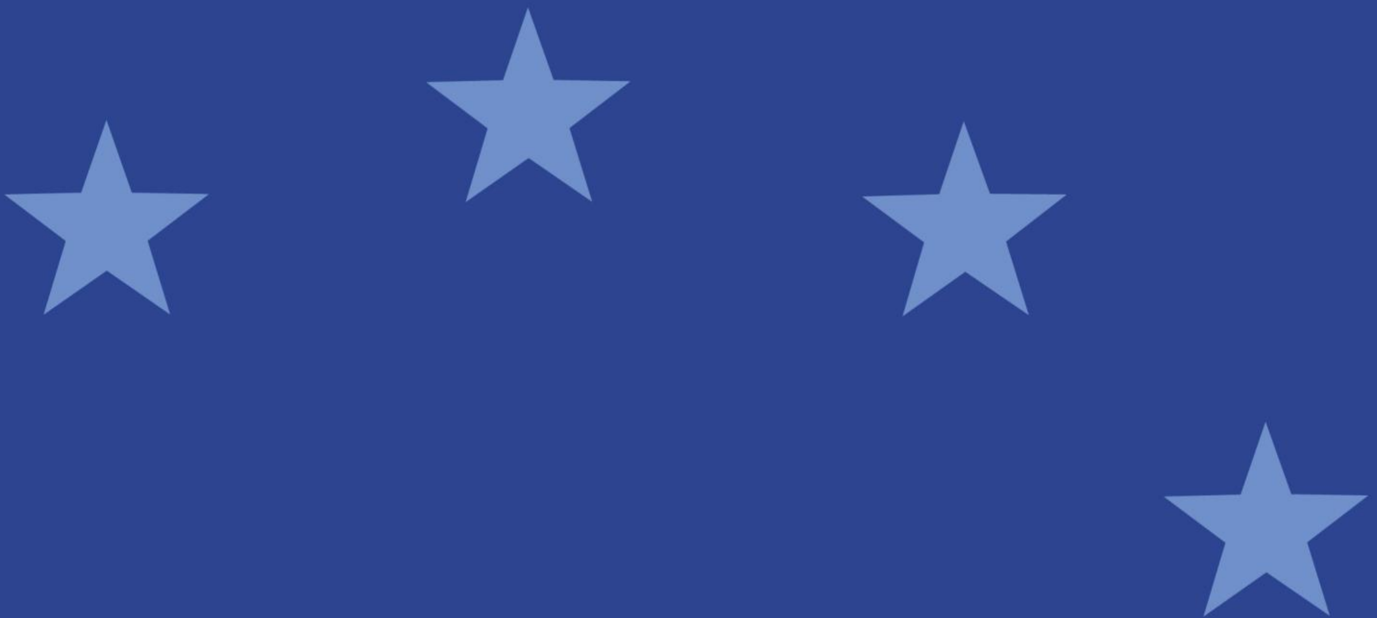
Report

17th Extract from the EECS's Database of Enforcement



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The decisions included in this extract were taken by national enforcers in the period from February 2013 to November 2014. ESMA will continue publishing further extracts from the database on a regular basis, with the next extract expected to be published in the second half of 2015.

List of abbreviations and acronyms used in this report

AFS	Available for sale
CGU	Cash-Generating Unit
EEA	European Economic Area
EECS	European Enforcers Coordination Sessions
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IFRS IC	International Financial Reporting Standards Interpretation Committee
PPA	Purchase Price Allocation
PPE	Property, Plant and Equipment

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 strengthening supervisory convergence and 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, 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 of 41 European enforcers from 28 Member States and 2 countries in the European Economic Area (EEA) with responsibilities in the area of supervision and enforcement of financial information.

With responsibility for coordination of supervision of approximately 6 400 issuers listed on European regulated markets preparing IFRS financial statements, EECS currently constitutes the largest regional enforcers' network with supervision responsibilities for IFRS. Through EECS, European enforcers discuss and share their experience on the application and enforcement of IFRS. In particular, they discuss significant enforcement cases before or after decisions are taken in order to promote a consistent approach to the application of IFRS. In addition, EECS produces technical advice on the issuance of ESMA Statements and opinions on accounting matters which deserve specific focus. It also reviews accounting practices applied by European issuers to enable ESMA to monitor market developments and changes in those practices.

In taking enforcement decisions, European enforcers apply their judgement, knowledge and experience to the 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 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. Decisions taken by enforcers do not provide generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee (IFRS IC). These decisions are based on the IFRS requirements valid at the time of the IFRS financial statements and may be superseded by future developments in IFRS.

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

In accordance with the provisions of the Guidelines on the enforcement of financial information,[1] cases submitted to the enforcement database are considered as appropriate for publication if they fulfil one or more of the following criteria:

- The decision refers to a complex accounting issue or an issue that could lead to different applications of IFRS;
- The decision relates to a relatively widespread issue among issuers or within a certain type of business and, thereby, may be of interest to other enforcers or third parties;
- The decision addresses an issue on which there is no experience or on which enforcers have inconsistent experiences;
- The decision has been taken on the basis of a provision not covered by an accounting standard.

1 http://www.esma.europa.eu/system/files/2014-807_-_final_report_on_esma_guidelines_on_enforcement_of_financial_information.pdf

esma

I Decision ref EECS/0115-01 – Extinguishment of debt

Financial year end: 30 June 2013
Category of issue: Debt instruments
Standards or requirements involved: IAS 27 *Separate Financial Statements*; IAS 39 *Financial Instruments: Recognition and Measurement*; IFRS 10 *Consolidated Financial Statements*; IFRIC 19 – *Extinguishing Financial Liabilities with Equity Instruments*

Description of the issuer's accounting treatment

1. The issuer provides financial services to institutional investors. In 2008, it issued bonds redeemable in 2013. Before the end of the maturity period, the issuer forecasted a cash shortfall that would prevent their reimbursement and negotiated an alternative to cash repayment with the bondholders. The parties reached an agreement whereby the issuer would give 33% of the shares of its fully owned and consolidated subsidiary A in exchange for the redemption of the bonds.

2. At the date of the settlement, the carrying value of the liability was CU 8,000[2] and the book value of 33% stake in subsidiary A was CU 5,000. The fair value of the 33% stake in subsidiary A was estimated at CU 8,500 at the date of the transaction on the basis of an independent expert evaluation. The premium was paid to extinguish the debt because the issuer could not repay the bonds in accordance with their original terms.

3. The issuer considered that the transaction was not directly in the scope of IFRIC 19 because it did not involve the issuer's own equity instruments. However, the issuer applied IFRIC 19 by analogy. Consequently, in accordance with paragraph 41 of IAS 39, the issuer recognised a loss of CU 500 corresponding to the difference between the fair value of the shares (CU 8,500) and the carrying amount of the bonds (CU 8,000).

4. The issuer increased the non-controlling interests by CU 5,000 (accounting value of 33% of subsidiary A) and attributed the residual difference of CU 3,500 (fair value of 33% of subsidiary A i.e. CU 8,500 minus accounting value of CU 5,000) to equity on the basis of the requirements of paragraphs 30 and 31 of IAS 27 (new paragraphs 23 and B96 of IFRS 10) which require that any difference between adjustments to non-controlling interests and the fair value of consideration paid or received shall be recognised in equity.

The enforcement decision

5. The enforcer agreed with the accounting policy applied by the issuer.

Rationale for the enforcement decision

6. According to paragraphs 30 and 31 of IAS 27 (or new paragraphs 23 and B96 of IFRS 10), changes in ownership interest that do not result in a loss of control are equity

[2] In this decision, and in other decisions in this report, monetary amounts are denominated in 'currency units (CU)'.

transactions, where any difference between the amount by which non-controlling interests are adjusted and the fair value of the consideration received is recognised in equity.

7. In the fact pattern, the 'consideration received' for the disposal of the 33% stake in subsidiary A is the extinction of the liability (CU 8,000). The carrying amount of the liability corresponds to its fair value at the extinction date because the extinction occurs almost at maturity.

8. The enforcer acknowledged that the application of the provisions of IAS 27 (or now IFRS 10) would not have reflected a fair value of the consideration paid to redeem the liability (33% stake in subsidiary A, i.e. CU 8,500) higher than the accounting value of the liability (CU 8,000). The application of IFRIC 19 results in a loss, which reflects the economic substance of the operation, as the issuer paid a premium to extinguish its debt because it could not repay the bonds in accordance with its original terms.

9. The main purpose of the transaction was the debt extinction, which is achieved through the disposal of 33% stake in subsidiary A. Paragraph 41 of IAS 39 requires that any difference between the carrying amount of the liability and the consideration paid should be recognised in profit and loss. Therefore the sole application of IAS 27 (or now IFRS 10) would fail to represent faithfully the transaction which occurred. As such, the provisions of IAS 39 should take prominence over IAS 27 (now IFRS 10), and the guidance of IFRIC 19 can be used.

10. In 2012, the IFRS IC addressed a potential conflict between paragraphs 30 and 31 of IAS 27 and the provisions of IFRIC 17 *Distributions of Non-cash Assets to Owners on the issue of non-cash acquisition of non-controlling interests* in order to clarify whether the difference between fair value of the consideration given and the carrying amount of the assets transferred should be recognised in equity or in profit and loss. The IFRS IC noted[3] that paragraph 31 of IAS 27 deals solely with the difference between the carrying amount of non- controlling interests and the fair value of the consideration given; this difference is required to be recognised in equity. This paragraph does not deal with the difference between the fair value of the consideration given and the carrying amount of such consideration. The IFRS IC concluded that the difference between the fair value of the assets transferred and their carrying amount from the derecognition of those assets should be accounted for in profit and loss. Considering this decision, it can be argued that the same reasoning applies to the derecognition of a liability.

[3] IFRIC Update, IFRS Interpretation Committee, January 2013

II Decision ref EECS/0115-02 – Impairment charge for a decline in the fair value of available for sale financial assets

Financial year end: 31 December 2013
Category of issue: Impairment of financial assets
Standards or requirements involved: IAS 39 *Financial Instruments: Recognition and Measurement*

Description of the issuer's accounting treatment

11. The issuer invested in shares of unlisted companies, recognised them as available-for-sale (AFS) financial assets and measured them at fair value. According to paragraph 89 of IAS 39, declines in fair value are recognised as impairment charges when a significant or prolonged decline in an asset's fair value below its cost indicates that it is impaired.

12. The issuer developed an accounting policy that defined 'a significant decline' as a decrease in the fair value of the investments that was more than the relative decrease in value of a basket of relevant stock-market indices. As a consequence, the issuer did not recognise impairment charges on various occasions even when the absolute reduction in the fair value of some investments was 60 – 70% of cost.

13. The issuer believed that a decline over a period of 3 to 5 years indicated a prolonged decline in the fair value. However, even when either of the significant or prolonged thresholds had been reached, the issuer considered the circumstances further and did not necessarily recognise an impairment charge.

The enforcement decision

14. The enforcer disagreed with the issuer and considered that the issuer had made an unreasonable judgment in its definition of 'significant or prolonged'. It should have recognised an impairment charge equal to the reduction in the fair value of its AFS financial assets.

Rationale for the enforcement decision

15. Paragraph 67 of IAS 39 requires a decline in the fair value of an available-for-sale financial asset to be recognised in profit or loss when there is objective evidence that it has been impaired. As no quantitative threshold for 'significant or prolonged' is defined in IAS 39, the enforcer considered that issuers should determine appropriate thresholds by considering, for example, other available guidance and market practices.

16. The issuer's judgement was outside the range of thresholds that the enforcer had seen previously and understood to be commonly applied. The issuer was unable to explain the reasons for having a figure so far outside the range. In particular, the enforcer considered it was unreasonable for the issuer to have a policy that allowed a reduction in fair value as large as 60-70% of the original cost without considering the absolute decline to be significant.

17. The enforcer's view was supported by the findings of ESMA's *Review of Accounting Practices – Comparability of IFRS Financial Statements of Financial Institutions in Europe*[4], in which ESMA found that those institutions use a wide range of thresholds in their impairment assessment. Financial institutions considered that a decrease was 'significant' when ranging from 20% to 50% of the original cost and 'prolonged' when lasting from 6 months to 3 years. In its assessment of the financial institutions that used very high thresholds, ESMA expressed its doubt on the reasonability of these judgments.

[4] http://www.esma.europa.eu/system/files/2013-1664_report_on_comparability_of_ifrs_financial_statements_of_financial_institutions_in_europe.pdf

III Decision ref EECS/0115-03 – Measurement of financial instruments at fair value

Financial year end: 31 December 2013
Category of issue: Financial instruments
Standards or requirements involved: IFRS 13 *Fair Value Measurement*

Description of the issuer's accounting treatment

18. The issuer invested in shares of listed and unlisted entities. They were accounted for as AFS financial assets and represented over 50% of its total assets. The issuer measured the fair value of the listed securities on the basis of stock exchange prices when the shares were listed on an active market or based on valuation techniques when there was no active market.

19. In order to assess the existence of an active market, the issuer calculated a number of ratios and compared them against the following benchmarks:
    - daily % of average value of trades / capitalisation lower than 0.05%;
    - daily equivalent value of trades lower than CU 50,000 ;
    - daily bid-ask spread higher or equal to 3%;
    - maximum number of consecutive days with unvaried prices higher than 3;
    - % of trading days lower than 100%.

20. On the basis of this analysis and the limited trading volume of the shares, the issuer considered that its investments in listed companies A, B and C were not traded in active markets and measured the fair value of these investments using a valuation technique on the basis of level 3 inputs.

The enforcement decision

21. The enforcer disagreed with the issuer's assessment on the "active markets" and considered that quoted prices of financial assets should have been used to measure fair value as, in accordance with IFRS 13.

Rationale for the enforcement decision

22. Appendix A of IFRS 13 defines fair value as the price that would be received in an orderly transaction. Paragraph 72 of IFRS 13 establishes the concept of 'fair value hierarchy' and categories the inputs used in fair value measurement into three levels, giving the highest priority to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs. Paragraph 77 of IFRS 13 states that "a quoted price in an active market provides the most reliable evidence of fair value" and should be "used without adjustment to measure fair value whenever available". Paragraph 67 of IFRS 13 states that valuation techniques measuring fair value should "maximise the use of relevant observable inputs and minimise the use of unobservable inputs".

23. Appendix A of IFRS 13 defines active market as a market in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

24. Paragraph B37 of IFRS 13 provides indicators to identify a significant decrease in the volume or level of activity of traded instruments. The enforcer considered that the indicators used by the issuer were insufficient to conclude that the transaction price did not represent fair value or that transactions occurred with insufficient frequency and volume.

25. Paragraph B43 of IFRS 13 lists circumstances that may indicate that transactions are not orderly, as a significant decrease in the volume or level of activity is not sufficient to conclude that all transactions are not orderly.

26. The enforcer considered that the issuer did not gather sufficient information to determine whether transactions were orderly or took place with sufficient frequency and volume to provide pricing information. Therefore, based on available data, it was not possible to conclude that the markets, where the investments were listed, were not active and further analysis should have been performed to measure fair value.

27. Finally, the valuations used to measure the fair value of financial assets were far above quoted prices, which raised additional concerns.

IV Decision ref EECS/0115-04 – Fair value measurement in business combination

Financial year end: 31 December 2012
Category of issue: Fair value measurement
Standards or requirements involved: IFRS 3 *Business Combinations*; IFRS 13 *Fair Value Measurement*

Description of the issuer's accounting treatment

28. In 2012, the issuer acquired businesses A, B and C. The three acquisitions were mainly composed of fixed tangible assets, with a low value attributed to customer contracts, customer relationships, brand name or workforce. These acquisitions were accounted for through a Purchase Price Allocation (PPA), in which the issuer measured the fair value of the assets on the basis of the replacement cost of comparable utility.

29. As the fair value of the acquired assets and liabilities assumed was in excess of the purchase price of each acquisition, the issuer recognised a gain from bargain purchase for each acquisition.

30. In accordance with the provisions of paragraph 36 of IFRS 3, and before recognising a gain from bargain purchase, the issuer reassessed the assets acquired and liabilities assumed to ensure that their measurement reflected all available information at acquisition date. The issuer considered that bargain purchase occurred due to the economic environment as well as the willingness of every seller to dispose of non-core assets after unsuccessful selling attempts and no competition for the acquired businesses. Furthermore, the strong balance sheet liquidity and access to financial markets of the issuer reinforced the negotiating position of the issuer, which foresaw to realise higher benefits in the long term because of its operational knowledge and large customer base.

31. The PPA reflected the fair values of net assets in their current state. Furthermore, the issuer considered that future capital expenditures would result in price reductions and that bargain purchase would compensate for expected future losses or investments to be recognised.

The enforcement decision

32. The enforcer disagreed with the issuer and considered that the treatment of the business acquisitions was not in accordance with IFRS 3, as the excess of fair value of net acquired assets over purchase consideration was mainly due to measurement errors.

Rationale for the enforcement decision

33. As the determination of the fair value of tangible assets in the PPA excluded capital expenditure and additional investments, the enforcer considered that the assessment was inaccurate and should have included expectations of future cash outflows to reflect the

current status and level of performance of the assets. Paragraph BC39 of IFRS 13 indicates that the exit price of an asset embodies expectations about future cash inflows and outflows associated with this asset. Fair value of the assets includes expectations of future cash flows and reflects assets' current status and level of performance. In the enforcer's view, any market participant would have to carry out similar investments to sustain the current operation, and would consequently take these costs into account in the calculation of the net present value of the assets. Expectations of future expenses will depress the price an acquirer is willing to pay and consequently the net fair value of the assets.

34. Paragraphs B8 and B9 of IFRS 13 indicates that the cost approach is based on the acquisition cost for the acquisition or construction of a substitute asset of comparable utility, adjusted for obsolescence. In the enforcer's view, economic obsolescence should have been taken into account, as the acquired businesses faced environmental or regulatory requirements and reduced demand for the businesses' products.

35. The issuer strengthened its determination of the bargain purchases with the absence of other market participants for the acquired businesses. However, paragraph BC134 of IFRS 13 concludes that market inactivity does not indicate that a transaction price does not represent fair value, but that further assessment should be performed by the issuer. The enforcer considered that additional work undertaken was insufficient to justify the bargain purchase.

36. The issuer considered that the bargain purchase was realised due to its large customer base and operational knowledge. As the fair value is set from a market participant's perspective, an issuer’s assessment of future positive effects and own use cannot be used as an argument for recognition of a bargain purchase in accounting in accordance with paragraph B43 of IFRS 3.

37. Finally, even though the issuer reassessed some sections of the PPA, the enforcer considered that the use of independent valuations experts did not relieve management from its responsibility to ensure that appropriate valuation techniques and assumptions are used to estimate fair value. As such, the recognition and measurement of the assets acquired and liabilities assumed should have included a test of reasonableness of the entire transaction, including the appraisals of fixed assets.

V Decision ref EECS/0115-05 –Presentation of financial statements

Financial year end: 31 December 2013
Category of issue: *Investments in Associates*
Standards or requirements involved: IAS 1 *Presentation of Financial Statements*; IAS 28 *Investments in Associates and Joint Ventures*

Description of the issuer's accounting treatment

38. The issuer presented in its statement of comprehensive income a line for the 'share of the profit or loss of associates and joint ventures accounted for using the equity method'. As a component of the result from associates and joint ventures for the year was a material impairment for Property, Plant and Equipment (PPE), the issuer considered presenting this amount on a separate line of the statement of comprehensive income. By doing that, the issuer intended to present an adjusted measure of share of profit or loss of associates and joint ventures, which excluded the effect of the PPE impairment.

39. As the issuer presented a significant impairment of PPE unrelated to its associate and joint ventures in a separate part of the statement of comprehensive income, it considered that the presentation of associates and joint ventures on two separate lines was consistent with this treatment and justified because in accordance with paragraph 29 of IAS 1 items of dissimilar nature should be presented separately unless they are immaterial.

The enforcement decision

40. The enforcer disagreed with the issuer and considered that the presentation of two separate lines, presented in different aggregates, related to the 'share of the profit or loss of associates and joint ventures accounted for using the equity method' for one single associate was not in compliance with the requirements of IAS 1 and required the issuer to present this item on a single line.

Rationale for the enforcement decision

41. Paragraph 82(c) of IAS 1 requires the presentation of the 'share of the profit or loss of associates and joint ventures accounted for using the equity method' as a separate line item within the statement of comprehensive income.

42. Paragraph IG6 of IAS 1 provides examples of statements of comprehensive income where the share of profit of associates is presented in one single line and is described as 'the share of associates' profit attributable to owners of the associates i.e. it is after tax and non-controlling interests in the associates'. As the impairment of PPE is part of the share of the profit and loss of the associates, the enforcer concluded that it cannot be presented separately.

43. The enforcer concluded that separate presentation of elements (such as an impairment charge) related to the profit or loss of a single associate and/or a single joint venture

leading to an adjusted measure of the profit or loss, without presentation of the total amount does not comply with IAS 1.

VI Decision ref EECS/0115-06 – Accounting for claims in construction contracts

Financial year end: 31 December 2012
Category of issue: Construction contracts
Standards or requirements involved: IAS 11 *Construction Contracts*

Description of the issuer's accounting treatment

44. The issuer is an engineering and construction company and accounts for revenues and costs associated with fixed price contracts by applying the percentage of completion method, in accordance with IAS 11.

45. As the execution of some projects was delayed, the issuer faced additional costs as well as contractual penalties and considered making claims against customers. The issuer considered that making claims against customers was a valid reason not to include them within the total costs of these contracts, considering that they were contingent liabilities and that it was a common practice in the industry. Consequently, physical work-in-progress (cumulated physical proportion of the contract work achieved at the date) was lower than economic work-in-progress in the financial statements of the issuer, since no additional costs were considered in total contract costs. Economic work-in-progress is defined as the proportion of contract costs incurred for work performed to date to the estimated total contract costs.

46. Subsequent to the year end, the issuer recognised the penalties as costs associated to the contracts.

The enforcement decision

47. The enforcer disagreed with the issuer and considered that all costs attributable to a specific contract until its final completion should be considered when they occur and that the issuer should have included penalties in the total costs of the contract in the period in which they had been notified. As such, the enforcer considered that offsetting penalties by submitting claims to customers was not in compliance with the requirements of IAS 11.

Rationale for the enforcement decision

48. According to paragraph 25 of IAS 11, the percentage of completion method requires contract revenues to be matched with contract costs incurred in reaching completion, so that revenues, expenses and profit relate to the proportion of work completed. Furthermore, paragraph 21 of IAS 11 states that contract costs should include all costs attributable to a contract from the date of securing the contract to its final completion. The delay in project execution increased total expected costs, which were not considered by the issuer and a gap arose between physical work-in-progress and economic work-in-progress, confirming that the margins of the contracts were not representative of the costs borne by the issuer.

49. In accordance with paragraph 12 of IAS 11, contract revenues are measured at the fair value of the consideration received or receivable, and are revised when events occur and uncertainties are resolved. As such, contract revenues may vary from one period to the next, because of penalties caused by delays of the contractor in the completion of the contract.

50. In accordance with paragraph 13 of IAS 11, the submission of a modification to the contract could only have been included in total revenues if it was likely that the client would approve the claim on the additional cost. Paragraph 14 of IAS 11 recognises that the measurement of revenues arising from claims depends on the outcome of negotiations and is subject to a high level of uncertainty. On the basis of information available, the enforcer considered that negotiations had not reached an advanced stage, so that claims submitted to the clients could not be included in total revenues.

VII Decision ref EECS/0115-10 – Impairment testing

Financial year end: 31 December 2011
Category of issue: Impairment of assets, reasonable and supportable assumptions
Standards or requirements involved: IAS 36 *Impairment of Assets*; IFRS 6 *Exploration for and Evaluation of Mineral Resources*

Description of the issuer's accounting treatment

51. The issuer operates in the extractive industry and applies the successful efforts method to account for its exploration and evaluation costs. Exploration and evaluation assets are tested for impairment on an individual licence level.

52. In the past, the issuer acquired an interest in a gas discovery licence, whose ownership was regulated through a joint operating agreement between the owners. A contingent plan for the development of the licence had been filed with the authorities in 2001, stating that the reserves were too small to justify standalone development and that such development depended on additional drilling results as well as changes to the extractive industry. No subsequent drilling was performed.

53. The issuer tested its exploration and evaluation assets for impairment on an annual basis, irrespective of whether any of the impairment indicators in paragraph 20 of IFRS 6 were present. In 2011, the issuer calculated the value in use of the licence to be 50% higher than its carrying value in issuer's accounts and thus justified that no impairment had to be accounted.

The enforcement decision

54. The enforcer disagreed with the issuer and considered that it had not applied reasonable and supportable assumptions in measuring the value in use and that the license asset was materially impaired.

Rationale for the enforcement decision

55. Paragraph 18 of IFRS 6 specifies that exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of the asset exceeds the recoverable amount. The enforcer considered that several impairment indicators listed in paragraph 20 of IFRS 6 were present for the licence asset, as little activity had been performed to conclude on the commercial viability of the discovery since 2007, and substantive future exploration and evaluation expenditure relating to the license was neither budgeted nor planned. According to these paragraphs of IFRS 6, the impairment loss for the license shall be measured in accordance with IAS 36.

56. Paragraph 33(a) of IAS 36 requires that cash flow projections are based on reasonable and supportable assumptions. Documents from the license's joint operating committee showed divergent views on commerciality between the issuer and other owners, including the operator.

57. The differences not only prevailed over the years, but increased as the issuer did not include newer and updated technical and economical evaluations performed by the licence joint operating committee. These differences related primarily to the evaluation of resources in place and the recovery ratio, caused by the issuer including volumes from parts of the reservoir objectively deemed not to be exploitable. Other factors included the development design and estimated production profile. In a feasibility study performed in 2011, a working group consisting of representatives from all license owners advised not to develop the discovery. Even though differences in views between license owners are common, the differences identified and the results of the feasibility study should have been considered by the issuer in its estimation of the intangible asset's recoverable value.