European Securities and Markets Authority

Report

13th Extract from the EECS's Database of Enforcement

3 April 2013 | ESMA/2013/ 444

European Securities and Markets Authority

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Table of Contents

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

The European Securities and Markets Authority (ESMA) is publishing extracts from its confidential database of enforcement decisions on financial statements by individual European enforcers, 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 European Regulation no 1095/2010 establishing 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 European Economic Areas (EEA).

The European national 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.

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).

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 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 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; and
- 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/0113-01 – Recognition of financial expense on financial liabilities measured at amortised cost

Financial year end: 31 December 2010
Category of issue: Recognition of financial expense on financial liabilities measured at amortised cost
Standards or requirements involved: IAS 39 - *Financial Instruments: Recognition and Measurement*
Date decision taken: January 2012

Description of the issuer's accounting treatment

1. The issuer operates in the real estate industry. Its main activities are: construction in the residential sector, buying and selling of land and buildings, leasing of real estate and operation of hotels.

2. In May 2008, the issuer refinanced a significant amount of its debt, which consisted of a syndicated loan and other credit facilities. The final maturity of this debt was February 2011, subject to compliance with certain covenants. In July 2008, subsequent to breaking these covenants, the issuer agreed to file for receivership. Under the applicable law, when in receivership, the management of the issuer can continue to manage the normal tasks of the business with the authorization of the administrator named by the Court.

3. In March 2011, a judge approved an 'Agreement of Creditors', thus allowing the issuer to exit the receivership. The Agreement of Creditors gave the creditors the choice between two alternatives:
   - 70% nominal debt reduction with maturity of the revised principal in the form of five annual payments: 0.5% in each of 2011 and 2012, 1% in 2013, 23% in 2014 and 75% in 2015; or
   - no nominal debt relief. The maturity of the loan would be extended to eight years with an interest rate of Euribor + 0.5%, payable retrospectively from the date of filing for receivership (July 2008).

   The second alternative was accepted by a 76% of creditors.

4. In its 2010 IFRS annual financial statements, the issuer did not recognise any financial expense for the financial liabilities. The issuer argued that, because bankruptcy law had suspended the accrual of interest during the period of receivership and the Agreement of Creditors had not been approved by the court at the date of issuance of the financial statements, there was uncertainty about the amount of expense to be recognised.

5. Once the Agreement of Creditors was approved by the court in March 2011, the issuer assessed whether the terms of the new debt, according to the Agreement of Creditors, were substantially different from the old debt. The issuer considered that the conditions of the new debt differed substantially from those of the old debt and recognised the difference between the book value of the old debt and fair value of the new debt in the statement of comprehensive income. Effectively, the unrecognised financial expense was subsumed into this gain on derecognition of the original debt.

The enforcement decision

6. The enforcer found the that the accounting treatment was not in compliance with the requirements of IAS 39 paragraphs 9 and AG 8 related to effective interest rate and asked the issuer to recognise retrospectively financial expenses amounting to 354 million euro, and to spread them over the years between the filing for receivership in July 2008 and the court decision in March 2011 as the correction of an error in accordance with paragraph 42 of IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors*.

Rationale for the enforcement decision

7. The enforcer considered the legislation suspending the accrual of interest during the period of receivership to be a legal protection allowing the debtor to re-negotiate its debt arrangements. In addition, this suspension of accrual might not be permanent as, in situations when the Agreement of Creditors includes no nominal debt relief, the Court should remove the suspension effective from the date of receivership. The decision on permanent suspension of interest accrual depends on the content of the Agreement of Creditors approved by the court. In the case of the issuer, the agreement stipulated retrospective payment of interest as though the issuer had never applied for receivership.

8. In addition, the enforcer concluded that the bankruptcy law did not affect the accounting treatment and application of the measurement basis after initial recognition, i.e. amortised cost using the original effective interest rate continued to be appropriate. The fact that the issuer was experiencing financial difficulties that created uncertainty about its ability to fulfil its obligations in full should not interrupt the application of the measurement basis of the financial liability after initial recognition to the extent that the entity continues to be a going concern. Therefore, the enforcer concluded that the issuer should have continued applying the amortised cost method recognising financial expenses under the original effective interest rate.

II Decision ref EECS/0113-02 – Intangible assets with indefinite useful life

Financial year end: 31 December 2011
Category of issue: Intangible assets with indefinite useful life
Standards or requirements involved: IAS 38 - *Intangible Assets*
Date decision taken: May 2012

Description of the issuer's accounting treatment

9. The issuer is a listed company specialising in the distribution of photographic products and services. The issuer's statement of financial position included an intangible asset described as an "externally acquired customer relationship", which represented 7 % of total assets.

10. The issuer changed its assessment of the useful life of this intangible asset from 'finite' to 'indefinite'. The issuer argued that IAS 38 paragraph 88 requires an intangible asset to be considered as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. The issuer understood the lack of a foreseeable limit to mean the lack of a 'predictable limit'. According to this view, the fact that there is no precisely determinable limit would suffice for the assessment of an intangible asset as having indefinite useful life.

11. The issuer considered that an intangible asset has an indefinite useful life when it is impossible to foresee the period of its useful life and it argued that due to a number of factors (e.g., technological evolution, changing consumer behaviour), it had become impossible to foresee the useful life of the relationship with a consumer. In support of its argument, the issuer referred to IAS 38 paragraph 91 that states that the term 'indefinite' does not mean 'infinite'.

The enforcement decision

12. The enforcer found that the change in the assessment of the useful life of the externally acquired customer relationship from 'finite' to 'indefinite' did not comply with the requirements of IAS 38.

Rationale for the enforcement decision

13. Under IAS 38, an intangible asset has an indefinite useful life only if there is no 'foreseeable' limit (i.e. expected limit) to its useful life as e.g. in case of a brand name or a customer relationship with a corporate entity. In the case of the issuer, the customer relationship was with individuals and therefore there is by definition a time limit (namely the death of the customer).

14. IAS 38 paragraph BC 65(a) states that difficulties in accurately determining an intangible asset's useful life do not provide a basis for regarding that useful life as indefinite. IAS 38 paragraph BC 62 specifies that for intangible assets based on 'legal rights', where the cash flows are expected to continue for a finite period, the useful life of the asset is limited to that period, whereas if the cash flows are expected to continue indefinitely, the useful life is indefinite.

15. The concept of indefinite not meaning infinite life, explained by IAS 38 paragraph 91, refers to the fact that for intangible assets with an indefinite useful life, maintenance costs are necessary in order that cash inflows may continue for an unlimited period of time. For example, brand names do not have an infinite useful life if no investment is made in them. This argument did not apply to the circumstances of the case.

III Decision ref EECS/0113-03 – Presentation of revenue and expenses related to service concession arrangements

Financial year end: 31 December 2010
Category of issue: Service concession arrangements
Standards or requirements involved: IFRIC 12 - *Service Concession Arrangements*
Date decision taken: November 2011

Description of the issuer's accounting treatment

16. The issuer is the parent company of a group engaged in infrastructure management (under a service concession arrangement in the scope of IFRIC 12) that operates in five sectors: motorway concessions, telecommunications, airports, car parking and logistics facilities. Its main business operations are: construction, maintenance and operation of motorways, and the management of motorway concessions (as an operator of public-to-private service concession arrangements).

17. In its 2010 consolidated IFRS financial statements, the issuer applied different accounting policies to the contractual rights received by the operator of service concession arrangements as consideration for providing construction or upgrade services, depending on the nature of those rights. These rights were recognised as either additions to the intangible assets or receivables recognised in the statement of financial position (depending on the policy applied). The issuer did not account for an expense in the statement of comprehensive income in relation to the construction services rendered.

18. The issuer justified its accounting policy stating that the construction of the infrastructure was done by a third party (a building contractor) that constructed it on its behalf, following its instructions. Since the issuer did not construct the infrastructure itself, it considered that IAS 11 - *Construction contracts* was not applicable and the acquisition of the asset should be recorded as any other asset acquisition, without any effect on the statement of comprehensive income. Revenue and expenses related to the construction were not recognised as the issuer did not assume the risks and benefits associated with the construction.

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

The enforcement decision

20. The enforcer concluded that, when applying IFRIC 12, revenue should not be offset against construction costs in the statement of comprehensive income either when the issuer constructs the asset on its own account or using a contractor. Consequently, the enforcer required the issuer to record separately the revenue and the construction or upgrade costs in accordance with IAS 11 and to correct its financial statements according to IAS 8 paragraph 19.

Rationale for the enforcement decision

21. Based on IFRIC 12 paragraph 14, an operator shall account for revenue and costs relating to construction or upgrade services in accordance with IAS 11. IFRIC 12 paragraph BC34 refers to situations when total revenue does not equal total cash inflows and explains that the reason for this outcome is that, when the operator receives an intangible asset in exchange for its construction services, there are two sets of inflows and outflows rather than one. In the first set, the construction services are exchanged for the intangible asset in a barter transaction with the grantor. In the second set, the intangible asset received from the grantor is used up to generate cash flows from users of the public service.

22. The enforcer concluded that the issuer accounting policy could only be accepted if the issuer had carried out this activity as an agent and not as a principal, as defined in IAS 18 - *Revenue*. From the specific facts and circumstances the enforcer established that that the issuer did not act as an agent. Even though the issuer did not construct the infrastructure directly, but outsourced it to a third party, the building contractor constructed it on behalf of the issuer and under its instructions. The issuer was exposed to significant risks and benefits derived from the construction and was liable for the fulfilment of all technical criteria, terms and conditions specified in the concession service agreement.

IV Decision ref EECS/0113-04 – Value in use calculation

Financial year end: 31 December 2011
Category of issue: Value in use calculation
Standards or requirements involved: IAS 36 – *Impairment of Assets*
Date decision taken: June 2012

Description of the issuer's accounting treatment

23. The issuer recognised in its statement of financial position a significant amount of goodwill exceeding 100% of its equity. For the purposes of the impairment test of goodwill, the issuer identified six CGUs.

24. The recoverable amount of each CGU was determined based on its value in use by applying the discounted cash flow method. When determining the cash flow estimates for the CGUs, costs related directly to the CGUs and a portion of issuer's sales, general and administration costs (i.e. indirect corporate costs) were included. The cash flows did not include the following in the indirect corporate costs: the Costs of Sales Director, Human Resources Director, Chief Financial Officer and Chief Information Officer. The issuer believed that these costs of corporate officers should not be allocated to the CGUs. This is on the basis that the independency of cash flows was an important criterion when determining the cash inflows and outflows of a CGU, and these cash flows benefited the company as a whole rather than the individual CGUs.

25. The unallocated corporate costs represented costs that were needed for corporate level optimisation but not to improve the performance of the individual CGUs. For example, if a CGU was sold, the costs of these corporate officers would not be taken into account when determining the sale price but would remain with the issuer after the sale.

The enforcement decision

26. The enforcer concluded that excluding certain corporate costs from the costs allocated to CGUs did not comply with requirements of IAS 36 and that all cash outflows had to be included in the cash flows forecasts.

Rationale for the enforcement decision

27. The enforcer concluded that the corporate costs were cash outflows that, according to IAS 36 paragraph 39(b), were necessarily incurred to generate the cash inflows from continuing use of the assets and could be allocated on a reasonable and consistent basis to the asset. In addition, in its internal management reports, the issuer had allocated all costs (including the costs of corporate officers) to CGUs.

28. As the goodwill and other intangible and tangible assets were fully allocated to CGUs, and all estimated cash inflows were included in the cash flows projections, it was not reasonable to exclude from the CGU's estimated cash flows any corporate level costs.

29. The guidance in IAS 36 paragraph 45(b) was not applicable in these circumstances as it referred to situations where the performance of tangible or intangible assets was enhanced. Additionally, the independency of cash flows according to definition in IAS 36 paragraph 6 and as further explained in IAS 36 paragraphs 68-69 referred to cash inflows and not to cash outflows as referred to by the issuer.

V Decision ref EECS/0113-05 – Assessment of materiality of an error

Financial year end: 31 December 2010
Category of issue: Materiality, correction of an error
Standards or requirements involved: IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors,* IAS 40 – *Investment Property*
Date decision taken: December 2011

Description of the issuer's accounting treatment

30. The issuer is a financial institution that provides banking services, including granting loans and advising in investment activities, to private, corporate and public sector customers. The issuer owned several properties classified as investment properties. According to the issuer's accounting policy, investment property is measured using the cost model, as allowed by IAS 40. The book value of the investment property in the 2010 annual financial statements was 2.2 million euro.

31. The notes to the IFRS financial statements explained that a professional valuer had estimated the fair value of one of the investment properties as being 0.8 million euro higher than its book value. Contrary to its accounting policy, the issuer recognised this amount as a revaluation gain through its statement of comprehensive income in 2010. The issuer did not indicate any voluntary change in the accounting policy and did not revalue any other investment property in its portfolio. The issuer's net loss after tax for the year 2010 was 1.6 million euro, including the revaluation of the investment property. The effect of the revaluation, net of tax, was 0.6 million euro.

32. The issuer argued that the revalued investment property was supposed to be sold during 2010 but the sale had been postponed. Finally, the sale was finalised in late 2011, with the price being the book value of the investment property plus 0.8 million euro. The issuer argued that the gain on revaluation of the investment property was immaterial to its financial statements.

33. The auditor, in its audit review memorandum, had noted that the revaluation was not in compliance with the accounting policy of the issuer but concluded that the error was not material. The issuer did not consider the error material because, amongst other things, it would not have had a material impact on equity.

The enforcement decision

34. The enforcer concluded that the revaluation of one investment property was not in accordance with the requirements of IAS 40 and that the revaluation constituted a material error in the financial statements. Consequently, the enforcer asked the issuer to retrospectively correct the error in its 2011 financial statements.

35. The enforcer pointed out that IAS 8 paragraph 42 requires an entity to correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery and IAS 8 paragraph 49 requires specific disclosures of prior period errors.

Rationale for the enforcement decision

36. The accounting policy for measurement of investment properties was the cost model. As the issuer did not change its accounting policy to the fair value model, and other investment properties were not revalued, the enforcer concluded that the revaluation of the investment property was not performed in accordance with requirements of IAS 40.

37. The enforcer was of the view that the amount recognised for the revaluation of the investment property led to a material error in the 2010 annual financial statements. The enforcer noted that the reported net loss for the period of 1.6 million euro would have amounted to a loss of 2.2 million euro without the revaluation and considered this difference to be material.

VI Decision ref EECS/0113-06 – Related party disclosures in interim financial statements

Financial year end: 31 March 2011
Category of issue: Related party disclosures in interim financial statements.
Standards or requirements involved: IAS 24 – *Related Party Disclosures,* IAS 34 – *Interim Financial Reporting*
Date decision taken: September 2011

Description of the issuer's accounting treatment

38. The issuer manufactures industrial metals. One major shareholder owned 64% of its shares. The 'other financial assets' balance increased significantly during the first quarter of 2011 and totalled 17% of equity, however the issuer provided no explanation about the change in other financial assets in its interim financial statements as at 31 March 2011.

39. Other financial assets included the shares of company B, which were bought in January 2011. The transaction resulted from a decision by the issuer's board of directors to invest excess cash in shares. At the same time it was decided that the issuer would enter into an option contract with its major shareholder, who was also the chairman of the board of directors, allowing the issuer to sell the shares of company B for the same price as it had bought them in January 2011. This provided protection against the risk of the share price subsequently decreasing.

40. The option contract stated that the issuer could sell company B's shares to its major shareholder at any time it chose during the contract term, until the end of April 2011. As the price of shares of company B decreased during spring 2011, the issuer decided to sell these shares to its major shareholder based on the option contract. The sale took place on 13 April 2011 at a price considerably higher than the market price at the date of the sale. As the shares were sold at the same price as they were bought, the transaction had no impact on the net profit of the issuer. The issuer did not include any related party disclosures in its March 2011 interim financial statements.

The enforcement decision

41. The enforcer considered that the issuer's lack of disclosure of material changes in other financial assets and of the option contract with its biggest shareholder in its March 2011 interim financial statements was not in compliance with IAS 34 paragraph 15B and IAS 24 paragraphs 18 and 19.

Rationale for the enforcement decision

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

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

VII Decision ref EECS/0113-07 – Definition of a business

Financial year end: 31 December 2010
Category of issue: Definition of a business
Standards or requirements involved: IFRS 3 – *Business combinations*
Date decision taken: March 2012

Description of the issuer's accounting treatment

44. The issuer operates in the shipping industry and owns vessels for transportation of cars and other rolling cargoes. In June 2010 the issuer acquired all the shares in Company B from Company A. Company B owned all the shipping industry investments of Company A. These investments consisted of shares in holding companies (Entities C1 – C4, owned 100% by Company B) that owned shares in single purpose companies (Entities D1 – D4, owned by C1 - C4 respectively, with different ownership percentages). The single purpose companies each owned and operated one or two shipping vessels.

45. There were no employees in Company B or its subsidiaries. At the acquisition date, there were only limited activities related to managing the respective companies; other activities were outsourced. All the employees in Company A were employed by a management company that was a sister company of Company B and was not part of the transaction ('management company'). The management company was a matrix organization where the employees handled several investments areas. Three employees in the management company were offered and accepted employment in the issuer as part of the transaction.

46. The companies owning the vessels (D1 - D4) had an agreement with the management company concerning assistance with chartering and purchase and sale of vessels. The management company used a shipbroker to assist the company with: marketing of the vessels, entering into new charter agreements and serving customers. The broker assisted in purchases and sales of the vessels. Technical management was outsourced from the vessel owning entities to the management company until autumn 2009 and subsequently outsourced to an independent third party company.

47. The issuer accounted for the transaction as an asset acquisition. The consideration paid and related transaction costs were recognised as the acquisition price of the vessels.

48. The issuer argued that the vessels were only passive investments and that Company B did not own a business consisting of processes, since all activities regarding commercial and technical management were outsourced to either the management company or to an independent third party company. Consequently, the acquisition was accounted for as if the vessels were acquired on a stand-alone basis.

The enforcement decision

49. The enforcer considered that accounting for the transaction as an asset acquisition did not comply with the requirements of IFRS 3 and required the issuer to account for the transaction as a business combination. As a result, transaction costs were expensed, the vessels were recognised at fair value, deferred tax was recognised at nominal value and the difference between these amounts and the consideration paid was recognised as goodwill.

Rationale for the enforcement decision

50. In accordance with IFRS 3 paragraph 3, an entity shall determine whether a transaction or other event is a business combination by applying the definition of a business in IFRS 3. A business is defined in Appendix A as an integrated set of activities and assets that is capable of being conducted and managed for the

purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants. Further guidance on the definition of business is given in IFRS 3 paragraph B7, which states that a business consists of inputs and processes applied to those inputs that have the ability to create outputs.

51. When analysing the transaction the following elements were considered relevant by the enforcers:

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

52. IFRS 3 Appendix B11 states that whether a seller operated a set of assets and activities as a business or whether the acquirer intends to operate it as a business is not relevant in evaluating whether a particular set is a business. Accordingly, it was not relevant that the seller had outsourced some activities (e.g. management services for which fees were paid) to a third party as a market participant could chose to conduct and manage the integrated set of assets and activities as a business. Consequently, the acquisition included all the elements that constitute a business, in accordance with IFRS3.

VIII Decision ref EECS/0113-08 – Disclosures related to fair value of financial instruments

Financial year end: 31 December 2009
Category of issue: Fair value disclosures
Standards or requirements involved: IFRS 7 – *Financial Instruments: Disclosures;* IAS 39 – *Financial Instruments: Recognition and Measurement*
Date decision taken: May 2011

Description of the issuer's accounting treatment

53. The issuer is a holding company that carries out banking activities through a subsidiary. In 2010, the prudential regulator withdrew the banking license of the subsidiary for breaches of the banking regulations, especially regarding: risk management procedures in its trading activities, valuation of the derivatives and consequent failures to correctly calculate and report the capital requirements of the bank.

54. The trading derivatives portfolio of the bank included trading assets of which approximately 80 % were classified in level 3 of the fair value hierarchy and trading liabilities of which 60 % were classified in level 3. The issuer claimed that a level 3 valuation was needed as the market for the derivatives (mainly derivatives on the stock indexes, with various maturities) was inactive. According to the issuer's accounting policy, a market is considered active if: more than 50 % of its positions were traded every day, at least three such days occurred during a week and at least three such weeks had occurred during the last three months.

55. In its 2008 financial statements, the issuer early-applied amendments to IFRS 7 with regards to the fair value hierarchy.

56. The issuer's accounting policy was to recognise the difference between the transaction price at initial recognition and the value according to its internal model in the statement of comprehensive income at initial recognition (a day one gain/loss). The 2008 financial statements disclosed that these gains/losses were immaterial. That statement was no longer included in the 2009 financial statements but no explanation for its removal was disclosed.

The enforcement decision

57. The enforcer concluded that that the issuer did not comply with the IFRS requirements with regards to usage of level 3 of the fair value hierarchy where market information was available and the failure to comply with the disclosure requirements of level 3. Additionally, the enforcer found that the issuer did not comply with the IFRS requirements related to the initial recognition of a day one gain/loss.

Rationale for the enforcement decision

58. IAS 39 paragraph 48A states that the best evidence of fair value is quoted prices in an active market. The relevant guidance on valuation is found in IAS 39 paragraph AG76, which requires a valuation technique to incorporate all factors that market participants would consider in setting a price and to be consistent with accepted economic methodologies for pricing financial instruments. In addition, IAS 39 requires an entity to calibrate the valuation technique and test it for validity using prices from any observable current market transactions in the same instrument or based on any available observable market data.

59. IAS 39 paragraph AG 64 states that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in

the same instrument or based on a valuation technique whose variables include only data from observable markets.

60. The investigation by the prudential regulator showed that there was market information on the instruments available for all trading days during 2009 and the first quarter of 2010 and that there were market transactions for part of the instruments held at times close to the issuers reporting dates. There were doubts raised about the valuation model used, but the enforcer did not pursue this further as the availability of market information already clarified that level 3 categorisation was not appropriate. Consequently, the trading portfolio was materially overstated as at 31 December 2009, relative to a valuation based on market observable inputs.

61. Although the usage of level 3 was not appropriate in all cases, the issuer classified substantial part of its portfolio as level 3. As a consequence of using a level 3 fair value, IFRS 7 paragraph 27B requires additional disclosures that were not provided.

62. IAS 39 paragraph AG76A requires that where no gain or loss is recognised on initial recognition of a financial instrument, a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

63. The issuer argued that the accounting policy regarding the recognition of a day one gain was not in accordance with IAS 39 as its systems were not capable of calculating the amounts. These arguments were not accepted by the enforcer.

IX Decision ref EECS/0113-09 – Discount rate in value in use calculation

Financial year end: 31 December 2009
Category of issue: Discount rate in value in use calculation
Standards or requirements involved: IAS 36 – *Impairment of Assets*
Date decision taken: February 2010

Description of the issuer's accounting treatment

64. The issuer operates in the renewable energy sector and manufactures and sells solar panels. It was in the process of listing on a regulated market. The prospectus under review included IFRS financial information for the years 2009, 2008 and 2007.

65. In 2007, the issuer recorded 171 million euro of goodwill as a consequence of the acquisition of the solar panels´ manufacturing business from another entity. This was the only intangible asset with indefinite useful life recognised in the statement of financial position.

66. More than 99% of the goodwill was allocated to the manufacturing of solar panels CGU. In its impairment test, the recoverable amount of the CGU was determined by calculating value in use based on pre-tax cash flows over a six year period. The issuer disclosed the key assumptions used to determine the value in use: the operating profit, the terminal growth rate and the post-tax discount rate for each of the periods. Nonetheless, some data in the value in use calculations (e.g. operating profit) differed from the information disclosed in the segment note to the financial statements.

67. In determining the discount rate, the issuer calculated the cost of debt as the average of the interest rates on its outstanding borrowings, but excluded a long-term subordinated loan from the calculation.

68. The issuer disclosed that no goodwill impairment losses had been recognised. The budgeted gross margins that were disclosed considered the expected market development. The growth rates were consistent with those forecasted in the industry sector and the discounts rates were determined before tax and reflected specific risks related to the relevant segments. The issuer disclosed that an increase of 0.5 percentage points in the discount rate would not lead to recognition of goodwill impairment. Nonetheless, the decrease in the disclosed discount rate from 2008 to 2009 was larger than the 0.5 percentage points scenario included in the sensitivity analysis in the 2009 financial statements.

The enforcement decision

69. The enforcer considered that the issuer did not comply with the requirements of IAS 36 and required it to review the impairment calculations, to record the resulting goodwill impairment and to provide additional disclosures as required by IAS 36 in its 2009 financial statements.

Rationale for the enforcement decision

70. IAS 36 paragraph 33 requires an entity measuring value in use to base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset on the basis of the most recent financial budgets approved by management. The entity should exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.

71. The enforcer found that the cash flows used as the basis of the projections (i.e. expectations of future operating profits) differed significantly from the operating profit before depreciation included in the 2009 and 2008 segment notes to the financial statements. The estimated cash flows before taxes used to determine the CGU recoverable amounts reported were inadequate because the expectations for operating profit were not based on the financial budgets approved by the Board of Directors, which covered a 6 year period. As a consequence, the enforcer found a need for adjustments to the estimated cash-flows used in the calculation.

72. IAS 36 paragraph 55 requires the discount rate used in impairment testing and disclosed in financial statements to be a pre-tax rate. Accordingly, the enforcer concluded that the discount rate disclosed for 2009 was not correct, since it disclosed a post-tax rate and not the pre-tax rate that the entity effectively used in its calculation.

73. IAS 36 paragraphs 55 - 57 require the discount rate to be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. In particular, the enforcer noted that IAS 36 paragraph A19 requires the discount rate to be independent of the entity’s capital structure and the way the entity financed the purchase of the asset.

74. The enforcer did not agree with the cost of debt used by the issuer in the post-tax weighted average cost of capital (WACC) calculation, since the credit risk spread applied did not reflect current market assessments of the time value of money and the risks specific to the asset. The enforcer requested the entity to recalculate its debt rate, considering as a starting point (IAS 36 paragraphs A17 - A19) all new loans entered into by the issuer in 2009 that reflect the current market assessment of credit risk, as well as the long term subordinated loan that was originally excluded from the calculation.

X Decision ref EECS/0113-10 – Residual value of property

Financial year end: 31 December 2011
Category of issue: Residual value of property
Standards or requirements involved: IAS 16 – *Property, Plant and Equipment*
Date decision taken: March 2012

Description of the issuer's accounting treatment

75. The issuer both owns and operates a fleet comprising supply and subsea vessels and provides services to the subsea market. These vessels constitute a material part of the issuer's total assets. The economic life of the vessels is estimated to be 30 years, but the useful life is 20 years since the issuer's policy is to sell the vessels when they are 20 years old.

76. The issuer estimated the residual value of the vessels to be to 50 % of acquisition cost. This residual value was assumed to be constant during the useful life. The issuer observed in its financial statements that a residual value was an estimate with a high level of uncertainty especially when the realisation was over a significant period. As the average age of the fleet was six years, the expected realisation would have taken place, on average, in 14 years.

77. In its correspondence with the enforcer, the issuer explained that the vessel's valuation, using discounted cash flows, was calculated based on its acquisition cost and a required rate of return. The required rate of return, used to discount the cash flows, was fixed through the useful life of the vessel. The calculation resulted in an estimated market value after 20 years of approximately 65 % of acquisition cost, which corresponded to cash flows from year 20 to year 30 discounted to the present value in year 20. The calculation did not allow for inflation.

78. Older vessels have a greater inherent need for maintenance, and significant maintenance is required when the vessel is between 10 and 20 years old in order for the vessel to have a useful life of 30 years. These conditions were taken into account in the estimate, by setting the residual value to 50 % of acquisition cost and not 65 % that resulted from the annuity calculation.

79. The issuer argued that the estimates used are conservative in view of an immature market with a high degree of uncertainty and presented statistics that documented that newer vessels, built after 2000, were sold for a price considerably over cost. Consequently, it was difficult to compare today's vessels with eventual proceeds for the vessels for in 20 years, since the offshore market had a relatively short operating history with limited vessel sales.

80. In connection with estimating the residual value, the issuer made a comparison against broker valuations. If the estimate had been based on broker valuations, the residual value would have been considerably higher than that calculated using discounted cash flows. The issuer chose not to base its assessment on broker valuations, since it would result in greater volatility in the financial reporting. The issuer had a long-term perspective and reflected only changes in long-time trends in changes of residual values.

The enforcement decision

81. The enforcer did not accept the issuer's calculation of residual amount and concluded that estimating residual value based on acquisition cost did not comply with the requirements of IAS 16 paragraph 6. Consequently, the enforcer required the issuer to prepare a new model when determining residual value that would take account of broker valuations at the end of each reporting period and which would produce zero depreciation charge when estimated residual value was higher than the carrying amount.

Rationale for the enforcement decision

82. IAS 16 paragraph 6 defines residual value as the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already at the age and in the condition expected at the end of its useful life. The definition of residual value implies that the issuer shall make an estimate of what the vessel could have been sold for today, if the vessel already was 20 years old.

83. IAS 16 paragraph 51 requires the residual value to be reviewed at least at the end of each reporting period. According to IAS 16 paragraph 50 the depreciable amount of an asset shall be allocated on a systematic basis over its useful life. IAS 16 paragraph 53 specifies that the depreciable amount of an asset is determined after deducting its residual value.

84. The issuer's original model implied that the residual value was constant for the vessel's entire useful life. The enforcer noted that the residual value had to be adjusted especially when the expected sale approached, and residual value had to come closer to disposal proceeds minus disposal costs at the end of the useful time. This is confirmed in IAS 16 paragraph 54 that notes that in cases when the residual value is greater than the asset's carrying amount, the depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

85. The residual value shall be estimated to be the value at the reporting date as if the vessel were already of the age and in the condition expected at the end of its useful life. According to IAS 16 paragraph BC 29, an increase in the expected residual value of an asset because of past events will affect the depreciable amount, while expectation of future changes in residual value other than the effects of expected wear and tear will not.

86. IAS 16 does not provide guidance how to estimate residual value when the useful time is considered to be shorter than the economic life. Even though there was considerable uncertainty associated with the estimate of residual value, especially for newer vessels when there is no vessel in the market, the estimate for residual value should correspond to market value (after costs of disposal) for similar 20-year old vessels. When there are no such vessels, residual value had to be estimated from a relevant market value.

87. The issuer did not use broker valuations directly, since it would have given more volatility in the estimates. The enforcer considered that undesirable volatility was not a convincing argument to support an accounting treatment, and broker valuations could be a useful starting point to estimate residual value. The enforcer noted that some vessels older than 10 years had broker values above residual value. This might have indicated that the residual value was too low, and that the issuer should have stopped depreciation at an earlier stage.