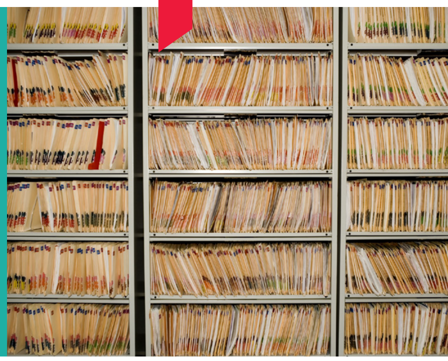
ESMA's SIXTEENTH EXTRACT FROM ITS DATABASE OF ENFORCEMENT DECISIONS TAKEN BY EU NATIONAL ENFORCERS OF FINANCIAL INFORMATION (IFRS)

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2014/25



STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Additional guidance for the application of IFRSs.

Background

The European Securities and Markets Authority (ESMA) have, as a source of information to assist in the appropriate application of International Financial Reporting Standards (IFRSs), developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). This forum involves 38 European enforcers from the 28 member states and the two countries in the European Economic Area (EEA) who have responsibilities in the area of supervision and enforcement of financial information. The EECS is a forum in which European enforcers of financial information meet to exchange views and discuss practical experiences of enforcement of IFRS financial information provided by companies which have, or are in the process of having, securities admitted to trading on a regulated market in Europe.

European national enforcers apply their judgement, knowledge and experience to the particular circumstances of the cases that they consider. 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. Situations which seem similar may in substance be different, and consistent application of IFRS means consistent with the principles and treatments permitted by IFRS.

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. However, decisions taken by enforcers do not constitute generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee.

On 18 November 2014, ESMA published its sixteenth 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/2014-esma-1373_-_16_extract_eecs_database_published.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, 2012/03, 2012/04, 2012/14, 2013/11, 2013/21, and 2014/04.

Transactions and related IFRSs covered by the extracts

1. Disclosure of forborne loans (IAS 1, IAS 39, IFRS 7)
2. Fair value of consideration paid in shares (IFRS 3, IFRS 13)
3. Recognition of liability payable to equity holders (IAS 32)
4. Presentation of statement of cash flows (IAS 7, IAS 16, IAS 18)
5. Presentation of discontinued operations (IFRS 5)
6. Presentation of non-current assets held for sale (IFRS 5)
7. Deferred tax assets upon disposal of a subsidiary (IAS 12)
8. Accounting for the effects of specific tax regime (IAS 12, IAS 16, IAS 40)
9. Key assumptions used in the impairment test of goodwill (IAS 36)
10. Disclosures related to capitalised costs (IAS 38, IFRS 6)
11. Disclosure of major customers (IFRS 8).

Summary of extracts

1. Disclosure of forborne loans (IAS 1, IAS 39, IFRS 7)

The issuer, a financial institution, provided forbearance measures on some of the loans granted to its customers, with a narrative description of the forbearance strategies. In addition, the entity provided an additional report with quantitative and qualitative information about the forborne loans and credit risk data that related to it. The majority of the forbearance data in this report was unaudited and therefore not part of the audited financial statements. The issuer did not consider forborne loans to be a distinct class of loans and therefore provided no specific disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures*.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted additional disclosures were required in order to comply with IFRS 7.31, 35 and B3, and paragraph 112 of IAS 1 *Presentation of Financial Statements*. The following requirements apply:

– IFRS 7.B5(g) refers to the renegotiation of terms of financial assets that are either past due or impaired
– IAS 39.59 points to instances where the lender grants concessions to the borrower that the lender would otherwise not consider
– IFRS 7.31 requires entities to provide information that enable users of financial statements to evaluate the nature and extent of risks that arise from financial instruments
– IFRS 7.35 states that an entity should provide further information if the quantitative information provided are not representative of the risk exposure of the entity
– IAS 1.112(c) requires to disclose information that is presented elsewhere in the financial statements but is necessary for an understanding
– IAS 1.122 and 125 require an entity to disclose significant accounting judgements and estimates
– IFRS 7.B3 follows the approach that useful information should not be obscured by too much detail.

The enforcer considered that, although not necessarily an indicator of impairment, granting forbearance indicates an increased credit risk amongst the related borrowers, and poses a higher risk to the performance and financial position of the borrower. Forborne loans are likely to result in:

– A higher probability of default
– Higher loan-to-value ratios
– Significant impairment charges
– Uncertain future cash flows.

Accordingly, the enforcer required the entity to include the disclosures set out above about the increased risk in the notes to its financial statements in order to provide users of financial statements with appropriate information about the risks associated with the forborne loans.

2. Fair value of consideration paid in shares (IFRS 3, IFRS 13)

The issuer is a holding company that acquired two companies of which one (Company B) was a listed company in a foreign country. The transaction was accounted for as a reverse acquisition with Company B being the acquirer for accounting purposes. The consideration was paid in shares transferred of the acquiring company and therefore measured at fair value in accordance with IFRS 3 *Business Combinations*.

The issuer assessed the fair value hierarchy and concluded that no active market existed for the shares for the following reasons:

- An index provider classified the stock market as an 'emerging market' due to restrictions of in-kind transfers, off-exchange transactions, and the absence of stock lending and short selling
- Significant decrease in the average daily trading volume
- High price volatility (prices ranging from 270% - 502%)
- 60% decrease in the stock market index with a 70% reduction in stock market capitalisation over the last five years
- No further listings on the market since 2007 while a number of entities asked to be delisted.

In consequence, the issuer valued the shares on the basis of level 3 inputs, in accordance with paragraph 79 of IFRS 13 *Fair Value Measurement*, instead of using the quoted market price.

The enforcer's decision

The enforcer did not agree with the issuer's assessment that there was no active market for shares of entities listed in the foreign country.

Accordingly, the issuer should have used the quoted price to determine the fair value of the consideration paid in shares. The enforcer noted that IFRS 13.67 generally requires an entity to maximise the use of observable inputs and minimise the use of unobservable inputs. If available, an entity is therefore required to use quoted prices in an active market to comply with IFRS 13.69 and 79.

With regard to the classification of the stock market as an 'emerging market' by the index provider, the enforcer noted that the definition used differs from the definition in IFRS 13 which defines an active market as:

> *'a market in which transactions [..] take place with sufficient frequency and volume to provide pricing information on an ongoing basis.'*

The enforcer considered that classification as an 'emerging market' did not imply that this market was inactive. Taking into account information provided by the enforcer in the foreign country, together with guidance in IFRS 13.B37 relating to circumstances when there has been a significant decrease in the volume or level of trading activity for a particular asset or liability, the enforcer concluded that investors in the stock market were regularly and sufficiently informed and that prices based on current information were available. A decrease in the average trading volume was not an indicator of an inactive market as daily transactions were still occurring and represented a volume that was sufficient to determine the price on a continuous basis. Furthermore, the price volatility observed by the issuer was insufficient to conclude that the quoted prices in the market did not represent fair value; short term volatility should have also been assessed.

The enforcer also noted that the guidance in paragraph B38 of IFRS 13 is clear that an additional analysis is necessary in cases of a decreased level of activity if it is to be demonstrated that the quoted price does not represent fair value.

3. Recognition of a liability payable to equity holders (IAS 32)

The issuer granted its shareholders free allocation rights where the shareholders are able to choose between the following options ('scrip issue'):

- Receiving newly issued shares
- Transfer of the free allocation rights back to the issuer for a fixed price
- Selling the free allocation rights on the market at market price.

The paid-up capital increase took place as follows:

- As of December 2012, the number of free allocation rights to be delivered in order to receive one new share and the guaranteed fixed price for the transfer back to the issuer was set
- At the beginning of January 2013, the issuer attributed the free allocation rights to the shareholders and the trading period for them was opened
- During the second half of January 2013 the free allocation rights from the shareholders that required the transfer back were acquired by the issuer
- At the end of January 2013, trading of the newly issued shares began.

The issuer did not record a financial liability in its financial statements as at 31 December 2012 for the commitment to buy free allocation rights at a fixed price. The issuer considered that the recognition criteria for a financial liability were not met because it was not possible reliably to determine the amount to be paid; the number of free allocation rights would not be known until January 2013 and similar schemes in the past had exhibited high volatility. The issuer also argued that the recognition of a financial liability would have reduced the share capital by the maximum amount payable and would have led to confusion because the final amount to be paid would only be known after shareholders asked to transfer their free allocation rights back to the issuer. Consequently, the issuer instead disclosed the transaction as a non adjusting event after the reporting period in accordance with paragraph 8 of IAS 10 *Events after the Reporting Period*.

The enforcer's decision

The free allocation rights were economically equivalent to a written put option because they represented an obligation of the entity to purchase its own equity instruments. Paragraph 23 of IAS 32 *Financial Instruments: Presentation* therefore required that a financial liability should be recognised at the present value of the redemption amount.

The financial liability already existed in December 2012 because the issuer had already set up conditions for the share capital increase, being:

- The number of free allocation rights required to receive a share
- The exercise price of the purchase commitment.

Accordingly, the enforcer considered that a financial liability existed in December 2012 and should have been recognised at the present value of the maximum amount payable to shareholders. The fact that the attribution of the free allocation rights was carried out in January 2013 had no impact on this conclusion.

4. Presentation of statement of cash flows (IAS 7, IAS 16, IAS 18)

The issuer is an automotive retail company which leases vehicles under operating leases and regularly sells vehicles previously held for rental purposes. The lease vehicles were classified as property, plant and equipment (PPE) in accordance with IAS 16 *Property, Plant and Equipment*. Once the vehicles ceased to be held for rental, they were transferred to inventory at their carrying amount.

The transfers to inventory were neither disclosed in the PPE note, nor were the cash flows arising from the initial purchases of vehicles or their subsequent sale presented as separate line items in the statement of cash flows.

Instead the following information were provided in the financial statements:

- PPE note: Vehicles transferred to inventory were included within the line for disposals
- Revenue: Sale proceeds from the subsequent sale
- Cost of sales: Cost of inventory
- Cash flow statement in investing activities:
  - Cash outflows for the initial purchase
  - Cash inflows related to the disposal of the vehicles.

The enforcer's decision

The enforcer did not agree with the issuer's presentation.

Based on the guidance in IAS 16.68A, entities that regularly sell items of PPE that were primarily held for rental purposes are required to transfer these items to inventory at their carrying amount when they cease to be rented and are held for sale. Subsequent proceeds are recognised as revenue in accordance with IAS 18 *Revenue*.

For the statement of cash flows, paragraph 14 of IAS 7 *Statement of Cash Flows* requires that cash outflows to acquire the asset and subsequent cash inflows from the sale of the asset are presented as part of the operating activities section of the cash flow statement.

5. Presentation of discontinued operations (IFRS 5)

The issuer disposed of two major subsidiaries in 2011 that were presented as discontinued operations in its 2011 financial statements. Part of the consideration received was contingent on the future performance of the subsidiaries over a defined period of time (earn-out).

In 2012 the issuer received the additional consideration and presented it as finance income. The amount of additional consideration to be received was recognised as a financial asset in the 2012 financial statements in accordance with paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* as the contingent consideration provided a right to receive cash.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

Instead of being recognised as finance income, the additional consideration was required to be presented within discontinued operations in the 2012 financial statements. Paragraph 35 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation to be classified separately in discontinued operations. In doing so, investors receive appropriate information about the future revenues of the continuing operations of the entity in accordance with IFRS 5.30.

6. Presentation of non-current assets held for sale (IFRS 5)

The issuer owned a subsidiary as of 31 December 2012 which formed a large portion of the entity's total assets (80%). As of 7 December 2012, the entity informed the market about a binding divestment offer that has been made and accepted, which was expected to be completed by the end of 2012. However, the agreement was not finalised until 15 January 2013 and the issuer had control over the subsidiary until 31 January 2013.

In its 31 December 2012 financial statements, the issuer measured the assets and liabilities of the subsidiary at the lower of the carrying amount and the fair value less costs to sell in accordance with paragraph 15 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. However, the assets of the subsidiary were not classified as held for sale. This was because the issuer was aware of uncertainties arising from negotiations with the buyer which could have meant that the sale would not be completed; this information was not disclosed to the market.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that strong indicators for a highly probable transaction in the context of IFRS 5.8 existed at 31 December 2012 and that the subsidiary should have been classified as held for sale at that date for the following reasons:

- The issuer's acceptance of a binding divestment offer at the end of 2012; and
- The communication of the information to the market.

To classify as a non-current asset held for sale IFRS 5.7 does not require the existence of a binding sales agreement but a high likelihood of occurrence of the sale. The existing evidence as of the end of 2012 indicated that the transaction met the criteria for a classification as held for sale. The agreement on 15 January 2013 only confirmed the situation that already existed at the end of 2012.

The enforcer also noted that the measurement criteria of IFRS 5 cannot be applied without applying the presentation requirements. Because the assets met the criteria to be classified as held for sale, they should have been presented as such in the 31 December 2012 financial statements.

7. Deferred tax assets upon disposal of a subsidiary (IAS 12, IFRS 5)

The issuer had the intention to sell one of its subsidiaries. Just before the end of its reporting period (31 December 2013) the issuer received a letter of intent from a potential acquirer to buy the subsidiary for a notional amount of CU1. Based on the letter of intent the issuer considered the sale to be highly probable and considered it to be a single coordinated plan to dispose of a major line of business which fulfilled the definition of a discontinued operation. As a result, the assets and liabilities of the subsidiary were classified as held for sale with a net carrying amount of zero in the consolidated financial statements at the end of the reporting period. Additionally, the issuer recognised a deferred tax asset due to the tax benefit of the tax loss resulting from the sale of the subsidiary. The deferred tax asset was equal to the value of the subsidiary for tax purposes, multiplied by the applicable tax rate. The issuer expected to benefit from future taxable profits against which the existing tax losses can be charged.

The enforcer's decision

The enforcer concluded that the accounting did not conflict with the requirements of paragraph 44 of IAS 12 *Income Taxes* and therefore agreed with the issuer's treatment.

According to the guidance in IAS 12.44 a deferred tax asset need to be recognised for a deductible difference from an investment in a subsidiary if:

- It is likely that the temporary difference will reverse in the foreseeable future; and
- A taxable profit will be available against which the temporary difference can be utilised.

Both conditions were fulfilled as of 31 December 2013 as the sale was highly probable and taxable profits were likely to be available to utilise the temporary difference.

8. *Accounting for the effects of specific tax regime (IAS 12, IAS 16, IAS 40)*

The issuer, a real estate company, was situated in a jurisdiction that provides a specific tax regime for listed real estate companies if they distribute most of its profits to its shareholders. On first-time adoption of the specific tax regime, an 'exit tax' is payable on the unrealised gains related to its investment properties (a tax charge on their fair values less tax carrying amounts).

In January 2011 the issuer merged with another real estate company and accounted for the acquired assets and liabilities using the cost model. The issuer opted for the specific tax regime after the merger, and paid the 'exit tax'.

The issuer considered the exit tax paid as a cost necessary to bring the buildings in the condition necessary for operation and hence capitalised the cost as part of the value of the investment according to paragraph 16(b) of IAS 16 *Property, Plant and Equipment*.

The enforcer's decision

The enforcer disagreed with the decision of the accounting of the issuer.

The enforcer considered that the exit tax was an expense that should have been recognised in the statement of comprehensive income. The guidance in paragraph 21 of IAS 40 *Investment Property* states that the cost for an investment property comprise of the purchase price and any direct attributable expenditures (e.g. professional fees for legal services, property transfer taxes, other transaction costs). IAS 16.6 notes that the cost of an item of property plant and equipment (PPE) comprise any costs directly attributable to bringing the asset in the condition necessary for it to be capable of operating in the manner intended by management. Administrative and general overhead costs are excluded from the cost of an item of PPE by IAS 16.19.

The enforcer concluded that the exit tax was not linked to bringing the asset to the condition necessary for its operations as the asset would have been operational without the exit tax. The exit tax therefore represented an expense in accordance with paragraph 58 of IAS 12 *Income Taxes* and should have been included in profit or loss for the period, unless it had arisen from a transaction recognised outside profit or loss.

9. *Key assumptions used in the impairment test of goodwill (IAS 36)*

The issuer presented goodwill, which represented 15% of its total assets and 50% of its total equity, in its consolidated financial statement. A goodwill impairment test was carried out on a value in use basis at the end of the reporting period. The calculation was based on the management's estimate of future cash flows, discount rate and growth rate.

The disclosures provided by the issuer comprised only generic information about the key assumptions used. It was noted that key parameters used were revenue, gross margin, growth expectations for the forecast period and the terminal value.

The impairment test did not result in the recognition of an impairment loss.

The enforcer's decision

The enforcer considered that the disclosures did not comply with the requirements of IAS 36 *Impairment of Assets*, specifically paragraphs 134(d)(i)-(iii). The disclosures were not entity specific and not sufficient to assess the expected developments in revenue and cash flows.

Instead the issuer should have provided information about the key assumptions to which the recoverable amount was most sensitive for each CGU. The disclosures should also have included a description of the management's approach to determine the value assigned to each of those key assumptions together with the period over which the cash flows had been projected.

10. Disclosures related to capitalised costs (IAS 38, IFRS 6)

The issuer was a company in the extractive industry and had not generated any revenue from its activities over the reporting period. The segment reporting of the issuer consisted of eight operating segments with the activity of each segment based on more than one licence. Expenses for exploration and evaluation expenses were accounted for as intangible assets in accordance with paragraphs 8 and 18 of IFRS 6 *Exploration for and Evaluation of Mineral Resources*. These were initially measured at cost, and subsequently tested for impairment. Disclosures included a description, carrying amount and the remaining amortisation period, which were provided on a segment basis.

The enforcer's decision

The enforcer considered that the disclosures provided by the issuer were insufficient.

The enforcer noted that information should be presented on the basis of every individual licence in accordance with IAS 38 *Intangible Assets*. Consequently, disclosures about the intangible asset by segment, each of which contained multiple licences, did not comply with IAS 38.

For the recognition and measurement of exploration and evaluation assets that fall within the scope of IFRS 6, the general provisions of IAS 38 do not apply. However, for the purposes of the disclosure requirements, IFRS 6.25 requires an entity to treat exploration and evaluation assets as an individual class of assets and make the disclosures required by either IAS 16 *Property, Plant and Equipment* or IAS 38, consistent with the classification of the assets. Accordingly, the issuer should have provided the disclosures on the basis of every individual asset and provided the following information (IAS 39.122(b)):

- Description of the individual intangible asset
- Carrying amount
- Remaining amortisation period.

Because the issuer had not yet generated any revenue, information about the capitalised cost of individual assets was material information that needed to be disclosed.

11. Disclosure of major customers (IFRS 8)

The issuer reported entity-wide disclosures about its products/services and geographical areas in accordance with paragraphs 32 and 33 of IFRS 8 *Operating Segments* based on one segment. The issuer did not include any information about its major customers as required by paragraph 34 of IFRS 8 even though two customers each accounted for more than 10 percent of the entity's revenue. The issuer argued that this information was commercially sensitive.

The enforcer's decision

The enforcer disagreed with the non-disclosure about major customers of the issuer.

The enforcer noted that IFRS 8.34 requires an entity to provide information about the extent of its reliance on major customers if the revenue amount from a single external customers is above 10 per cent. The disclosure requirements apply to all entities preparing IFRS financial statements, including those with a single reporting segment (IFRS 8.31).

Paragraphs BC43 to 45 of IFRS 8 do not include any exemption for disclosures on the basis that they are of commercially sensitive information that could cause competitive damage.

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