



European Securities and  
Markets Authority

# Report

12<sup>th</sup> Extract from the EECS's Database of Enforcement



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## List of abbreviations and acronyms used in this report

CAPM	Capital Asset Pricing Model
CGU	Cash-generating Unit
EEA	European Economic Area
EECS	European Enforcers Coordination Sessions
EU	European Union
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
IFRS IC	International Financial Reporting Standards Interpretation Committee
WACC	Weighted Average Cost of Capital



## Introduction

According to European Regulation no 1095/2010 establishing the European Securities and Markets Authority (ESMA), ESMA shall act in the field of financial reporting, to ensure the effective and consistent application of European Securities and Markets legislation. Those responsibilities are organised by ESMA through European Enforcers Coordination Sessions (EECS), a forum containing 37 European enforcers from 29 countries in the EEA.

The European national enforcers of financial information monitor and review financial statements published by issuers with securities traded on a regulated market and 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.

Operating under ESMA, EECS is a forum that promotes a high level of harmonisation in the application of IFRS and consistency amongst enforcers in decision taken when reviewing the IFRS financial statements. A key function of EECS is the analysis and discussion of decisions taken, or to be taken, by national enforcers in respect of IFRS financial statements. According to the ESMA Regulation, new legal instruments, such as opinions can be used to achieve consistency in enforcement.

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, which remains the role of the IFRS Interpretations Committee (IFRS IC).

In accordance with CESR Standard No 2 on Financial Information, "Co-Ordination of Enforcement Activities", 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. ESMA is committed to publish extracts of the database to provide issuers and users of financial statements with similar assistance.

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.

Decisions that deal with simple or obvious accounting matters will not normally be published, even if they were 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 will be published.

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 that, even having been considered a material infringement, does not in itself have any accounting merit;
- there is no agreement between European enforcers to support the submitted decision;
- a particular European national enforcer, on a grounded and justified basis, believes that the decision should not be published;

ESMA will continue publishing further extracts from the database on a regular basis.



## **I Decision ref EECS/0112-01 – Capitalisation of intangible assets**

**Financial year end:** 31 December 2009

**Category of issue:** Capitalisation of intangible assets

**Standards or requirements involved:** IAS 38 *Intangible Assets*

**Date decision taken:** 1 October 2011

### *Description of the issuer's accounting treatment*

1. The issuer is a provider of specialist recruitment services. In its 2009 financial statements, the statement of financial position included 'Candidate database', an internally generated intangible asset related to identifying and recruiting the candidates.
2. The note on disclosure of critical accounting estimates explained that the asset represents the cost of the database of candidates looking for international permanent placements based on the judgement that the asset satisfies the criteria set out in IAS 38 for the recognition of an internally generated intangible asset.
3. The accounting policy disclosure specified that costs directly associated with the production of the candidate database are recognised as intangible assets and that direct costs include employee costs and external costs incurred in identifying and recruiting the candidates.
4. The issuer confirmed to the enforcer that the database contained information for international candidates and that most of the recognised costs related to collection of information about individual candidates. Increments to the cost of the asset were represented by the costs of collecting and processing batches of candidate information. System development costs represented a small proportion of the costs of the intangible asset. The enforcer also found that travel costs were capitalised.
5. Paragraph 63 of IAS 38 prohibits internally generated brands, mastheads, publishing titles, customer lists and items similar in substance from being recognised as intangible assets as expenditure on such items cannot be distinguished from the cost of developing the business as a whole.
6. The issuer put forward several arguments in support of the accounting treatment adopted:
  - As the candidate database contained detailed information in respect of individuals that the company wished to place in employment, rather than information about the organisations (the customers) into which the candidates would be placed, the prohibition in paragraph 63 of IAS 38 in respect of customer lists would not apply.
  - The costs of developing the database were very specific in nature and, therefore, distinguishable from the costs of developing the business as a whole, unlike the types of expenditure listed in paragraph 63 of IAS 38. The issuer also explained that the process of procuring an 'international candidate' might take up to 4 years to complete.



### *The enforcement decision*

7. The enforcer found that recognition of the candidate database as an intangible asset was not in compliance with IAS 38.

### *Rationale for the enforcement decision*

8. The enforcer noted that the candidate database was similar in substance to an internally generated customer list and consequently its recognition as an intangible asset was prohibited by IAS 38.
9. The enforcer did not accept the issuer's arguments for the following reasons:
  - The prohibition in paragraph 63 of IAS 38 extends to items 'similar in substance' to customer lists. The enforcer's view was that the information was collected for the purpose of securing customer contracts and was, therefore, similar in nature to a customer list.
  - The size and extent of reliance on the database in the issuer's operations and the fact that most of the database costs related to collecting and processing information for individual candidates on a continuing basis, indicated that the candidate database costs were not distinguishable from the costs of developing the business as a whole.

## **II Decision ref EECS/0112-02 – Control over a subsidiary**

**Financial year end:** 31 December 2010

**Category of issue:** Definition of control

**Standards or requirements involved:** IAS 27 *Consolidated and Separate Financial Statements*

**Date decision taken:** 27 July 2011

### *Description of the issuer's accounting treatment*

10. The issuer is a holding company that invests in companies that are engaged, directly or indirectly, in operating activities. Altogether 20 subsidiaries were fully consolidated in the 2010 consolidated financial statements of the issuer. For 11 of these subsidiaries, the issuer assumed it controlled them even if it held less than 50% of the share capital / voting rights.
11. A sister company of the issuer, another listed company controlled by the parent of the issuer, also assumed it controlled those subsidiaries and hence fully consolidated them in its own 2010 consolidated financial statements.
12. The issuer and its sister company ('the issuers') both justified the control and full consolidation of those 11 subsidiaries based on the following arguments :
  - No potential voting rights exist and control only relies on the actual voting rights held by the issuers.
  - None of the issuers has power over more than half of the voting rights by virtue of an agreement with other investors (IAS 27.13(a) not applicable);
  - None of the issuers has power to govern the financial and operating policies of the subsidiaries under a statute or an agreement (IAS 27.13(b) not applicable);
  - Both issuers have the power to appoint or remove the majority of the members of the board of directors: a majority of the members of the board of directors of the subsidiaries are directors of the ultimate parent who are also directors of the issuers (IAS 27.13(c) applied)



- Both issuers have the power to cast the majority of votes at meetings of the board of directors: a majority of the members of the board of directors of the subsidiaries are directors of the ultimate parent who in turn are also directors of the issuers (IAS 27.13(d) applied).

#### *The enforcement decision*

13. The enforcer did not accept this accounting treatment and asked the issuers to re-assess the existence of control over those subsidiaries as IAS 27 permits only one entity to have control of another entity.

#### *Rationale for the enforcement decision*

14. Paragraph IG4 to IAS 27 notes that the definition of control in IAS 27 permits only one entity to have control of another entity. Consequently, IAS 27 requires, when two or more entities each hold significant voting rights, both actual and potential, reassessment of the factors in paragraph 13 of IAS 27 to determine which entity has control.
15. The enforcer did not agree with the approach applied by the issuer: a subsidiary cannot be controlled by two different companies. Therefore, the enforcer asked the issuers to review the assumptions in order to determine which of the two issuers actually controls those subsidiaries. If no control exists, the existence of joint control or significant influence should be considered.

### **III Decision ref EECS/0112-03 – Fair value of investment property: Disclosure**

**Financial year end:** 31 December 2010

**Category of issue:** Fair value of investment property

**Standards or requirements involved:** IAS 40 *Investment Property*, IAS 1 *Presentation of Financial Statements*

**Date decision taken:** 21 December 2011

#### *Description of the issuer's accounting treatment*

16. The issuer is an externally managed close-ended real estate investment fund which owns a portfolio of investment properties, mainly composed of distribution facilities. In its 2010 consolidated financial statements, investment properties recognised at fair value represented nearly 97% of the total consolidated statement of financial position.
17. In the notes to the 2010 consolidated financial statements, the main information disclosed on the accounting and measurement policies applied by the issuer in relation to investment properties related to the application of the fair value model according to IAS 40. Measurement of the fair value of investment properties was determined by independent valuers in accordance with a definition provided by the International Valuation Standards Council (IVSC).
18. The issuer disclosed that the fair value was largely based on estimates using property valuation techniques and other valuation methods. The issuer disclosed that such estimates are inherently subjective and actual values can only be determined in a sales transaction. In the disclosure of accounting policies the issuer specified that valuations were predominantly undertaken on an income capitalisation approach using comparable recent market transactions on arm's length terms and that they were based on various assumptions as to tenure, letting, town planning, the condition and repair



of buildings and sites as well as the best estimates of applicable net operating income, reversionary rents and leasing periods.

#### *The enforcement decision*

19. The enforcer assessed that the information disclosed in the consolidated financial statements in respect of the methods actually applied (income capitalisation approach) and the assumptions used was not sufficient and did not satisfy the requirements of IAS 1 and IAS 40. The issuer was asked to improve its description and disclosures related to the methods and significant assumptions applied in determining the fair value of investment properties, notably by disclosing the methods and significant assumptions applied by the independent valuers and underlying their calculation (e.g., yields, vacancy rates, estimated rental values), as well as other useful information such as the sensitivity of carrying amounts to the methods.

#### *Rationale for the enforcement decision*

20. Paragraph 75(d) of IAS 40 requires, among others, the disclosures of the methods and significant assumptions applied in determining the fair value of investment property.
21. When assessing significant assumptions and their impact on the measurement of investment property, the requirements of paragraph 129(b) of IAS 1 should be considered, in particular, by disclosing information about the sensitivity of the fair value of investment property to the methods and assumptions applied. The enforcer concluded that information related to the actual valuation methods used by each independent valuer and the different assumptions made (e.g., yields, vacancy rates, estimated rental values (ERVs)) should have been disclosed in the notes to the consolidated financial statements as well as other information such as the sensitivity of carrying amounts to these assumptions. The need for disaggregation of the disclosure was justified by the significance of investment property in the consolidated statement of financial position of the issuer.

## **IV Decision ref EECS/0112-04 – Revenue recognition**

**Financial year end:** 31 December 2009

**Category of issue:** Revenue recognition

**Standards or requirements involved:** IAS 18 *Revenue*

**Date decision taken:** 13 April 2011

#### *Description of the issuer's accounting treatment*

22. The issuer is a real estate developer that buys land for construction of apartments. One business area is to identify and buy land and prepare it for construction of apartments that will be owned and managed by a housing cooperative. In such a project, the issuer sells the land to the housing cooperative before construction starts. The housing cooperative is the formal owner of the building during construction and upon completion, but the issuer provides comprehensive guarantees with respect to constructing the building and the sale of the rights in the cooperative.
23. When the design of the building is completed, the issuer establishes a housing cooperative and subscribes for all the rights. The issuer establishes the board of the housing cooperative which normally consists of three persons. One person represents the issuer, while two other board members (including the chairman) are independent professionals. The issuer markets and sells the rights to



potential members of the housing cooperative. When an adequate number of the rights have been sold, the issuer obtains financing from a bank for completion of the apartments. The loan agreement is between the housing cooperative and the bank, but the issuer is guarantor for the loan and bears the risk of increases in the loan's interest rate above a specified rate.

24. The issuer then enters into an agreement with a contractor regarding procurement and construction of the apartments. That agreement is between the housing cooperative and the contractor but the issuer acts on behalf of the housing cooperative. The board of the housing cooperative may propose alterations to the contract but the issuer is responsible for any additional construction costs in excess of the amount stated in the contract. Thereafter, the issuer sells the land to the housing cooperative and construction begins.
25. The issuer underwrites the sale of rights. This means that the issuer subscribes for the rights and is responsible to pay rent (joint operating expenses) for the rights not sold. The issuer also provides a price guarantee that the housing cooperative will not be liable if the budgeted construction costs in the building period are exceeded.
26. The issuer recognised income for the entire project when the land was transferred to the housing cooperative. The income recognised upon sale of the land represented the entire difference between the total sales price for the finished apartments and the total estimated costs for construction of the apartments. This meant that revenue for the period included the entire profit for the completed project even though construction had not been completed.
27. The issuer argued that the transfer represented a sale of goods that fulfils the revenue recognition criteria in paragraph 14(a) and 14(b) of IAS 18 for the following reasons:
  - The issuer transferred to the housing cooperative the significant risks and rewards of the land. The issuer retained the financial responsibility for the unsold rights in the housing cooperative but the issuer purported that the risk regarding these rights was different to the risks associated with the land.
  - The issuer retained neither continuing managerial involvement nor effective control over the land since it was transferred to the housing cooperative as it did not have the majority of the members of the board of the housing cooperative.

#### *The enforcement decision*

28. The enforcer found that the criteria for revenue recognition required by paragraphs 14(a) and 14(b) of IAS 18 were not met and that no revenue should have been accounted for as of the date of the transfer of land to the housing cooperative.

#### *Rationale for the enforcement decision*

29. The enforcer considered whether the risks for the project had been transferred to the buyer (the cooperative) and whether the issuer had control over the project during the construction period in accordance with paragraphs 14(a) and 14(b) of IAS 18.





### Transfer of risks

30. Even if the risk associated with the land was different to the risk associated with a right in the housing cooperative, the enforcer was of the opinion that the issuer should assess the risks for the entire project since it was exposed to material risks during the construction period. The issuer provided a price guarantee, was exposed to the risk of the contractor going bankrupt, to certain increases in the interest rate over expectations and to variations in the procurement and construction contract that the contractor would not cover. Furthermore, the issuer guaranteed the payment for the housing cooperative's debt on the building loan.
31. The enforcer was of the view that the issuer was exposed to risk as if it had built the apartments itself because it gave comprehensive guarantees in respect of the construction process. The issuer argued that the risks were transferred to the contractor through the procurement and construction contract. Paragraph 14(a) of IAS 18 requires the entity to transfer to the buyer the significant risks and rewards of ownership of the goods. Since the buyer is the housing cooperative and not the contractor, the enforcer was of the view that this condition was not met. Using subcontractors even when constructing real estate for one's own account does not change the risks undertaken by the issuer.

### Control

32. Since the issuer determined the membership of the board of the housing cooperative and appointed the same independent members to boards of several other housing cooperatives, the enforcer questioned whether the board was independent from the issuer. As members in the housing cooperative have no voting rights before they have paid their deposit, which is usually when the apartment is finished and delivered, the enforcer believed that the board was not independent from the issuer.
33. The issuer had a responsibility to monitor the agreement with the contractor during the construction period. The issuer guaranteed that the housing cooperative would not be liable if budgeted construction costs were exceeded, so the issuer was exposed to financial risk in the construction process.
34. Therefore, the enforcer believed that the issuer retained significant risks and had effective control of the land it had sold (and also the entire construction process). Consequently, the revenue recognition criteria in paragraphs 14 (a) and 14(b) of IAS 18 were not met and the issuer should have accounted for the whole project as if it had built apartments itself. Accordingly, revenue should have been recognised when the apartments were finished and delivered to the buyer of the rights, in accordance with IAS 18 and IFRIC 15.

## **V Decision ref EECS/0112-05 – Identification of chief operating decision maker and one operating segment**

**Financial year end:** 31 December 2010

**Category of issue:** Identification of chief operating decision maker and one operating segment

**Standards or requirements involved:** IFRS 8 *Operating Segments*

**Date decision taken:** 19 March 2012



#### *Description of the issuer's accounting treatment*

35. The issuer is a shipping company for chemical products, transporting a wide variety of cargoes such as organic chemicals, non-organic chemicals, clean and dirty petroleum products, vegetable oils and lube oils in trade lanes worldwide. Its fleet comprises vessels bought or held under a finance lease. Each vessel has from four to 30 tank-containers. This implies that a vessel can carry different types of cargoes and can be chartered on behalf of several customers at the same time. Even though the size varies, the vessel can sail almost anywhere. The issuer's strategy is to be a supplier of freight-services and not a tonnage provider (i.e. lessor of vessels).
36. The issuer identified the entire board of directors ('the board') as chief operating decision maker (CODM). The board consists of both executive and non-executive directors. All important operating and strategic decisions are made by the board. Decisions made by the board, include among others, decisions related to investing and disposing of vessels and decisions relating to financing. Some board members are dedicated to specific tasks related to the operations of the company. Important stakeholders are represented on the board, including the major shareholder who has sufficient voting shares to veto decisions of the board.
37. Monitoring of performance and profitability by the board is carried out based on consolidated figures. The board receives monthly consolidated financial statements, including a statement of financial position and income statement. The income statement presents monthly actual figures, monthly budget figures, together with actual and budget figures "year to date".
38. In addition, the board receives information of "time charter equivalent" (TCE) per day for the entire fleet and for five classes of vessels based on their size. TCE per day is calculated by dividing freight income less voyage related expenses (bunkers and port charges/fee) by number of available days in a fixed period. The issuer considered TCE per day to be a type of revenue figure and not an operating results figure. TCE per day is calculated without including expenses other than bunker expenses and port charges. Although TCE per day was reported monthly for classes of vessels and the figure is used to analyse revenue, TCE is not used to assess performance of the entity and the issuer believed it was not suitable to allocate resources to classes of vessels.
39. The issuer operates on an integrated basis with a single business activity; transportation of chemicals. The vessels are not dedicated to specific cargoes or trade lanes, and the business is not organised according to the size of the vessels or types of tanks. The issuer has centralised operating functions, including freight contracting and technical management. The vessels are monitored as a portfolio due to the fact that the vessels are not dedicated to a specific cargo or specific geographical area. The board reviews operating results only on a consolidated basis.
40. Consequently, based on the information received and the operating results reviewed by the CODM, the issuer identified one operating segment – "*Chemical tankers*".

#### *The enforcement decision*

41. The enforcer did not disagree with the accounting treatment of the issuer that identified the board of directors as the CODM and identified only one operating segment.



### *Rationale for the enforcement decision*

42. According to paragraph 7 of IFRS 8 the function of the CODM is to allocate resources to and assess the performance of the operating segments of an entity. The issuer's board reviews and assesses performance based on the monthly information described above. The management, who do not include any board members, did not receive information of operating results at a lower level than the consolidated level. The information received by the management was similar to the information received by the board, but included some additional details. No income statement information was provided to the management at a lower level than the consolidated income statement and balance sheet.
43. In addition to consolidated operating results, the board received monthly information of TCE per day for each of the five classes of vessel based on their capacity. The enforcer questioned if TCE per day was an operating result, referred to in paragraph 5 of IFRS 8, which was regularly reviewed by the CODM to allocate resources and to assess performance and hence whether the issuer had five operating segments. However, it appeared that TCE was not suitable to allocate resources to classes of vessels.
44. Consequently, the enforcer concluded that the information and explanation provided supported the issuer's conclusion that the entire board of directors was identified as the CODM and the entire fleet represented one operating segment in accordance with IFRS 8. The conclusion in respect of there being only one segment was supported by the fact that there were no segment managers identified, as indicated in paragraph 9 of IFRS 8.

## **VI Decision ref EECS/0112-06 – Impairment of Assets: Discount rate used in determining value in use**

**Financial year end:** 31 December 2008

**Category of issue:** Calculation of value in use

**Standards or requirements involved:** IAS 36 *Impairment of Assets*

**Date decision taken:** 9 July 2010

### *Description of the issuer's accounting treatment*

45. The issuer is an international company providing auto parts for the automotive, commercial vehicle and industrial markets, operating in many different jurisdictions with different currencies. During 2008 the issuer experienced financial difficulties marked by a decline in revenue, a reorganisation and restructuring of the business and it reported a loss for the year. An impairment test of goodwill was performed but no impairment was recognised.
46. For the purpose of impairment testing of goodwill the issuer calculated the value in use for each CGU using a discounted cash flow (DCF) model. The discount rate used was the issuer's weighted average cost of capital (WACC) which is a weighted average of the cost of equity and the cost of debt. The cost of equity was determined by using the Capital Asset Pricing Model (CAPM). The CAPM calculates the expected return of an asset based on the risk free rate, beta and market risk premium.
47. The issuer had determined the cost of equity to be 9.2 % and the cost of debt to be 9.0 %. Pre-tax WACC was estimated to be 9.0 %, but a discount rate of 11.0 % was used in the impairment test in order to be prudent.



### *The enforcement decision*

48. In the opinion of the enforcer, the discount rate used was not calculated in accordance with the requirements of IAS 36. The errors identified by the enforcer relating to the inputs used to estimate the discount rate (i.e., cash flows denominated in a foreign currency, market risk premium, beta, cost of debt, debt/equity ratio and usage of discount rate per CGU) implied that the discount rate applied to determine the asset's value in use was understated.

### *Rationale for the enforcement decision*

49. The enforcer investigated the following six inputs and elements of the discount rate where it was considered that they did not comply with the requirements of IAS 36: treatment of cash flows denominated in a foreign currency, determination of market risk premium, use of beta, calculation of the cost of debt, determination of the debt/equity ratio and the determination of a discount rate for each CGU.

### Cash flows denominated in a foreign currency

50. The issuer applied one discount rate for all cash flows, irrespective of the currency in which the cash flows would be generated. Because of its complex structure, the issuer built its model using a forecast denominated in the functional currency of the parent company. The issuer was of the opinion that the forecast would not be more precise by predicting how exchange rates would fluctuate and affect the company over the long-term. The issuer argued that such an approach required a level of detail that was unrealistic and impracticable.
51. According to paragraph 54 of IAS 36, the future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. Paragraph 54 of IAS 36 requires the present value to be translated using the spot exchange rate at the date of the value in use calculation.
52. Furthermore, the currency in which the estimated cash flows are denominated affects many of the inputs to the WACC calculation, including the risk free interest rate, beta, and cost of debt. The issuer used the 10-year government bond rate for its jurisdiction as the risk free rate in the calculation of the cost of equity using the CAPM model. As government bond rates differ between countries (e.g., due to different expectations about future inflation), value in use could be calculated incorrectly due to the disparity between the expected inflation reflected in the estimated cash flows and the risk free rate.

### Market risk premium

53. The issuer used a forward-looking risk premium of 3.35 % after tax based on analysis with time periods of 3-5 years when calculating the cost of equity using CAPM. The issuer collected information about forward-looking premiums from three independent providers of such data (4.7 % for an infinite time period, 3.6 % for 3-5 years, and 3.1 % for 5 years). The issuer used an average for a 3-5 year period as in the issuer's opinion this time period corresponded most closely with the time period of the estimated future cash flows.
54. In the issuer's opinion, the use of a forward-looking risk premium better reflected estimated future cash flows than a historical risk premium. In the enforcer's view the cost of capital should be calculated using a long-term perspective as the value in use calculation was based on long-term cash



flows. According to paragraph 56 of IAS 36 the discount rate is a rate that reflects current market assessments of the time value of money and the risks specific to the asset. It is the return that investors would require if they were to choose an investment that would generate cash flows of amount, timing and risk profile equivalent to those that the entity expects to derive from the asset. Consequently, the enforcer concluded that a forward-looking premium with an infinite time period better reflected estimated long-term future cash flows.

### Beta

55. Beta is the systematic risk of a security compared to the market as a whole. The levered beta is a beta which includes the financial effects from leverage. The unlevered beta is the beta of a company without any debt. Unlevering a beta removes the financial effects from leverage. Only the levered beta is observable.
56. The issuer used an independent data provider to calculate its beta and the beta for a peer group. The calculation showed a levered beta for the issuer of 2.5 and an unlevered beta of 1.0. The median of unlevered betas from a peer group in the same industry was calculated as 0.9. The issuer used a beta of 1.2 in the CAPM in order to be conservative.
57. Paragraph 55 of IAS 36 requires a company to use a pre-tax discount rate that reflects the time value of money and the risks specific to the assets in question. Paragraphs 56-57 and Appendix A15-21 of IAS 36 give further guidance. In the enforcer's opinion, when CAPM and WACC are used to estimate the discount rate, the issuer should follow the rationale behind CAPM and WACC to the extent that this does not contradict the principles of IAS 36.
58. The enforcer determined that the issuer had incorrectly used the median of the peer group's unlevered beta and had not recalculated the unlevered beta into a levered beta. The enforcer was of the opinion that by using the unlevered beta the calculated cost of capital did not take into account the financial risk shareholders were facing.

### Cost of debt

59. The issuer calculated its cost of debt using a base rate plus a margin. The base rate was estimated using treasury bills with maturities of 3 months, with 1% added for expected future increase in the borrowing rate. The issuer had long-term borrowings in major international currencies. The base rate was weighted based on each currency's share of the total long-term borrowings. The issuer had refinanced the debt shortly before year end and had used the recently renegotiated margin in calculating its cost of debt. The issuer also added an element to cover future expected increases in the interest rate without any explanation about how these increases were determined.
60. The enforcer was of the view that the cost of debt should be calculated based on a long-term perspective (corresponding to the long-term cash flows used in the impairment test). According to paragraph 56 of IAS 36 the discount rate is a rate that reflects current market assessments of the time value of money and the risks specific to the asset. Therefore, the enforcer concluded that an entity's cost of debt cannot be estimated by using a short-term rate plus a debt margin. In the enforcer's view the issuer should have used observable interest rates that were consistent with the time period of the cash flows.



61. The enforcer also concluded that the use of the risk free rate in the cost of equity and cost of debt should be consistent. The issuer had used a 10-year risk free rate in the calculation of its cost of equity and the enforcer was of the opinion that this time period should also be reflected in the risk free rate used to calculate the issuer's cost of debt.

#### Debt/equity ratio

62. The issuer calculated its weighted average cost of capital using the proportions of 85 % debt and 15 % equity. The weighting was based on recognised values in the annual financial statements as of 31 December 2008. According to the issuer, a typical capital structure in the industry is 35 % equity and 65 % debt.
63. Paragraph A19 of IAS 36 requires the discount rate to be independent of the entity's capital structure and the way the entity financed the purchase of the asset. Accordingly, the enforcer was of the opinion that the WACC-model should not reflect the relationship between debt and equity of the issuer, but should be based on the weighting of debt and equity in the capital structure of the peer group of companies which reflected the capital structure of the industry.

#### Discount rate per CGU

64. The issuer used the same discount rate for all cash-generating units. The issuer argued that the different CGUs represented different risk profiles in the short-term, but over a longer business cycle there was no basis for claiming that the risk profile was different. The issuer argued that even if there could be short-term phase lags, all CGUs have the same business cycle over the longer term. The issuer also informed the enforcer that the internal targeted rate of return was essentially the same for all the CGUs, but can be adjusted for time lags due to the different CGUs being in different phases of their cycle. The issuer was of the opinion that since impairment tests cover a long-time period, there was no reason to apply different discount rates to the cash flows of the different CGUs.
65. According to paragraph 55 of IAS 36 the discount rate shall reflect the risks specific to the asset. Accordingly, the enforcer was of the opinion that one discount rate for all the CGUs does not represent the risk profile of each CGU. This was further supported by the fact that when determining the betas, the issuer had selected different peer companies for different CGU which indicated different risk profiles for each of the CGUs.

### **VII Decision ref EECS/0112-07 – Reasonable changes in estimates**

**Financial year end:** 31 December 2008

**Category of issue:** Reasonable changes in estimates

**Standards or requirements involved:** IAS 36 *Impairment of Assets*

**Date decision taken:** 09 July 2010

#### *Description of the issuer's accounting treatment*

66. The issuer performed an impairment test of goodwill at the year-end, but no impairment charge was recognised. For the purpose of impairment testing of goodwill the issuer calculated the value in use using a discounted cash flow (DCF)-model. The issuer used a discount rate of 11 % in the impairment test for all CGUs.



67. No disclosures about sensitivity to key assumptions were provided in the financial statements. The issuer prepared a sensitivity analysis that showed that for CGU A a discount rate up to 15 % would not result in impairment, while for CGUs B and C a discount rate of 14 % or higher would lead to impairment. According to the issuer, this implied that a reasonable change in the discount rate would not result in impairment, and that disclosures of sensitivity were not required according to paragraph 134(f) of IAS 36.

*The enforcement decision*

68. The enforcer found that disclosure of the sensitivity to key assumptions used in the impairment test of goodwill should have been disclosed as a combination of reasonable changes in several key assumptions would have led to an impairment loss.

*Rationale for the enforcement decision*

69. According to paragraph 134(f) of IAS 36, information about the sensitivity to key assumptions shall be given if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount.
70. In the enforcer's opinion, it was not sufficient to consider only a reasonably possible change in the discount rate. Consideration should have been given to a reasonably possible change in any of the key assumptions used to estimate future cash flows that would have resulted in the carrying amount of a CGU exceeding value in use, and if a reasonably possible change in the cash flows and a reasonably possible change in the discount rate together would have resulted in an impairment loss.

## **VIII Decision ref EECS/0112-08 – Impairment testing of goodwill**

**Financial year end:** 31 December 2010

**Category of issue:** Impairment test of goodwill

**Standards or requirements involved:** IAS 36 *Impairment of Assets*

**Date decision taken:** 31 May 2011

*Description of the issuer's accounting treatment*

71. The issuer specialises in the communications and media sector with three main operating segments: magazines, outdoor advertising and digital (magazine websites and portals). Goodwill amounted to 22% of total assets.
72. The issuer performed an impairment test of various cash-generating units ('CGUs'). The cash flow projections were based on the most recent financial budgets approved by management. Despite the fact that the realised cash flows for CGU 1 in 2010 were negative and far below budgeted cash flows for that period, management had significantly raised cash flows forecasts for 2011 without sufficient justification.
73. The calculation of the projected cash flows was simplified. Cash flows were calculated by adding back depreciation charges to the budgeted result for the period. Expected changes in working capital and capital expenditure were not taken into account.





### *The enforcement decision*

74. The enforcer asked for justification of the assumptions used in the impairment test and concluded that it was not prepared based on reasonable and supportable assumptions as required by paragraph 33(a) of IAS 36.
75. Furthermore, the cash flow projections used by the issuer did not take into account investments in working capital or in operating assets to maintain the CGUs in their current condition and were therefore not in compliance with paragraph 39 of IAS 36.

### *Rationale for the enforcement decision*

76. Paragraph 33 (a) of IAS 36 states that cash flow projections used in measuring value in use shall 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. Furthermore, paragraph 34 of IAS 36 states that management must assess the reasonableness of the assumptions by examining the causes of differences between past cash flow projections and actual cash. Management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes.
77. Despite the fact that the realised cash flows for CGU 1 in 2010 were negative and far below projected cash flows for 2010 (after being below projected cash flows in previous periods), management had significantly raised budgeted cash flows for 2011 without sufficient justification. In its correspondence with the enforcer, the issuer provided no specific arguments to explain the difference between budgeted past and actual results. As a result, the enforcer had serious doubts about management's ability to establish realistic budgets.
78. Based on the lack of justification from the issuer about the assumptions underlying the cash flow projections prepared by management and management's tendency to be overly optimistic, it was the enforcer's opinion that the cash flow projections were not based on reasonable and supportable assumptions and, therefore, were not in compliance with paragraph 33(a) of IAS 36.
79. According to paragraph 39 of IAS 36 estimates of future cash flows shall include: (a) projections of cash inflows from the continuing use of the asset; (b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset and (c) net cash flows to be received (or paid) for the disposal of the asset at the end of its useful life. Further, paragraphs 41 and 49 of IAS 36 state that projected cash outflows shall include those for the day-to-day servicing of the asset (which include future cash outflows to maintain the level of economic benefits expected to arise from the asset in its current condition).
80. Although the cash flows used to measure value in use may not reflect a future restructuring to which an entity is not yet committed or the effect of improving or enhancing the asset's performance (paragraph 44 of IAS 36), given the expected growth rate of 5 % assumed, it was highly unlikely that no investments in working capital or operating assets would need to be made to maintain the assets of the CGUs in their current condition. Therefore, the enforcer was of opinion that the cash flow projections used by the issuer were not in compliance with paragraph 39 of IAS 36.





## **IX Decision ref EECS/0112-09 – Disclosure of cash-generating units**

**Financial year end:** 31 December 2010

**Category of issue:** Disclosure of cash-generating units

**Standards or requirements involved:** IAS 36 *Impairment of Assets*

**Date decision taken:** 01 September 2011

### *Description of the issuer's accounting treatment*

81. The issuer is active in five different sectors and possesses a portfolio of over 60 brands. Those five sectors were identified as operating segments. In its financial statements as at 31 December 2010, the issuer presented the gross and net carrying amounts of brands and trade names by operating segment, but without any corresponding analysis of goodwill.
82. With respect to impairment testing of intangible assets with indefinite useful lives, the issuer presented the following information in the note to its consolidated financial statements:
  - (a) The main assumptions for the determination of the forecasted cash flows in the form of a table showing the discount rate (post-tax and pre-tax) and the growth rate for each operating segment; and
  - (b) The sensitivity to a 0.5 percentage-point change in the post-tax discount rate or in the growth rate in the form of a table showing intangible assets with indefinite useful lives close to breakeven and the related impairment charges that would result from such a change by operating segment.

### *The enforcement decision*

83. The enforcer concluded that disclosures of the allocation of goodwill and intangible assets to the cash-generating units (CGUs) did not comply with the requirements of paragraph 134 of IAS 36, especially on disclosure of information on goodwill for each CGU.

### *Rationale for the enforcement decision*

84. Paragraph 134 of IAS 36 requires disclosure of information for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives.
85. The enforcer established from correspondence and meeting with the issuer that the CGUs containing goodwill and intangible assets with indefinite useful lives were determined by brand and trade name and that they were smaller than the operating segments. Nevertheless, the issuer did not disclose for each year presented the carrying amounts of goodwill and intangible assets with indefinite useful lives by CGU for confidentiality reasons.
86. The enforcer noted the significant net carrying amounts of goodwill and brands and trade names in the issuer's financial statements.
87. The enforcer concluded that confidentiality was not a valid reason for not disclosing the carrying amounts of goodwill and intangible assets with indefinite useful life by CGU.