and, therefore, were a component of the "costs to sell".

All three items, for an aggregate amount of CU 2.2 million, should therefore have been taken into account in the calculation of "fair value less costs to sell" and should not have been presented as provisions relating to continuing operations of the issuer in its statement of financial position.

2. Classification of subsidiary held for sale (IFRS 5)

A general shareholder meeting had authorised management to sell 51% of the issuer's subsidiary. The issuer classified the subsidiary as held for sale and its result as discontinued operations in its annual financial statements for 2008 and 2009 and also in the three quarterly reports in 2010. The enforcer had accepted that the subsidiary should be classified as held for sale and its result as discontinued operations in its previous review of the 2008 financial statements.

The 2008 (2009) financial statements showed a loss from discontinued operation of CU 2.7 million (CU 0.9 million) and a profit from continued operation of CU 0.4 million (CU 2.1 million) resulting in a total loss of CU 2.3 million (total profit of CU 1.2 million).

The enforcer found that the presentation of the subsidiary as a disposal group held for sale and as a discontinued operation did not comply with IFRS 5. The issuer did not meet the criteria set out in IFRS 5 in order to present the subsidiary as a disposal group for a period longer than 12 months.

A disposal group can, exceptionally, be classified as held for sale and discontinued after a period of 12 months if it meets the criteria set out in paragraph 9 of IFRS 5.

The enforcer found that the issuer's evidence to support a completion period in excess of one year from the date of classification was not sufficiently related to the subsidiary in its present condition as at the point of classification as held for sale as required by IFRS 5. It became clear that the issuer had made certain organisational changes during 2010 which resulted in additional activities being transferred to the subsidiary.

The enforcer also noted that the shareholders' authorisation to sell the subsidiary in 2008 was only granted for one year and was not renewed in 2009.

3. Impairment of financial assets (IAS 39)

At 31 December 2009, entity A, a related company, being a subsidiary of the issuer's ultimate 95% owner, owed CU 10 million in the form of accounts receivables to the issuer. This was overdue by 90 days and accounted for 51% of the issuers current assets and 23% of its total assets.

Entity A had suffered losses in the two previous years: CU 5 million in 2009 and CU 5.8 million in 2008 and its current liabilities materially exceeded its current assets by CU 19.3 million in 2009 and by CU 15.1 million in 2008. Entity A's 2009 financial statements disclosed that as at 31 December, it had no possibility of borrowing from any financial institution and that its continuing activities were dependent on the financial support of its sole shareholder. The auditor had qualified its opinion in respect of the accounts for going concern risk.

The issuer agreed that the amounts due from entity A did show evidence of a possible impairment but that it had not conducted an impairment assessment on account of the cost involved which it could not sustain given its financial position at that time.

The enforcer found that, consistent with IAS 39 paragraphs 59 (a) and (b), there was objective evidence of a possible impairment in the amounts receivable from entity A given its failure to settle its obligations to the issuer and in the light of its severe financial difficulties.

The issuer had failed to conduct an impairment assessment and was, therefore, in breach of IAS 39 paragraph 63 which requires that if there is objective evidence of a loss on loans and receivables carried at amortised cost then the loss is measured based on the present value of the future cash flows (repayments) discounted at the original effective interest rate of the relevant financial asset.

4. Aggregation of operating segments (IFRS 8)

The issuer had identified its operating segments as follows:

Entity A	City bus operations
Entity B	Major Towns' bus operations
Entity C	Region A Trains
Entity D	Region B Trains
Entity E	Region C Trains
Entity F	Aviation operations

The company disclosed information for three reportable segments. A and B were aggregated into one reportable operating segment, segments C, D and E were also aggregated into one segment. Segment F was reported as a single segment.

The enforcer found that segments A and B had different customers (the transport authority for A and passengers for B) and did therefore not fulfil the aggregation criteria of IFRS 8.

The aggregation criteria require in paragraph 12 (c) that the operating segments have a similar type or class of customers.

The issuer explained that all of their end customers are members of the public. The fact that they contract through a transport authority does not change their end customer.

The enforcer understood that, in the City bus market, contracts were awarded following a competitive tender process, on a cost per mile basis and, consequently, there is no exposure to near term passenger revenue risk. The ticket prices paid by passengers are set by a transport authority and not the issuer. By contrast, the enforcer understood that, in the major towns' bus market, ticket prices were generally set by the company and its revenues were, therefore, the fares paid by the customers travelling on the particular bus. In this set of circumstances the company was exposed to passenger revenue risk. The enforcer also noted that the principal risk and uncertainties disclosed in the narrative report specifically highlighted different factors affecting the city bus operations and the major towns' operations. The enforcer was of the view that the bus operations should not have been aggregated to form a single reportable segment.

5. Distribution of non-cash assets to shareholders (IAS 39, IFRIC 17)

The issuer had two core businesses A and B which were demerged, following the approval of the shareholders on 29 June 2010. The issuer retained core business A. Core business B was contributed to the newly created entity ABC. The shares of ABC were then distributed on 2 July to the issuer's shareholders so that they held one ABC share for each share held in the issuer.

At 30 June 2010, the carrying amount of the dividend payable was CU 2.6 billion, calculated as the number of ABC shares to be issued at the reference market price of CU 11.40 per ABC share, being considered to be the fair value of the assets to be distributed.

On 2 July 2010 however when the ABC shares were distributed and listed the opening quoted price was CU 13.00 a share rising to CU 14.80 per share at the close.

As regards the valuation of the liability on settlement (i.e. 2 July 2010), the issuer considered the following facts as required by IFRIC 17, paragraph 13:

- There had been no significant change in the market conditions in the period from 29 June to 2 July.
- The volume and volatility of ABC shares had been significantly higher than those of the market in the first month following the initial quotation. The entity had, therefore, prepared an analysis that aimed to demonstrate that once the market price was adjusted for the unusual "eagerness" from market participants observed in the first month, on 2 July the adjusted market price of ABC would have been CU 11.70 per share, close to the reference market price of CU 11.40 per share used on 30 June.
- The obligation towards the shareholders had to be settled prior to quotation.

As a consequence, the issuer concluded that the fair value assessment had to be determined before any market price was available, and that the market prices observed during the first day of quotation were not relevant.

The enforcer did not agree with the issuer's view, having regard to paragraph 13 of IFRIC 17 which requires that, "At ... the date of settlement, the entity shall review and adjust the carrying amount of the dividend payable". The carrying amount of the dividend payable should have been adjusted at the date of its settlement (i.e. 2 July 2010) on the basis of the quoted market price of that day.

The enforcer was of the view that IAS 39.AG71 and AG72 should be applied in the determination of fair value. These paragraphs provide that:

- "The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial liability"; and
- "The current bid price is usually the appropriate price to be used in measuring the fair value of an asset held".

Adopting the opening market price of CU 13.00 per share, resulted in an increase of the issuer's net result of CU 360 million.

6. Investment Properties (IAS 40)

The issuer is a real estate company specialised in industrial property. All investment property is held at fair value. The issuer stated that "for determining the fair value of the real estate, the latter is measured using the 'new-build value less obsolescence' and not the return based expected rent value." The independent real estate appraiser determined fair value by means of a detailed measurement and calculation, from which obsolescence was then deducted. The appraiser stated that this method of calculation is complex but gives a very precise result.

The issuer argued that users of industrial property have a limited choice between renting, buying or erecting a building that meets their specific requirements (the "Rent-buy-make" decision). This "Rent-buy-make" decision is taken on the basis of the cost-benefit analysis between, on the one hand, the new-build value of a new structure and, on the other hand, the new-build value less obsolescence of an existing building versus the rental income charged for it.

The enforcer found that a valuation based on new-build value less obsolescence does not reflect the fair value of investment property as it does not reflect market conditions as required by IAS 40.38. Nor does it take account of information including discounted cash flow projections, supported by the terms of any existing lease contracts. A potential buyer, when determining the price he is willing to pay for investment property, would take account of existing lease contracts.

The enforcer also pointed out that IAS 40, paragraph 46 (c) specifically provides that: "In the absence of current prices in an active market [...] an entity considers information from a variety of sources, including: [...] discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts [...] and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

7. Disclosure on financial instruments (IFRS 7, IAS 1)

The issuer is a debt issuer whose business is the securitisation of a portfolio of underlying investments (e.g. securities, funds and loans). The purchase of the investments is financed by the issuance of listed note-specific, limited recourse notes.

The repayment of the specific notes is dependent upon the performance of the underlying investments. Note holders bear the ultimate risk and rewards of ownership of the underlying investments.

The enforcer considered whether the issuer should have considered the note holders as being amongst the primary users of the financial statements as they were the sole source of finance and should have provided disclosures about the note holders exposure to risks. The enforcer was concerned it was too narrow only to concentrate on the shareholders as primary users of the financial statements. The enforcer also believed that the level of aggregation was not appropriate given that there were specific risks attached to the different notes.

The enforcer concluded that:

- The issuer should have included the note holders as being amongst the primary users of the financial statements.
- The risk disclosures required by IFRS 7 should include information relating to the note holders (by individual series of notes where practicable) to ensure that significant differences between various series of notes were identifiable.

IAS 1 paragraph 9 states that the objective of financial statements is to provide information that is useful to a wide range of users in making economic decisions. IFRS 7 requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance.

IFRS 7 paragraph 33 states that an entity shall disclose for each type of risk arising from financial instruments:

- The exposures to risk and how they arise.
- Its objectives, policies and processes for managing the risk and the methods used to measure the risk.

Paragraph B3 of Appendix B to IFRS 7 states that, an entity is required not to combine information with different characteristics. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

8. Presentation of fair value changes in the Profit and Loss account (IAS 1)

A real estate company presented its changes in the fair value of investment property (separated lines for realised and unrealised) and fair value changes in derivative financial instruments in its profit and loss account after subtotals for operating results and net finance.

The enforcer found that, whilst IAS 1 does not prescribe the presentation of fair value changes in the profit and loss account, the issuer should present the fair value changes for investment property as part of the operating result. The enforcer also concluded that presenting a subtotal "net finance" is misleading if it excludes the fair value changes in derivative financial instruments (mainly interest swaps).

The enforcer did not agree with the issuer's rationale that there are no detailed requirements in IAS 1 on how to present fair value changes in the income statement. The enforcer referred to IAS 1 paragraph 56 in the Basis of Conclusions. "The Board recognises that an entity may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases the Board notes that the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as "operating". In the Board's view it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice."

The enforcer was of the view that fair value changes in investment property are a normal part of the activities of a real estate company that has opted to account for investment property in accordance with the fair value model under IAS 40.

9. Financial instruments – Disclosure (IFRS 7)

The issuer is an offshore services company which operates on a global basis serving the oil and gas market, the offshore renewable market and the market for submarine power interconnectors. The issuer charters construction support and fast support vessels, and provides installation and lay equipment for rent.

In its 2008 financial statements the issuer's liquidity position was very tight. The directors' and the auditors' reports both emphasised the considerable risk of not being able to continue as a going concern. The situation worsened in the first quarter 2009 with the result that the issuer breached its covenants at 31 March 2009. The 2008 financial statements were authorised for issue at the end of April 2009.

The issuer only confirmed upon request from the enforcer that, at 31 December 2008, it had been close to breaching the covenants in respect of free cash-flows and equity ratio requirements no such information however was provided in the financial statements. Indeed the financial statements indicated that there was "ample" compliance with all covenants as at the balance sheet date.

The enforcer found that the issuer should have disclosed information about the covenants including the amount of headroom as deemed appropriate under IFRS 7. The subsequent breach of the covenants represented a material event after the reporting period and should have given rise to relevant disclosures required by IAS 10 paragraph 21, in relation to material non-adjusting events after the reporting period.

According to IFRS 7 paragraphs 31 and 32, an entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

The enforcer was of the view that disclosure of information was necessary to a greater extent in situations where the issuer is close to breaching covenants and in situations where uncertainty is expressed in relation to the going concern assumption.

The enforcer also argued that identification of which covenants were breached after the end of the period, the new covenants required as a consequence of the breaches and acknowledgement of the consequences for the maturity analysis for financial liabilities as at the year-end were all relevant to the issuer's situation.

The enforcer also noted the apparent inconsistency between the information provided in the directors' report and that which was included in the financial statements.

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