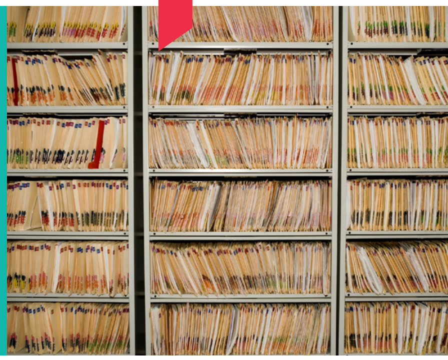
ESMA'S THIRTEENTH EXTRACT FROM ITS DATABASE OF ENFORCEMENT DECISIONS TAKEN BY EU NATIONAL ENFORCERS OF FINANCIAL INFORMATION (IFRS)

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/11



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 04 April 2013, ESMA published its thirteenth 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/2013-444.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, and 2012/14.

Transactions and related IFRSs covered by the extracts

1. Recognition of financial expense on financial liabilities measured at amortised cost (IAS 39)
2. Intangible assets with indefinite useful life (IAS 38)
3. Presentation of revenue and expenses related to service concession arrangements (IFRIC 12)
4. Value in use calculation (IAS 36)
5. Discount rate in value in use calculation (IAS 36)
6. Assessment of materiality of an error (IAS 8) (IAS 40)
7. Related party disclosures in interim financial statements (IAS 24) (IAS 34)
8. Definition of a business (IFRS 3)
9. Disclosures related to fair value of financial instruments (IFRS 7) (IAS 39)
10. Residual value of property (IAS 16).

Summary of extracts

1. Recognition of financial expense on financial liabilities measured at amortised cost (IAS 39)

The issuer, subsequent to refinancing a significant portion of its debt, breached several lending covenants and agreed to file for receivership in July 2008. In the issuer's jurisdiction, the law provides that when in receivership, the management of the issuer can continue to manage the normal tasks of the business with the authorisation of the administrator named by the Court.

Almost three years later, in March 2011, a judge approved an 'Agreement of Creditors' (AoC). The AoC allowed the issuer to leave the receivership by giving the creditors two alternatives, both of which would result in new loan conditions (i.e. term, maturity, payment schedule, interest rate etc.) that were substantially different from the old loan conditions.

Between July 2008 and March 2011 (including the issuers 2010 IFRS financial statements that were reviewed by the enforcer) the issuer did not recognise any financial (interest) expense in its financial statements for the financial liabilities, arguing that:

- Bankruptcy law had suspended the accrual of interest during the period of receivership
- Because the AoC had not been approved by the court there was uncertainty about the amount of expense to be recognised.

However, neither the law governing receivership nor the AoC provided any relief in the form of suspension of interest payable by the issuer.

Subsequently, after the AoC had been approved, the issuer assessed and concluded that the conditions of the new debt differed substantially from those of the old debt, and recognised the difference between the book value of the old debt and fair value of the new debt in the statement of comprehensive income – which was a gain. This treatment effectively resulted in unrecognised financial expense (for the period between July 2008 and March 2011) being subsumed within the derecognition gain that was ultimately recognised after the approval of the AoC.

The enforcers decision

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

The enforcer noted that the bankruptcy law, as well as uncertainty regarding the issuer's ability to fulfil its obligations due to receivership (so long as it remained a going concern), did not affect the accounting treatment and application of the measurement basis of the issuers debts after initial recognition (i.e. measurement at amortised cost using the original effective interest).

In addition, the enforcer considered that the legislation that resulted in the suspension of interest accrual constituted a legal protection to allow the debtor to renegotiate the terms of its debt. It was possible, in any AoC, that there would be no waiver and the enforcer noted that in this case, the AoC stipulated that the issuer make retrospective payment of interest as though the issuer had never applied for receivership.

Accordingly, the enforcer concluded that the issuer had not complied with the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* paragraphs 9 and AG 8, relating to application of the effective interest rate method.

The issuer was therefore asked to recognise and error accordance with paragraph 42 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This resulted in a retrospective adjustment (totalling €354m) that was then required to be spread between July 2008 and March 2011 (being the period during the issuer had suspended the recognition of interest).

2. Intangible assets with indefinite useful life (IAS 38)

The issuer had recognised in its statement of financial position an intangible asset described as an 'externally acquired customer relationship'. This asset represented 7% of the issuers total assets. The issuers customers were made up of individuals (rather than corporate entities).

During the period of review, the issuer changed its assessment of the useful life of this intangible asset from 'finite' to 'indefinite'.

The issuer argued that that due to a number of factors (e.g., technological evolution, changing consumer behaviour), it had become impossible to foresee the useful life of the relationship with a consumer, and as a result, the asset was considered to have an indefinite useful life in accordance with IAS 38 *Intangible Assets* paragraph 88:

> *'…An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is* ***no foreseeable limit*** *to the period over which the asset is expected to generate net cash inflows for the entity.'*

The enforcers decision

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

Per IAS 38.88, an intangible asset has an indefinite useful life only if there is no 'foreseeable' limit (i.e. expected limit) to its useful life. Because the issuers 'customers' where individuals, a foreseeable limit did exist, namely the death of the customer (as opposed to a customer relationship with a *corporate entity*, where it can be argued that no 'foreseeable' limit does in fact exist).

In addition the enforcer noted:

- Difficulties in accurately determining an intangible asset's useful life do not provide a basis for determining useful life as being indefinite (IAS 38.BC65(a))
- Where intangible assets are based on 'legal rights', if the cash flows are expected to continue for a finite period (as they were in this case), the useful life of the intangible asset is limited to that period. In contrast, where the cash flows are expected to continue indefinitely, the useful life of the intangible asset is considered to be indefinite (IAS 38.BC62).

3. Presentation of revenue and expenses related to service concession arrangements (IFRIC 12)

The issuer was the parent company of a group engaged in infrastructure management (under a service concession arrangement in the scope of IFRIC 12 *Service Concession Agreements*), operating and engaging in various industries and business activities, including construction projects.

Under IFRIC 12.14, an operator is required to account for revenue and costs relating to construction or upgrade services in accordance with IAS 11 *Construction Contracts*.

In relation to its construction projects, the issuer engaged building contractors (external third parties) to undertake the physical construction on its behalf, but strictly under the issuers instructions.

Depending on the nature of the contractual rights received, the issuer applied different accounting policies for the recognition of consideration for providing construction or upgrade services, being either as:

– Additions to the intangible assets
– Receivables (financial assets).

In no instances did the issuer recognise an expense in the statement of comprehensive income in relation to the construction services rendered.

The issuer argued that as it did not construct the infrastructure itself (i.e. construction was contracted out to third parties):

– The requirements of IAS 11 were not applicable, and therefore the acquisition of the asset should be recorded in the same way as any other asset acquisition, without any effect on the statement of comprehensive income
– The risks and benefits associated with the construction were not assumed by the issuer, and therefore revenue and expenses related to the construction was not recognised.

The issuer referred to the local GAAP applicable to concession arrangements to support its accounting policy.

The enforcers decision

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

The issuer's treatment would only be acceptable if the issuer were acting as an agent (rather than principal) in accordance with IAS 18 *Revenue*. However, despite outsourcing the physical construction to third parties, the issuer was still exposed to significant risks and benefits of the construction and ultimately was solely responsible for the fulfilment of all requirements of the concession service agreement. Therefore the issuer was clearly not acting in the capacity as an agent.

The enforcer noted that under IFRIC 12.14, an operator must account for revenue and costs relating to construction or upgrade services in accordance with IAS 11, and therefore revenue should not be offset against construction costs (irrespective of whether the issuer constructs the asset on its own account, or uses external third parties).

4. Value in use calculation (IAS 36)

The issuer had a significant amount of goodwill (which exceeded 100% of its equity) which had been allocated across six identified cash generating units (CGUs) for the purposes of impairment testing in accordance with IAS 36 *Impairment of Assets*.

The recoverable amount of each CGU was determined based on its value in use by applying the discounted cash flow (DCF) method.

The DCF's prepared for each CGU included the complete allocation of the issuers balances relating to goodwill, intangible assets, tangible assets, and cash inflows.

In determining the cash outflows to be included in the DCF for each CGU, the issuer excluded a number of corporate cash outflows, on the basis that these cash flows benefited the company as a whole (i.e. corporate level optimisation) rather than the individual CGUs – the issuer argued that if a CGU were to be sold, these costs would not be taken into account [by the purchaser] when determining the sale price and would instead remain with the issuer.

These corporate cash outflows included those attributable to the Costs of Sales Director, Human Resources Director, Chief Financial Officer and Chief Information Officer.

However, inconsistently with its IAS 36 impairment test allocations, these corporate cash outflows were allocated to the six CGU's for the purposes of the issuer's internal management reports.

The enforcers decision

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

The enforcer concluded that the entity's corporate cash out flows met the requirements of IAS 36.39(b) and were therefore required to be allocated to their respective CGUs for the purposes of determining recoverable amount. This was on the basis that the corporate cash outflows:

– Were necessarily incurred to generate the cash inflows from continuing use of the assets
– Could be directly attributed, or allocated to the assets on a reasonable and consistent basis (as had been evidenced in the preparation of the entity's internal management reports).

In addition, the enforcer noted that because the total amounts of goodwill, other intangible and tangible assets, and cash inflows had been fully allocated across the six CGUs, it was not appropriate to exclude the corporate cash outflows from the allocation.

Further, as the nature of these corporate cash outflows did not directly 'improve or enhance' performance of cash inflows, IAS 36.45(b) was not applicable (which requires such cash outflows to be excluded from the DCF).

5. Discount rate in value in use calculation (IAS 36)

The issuer had a significant amount of goodwill of which 99% had been allocated to a single cash generating unit (CGU) for the purposes of impairment testing in accordance with IAS 36 *Impairment of Assets*. The issuer was in the process of listing on a regulated market, and the prospectus reviewed by the enforcer included IFRS financial statements for the years 2007 – 2009. The goodwill arose from a business combination in 2007.

The recoverable amount of the CGU was determined based on its value in use by applying the discounted cash flow (DCF) method.

Key points regarding the DCF calculation were:

a) The cash flows used as the basis of the projections were not based on the financial budgets approved by the Board of Directors (which were for a six year period) and instead were based after including the effects of expected future market development. This resulted in the actual operating profit before depreciation included in notes to the financial statements being significantly different to the operating profit before depreciation disclosed and used for the purposes of impairment testing

b) The average cost of debt used in the determination of the weighted average cost of capital (WACC) did not include consideration of current market assessments of the time value of money. In particular, the issuer did not take into account new loans entered into in 2009, nor did it consider a long-term subordinated loan

c) The recoverable amount determined by the DCF is required to be calculated using a pre-tax discounted rate. However, although the issuer used a pre tax rate for its calculations, it disclosed a post-tax discount rate in its financial statements

d) For the purposes of the issuer's sensitivity analysis, the issuer applied a range of ± 0.5% to the discount rate. However the actual movement in the discount rate between 2008 and 2009 was higher than this range.

The enforcer's decision

The enforcer concluded that the issuer did not comply with a number of significant requirements of IAS 36 (detailed below). Ultimately the enforcer required the issuer to:

– Review various aspects of its impairment calculations
– Record the resulting goodwill impairment
– Provide additional/amended disclosures.

Cash flows

IAS 36.33 requires that where an entity utilises a DCF for the purposes of determining recoverable amount of a CGU under value in use, the cash flow projections must:

– Be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset on the basis of the most recent financial budgets approved by management
– Exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.

A noted at point (a) above, the issuer complied with neither of the above requirements.

Discount rate

IAS 36.55 requires the discount rate used to reflect the current market assessments of:

– The time value of money
– The risks specific to the asset for which the future cash flow estimates have not been adjusted.

Due to the determination of the discount rate excluding consideration of new loans taken out in 2009 and of the issuers long-term subordinated loan (point (b) above), the issuer had not complied with the requirements of IAS 36.55.

Disclosure - Discount rate

IAS 36.134(d)(v) requires the disclosure of the discount rate(s) applied to the cash flow projections.

As noted at point (c) above, the issuer (correctly) applied a pre-tax discount rate, however (incorrectly) disclosed a post-tax rate. Therefore the issuer was not in compliance with the disclosure requirements of IAS 36.134(d)(v).

Disclosure – Reasonably possible change (in discount rate)

IAS 36.134(f) requires the disclosure of the effect of a reasonably possible change in a key assumption on which management has based its determination of the CGUs recoverable amount, if that reasonably possible change would cause the CGUs carrying amount to exceed its recoverable amount.

As noted at point (d) above, the reasonably possible change disclosed by the issuer in relation to the discount rate was ± 0.5%, despite the fact the actual movement in the discount rate between 2008 and 2009 was higher. Consequently, the reasonably possible change disclosed by the issuer was understated.

6. Assessment of materiality of an error (IAS 8) (IAS 40)

The issuer owned several properties classified as investment properties, which were measured in accordance with the cost model in IAS 40 *Investment Properties*.

During the period (contrary to its stated accounting policy) the issuer recognised in its financial statements the revaluation gain from one of its investment properties.

In the same financial statements:

– There was no indication of any voluntary change in the accounting policy relating to investment property (i.e. from the cost model to the fair value model), and in addition
– No revaluation gains/losses were recognised for any of the other investment properties.

The result of the recognition of the single investment property's revaluation gain was a €0.6m decrease in post-tax loss from €2.2m to €1.6m (approximately equal to a 27% decrease).

The issuer argued that:

– The investment property had been planned to be sold during the period (for a gain) but the sale had been postponed as at period end. When the investment property was eventually sold in the subsequent period the sale price was €0.8m higher than book value
– The revaluation gain was immaterial (as, amongst other things, it had no material impact on equity).

The auditor had noted in the audit review memorandum that the revaluation was not in compliance with the accounting policy of the issuer, but has also concluded that the error was not material.

The enforcers decision

The enforcer did not agree with the issuers treatment, as well as its assessment that the error was not material to the financial statements.

IAS 40.30 requires that after initial recognition and entity must choose to value ***all*** of its investment properties under either the:

– Fair value model, or
– Cost model.

[Note: Should an entity decide to subsequently change the measurement basis for one of its investment properties it would need to do so for all other investment properties it holds. This would need to be accounted for as a change in accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.]

Therefore the fact that the issuer had applied the fair value model to only one of its investment properties (while continuing to measure the remainder under the cost model) did not comply with the requirements of IAS 40.30.

In addition, the enforcer disagreed with the issuer's assessment that the effect of the revaluation (and therefore size of the error) was not material, as their appeared to be a noticeable impact to the issuer's post-tax earnings (approximately a 27% increase).

The issuer was therefore required to recognise an error in its subsequent financial statements, in accordance with IAS 8.42 in relation to the revaluation gain recognised, and to provide the additional disclosures required by IAS 8.49.

7. Related party disclosures in interim financial statements (IAS 24) (IAS 34)

During the issuer's first interim period after its annual reporting date, the following transactions occurred:

– The issuer's board of directors made a decision to invest excess cash in shares in company B. This resulted in a significant increase in the level of reported 'other financial assets' in the statement of financial position (which then represented 17% of equity).
– Concurrently, the issuer's board of directors made a decision that the issuer would enter into an option contract with its major shareholder (who held a 64% share) allowing the issuer to sell the shares of company B for the same price as it had bought them during the contract term. This provided protection against the risk of the share price subsequently decreasing. The major shareholder was also the chairman of the board of directors.

Ultimately, the issuer exercised its put option and the sale took place after the interim reporting date at a price considerably higher than the market price of company B's shares at the date of the sale. As the shares were sold under the put option at the same price as they were bought, the transaction had no impact on the net profit of the issuer.

In respect of all of the above, the issuer did not include any related party disclosures in its interim financial statements.

The enforcer's decision

The enforcer did not agree with the issuer's lack of disclosure in its interim financial statements in respect of the above transactions [on the basis that, respectively, they were material, and were with a related party].

IAS 34 *Interim Financial Statements* paragraph 15B (h, j and l) requires the disclosure of changes in the business or economic circumstances that affect the fair value of an entity`s financial assets and financial liabilities, related party transactions and changes in classification of financial assets as a result of a change in the purpose or use of those assets.

Further, IAS 24 *Related Party Disclosures* paragraphs 18 and 19 require disclosure of the nature of related party relationships as well as information about transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on financial statements.

Accordingly, the enforcer concluded that the issuer's interim financial statements were not in compliance with the requirements of IAS 34 and IAS 24.

8. Definition of a business (IFRS 3)

The issuer purchased 100% of the shares in company B from company A.

Company B held 100% of the shares in several holding companies (companies C), that in turn held various ownership percentages in several single purpose companies (companies D) that each owned and operated one or two shipping vessels.

In terms of the pre-acquisition operations of the shipping vessels, these were outsourced to a management company (that was a sister company of company B – but not a party to the transaction although three employees of the management company were offered and accepted employment with the issuer as part of the transaction).

The management company had previously engaged shipbrokers to assist the company with:

- The marketing of the vessels
- Entering into new charter agreements
- Serving customers
- Purchases and sales of the vessels.

The management company had historically handled the technical management of the vessels, until a few months prior to the issuer's acquisition of company B when this was outsourced to an independent third party company.

The issuer believed that because all activities regarding commercial and technical management had been previously outsourced (to either the management company or to an independent third party company), company B held only a 'passive' investment in companies C and D, and therefore the issuer was not acquiring a 'business' as defined by IFRS 3 *Business Combinations*.

Accordingly the issuer accounted for the transaction an asset acquisition (rather than a business combination under IFRS 3), and capitalised directly attributable transaction costs into the purchase price.

The enforcer's decision

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

IFRS 3 applies to all transactions (or events) that involve the acquisition of a business as defined.

IFRS 3 appendix A and paragraph B7 define a 'business' as being:

> *'An integrated set of activities and assets that is* ***capable*** *of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.'*

> *'A business consists of inputs and processes applied to those inputs that* ***have the ability*** *to create outputs…'*

The enforcer noted the following in respect to the *inputs*, *processes*, and *outputs* of the transaction:

- ***Inputs***: Shares in four vessel owning companies, charter agreements, agreement about outsourcing, relationship with a shipping broker and customer relations
- ***Processes***: Activities regarding chartering and operations of the vessels, financing liquidity management and interest rate risk management as well as purchase and sales of vessels
- ***Outputs***: Company B generated profit from charter agreements, and also had the ability to get economic benefits from the vessels and the established processes for entering into new contracts.

In addition, whether or not the seller (i.e. company A) operated the set of assets and activities as a business was irrelevant in the application of IFRS 3 from the perspective of company B. The fact that company A had previously chosen to outsource some activities did not restrict another market participant from subsequently acquiring and managing the integrated set of assets and activities as a business.

As a result, the enforcer concluded that the substance of the acquisition included all the above elements that constitute a business (as defined by IFRS 3).

Accordingly, the enforcer required the issuer to account for the transaction in accordance with IFRS 3, requiring:

- Transaction costs to be expensed
- Assets (i.e. vessels) to be recognised at fair value
- Recognition of deferred tax in accordance with IAS 12 *Income Taxes*
- Recognition of goodwill for the difference between the fair value of the net assets acquired and the fair value of consideration paid.

9. Disclosures related to fair value of financial instruments (IFRS 7) (IAS 39)

The issuer was a holding company that carried out banking activities through a subsidiary, which included a trading derivatives portfolio, with level 3 fair values being applied for:

- 80% of the trading assets
- 60% of the trading liabilities.

The issuer claimed that as the market for the derivatives (mainly derivatives on the stock indexes, with various maturities) was inactive, a level 3 valuation was needed (i.e. there were no observable market inputs upon which to derive fair value).

According to the issuer's accounting policy, a market was only considered active if:

- More than 50% of its positions were traded every day
- At least three such days occurred during a week, and
- At least three such weeks had occurred during the last three months.

In respect of initial recognition, the issuer's accounting policy was to recognise a 'day one gain/loss' equal to the difference between the transaction price at and the value of the instrument according to its internal model. In the comparative period the issuer stated these gains/losses were immaterial, but in the current year this statement was removed without explanation.

In addition, many of the disclosure requirements of IFRS 7 *Financial Instruments: Disclosure* in respect of financial instruments classified as level 3 had not been made.

Subsequent to the reporting period reviewed by ESMA, the prudential regulator withdrew the banking licence of the subsidiary for breaches of banking regulations (including amongst other things, the valuation of the derivatives).

The prudential regulator's investigations showed that:

- There was available market information on the instruments for all trading days during the period
- There were market transactions for part of the instruments held at times close to the issuers reporting dates.

The enforcer's decision

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

IAS 39 *Financial Instruments: Recognition and Measurement* requires and states the following:

- The best evidence of fair value is quoted prices in an active market (IFRS 7.48A)
- Valuation techniques must incorporate all factors that market participants would consider in setting a price and to be consistent with accepted economic methodologies for pricing financial instruments (IAS 39.AG76)
- The valuation technique must be calibrated and tested for validity using prices from any observable current market transactions in the same instrument or based on any available observable market data (IAS 39.48A)
- The best evidence fair value at initial recognition is the transaction price, unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets (IAS 39. AG64)
- Where no gain or loss is recognised on initial recognition of a financial instrument, a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price (IAS 39.AG76A).

Accordingly, the enforcer concluded that the issuer had not complied with a number of IFRS requirements resulting in:

- Incorrect use of level 3 of the fair value hierarchy (as market information was available as described above)
- Lack of disclosures in relation to level 3 financial instruments
- Incorrect initial recognition of a day one gain/loss.

Ultimately, the issuer's classification of the financial instruments in level 3 of the valuation hierarchy, and the use over the issuer's own internal valuation model based on unobservable inputs, resulted in the carrying amount of the trading portfolio being materially overstated in comparison with a valuation based on market observable inputs.

The issuer had also argued that it could not apply an IAS 39 compliant accounting policy regarding the recognition of a day one gain/loss as its systems were not capable of calculating the amounts. This argument was not accepted by the enforcer.

10. Residual value of property (IAS 16)

The issuer owned and operated specialised items of property (i.e. supply and subsea vessels), which constituted a material proportion of the issuer's total assets.

The items had an estimated economic life of 30yrs, but the issuer set the useful life at 20yrs as it was its policy to sell the items at that point.

The issuers estimated the residual value for the items at 50% of their acquisition cost, which remained constant over their useful life.

The entity argued that this was a 'conservative' estimate, given that the discounted cash flows it had prepared over the item's useful life had yielded a residual value of 65% of acquisition cost (this included factoring in greater inherent need for maintenance, particularly between years 10 and 20, but did not allow for inflation).

The issuer also noted that basing the residual value on current broker valuations for a similar items would result in increased volatility in the estimate of residual value (and therefore the depreciation expense recognised) over the useful life. However, if broker valuations had been used the residual value would have been considerably higher.

The enforcer's decision

The enforcer did not agree with the issuer's treatment for setting residual value of these items at 50% of acquisition cost over its entire useful life.

IAS 16 *Property, Plant and Equipment* paragraph 6 defines residual value as the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already at the age and in the condition expected at the end of its useful life – i.e. an estimate should be made of the net proceeds from the sale of the item at reporting date, as if the vessel was already at the end of it's the useful life.

Other relevant requirements of IAS 16 include:

– The residual value must be reviewed at least at the end of each reporting period (IAS 16.51)
– The depreciable amount of an asset shall be allocated on a systematic basis over its useful life (IAS 16.50)
– The depreciable amount of an asset is determined after deducting its residual value (IAS 16.53)
– Instances in which the residual value is greater than the asset's carrying amount result in a nil depreciation charge, unless and until its residual value subsequently decreases to an amount below the asset's carrying amount (IAS 16.54).

The enforcer noted that IAS 16 does not provide guidance how to estimate residual value when the useful life (for accounting purposes) is determined to be shorter than the asset's overall economic life.

However, even though in this instance considerable uncertainty existed in association with the estimate of residual value (in particular for newer vessels when there is no vessel in the market) the estimate for residual value should correspond to market value (after costs of disposal) for similar items of property. When there are no such items, residual value had to be estimated from a relevant market value.

The enforcer considered that undesirable volatility was not a convincing argument to support the issuers accounting treatment, and noted that broker valuations could be a useful starting point to estimate the items' residual values.

In addition, the enforcer noted that some items that were older than 10 years had broker values that were higher than their residual value. Accordingly, this may have indicated that the estimated residual value had been set too low, and that the issuer should have ceased to apply depreciation at an earlier stage.

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