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

## INTERNATIONAL FINANCIAL REPORTING BULLETIN 2014/04

**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). 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 the 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 9 April 2014, ESMA published its fifteenth extract from the database. The full report can be found on the ESMA website at the following address:

http://www.esma.europa.eu/news/ESMA-publishes-15th-extract-EECS-enforcement-decisions?t=326&o=home

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, and 2013/21.

### Transactions and related IFRSs covered by the extracts

1. Classification of contingent consideration based on continuing employment (IFRS 3)
2. Allocation of goodwill on sale of an operation (IAS 36)
3. Sale of single licenses presented as discontinued operations (IFRS 5)
4. Identification of a cash generating unit (IAS 36)
5. Determination of the fair value of land (IAS 40)
6. Change of presentation of share in the profit or loss of associates and joint ventures accounted for using the equity method (IAS 1, IAS 8, IFRS 11)
7. Cost of listing (IAS 32)
8. Conditions for hedge accounting (IAS 39)
9. Hedging of presentation currency (IAS 39, IFRIC 16)
10. Minimum funding requirements (IAS 19, IFRIC 14)

## Summary of extracts

### *1. Classification of contingent consideration based on continuing employment (IFRS 3)*

The issuer entered into a business combination where part of the consideration payable was contingent on the future performance of the acquired business, with the amount payable calculated at the end of a specified earn-out period. In order to be eligible to receive this part of the consideration payable, the vendor was required to remain an employee of the group during the earn-out period, otherwise these amounts would be forfeited.

The issuer treated the contingent amounts as 'contingent consideration' in accordance with IFRS 3 *Business Combinations* and initially recognised the amount in the statement of financial position at fair value, with a corresponding amount to goodwill.

The issuer explained that it had considered all eight indicators of paragraph B55 of IFRS 3 relating to contingent payments to selling shareholders (of which 'continuing employment' is specifically mentioned) and concluded that the contingent payments were additional consideration rather than remuneration for post-acquisition employment.

#### *The enforcer's decision*

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

The enforcer noted that IFRS 3.B55(a) states that, where payments in such arrangements are automatically forfeited if employment is terminated (provide that the service period of the arrangement is substantive), these are to be treated as an employee expense for post-combination services (i.e. not contingent consideration as part of the business combination).

The enforcer also referred to a previous IFRS Interpretations Committee (IFRS IC) agenda decision from January 2013, where the IFRS IC was asked to consider a similar scenario. The IFRS IC concluded that the arrangement was compensation for post-combination services rather than additional consideration, and that this was not dependent on the company's assessment of the other seven indicators in paragraph B55 of IFRS 3. This would always be the case unless the service condition is not substantive.

Based on the requirements IFRS 3.B55(a) and the comments from the IFRS IC agenda decision, the enforcer concluded that the continuing employment condition specified in the contract was **conclusive on its own** to determine that the contingent payments were consideration for post-combination services, and not contingent consideration as part of the business combination.

### *2. Allocation of goodwill on sale of an operation (IAS 36)*

In 2007, the issuer (operating in the extractives sector) purchased Company A in a business combination which included a number of exploration licences. The business combination accounting applied to the acquisition of Company A resulted in:

- A significant fair value uplift of the acquired exploration licenses
- Deferred tax assets (which predominately related to the fair value uplift of the acquired exploration licenses)
- Goodwill.

The goodwill recognised was then allocated to three cash generating units (CGUs), based on three geographic locations.

In 2011 the issuer sold seven exploration licenses, four of which had originated from the acquisition of Company A in 2007.

As part of the disposal of licenses in 2011, goodwill was allocated to the groups of CGUs that included the sold licenses. Paragraph 86 of IAS 36 *Impairment of Assets* requires goodwill associated with the operation disposed of to be included in the carrying amount of the operation when determining the gain or loss on disposal. The allocation of the goodwill is specified in IAS 36.86(b), which states that the goodwill associated with the operation disposed of should be measured:

- On the basis of the relative values of the operation disposed (the 'general method'), or
- Some other basis (provided that the entity can demonstrate that this better reflects the goodwill associated with the operation disposed of).

Instead of using the 'general method', the issuer applied its own method involving a hypothetical price and purchase allocation analysis where the difference between the recoverable amount and the net book value of the licenses was calculated.

Subsequently, the portion of goodwill to be included in the determination of the result was calculated on the basis of the relative value of the excess value of the sold licenses over the sum of the corresponding excess value for all the licenses calculated at the time of the sale.

The identified goodwill mainly relate to deferred tax on the fair value adjustment related to licenses. Of the total 2007 fair value adjustments to all licenses in geographic locations 1 and 2, approximately 80% and 50% related to the four licenses sold in 2011.

However, the goodwill associated with the exploration licenses disposed of calculated by the issuers method was approximate 60% lower than the amount calculated using the general model, and therefore resulted in a larger profit on disposal.

#### *The enforcer's decision*

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

The enforcer noted that the issuer should have used the general method prescribed by IAS 36.86.

The enforcer acknowledged that IAS 36 does allow entities to use alternative methods to the general method, some of which are discussed in the *Basis for Conclusions* to IFRS 3 (paragraphs BC153-156). However, in this instance the issuer was unable to demonstrate why the alternative method used was more relevant and appropriate than the general method.

### *3. Sale of single licenses presented as discontinued operations (IFRS 5)*

The issuer (operating in the extractives sector) had various exploration licenses that were classified as either:

- Producing fields
- Fields under development, or
- Fields in the discovery phase.

In 2011 the issuer sold seven of its licenses:

- Three production fields
- Three fields under development, and
- One discovery license.

The sale of the exploration licenses was not viewed as a strategic decision to end a specific line of business.

Six of the exploration licenses were considered to be separate CGUs.

In accounting for the disposal of the seven exploration licenses, the issuer made the following distinctions:

**(i) Producing fields and Fields under development:**

- Defined as a major line of business
- Presented as a discontinued operation.

**(ii) Fields in the discovery phase:**

- Defined as a major line of business subject to passing a fixed threshold based on the size of the sales consideration received for the disposal.

The issuer believed that presenting the sale of the exploration licenses as discontinued operations provided more relevant and better information to users of financial statements, and therefore as a result presented the net income attributed to the seven exploration licences as a single line in the entity's statement of comprehensive income in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

### *The enforcer's decision*

The enforcer did not agree with the issuer's treatment and the presentation of the sale of the exploration licenses as discontinued operation.

The enforcer noted that IFRS 5 *Appendix A* defines 'discontinued operation' as a 'component of an entity', that has been disposed of or is held for sale, that either:

a) Represents a separate major line of business or geographical area of operations
b) Is part of a single coordinated plan to dispose of a)
c) Is a subsidiary acquired exclusively for the purpose to re-sell.

Further, IFRS 5 *Appendix A* defines a 'component of an entity' as:

> *'Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.'*

The enforcer therefore concluded that the term 'component of an entity' represents a level which is:

a) Normally higher than the individual cash generating unit, but
b) Lower than a segment.

In determining its rationale for its decision, the enforcer specifically noted that:

- The assessment of the issuer was not sufficient to conclude whether or not each sale constituted a component of an entity representing a separate major line of business
- The issuers assessment of exploration licenses classified under *Fields in the discovery phase* based solely on a numerical determination was (on its own) inadequate to assess the magnitude and relative importance of the business
- The sale of the seven licenses was not due to a coordinated strategic decision to end a specific line of business, and instead appeared to be part of the issuers normal course of business
- Only in exceptional cases would the sale of one of the many individual licenses in the issuers portfolio be considered a 'component of an entity'.

Accordingly, none of the criteria of IFRS 5.32 were fulfilled. Therefore the seven exploration licences sold did not represent discontinued operations of the issuer and should not have been presented as such.

### 4. *Identification of a cash generating unit (IAS 36)*

The issuer's business included a significant network of branches of merchants and retailers, containing various brands.

Cash generating units (CGUs) for the purposes of impairment testing were determined to be at the 'brand-level', rather than for each individual branch.

The issuer believed that determining the CGUs at the brand-level (rather than at the individual branch level) was appropriate as each individual branch did not operate on a standalone basis in respect of certain cash flows, including:

- Volume rebates, and
- Costs.

Rather, these cash flows were dependent on the whole branded business.

Volume rebates represented approximately 7% of gross revenue.

In order to make decisions regarding the operations of its individual stores, the issuer received and used daily sales information and monthly income statements.

#### *The enforcer's decision*

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

The enforcer noted, that according to paragraph 6 of IAS 36 *Impairment of Assets*, a CGU is defined as the smallest identifiable group of assets generating cash inflows that are largely independent from the cash inflows from other assets or groups of assets.

IAS 36.69 notes that one factor to be considered in determining an entity's CGUs is how the entity monitors its operations.

Based on the nature of the entity's business and the way in which it monitored its operations, the enforcer noted that it appeared that each individual branch generated cash inflows that were largely independent from other branches, and therefore each branch should have been considered as a separate CGU.

The enforcer also noted that rebate income was insignificant compared to gross revenues.

### 5. *Determination of the fair value of land (IAS 40)*

The issuer operated in the commercial and agricultural industry and owned a large plot of land.

The land was used in the issuer's normal course of business and was classified as property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment*.

Over time the issuer has acquired additional land on a continuing basis.

In July 2011:

- Agricultural production on the land had stopped. A major factor involved difficulties in transporting the harvest to the markets.
- The land was transferred from owner-occupied to investment property in accordance with IAS 40 *Investment Property* (as the issuer intended to either sell or lease the land), and accounted for under the fair value model.
- However due to an unclear legal structure related to the ownership of the land, the issuer claimed that it was unable reliably to determine the fair value of the land. The issuer instead treated the land as 'property under construction' measured at cost (IAS 40.53).
- Legal costs and costs incurred in connection with clearing the land and making it more attractive to potential buyers/lessees were expensed as incurred.

In December 2011:

- The legal status of the land had been clarified by the issuer, meaning that its fair value could be reliably measured.
- A fair value gain was subsequently recognised in the income statement in accordance with IAS 40.65.

#### *The enforcer's decision*

The enforcer did not agree with the treatment of the issuer.

**(i) Classification of the land:**

- Land with unclear legal status cannot be treated as investment property under construction
- The work performed on the land did not lead to physical changes as it mainly related to legal assistance that did not constitute construction costs
- Accordingly, the land could not be treated as investment property under construction as IAS 40.53 requires that some physical changes that must be made to the asset.

**(ii) Determination of fair value**

- IAS 40.48 states that it is only in exceptional cases that the fair value cannot be measured reliably
- The enforcer assumed that the issuer had a good understanding of how to determine the fair value of land due to its experience in various acquisitions of land.

**(iii) Recording the difference between book value and fair value**

- IAS 40.61 requires that if an owner-occupied property becomes an investment property carried at fair value, any differences between the book value and the fair value must be treated in the same way as a revaluation in accordance with IAS 16. Consequently, the difference should not have been recorded in profit or loss, instead being recognised in the other comprehensive income.

### *6. Change of presentation of share in the profit or loss of associates and joint ventures accounted for using the equity method (IAS 1, IAS 8, IFRS 11)*

Prior to the adoption of IFRS 11 *Joint Arrangements* the issuer presented 'share in the profit or loss of associates and joint ventures accounted for using the equity method' as part of its operating results in its income statement (i.e. within operating profit). The issuer disclosed that after the initial application of IFRS 11, it intended to present two separate line items in its income statement for results from associates and joint ventures that it determined to be:

- Operating, and
- Non-operating.

The issuer disclosed that equity accounted investments would be classified as 'operating' if they:

- Conducted activities related to the operating activities of the group
- The items of the equity accounted investee's profit or loss were operating in nature (i.e. if profit or loss was made up mainly from items such as interest income and expense, this would indicate the items of the equity accounted investee's profit or loss were not operating in nature)
- Where relevant, the entity has started production.

Based on its own above criteria, the issuer disclosed that it intended to change the presentation of the share in the profit or loss of one of its joint venture in its start-up phase, as:

- The assets of the joint venture consisted mainly of a factory under construction
- The functional currency was different from the functional currency of the issuer
- The joint venture's items of profit or loss were not operating in nature (rather they were predominately financing in nature), and were different in nature to the issuer's start-up subsidiaries in other regions and functional currencies.

The issuer believed that IFRS does not provide sufficient guidance about the presentation of this type of result, and noted that paragraph 82(c) of IAS 1 *Presentation of Financial Statements* requires at least a separate line item for the share of the profit or loss of associates and joint ventures accounted for using the equity method, but it does not:

- Indicate where this line should be presented, nor
- Prohibit the use of two line items.

#### *The enforcer's decision*

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

The enforcer noted that the separate presentation of the share in the profit or loss of a joint venture in a start-up phase within the issuers non-operating result would not provide more relevant information. It would be inappropriate to exclude items from an entity's operating result simply because:

- They occur irregularly
- They are unusual in amount, or
- They do not involve cash flows (e.g. depreciation and amortisation).

Additionally, the activities of the 'start-up' joint venture were similar in nature to some core activities of the issuer that it considered to be part of the normal business of the group in new regions.

The enforcer also noted that once an issuer has decided to present its share in the profit or loss of associates and joint ventures as part of its operating result it should present 'start-up' associates and joint ventures no differently from the way in which it presents its 'mature' operations. Accordingly, whether or not an entity is in the start-up phase, on its own, is not a valid reason to consider that its results are not of an operating nature.

## *7. Cost of listing (IAS 32)*

The issuer was listed for the first time on the stock exchange in 2010. As part of the listing, the issuer issued new shares in addition to its existing shares.

Certain costs associated with the listing were recognised in both:

- The income statement (i.e. those costs, or portion of costs, that related to the existing shares)
- The statement of changes in equity (i.e. those costs, or portion of costs, that related to the new shares issued).

The different costs associated with the listing were treated as follows:

- The lawyer's fees were allocated between the listing and the capital increase according to their nature
- The investment bank success fee was directly attributable to the capital increase and recognised directly in equity
- The costs of preparation of the prospectus in accordance with foreign rules for the subscription of new shares was attributed to sales promotion and expensed accordingly (these costs would not have been incurred if the company did not want to attract foreign investors).

### *The enforcer's decision*

The enforcer concluded that the above allocation did not conflict with the requirements of IAS 32 *Financial Instruments: Presentation*, and therefore agreed with the issuers treatment.

IAS 32.35 requires that transaction costs of an equity transaction are accounted for as a deduction from equity, net of any related income tax benefit.

IAS 32.37 states that the costs incurred by an entity for the issuance of equity might include:

- Registration and other regulatory fees
- Amounts paid to legal, accounting and other professional advisers
- Printing costs, and
- Stamp duties.

The costs are accounted for as a deduction from equity to the extent they are incremental costs that are directly attributable to the equity transaction (i.e. costs that otherwise would have been avoided had the transaction not occurred).

If transaction costs relate jointly to more than one transaction (i.e. one transaction issuing existing shares and one transaction issuing new shares), IAS 32.38 requires these costs to be allocated using a basis of allocation that is rational and consistent with similar transactions.

## *8. Conditions for hedge accounting (IAS 39)*

The issuer entered into forward exchange contracts to hedge forecast transactions, and elected to account for them as cash flow hedges in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

The hedge relationship was set up as follows:

- The issuer designated the first part of expected cash receipts each month as the cash flows being hedged
- Forward exchange contracts existed for a maximum of 80% of the expected cash receipts
- The hedging documentation did not include a clear reference to the relationship between the forward exchange contracts and the forecast transactions
- The documentation did not state whether it was a forward price or a spot price that was hedged
- Effectiveness testing was performed by the comparison of the actual receipts with the cash flows from the settlement of the forward contracts
- The effectiveness test showed, that the actual receipts exceeded the forward contract amounts in most months with some exceptions
- The issuer explained, in months in which actual receipts were less than the forward contract amounts, cash had been received in the prior month
- With reference to paragraph F.5.6 of the *Implementation Guidance* of IAS 39, the issuer believed that the forward price could be designated for hedging purposes in a cash flow hedge
- Accordingly, the issuer did not recognise any gain or loss in the income statement
- The issuer argued, that the hedge relationship was fully effective, because cash receipts in each period exceeded the amounts paid to settle the forward exchange contracts.

### *The enforcer's decision*

The enforcer did not agree with the treatment of the issuer, as not all of the following conditions of IAS 39.88 for hedge accounting were met:

- At inception of the hedge a formal designation and documentation is required that includes the identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess effectiveness
- The hedge is expected to be highly effective
- The forecast transaction that is hedged is highly probable
- Effectiveness can be reliably measured
- The hedge is assessed on an on-going basis and determined to have been highly effective.

The enforcer noted that:

- There was no clear reference between the forward exchange contract and the forecast transaction from inception and throughout the whole hedging period
- The relationship between the forward exchange contract and the payments was documented only retrospectively
- Paragraph F.5.6 of the *Implementation Guidance* of IAS 39 allows the forward price to be designated, when the hedged item does not fall due before the hedging instrument. This guidance was not applicable as the cash could have been received before the hedging instrument fell due.

### *9. Hedging of presentation currency (IAS 39, IFRIC 16)*

During the period, Subsidiary A borrowed from an external party in its functional currency (X), and lent these funds to Subsidiary B which had a different functional currency (Y).

The presentation currency of the issuer's consolidated financial statements was also currency (Y).

Subsidiary A entered into a (X)/(Y) cross-currency interest rate swap to hedge its foreign currency exposure.

**(i) Treatment in the separate financial statements of Subsidiary A**

- The cross-currency interest rate swap was designated as a hedging instrument and accounted for as a cash flow hedge.

**(ii) Treatment in the consolidated financial statements of the issuer**

- The cross-currency interest rate swap was designated as a hedging instrument in a cash flow hedge of the group's foreign currency exposure on its external borrowings denominated in currency (X) (hedged item).
- The intragroup borrowings between the Subsidiary A and Subsidiary B were not identified as the hedged items in the hedging documentation.

#### *The enforcer's decision*

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

IAS 39 *Financial Instruments: Recognition and Measurement* paragraph 80 only allows an entity to designate the following as hedged items, if the transactions involve a party which is external to the entity:

- Asset/liabilities
- Firm commitments
- Highly probable forecast transactions.

Consequently, hedge accounting can be applied to entities in the same group only in their own separate financial statements, and **not** in the consolidated financial statements of the group, unless specific conditions are met.

The hedging documentation showed that the issuer designated the external borrowings denominated in currency (X) as the hedged item in a cash flow hedge in the consolidated financial statements.

Paragraph BC14 of IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* notes that, only functional currencies (i.e. not presentation currencies) can create an exposure to changes in cash flows or fair values.

In this case, the presentation of the issuer's group accounts in currency (Y) did not create a currency (X)/(Y) exposure to which hedge accounting could be applied.

### *10. Minimum funding requirements (IAS 19, IFRIC 14)*

The issuer's pension scheme was in deficit as at 31 March 2012 in respect of statutory minimum funding requirements.

In order to eliminate the deficit, the issuer and the pension scheme trustee set up a schedule of contributions.

On 31 August 2012 the amount payable under the schedule of contributions was subject to indexation over a six and a half year period. At the same date, the provision for the pension scheme in accordance with IAS 19 *Employee Benefits* was in surplus. The difference between the IFRS and the statutory minimum funding requirements was due to different assumptions and calculation methodologies.

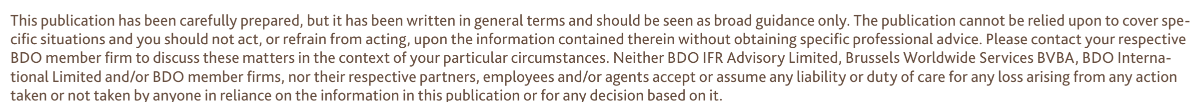
The issuer did not recognise a liability for its statutory obligation to fund the pension scheme and the schedule of contributions.

#### *The enforcer's decision*

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

The enforcer noted that:

- Paragraphs 23 and 24 of IFRIC 14 *IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* require an additional liability to be recognised for a minimum funding requirement if the entity does not have an unconditional right to a refund or the ability to reduce future contributions.
- In this case, the requirement to cover an existing shortfall on the minimum funding basis was defined in the national law.
- The issuer therefore did not have an unconditional right to a refund or the ability to reduce its future contributions.
- Accordingly, the issuers should have recorded a liability for the minimum funding requirement.



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