Report

14th Extract from the EECS' Database of Enforcement

29 October 2013 | ESMA/2013/1545

European Securities and Markets Authority

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List of abbreviations and acronyms used in this report

CGU	Cash-Generating Unit
CU	Currency Units
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortisation
EEA	European Economic Area
EC	European Commission
EEC	European Economic Communities
EECS	European Enforcers Coordination Sessions
EU	European Union
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFRS IC	International Financial Reporting Standards Interpretation Committee
NCI	Non-Controlling Interest
NPV	Net Present Value

Introduction

The European Securities and Markets Authority (ESMA) is publishing extracts from its confidential database of enforcement decisions on financial statements, with the aim of providing issuers and users of financial statements with relevant information on the appropriate application of the International Financial Reporting Standards (IFRS).

According to its founding regulation (European Regulation no 1095/2010), ESMA shall act in the field of financial reporting, to ensure the effective and consistent application of European Securities and Markets legislation. In order to fulfil these responsibilities, ESMA organises the European Enforcers Coordination Sessions (EECS), a forum gathering 38 European enforcers from 30 countries in the European Economic Area (EEA).

European enforcers monitor and review financial statements published by issuers with securities traded on a regulated market who prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) and consider whether they comply with IFRS and other applicable reporting requirements, including relevant national law.

Through the EECS, European enforcers are able to share and compare their practical experiences on the enforcement of IFRS financial information provided by companies who have, or who are in the process of having, securities admitted to trading on a regulated market in Europe. It provides a forum to discuss enforcement cases before or after decisions are taken by the European enforcers. As a forum of technical experts, this group provides technical advice for the preparation of ESMA statements and/or opinions on accounting matters. In addition, the EECS enables ESMA to review accounting practices applied by European issuers and monitors market developments and changes in those practices.

In taking enforcement decisions, European national enforcers apply their judgement, knowledge and experience to the particular circumstances of the cases that they consider. Relevant factors may include other areas of national law beyond the accounting requirements. Interested parties should therefore consider carefully the individual circumstances when reading the cases. As IFRS are principles based, there can be no one particular way of dealing with numerous situations which may seem similar but in substance are different. Consistent application of IFRS means consistent with the principles and treatments permitted by the standards.

Decisions taken by enforcers do not provide generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee (IFRS IC).

ESMA has developed a confidential database of enforcement decisions taken by individual European enforcers as a source of information to foster appropriate application of IFRS. Decisions that deal with simple or obvious accounting matters are normally not published, even if they related to material breaches leading to sanctions. The selection criteria are based on the above stated objectives, and accordingly, only decisions providing market participants with useful guidance are published.

Publication of enforcement decisions will inform market participants about which accounting treatments European national enforcers may consider as complying with IFRS; that is, whether the treatments are considered as being within the accepted range of those permitted by IFRS. Such publication, together with the rationale behind these decisions, will contribute to a consistent application of IFRS in the EEA.

On this basis, all cases submitted to the enforcement database are considered as appropriate for publication, unless:

- similar decisions have already been published by ESMA, and publication of a new one would not add any substantial value to the fostering of consistent application;
- the decision deals with a simple accounting issue;
- there is no agreement between European enforcers to support the submitted decision; and
- a particular European national enforcer, on a grounded and justified basis, believes that the decision should not be published.

Decisions included in this extract were taken by national enforcers in the period from July 2012 to March 2013. ESMA will continue publishing further extracts from the database on a regular basis, with the next extract expected to be published in the first half of 2014.

I Decision ref EECS/0213-01 – Derecognition of financial assets and liabilities

Financial year end: 31 December 2011
Category of issue: Derecognition of financial assets and liabilities
Standards or requirements involved: IAS 39 – *Financial Instruments: Recognition and Measurement*
Description of the issuer's accounting treatment

1. In 2011, the issuer granted a loan to its ultimate parent through a facility agreement and arranged issuance of preferred securities through an offer document with a support agreement. The issuer argued that the entire transaction has been set up with the intention of being a 'pass-through' arrangement, with no commercial substance from the issuer's perspective. Accordingly, the issuer accounted for the combined transactions as one.

2. The issuer stated that both financial assets resulting from granting the loans and financial liabilities resulting from issuance of the preferred securities should be derecognised upon inception of the contracts because they had the same contractual terms and cash received from the assets was used to repay the liability.

3. In the view of the issuer, the derecognition of the assets is required by IAS 39, because:

   - Paragraph 19(a) of IAS 39 requires an entity to have no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. As the terms of the issuer assets and liabilities are matched exactly and the issuer had no other assets from which it could possibly fund its obligations, the commercial substance of the transaction meets this condition.

   - Paragraph 19(b) of IAS 39 requires an entity to be prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows. Although the facility agreement could, in theory, potentially be sold or pledged, the support agreement may not be sold or pledged without the agreement of the preferred security holders. As the issuer believed both agreements should be considered together, the commercial substance of the transaction meets this condition.

   - Paragraph 19(c) of IAS 39 requires an entity to pass on the cash flows without material delay. As the terms of the assets and liabilities are exactly matched, the issuer believed the commercial substance of the transaction meets this condition.

4. The issuer argued that the financial liability should be derecognised in accordance with paragraph 39 of IAS 39, which requires derecognition of a financial liability when it is extinguished (i.e. when the obligation specified in the contract is discharged or cancelled or expires). As the issuer's transactions were entered into concurrently and in contemplation of each other, the liability should be considered concurrently with the assets when considering the derecognition criteria. The issuer transferred substantially all of the risks and rewards of ownership of the assets to the holders of the preferred securities, leading to their derecognition. Such transfer discharges the issuer's obligations under the preferred securities, as the issuer has no further obligation other than to remit such cash flows as they are received from the assets.

The enforcement decision

5. The enforcer disagreed with the derecognition of the financial assets and financial liabilities and considered that both should be presented in the statement of financial position.

Rationale for the enforcement decision

6. The preferred securities holders have first recourse to the issuer. Applying paragraphs 19 and 39 of IAS 39 leads to an analysis of the contractual arrangements in the separate contracts. The lack of a contractual link between the agreements meant that there was no pass-through arrangement and the issuer was subject to two separate contracts that resulted in coinciding receipt and payment of cash. As there was no contractual obligation stating that cash flows received from the ultimate parent must be 'passed through' to the preferred securities holders, the requirements of paragraph 19(a) of IAS 39 were not met and the assets could not be derecognised.

7. As the contractual documentation did not include prohibition from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows, the requirements of paragraph 19(b) of IAS 39 were not met.

8. Although both agreements stipulate the same payment date, there is no contractual obligation binding these agreements. Accordingly, the issuer collects the amounts under the facility agreement on its own behalf, in order to fulfil its obligations towards its preferred securities holders. Therefore, the requirements of paragraph 19(c) of IAS 39 were not met.

9. As the asset did not qualify for derecognition, there was no pass-through arrangement and the financial liability resulting from preferred securities was not extinguished. Consequently, the liability should not be derecognised in accordance with paragraph 39 of IAS 39.

II Decision ref EECS/0213-02 – Classification of financial assets as loans and receivables

Financial year end: 31 December 2011
Category of issue: Loans and receivables
Standards or requirements involved: IAS 39 – *Financial Instruments: Recognition and Measurement*
Description of the issuer's accounting treatment

10. The issuer issued bonds to third party investors and invested the proceeds in its parent company through a 'silent contribution' arrangement. The terms and conditions of the silent contribution were as follows:

    - The silent contribution has a right to profit participation on the nominal contribution amount at a rate of 7.25%.
    - Profit participation does not accrue if the parent company has or will have an annual loss.
    - The silent contribution will share in a loss in the parent company that shall be subsequently replenished if it does not cause or increase a loss of the parent company.
    - The silent contribution may only be terminated by the parent company with a two year's notice period and only if the book value of the silent contribution at the time of the notification is equal to the nominal contribution amount and the parent company's solvency ratio exceeds 9%. Profit or loss participation continues during those two years.

11. The issuer classified the silent contribution within '*loans and receivables*' using the criteria of paragraph 9 of IAS 39. Condition (c) of this paragraph prohibits an entity from classifying a financial instrument as a loan or receivable if the holder may not recover substantially all of its investment, other than because of credit deterioration. If that is the case, the financial instrument shall be classified as *'available for sale'*.

12. The issuer argued that the term *'credit deterioration*' in paragraph 9 of IAS 39 should not be linked to the definition of '*credit risk*' described in Appendix A of IFRS 7 as the risk that one party to a financial instrument causes a financial loss for the other party by failing to discharge an obligation. According to the issuer, '*credit risk*' is related to a certain point in time whereas '*credit deterioration*' occurs over time.

13. The issuer noted that a company that suffers a loss is likely to see a reduction in its creditworthiness. According to the issuer, a loss in the parent that causes loss participation by the subsidiary and '*credit deterioration*' are inseparable aspects of one scenario.

The enforcement decision

14. The enforcer disagreed with the classification of the silent contribution within *loans and receivables* and considered it should have been classified as '*available for sale'*.

Rationale for the enforcement decision

15. According to the terms of the contract, there are circumstances in which the holder of the silent contribution may not recover all of its investment for reasons other than credit deterioration. If the repaid amount is lower than the nominal contribution amount, the parent company is not required to repay the full amount of the investment to the issuer (holder of the silent participation). After the partial repayment the issuer is, according to the terms of the arrangement, fully discharged. This is when:

    - a reduction of the silent contribution occurs within the two year's notice period prior in which case the parent company will be required to repay an amount which is the lower of the book value and the nominal contribution amount; or
    - the book value of the silent contribution is reduced due to the absorption of losses of the parent company when the parent company bankrupts. In that case the note holders will have a reduced claim.

16. The credit risk is not a static notion but an integral aspect of any loan that may develop over time. Thus credit risk and credit deterioration refer to the same issue, the risk that a party may cause a loss to another party by failing to discharge an obligation.

17. Credit deterioration and participation in a loss are two different matters, even if there may be a certain level of interaction between them. In fact, a company may suffer a loss not resulting in credit deterioration.

III Decision ref EECS/0213-03 – Hedge accounting for an embedded floor in a loan portfolio

Financial year end: 31 December 2012
Category of issue: Hedge accounting
Standards or requirements involved: IAS 39 - *Financial Instruments: Recognition and Measurement*
Description of the issuer's accounting treatment

18. The issuer is a financial institution holding a mortgage loan portfolio with variable interest rates and embedded floors. At initial recognition, it was concluded that the embedded floor should not be separated from the host instrument and accounted for as a derivative as the economic characteristics and risks of the embedded floor were closely related to the economic characteristics and risks of the host contract based on the requirements of paragraph 11(a) of IAS 39. Paragraph AG33(b) of IAS 39 clarifies that the embedded

floor is closely related to the host contract if the floor is at or below market rate of interest when the contract was issued and the floor is not leveraged.

19. The embedded floors of the loans in the portfolio included a significant unrealised gain arising from the floor's fair value (i.e. the floors are in the money). The issuer planned to issue floors in order to realise and record that gain, by collecting in cash a premium from the third party acquiring the new issued floors, at a price equivalent to the fair value of the embedded derivatives at that date. Since issuing standalone floors would require them to be measured at fair value both at and after the initial recognition in accordance with paragraphs 43 and 47(b) of IAS 39, whereas the embedded derivatives included in the mortgage loan portfolio would not be measured at fair value, the issuer considered that this would generate artificial volatility after the initial recognition in the statement of comprehensive income.

20. To avoid such volatility, the issuer designed a fair value hedge that would allow the embedded derivative to be measured at fair value. The issuer planned to designate embedded floors corresponding to the hedged risk as a hedged item and to measure them at fair value when the hedge was designated. Recognition of the embedded floor at fair value would lead to recognition of an immediate gain in the income statement, which implied their separation from the host contract. The issued floors would be designated as a hedging instrument, and the premium collected would be recognised as a financial liability. Accordingly, any subsequent fair value changes in the embedded derivative and the issued floor due to the hedged risk would be symmetrically recorded to the extent of the hedge effectiveness.

Accounting for embedded floors in the case of a business combination

21. At the same time, the issuer was in the process of acquiring a financial business which also had embedded floors in its mortgage loan portfolio and proposed to apply the same accounting treatment as described above.

The enforcement decision

22. The enforcer disagreed with the separation of the embedded floors and their measurement at fair value subsequent to initial assessment of embedded derivatives outside the case of a business combination.

Rationale for the enforcement decision

23. At the inception of the hedge, the adjustment to the carrying amount of mortgage loan portfolio to separate the embedded floor and measure it at its full fair value does not comply with IAS 39 since the embedded floor was considered a non-separable embedded derivative at initial recognition. After initial recognition, outside of a business combination, such embedded derivatives cannot be separated in accordance with IFRIC 9 – *Reassessment of Embedded derivatives* unless there is a significant modification of the terms of the contract.

24. In accordance with paragraph 89(b) of IAS 39, the gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised in the income statement. Consequently, only changes in fair value of the embedded floor subsequent to the designation of the hedge relationship could be recognised in the income statement. The designation of the embedded floor as a hedged item does not mean the embedded derivative can be separated and measured at fair value.

Accounting for embedded floors following a business combination

25. In accordance with paragraph 18 of IFRS 3, the acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. Paragraph 16(c) of IFRS 3 specifies that the

acquirer shall make an assessment, on the basis of the conditions that exist at the acquisition date, of whether the embedded derivative should be separated from the host contract in accordance with IAS 39.

26. As a consequence, at the acquisition date, the acquirer would record the mortgage loan portfolio at its fair value and assess whether the embedded derivative has to be separated from the host contract. In accordance with paragraph AG 33(b) of IAS 39 it should, therefore, be assessed whether at the date of the business combination, the floor was above the market interest rate. If that is the case, the embedded floor should not be considered to be closely related to the host contract and shall be separated from the loan contract with both the embedded derivative and the host contract recorded at their fair values.

27. Subsequently, following IAS 39, the separated derivative should be measured at fair value with changes accounted in profit or loss, and the host contract should be recorded at its new amortised cost, which requires a recalculation of the initial effective interest rate.

IV Decision ref EECS/0213-04 – Nature and extent of risks arising from financial instruments

Financial year end: 30 April 2012
Category of issue: Risk disclosures
Standards or requirements involved: IFRS 7 - *Financial Instruments: Disclosures*
Description of the issuer's accounting treatment

28. The main activity of the issuers is to issue multiple series of limited-recourse notes, the proceeds of which are used to make investments. The assets acquired with the proceeds from each series of issued notes are held as collateral separately from the assets of any other series of notes. Noteholders bear the risks and rewards of exposure to the underlying investments. Some series of notes issued have hedged some risk by entering into derivatives such as interest rate swaps, currency swaps and credit default swaps. The equity share capital of these issuers is a nominal amount and equity shareholders do not participate in the profits. Returns on the notes are based upon the performance of the underlying investments. The following scenarios arose from three different issuers:

Issuer 1

29. Each series of notes issued is linked to one of the following categories of investments: total return swaps (linked to a portfolio of debt issuers), special investment funds, hedge funds in alternative investments, equity linked swaps, and inflation or interest linked investments. The financial statements stated that the issuer had no net exposure to the underlining investments and the risk disclosures were consequently minimised and boilerplate.

30. The credit risk disclosure in the financial statements contained a table of the credit quality of all assets i.e. at aggregated level. With regards to qualitative credit risk disclosure, the financial statements indicated that the issuer outsourced the responsibility of monitoring credit risk to an external service provider and referred only to the issuer having no net exposure to credit risk due to the limited recourse structure.

Issuer 2

31. The notes issued are a combination of asset backed notes and credit/derivative linked notes. Each series of note is secured by different combinations of financial instruments including corporate bonds, loans and derivatives. Financial instruments that underpin notes are either listed or unlisted, contain various

combinations of corporate bonds and loans and by virtue of investment in derivatives such a credit default swaps, are credit-linked to underlying portfolios of notional reference entities (e.g. corporate debt).

32. Given the limited recourse nature of the notes issued, the recoverability of the principal amount and returns are dependent upon the performance of the underlying financial instruments and the ability of the derivative counterparty to honour its commitments. The issuer's financial statements disclosed that the ultimate amount repaid to noteholders will depend on the proceeds from the sale of investments and derivatives held as collateral. With regards to the '*other price risk*', the disclosures provided the IFRS 7 definition but did not explain how this risk exposure arises and changes.

Issuer 3

33. The issuer made investments in corporate bonds (asset-backed notes) and derivative backed notes through, e.g., total return swaps and credit default swaps, with returns linked to a notional portfolio of reference debt entities. Each series of derivative backed notes issued by the issuer was secured by the purchase of derivatives, e.g., total return swaps whose value is linked to investments in a notional portfolio of debt securities, made up of different combinations of corporate bonds and loans.

34. The issuer disclosed that it entered into asset swap agreements for selected series of notes issued and that the ultimate amount repaid to the noteholders will depend on the proceeds from the total return swaps and any payment the swap counterparty is obliged to make under the terms of the swap agreement. It specified that the issuer was dealing with counterparties that have a credit rating defined in external documentation. Notwithstanding that the issuer dealt with only one derivative counterparty for all derivative transactions there was no qualitative counterparty risk disclosure (the issuer had identified the derivative counterparty and its credit rating, which deteriorated during the period). The issuer disclosed neither the exposure to derivative counterparty risk and the objectives, policies and processes for managing it, nor any changes in them from the previous period.

The enforcement decision

35. The enforcer considered that the financial statements did not contain the relevant quantitative and qualitative disclosures related to risks arising from holding financial instruments with regards to credit risk (issuer 1), '*other price risk'* (issuer 2) and concentration risk (issuer 3).

Rationale for the enforcement decision

36. Paragraph 33 of IFRS 7 requires an entity to disclose, for each type of risk arising from financial instruments, the exposures to risk and how they arise, its objectives, policies and processes for managing the risk and the methods used to measure the risk and changes compared to the previous period. Paragraph 112(c) of IAS 1, requires an entity to provide information that is not presented elsewhere in the financial statements, but is relevant to their understanding.

Issuer 1

37. Paragraph B3 of IFRS 7, clarifies that the level of disclosure should not be so aggregated that it obscures important differences between individual transactions or associated risks. Disclosure of credit risk at the issuer level can obscure important differences between individual transactions or associated risks as it suggests that all financial instruments (and all series of notes issued) share a similar credit risk exposure.

38. Nonetheless, the credit quality of the underlying assets and changes in the credit quality, diversity in the type of assets underpinning individual series of notes, and a change in the concentration of investments

evident from the financial statements suggested there were significant differences in the credit risk of different series of notes issued.

Issuer 2

39. '*Other price risk*' is a component of market risk and is defined in Appendix A of IFRS 7, as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

40. The disclosures made by the issuer did not contain sufficient information to enable users to evaluate the nature and extent of the other price risks arising from financial instruments to which noteholders were exposed as required by paragraphs 33 and 34 of IFRS 7 and paragraph 112(c) of IAS 1. Such disclosure should include a description of the nature of the exposure to other price risk (e.g. by virtue of type or concentration of investment type, issuer, currency, geographic location, listed or unlisted investments), changes in '*other price risk*' during the period and relevant quantitative other price risk disclosures including concentrations of risk, if any and sensitivity analysis, as necessary.

Issuer 3

41. While the use of derivatives may mitigate some risks, it gives rise to credit risk in that the issuer deals with only one derivative counterparty for all derivative transactions. There is greater potential exposure to counterparty risk in the case of derivative backed notes or credit linked notes as noteholders rely to a greater degree on the counterparties' abilities to honour their commitments to provide income and a return on the principal amount borrowed. The notes issued were backed by derivatives rather than by direct ownership in the underlying assets.

42. The financial statements did not contain qualitative disclosures about the risk arising from derivative counterparties, the issuer's objectives, policies and procedures for managing them, changes in those risks and, if any, the reasons for those changes. Given the particular circumstances of the issuer (derivative backed notes and the fact that only a single derivative counterparty was used for all derivative transactions) the risk disclosures in the financial statements did not contain sufficient information to enable users to evaluate the nature and extent of the noteholders exposure to derivative counterparty risk and its concentration arising from derivatives to which noteholders were exposed.

43. The disclosures should enable users to evaluate the nature and extent of the exposure to derivative counterparty risk and should reflect the specific circumstances of the issuer. Such disclosure should include a description of the nature of derivative counterparty risk and how it arises with regard to the particular circumstances of the issuer, an analysis of total derivative financial instruments per counterparty (as necessary), enhanced qualitative disclosure describing the impact of a credit downgrade of the credit quality of the derivative counterparty, and possible mitigation of the noteholders risk exposure to a derivative counterparty risk (e.g. by including what actions are triggered were the counterparty to default).

V Decision ref EECS/0213-05 – Cash flow classification of amounts paid to vary the notional amount of a commodity contract

Financial year end: 31 December 2011
Category of issue: Classification of cash flows
Standards or requirements involved: IAS 7 – *Statement of Cash Flows*

Description of the issuer's accounting treatment

44. The issuer operates in the mining industry and sells some of the production from its mines to a bank, under the terms of a fixed-price forward contract. The forward contract was initially set-up as a condition for obtaining financing from the bank in order to develop the mines; it is, however, a separate contract and repayment of the loan is independent from the level of production and the spot price of the commodity produced.

45. The issuer did not account for the forward contract as a derivative as it assessed that the contract fulfilled the own use exemption in paragraph 5 of IAS 39 – *Financial Instruments: Recognition and Measurement*. Sales under the contract were accounted for according to IAS 18 - *Revenue* instead.

46. During 2011, the issuer disposed of all of its operations in one region. As a result, there was a possibility that it would no longer be able to fulfil its supply obligations under the forward contract in periods when its production was lower. There was a risk that the issuer would have to make purchases on the spot market. It made, therefore, a one-off payment to the bank to reduce the notional amount of the forward contract.

47. The issuer classified the one-off payment in its cash flow statement as an outflow from financing activities because it did not consider the payment to be part of its operating activities. It also considered it to be relevant that the counterparty to the payment was the bank that provided the issuer with financing.

48. The issuer did not believe that this payment indicated that there was a change in the nature of the forward contract and continued to account for sales according to IAS 18.

The enforcement decision

49. The enforcer disagreed with the classification of the cash flow as a financing outflow and considered it to be an operating outflow instead.

Rationale for the enforcement decision

50. Paragraph 6 of IAS 7 defines financing activities as those that result in changes in the size and composition of the contributed equity and borrowings of the entity. The forward contract was not directly linked to the loan contract and was not recognised on the statement of financial position as part of borrowings. The payment did not, therefore, affect the issuer's equity or borrowings.

51. In addition, recurring cash receipts from sales under the contract were considered operating cash inflows. The one-off cash payment adjusted future cash inflows under the contract. Treating the cash outflow as an operating activity ensures that cash flows having the same nature are treated consistently.

VI Decision ref EECS/0213-06 – Presentation of cost of inventories in cost of goods sold

Financial year end: 31 December 2011
Category of issue: Presentation of income statement
Standards or requirements involved: IAS 1 – *Presentation of Financial Statements*
Description of the issuer's accounting treatment

52. During 2011, the issuer acquired a major business. The inventories acquired in this business combination were valued at their acquisition-date fair value in accordance with paragraph 18 of IFRS 3, causing a fair value step-up. An important part of the acquired inventories were sold in 2011.

53. In the income statement, the cost of inventories acquired in the business combination and sold by the acquirer after the business combination was split on two different lines, partly as cost of goods sold and partly as a 'non-recurring item' within operating income. The part presented under cost of goods sold corresponds to the carrying amount of those inventories in the acquiree's financial statements. The part presented as a non-recurring item corresponded to the fair value step-up recognised as part of the measurement of the business combination and amounted to 30% of the issuer's EBIT. The non-recurring item was explained in the notes to the financial statements.

54. The issuer underlined the fact that revaluing inventories at fair value would result in a fall in the issuer's gross margin due to the fair value step-up. The issuer argued that isolating this part of the margin in the non-recurring items, whose nature is transparently presented in the notes, enabled the user to evaluate the structural evolution of its gross margin.

55. In addition, the issuer argued that the definition of cost of goods sold/cost of sales, in IFRS is, in its opinion, not very precise and not entirely suited to reflect effects of business combinations. It also requires significant judgement when presenting income statement by function. At the same time the classification of operating costs according to recurring/non-recurring is conceptually different from a structure based on function and allocating non-recurring costs alternatively to a specific function of the entity should be possible.

The enforcement decision

56. The enforcer disagreed with the issuer and was of the opinion that the cost of the inventories sold should be presented as cost of goods sold/cost of sales.

Rationale for the enforcement decision

57. Paragraph 18 of IFRS 3 requires an acquirer to measure the identifiable assets acquired in a business combination at their fair values at the date of acquisition. Therefore, the carrying amount of the inventories originating from the acquiree is their acquisition-date fair value.

58. According to paragraph 34 of IAS 2 - *Inventories*, when inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. Paragraph 38 of IAS 2 defines cost of sales as costs previously included in the measurement of inventory that has now been sold and unallocated production overheads and abnormal amounts of production costs of inventories. Consequently, the entire carrying amount of inventory, including the effects of the fair value step-up, should be presented as cost of sales.

59. The issuer presents its analysis of expenses recognised in the income statement using a classification based on their function. Using such presentation, an entity discloses, according to paragraph 103 of IAS 1, its cost

of sales separately from other expenses. In accordance with paragraph 101 of IAS 1, expenses should be sub-classified to highlight components of financial performance that may differ in terms of frequency, potential for gain or loss and predictability. Thus it would be adequate to highlight the particular nature of the expense through additional disclosure within the cost of sales.

VII Decision ref EECS/0213-07 – Scope of consolidation

Financial year end: 31 December 2011
Category of issue: Scope of consolidation
Standards or requirements involved: IAS 27 – *Consolidated and Separate Financial Statements*
Description of the issuer's accounting treatment

60. In February 2010 the issuer, a dormant publicly listed company, acquired 100% of the outstanding shares in entity B. The issuer considered entity B to be an entity held exclusively with a view to its subsequent resale (in accordance with the applicable section of the national law derived from article 13 sub 3(c) of the Seventh Council Directive). As the issuer did not have any other subsidiaries, the exclusion of entity B from the scope of consolidation led to no consolidated financial statements being prepared. Only separate financial statements were prepared as the issuer considered that there was no obligation to prepare consolidated financial statements in accordance with IFRS. Consolidation of entity B would have made a material impact on the financial statements.

61. The issuer argued that all sections of the national law which had been transposed from article 1 to 15 of the Seventh Council Directive 83/349/EEC of 13 June 1983 (*Seventh Council Directive*) should be considered in determining whether or not consolidated financial statements should be prepared.

62. The issuer did not consider the comments issued by the European Commission concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting[1] ('EC Comments') to be part of the applicable legislation. The issuer stated that, as a result, the Comments cannot result in any obligation, such as preparing consolidated financial statements.

The enforcement decision

63. The enforcer disagreed with the assessment of the issuer and concluded that it should prepare consolidated financial statements in conformity with IFRS as endorsed by the EU.

Rationale for the enforcement decision

64. Although the EC Comments are not part of the endorsed legislation, they provide guidance how an entity should determine whether or not there is a requirement to prepare consolidated financial statements. Paragraph 2.2.2 of the EC Comments states amongst others that "*The determination of whether or not a company is required to prepare consolidated accounts will continue to be made by reference to national*

[1] Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting, European Commission, November 2003, http://ec.europa.eu/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf

law transposed from the Seventh Council Directive" and that "*Certain exclusions from the scope of the consolidation are provided for in Articles 13 to 15 of the Seventh Directive. As noted above, it is the national law derived from the Accounting Directives that determines whether or not consolidated accounts are required. However, if consolidated accounts are so required, it is the requirements of endorsed IASs that will dictate the scope of consolidation and, therefore, which entities should be included in those consolidated accounts and how they should be included. Accordingly, the exclusions from the scope of the consolidation derived from the Accounting Directives are not relevant – the consolidated accounts are prepared in accordance with endorsed IASs.*"

65. In the described case, when a company is of a type specified in Article 4 of the Seventh Council Directive, national law, as transposed from the Seventh Council Directive, is the basis for determining of whether this company is required to prepare consolidated financial statements. The following Articles of the Seventh Council Directive are relevant to this requirement: Articles 1, 2, 3(1), 4, 5-9, 11, 12 and 13(2a).

66. If, however and based on national law, consolidated financial statements are required to be prepared, the scope of consolidation should be determined based on IFRS requirements, which indicate the entities to be included in those consolidated financial statements. Accordingly, the exclusions from the scope of consolidation provided for in Articles 13 to 15 of the Seventh Council Directive (except Article 13(2a)) are not relevant when preparing consolidated financial statements in accordance with IFRS.

67. As a result, the section of the national law that has been derived from article 13 sub 3(c) of the Seventh Council Directive is not relevant for the determination of the requirement to prepare consolidated financial statements and the issuer is required to prepare IFRS consolidated financial statements.

VIII Decision ref EECS/0213-08 – Identification of intangible assets in a business combination

Financial year end: 31 December 2011
Category of issue: Identification of intangible assets in a business combination
Standards or requirements involved: IFRS 3 - *Business Combinations*, IAS 38 - *Intangible Assets*
Description of the issuer's accounting treatment

68. The issuer is a commercial bank that acquired, in 2011, part of the operations of a distressed bank. The transaction qualified as a business combination and the issuer recognised intangible assets with a finite useful life. The residual amount of CU 20 million (15% of issuer's total equity) was allocated to goodwill.

69. In its 2011 IFRS financial statements the issuer explained that goodwill could be primarily attributed to the expected return from the acquired activities, synergies from combining operating activities and the 'deposit surplus' (defined as the difference between the amounts of deposits and loans acquired). The issuer considered that most of the goodwill originated from a deposit surplus generated from the acquired customers. The acquired deposits were substantially larger than the acquired loans and the issuer expected that the customers would continue to have deposits in the bank in the future. Goodwill equal to the expected value of the deposit surplus was allocated to the cash generating unit that was the existing business without the acquired business, as the issuer expected the existing business to benefit from the deposit surplus. The rest of the goodwill was allocated to another cash-generating unit that was the acquired business.

70. The interest rates of the acquired deposits were substantially lower than the interest rates of the bonds the issuer had issued in order to fund activities in prior years. The issuer estimated that this resulted in substantially reduced annual funding costs for the bank amounting to CU 3.5 million per annum. The issuer expected the annual funding cost to be reduced linearly over 10 years, and its net present value

(NPV) represented 80% of the total goodwill acquired. According to the issuer, the benefit from using the deposit surplus was linked to the value of combining the two banks and that, since it related to synergies that are to be expected from combining the businesses, it should form part of goodwill.

The enforcement decision

71. The enforcer disagreed that the amount of the deposit surplus should be subsumed into goodwill and considered it to be a separately identifiable intangible asset with a finite useful life that should be recognised as part of the business combination.

Rationale for the enforcement decision

72. According to paragraph B34 of IFRS 3, an intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability. Therefore, the deposit surplus should be recognised as an intangible asset separately from goodwill, as it can be separated in combination with the customers' deposits and loans, another bank could benefit from it and the deposits have a low interest rate compared to alternative sources of funding in the current environment.

73. Paragraph 33 of IAS 38 states that the fair value of an intangible asset acquired in a business combination will reflect expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. The value of the benefit from using the deposit surplus is the price the issuer was willing to pay to acquire the deposit surplus. This price is based on the best available information about the future economic benefits that the issuer obtains from the acquired deposit surplus. The value of deposits includes the liquidity the bank receives because the deposits can be used e.g. to grant loans or as an alternative source of funding.

74. The benefit from using the deposit surplus was not a synergy from combining the two companies but a separately identifiable intangible asset with a finite useful life, which should have been identified and recognised separately from goodwill.

IX Decision ref EECS/0213-09 – Contingent payments to acquire a non-controlling interest

Financial year end: 31 December 2011
Category of issue: Contingent payments to acquire a non-controlling interest
Standards or requirements involved: IAS 32 - *Financial Instruments: Presentation*
Description of the issuer's accounting treatment

75. The issuer has a history of growth through acquisitions and frequently acquires a majority shareholding in a business together with an option on the remaining non-controlling interest ('NCI') to be exercised later. In 2011 the issuer acquired the remaining NCI from a business combination that occurred in 2009.

76. The payment for the NCI was structured so that it contained a fixed initial payment and a series of contingent amounts payable over the following three years. The contingent payments were to be based on the future EBITDA of the acquired business, up to a maximum amount.

77. The issuer recognised the fixed initial payment as an equity transaction, in accordance with paragraph 30 of IAS 27 – *Consolidated and Separate Financial Statements*. The contingent payments were not accounted for at that date. Instead, the issuer considered them to be contingent liabilities and disclosed

them in accordance with paragraph 86 of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*. The disclosure included the estimated timing of the payments and the directors' estimate of the amounts to be settled.

The enforcement decision

78. The enforcer disagreed that the contingent payments were to be treated as contingent liabilities and was of the opinion that they should be recognised as financial liabilities and measured at fair value at initial recognition.

Rationale for the enforcement decision

79. Contingent consideration for a business must be recognised at the time of acquisition, in accordance with paragraphs 39 and 40 of IFRS 3 – *Business Combinations*. However, IAS 27 does not contain any guidance when accounting for contingent consideration for the acquisition of a NCI in a subsidiary.

80. The contract for contingent payments does, however, meet the definition of a financial liability under paragraph 11 of IAS 32. The company has an obligation to pay cash to the vendor of the NCI under the terms of a contract. It is not within the issuer's control to be able to avoid that obligation.

81. The amount of the contingent payments depend on the EBITDA of the acquired business, which itself depends on a number of factors which are outside of the issuer's or vendor's control, such as customer demand. Paragraph 25 of IAS 32 is clear that a contingent obligation to pay cash that is outside the control of both parties to a contract meets the definition of a financial liability that shall be initially measured at fair value. Since the contingent payments relate to the acquisition of the NCI, the offsetting entry would be recognised directly in equity.

X Decision ref EECS/0213-10 – Deferred tax asset arising from tax losses carried forward

Financial year end: 31 December 2011
Category of issue: Valuation of a deferred tax asset
Standards or requirements involved: IAS 12 – *Income taxes*
Description of the issuer's accounting treatment

82. The issuer is a commercial bank. In the consolidated IFRS financial statements for 2011, the issuer recognised a net deferred tax asset of CU 21.6 million (representing 18.6% of its total equity), where CU 4.1 million represented taxable temporary differences and CU 25.7 million represented the carry-forward of unused tax losses. According to the local tax regulation there is no time limit regarding the period to which the unused tax losses can be used. The issuer disclosed that it expected that future taxable profits before tax would be available, within a period of seven years, against which the unused tax losses could be utilised.

83. This view was based on the budgets for the years 2012-2018. It expected a substantial reduction in impairments of loans, compared to the historical losses with a substantial effect on the future taxable profit, and low rates of impairment of loans compared to the impairment losses of other banks.

The enforcement decision

84. The enforcer disagreed with the full recognition of deferred tax asset arising from the carry forward of unused tax losses and considered it to be recognisable only to the extent of its taxable temporary differences.

Rationale for the enforcement decision

85. Paragraph 34 of IAS 12 states that a deferred tax asset shall be recognised for the carry-forward of unused tax losses to the extent that it is probable that future taxable profit will be available against which unused tax losses can be utilised. Paragraph 35 of IAS 12 explains that the existence of unused tax losses is strong evidence that future taxable profit may not be available.

86. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses can be utilised by the entity.

87. The issuer recognised material losses during the four previous years. In order to be able to use the deferred tax asset of CU 21.6 million, the issuer would have to recognise a profit of CU 86.4 million (at the existing corporate tax rate of 25 %). In comparison, the issuer recognised an average loss of CU 12 million per year during the five previous years.

88. There should be convincing evidence showing that there would be taxable profits available in the future in order to recognise a deferred tax asset because the issuer did not have sufficient taxable temporary differences. The enforcer questioned whether the budgets and the rationale behind the budgets could be considered such evidence. The most significant factor affecting the accuracy of the budgets was the issuer's ability to forecast levels of loans impairment.

89. A comparison of the issuer's budgeted results for the previous two years to its actual results indicated material differences relating principally to loan impairment losses. In the interim financial statements for the first half of 2012, the issuer recognised impairment losses of loans equal to budgeted impairment losses for the whole year. The issuer argued that its ability to forecast effectively could not be evaluated by comparing the budgets from 2010 and 2011 with the actual results in these two years, as these two years deviated from expectations for the whole banking sector. However, the enforcer believed that the unused tax losses did not result from identifiable causes which were unlikely to recur, as stated in paragraph 36(c) of IAS 12.

90. Consequently, the issuer's budgets and assumptions were not convincing other evidence because the issuer was not capable of making accurate forecasts in the past and there were material differences between the amounts budgeted and realised for the years 2010 and 2011. With regards to the impairment losses of loans, the issuer had presented future budgets primarily based on general assumptions about interest income and economic improvement indicators, rather than documentation showing what was expected to influence the future income and therefore enable the use of the deferred tax asset.

91. Finally, in its financial statements, the issuer disclosed a material uncertainty about its ability to continue as a going concern. Material uncertainty about the ability of the issuer to continue as a going concern should be considered when considering the recognition of a deferred tax asset.

XI Decision ref EECS/0213-11 – Segment disclosures – Information about geographical areas

Financial year end: 31 December 2011
Category of issue: Entity-wide disclosures
Standards or requirements involved: IFRS 8 – *Segment Reporting*
Description of the issuer's accounting treatment

92. The issuer has operations in many countries on several continents and has a significant amount of goodwill recognised in its financial statements. In the segment reporting note to the financial statements the issuer presented a geographical analysis of revenues and non-current assets as required by paragraph 33 of IFRS 8. Information about the country of domicile, along with two other countries considered material was identified separately and the remaining amounts of revenue and non-current assets were presented in an 'other' category.

93. The issuer included customer related intangible assets in its geographical analysis disclosures. However, it excluded goodwill from the geographical analysis of non-current assets.

The enforcement decision

94. The enforcer disagreed with the exclusion of goodwill from the geographical analysis of non-current assets.

Rationale for the enforcement decision

95. Paragraph 33(b) of IFRS 8, requires disclosure of non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (i) located in an entity's country of domicile and (ii) located in all foreign countries in total in which the entity hold assets. If assets in an individual foreign country are material, those assets shall be disclosed separately. Furthermore, paragraph BC56 of IFRS 8 explicitly refers including intangible assets in the disclosure of '*non-current assets*'.

96. The issuer had two operating segments, which related to the geographical areas in which it operated, and included goodwill as part of the segment assets reported for each of those segments. The CGUs were based on geographical areas and goodwill was allocated to each of these geographical areas for the purposes of goodwill impairment testing – most of the issuer's CGUs were based on a country or a limited group of countries. It was, therefore, possible to disclose the amounts of goodwill identified and allocated to the country of domicile and all other countries in total as required by paragraph 33(b) of IFRS 8.

XII Decision ref EECS/0213-12 – Disclosure of new standards that have been issued but are not yet effective

Financial year end: 31 December 2011
Category of issue: Disclosure
Standards or requirements involved: IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors*

Description of the issuer's accounting treatment

97. The issuer's annual financial statements have been prepared in accordance with IFRS as endorsed in the EU. In its financial statements it disclosed that it considered all new standards and interpretations and amendments to existing standards and interpretations that have been issued by the IASB and endorsed by the EU, but were not yet effective and were not early adopted in its financial statements, together with information relevant to assessing the possible impact when implemented for the first time. Therefore, only new standards and interpretations that were endorsed by the EU at the date of the approval of the financial statements were included in the issuer's assessment of paragraph 30 of IAS 8. No information was included about standards issued but not yet endorsed by the EU.

The enforcement decision

98. The enforcer disagreed with the limitation of disclosures concerning new standards, interpretations and amendments to existing standards that have been issued by the IASB but are not yet effective to those already endorsed by the EU. The enforcer required their disclosure regardless of whether they have been endorsed by the EU.

Rationale for the enforcement decision

99. Paragraph 30 of IAS 8 requires an issuer to disclose new standards that have been issued but are not yet effective and estimate the possible impact of their application on the financial statements in the period of initial application.

100. In the issuer's case, new standards of relevance that had been issued by the IASB but not yet endorsed by the EU included IAS 19 (2011) – *Employee Benefits*, IFRS 10 – *Consolidated Financial Statements*, IFRS 11 – *Joint Arrangements* and IFRS 13 – *Fair Value Measurement*. Given the nature of the issuer's activities, it was probable that some of these standards could have a material impact on the issuer's financial statements.

101. IAS 8 was endorsed by the EU and there is no amendment to paragraph 30 of IAS 8 as a result of the endorsement process. Accordingly, to limit application of this paragraph to those standards, interpretations and amendments that are already endorsed by the EU is inappropriate.

102. Furthermore, paragraph 112(c) of IAS 1 requires that the notes to the financial statements provide information that is not presented elsewhere in the financial statements, but is relevant to their understanding of any of them. Given the importance of the IAS 19 (2011) to this issuer, it was considered that the disclosure in the notes was relevant to understanding of the financial statements in accordance with paragraph 112(c) of IAS 1.