

ESMA'S EIGHTH EXTRACT FROM ITS DATABASE OF ENFORCEMENT DECISIONS TAKEN BY EU NATIONAL ENFORCERS OF FINANCIAL INFORMATION (IFRS) INTERNATIONAL FINANCIAL REPORTING BULLETIN 2012/01



Background

The European Securities and Markets Authority (ESMA) (previously called the Committee of European Securities Regulators) has, as a source of information to assist in the appropriate application of IFRSs, developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). EU National Enforcers monitor and review financial statements and consider whether they comply with IFRSs and other applicable reporting requirements, including applicable national law. The EECS is a forum in which all EU National Enforcers of financial information meet to exchange views and discuss experience of enforcement.

No decisions are taken at EECS, and decisions taken by EU National Enforcers are neither approved nor rejected. Relevant factors for each enforcement decision may include consideration of national law, the requirements of which may go beyond the requirements of accounting standards and interpretations. In consequence, when considering the cases that are publicly reported, careful consideration should be given to their individual circumstances.

ESMA regularly publishes extracts from its database, with the intention of informing market participants about which accounting treatments EU National Enforcers (the Enforcers), may consider as complying with IFRSs and thus contribute to a consistent application of IFRSs in the European Union. The published decisions generally include a description of the accounting treatment or presentation at issue, the decision taken by the Enforcer and a summary of the Enforcer's underlying rationale.

On 13 July 2010, ESMA published its eight extract from the database. The full report can be found on the ESMA web-site at the following address: http://www.esma.europa.eu/system/files/10_834.pdf. Set out below is a summary of the conclusions reached, which are in the same order as they have been presented in the report.

The previous extracts published by ESMA are summarised in IFRBs 2007/06, 2008/07, 2008/17, 2009/04, 2010/05, 2010/06 and 2010/07.

Transactions and related IFRSs covered by the extracts

1. Fair value of financial instruments (IAS 39)
2. Disclosure of financial instruments (IFRS 7, IAS 39)
3. Classification of assets and liabilities (IAS 1)
4. Impairment testing of intangible assets (IAS 36)
5. Impairment of intangible assets (IAS 36)
6. Intangible assets (IAS 38)
7. Revenue recognition (IAS 18)
8. Impairment of trade receivables (IAS 39)
9. Disclosure of financial instruments - liquidity risk (IFRS 7)
10. Earnings per share (IAS 33)
11. Related party disclosures (IAS 24)
12. Presentation of the income statement (IAS 1)
13. Impairment of assets (IAS 36)

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

Additional guidance for the application of IFRSs.

Summary of extracts

1. Fair value of financial instruments (IAS 39)

The issuer, a bank, valued shares in company A that were traded on a regulated market at about 50% above the quoted market price. The shares were held as collateral for three loans that were subject to impairment. The bank initiated negotiations to sell the shares as a consequence.

The bank expected to sell the shares at a price 50% above the quoted price. The expectation was based on indicative, non-binding offers from potential buyers that were unavailable to the public. The bank also provided various valuation techniques including DCF-calculations to support the estimated share price. The issuer was of the opinion that company A's shares were not traded on an active market.

Based on that information, the issuer valued the shares 50% above market price which reduced its impairment charge by 12 million Euros.

The enforcer concluded that the shares were traded in an active market and therefore, that they should be valued at their quoted price in accordance with AG 71 of IAS 39.

Trading had occurred on 98% trading days with more than 1,000 shares being traded on 62% of these days. The enforcer did not find any evidence that trades did not occur between willing parties at arm's length. The possible bid offers and valuation techniques were disregarded as the enforcer concluded that the shares were traded on an active market.

2. Disclosure of financial instruments (IFRS 7, IAS 39)

The issuer issued limited recourse debt in series and invested the funds raised in corporate bonds and loans. The notes to its financial statements stated that the fair values of the financial instruments was either based on quoted market prices or dealer price quotations and that they were reliably determined within a range of estimates. No further disclosure about the fair value of the instruments was provided. This did not allow readers to determine the extent that fair values based on market quotations or valuation techniques. There was also no apparent disclosure about reasonably possible changes in assumptions that would result in significantly different fair values being recognised.

The enforcer concluded that the issuer had inadequately disclosed the basis for the determinations of the fair value of the financial instruments as required by IFRS 7 paragraph 27 and that there was insufficient information to allow users to understand whether a reasonably possible change in one or more of the assumptions would significantly change the fair values.

Paragraph AG 72 of IAS 39 states that "The appropriate quoted market price for an asset or liability to be issued is usually the current bid price, and for an asset to be acquired or liability held, the asking price."

IFRS 7 paragraph 27 (a) requires an entity to disclose the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. IFRS 7 paragraph 27 (c) requires disclosure of whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change the fair value significantly, the entity is required both to state that fact and to disclose the effect of those changes.

3. Classification of assets and liabilities (IAS 1)

The main activity of a closed-ended fund is to invest in shares and debt on listed Asian exchanges with the objective of achieving long term capital appreciation. The manager's report indicated it was not the fund's intention to invest in short term trading positions. However, all assets and liabilities were classified as current in the statement of financial positions.

The enforcer found that the classification of all assets and liabilities as current did not comply with the requirements of IAS 1.

The issuer had chosen to present all assets and liabilities as current in the light of the following:

- The investments were traded on recognised exchanges and could be converted to cash within one year
- Investments had not been purchased for trading
- Over 77% of the portfolio of investments had been purchased over 1 year ago

The enforcer did not consider the current classification as appropriate given the requirements of paragraph 66 and 67 of IAS 1 and the explanations of the issuer. An entity shall present current and non-current assets and current and non-current as separate classification on the face of the statement of financial positions as stated in IAS 1 paragraph 60. IAS 1 paragraph 66 states that an entity shall classify an asset as non-current unless:

- (a) It expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
- (b) It holds the asset primarily for the purpose of trading;
- (c) It expects to realise the asset within twelve months after the reporting period; or
- (d) The asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

4. Impairment testing of intangible assets (IAS 36)

The issuer had constructed a database of information. Costs incurred in bringing information to a higher standard of performance are capitalised. Maintenance costs are expensed to profit or loss. The database is accounted for as a mainly internally developed intangible with an indefinite useful life.

The issuer tested the database for impairment annually as it is required for intangible assets with an indefinite useful life using estimated future cash flows which include:

- Maintenance expenses
- Capital expenses incurred in bringing the data to a level suitable for use
- The expected increase in turnover resulting from the above mentioned cash outflows

The enforcer found that the determination of the cash flows used for impairment testing did not comply with IAS 36 paragraph 44 which requires estimated future cash flows for value in use calculations to be measured at the current condition of the asset. These would not include cash inflows and outflows that are expected to arise from a future restructuring to which an entity is not yet committed or improving or enhancing the asset's performance.

Based on the issuers description of the cash flows utilised the enforcer concluded that they were not estimated for the asset in its current condition as they included cash out flows relating to

improvement maintenance and capital expenses and additional cash inflows resulting from the preceding cash out flows.

5. Impairment of intangible assets (IAS 36)

37% of total assets of a developer specializing in online games were represented by mainly internally generated intangible assets that generated 100% of the issuer's revenue. 90% of total intangible assets were allocated to two Cash Generating Units (CGU 1 and CGU 2).

The issuer reported an impairment charge in respect of the two CGUs representing 63% of the consolidated result before tax. The financial statements did not disclose the events and circumstances that led to the impairment nor allocate the impairment charge to the separate CGUs.

The events and circumstances that resulted in an impairment charge to CGU 1 were publicly known in the market, those responsible for the impairment in CGU 2 were not. There was no information provided indicating that part of the impairment charge related to CGU 2. Indeed the intangible allocated to CGU 2 included intangible assets under development for which the product was expected by the market to be successful.

The enforcer found that the issuer had not complied with the disclosure requirements of IAS 36, in that neither the events and circumstances that led to the impairment loss (paragraph 130(a)) nor the amounts attributable to the two CGUs were separately disclosed (paragraph 130 (d) (ii)).

The issuer had disclosed that cash flows are driven by the number of paying customers and that for managements this was the most important factor when estimating future cash flows. The issuer had also described the recoverable amounts in narrative and that the reader could conclude that the number of paying customers for CGU 1 was less than expected. The issuer also noted that the directors' report explained that CGU 1 had not developed as expected. Notwithstanding these disclosures, the enforcer concluded that the relevant information required by IAS 36 was not provided.

6. Intangible assets (IAS 38)

A professional football club had significant intangibles assets that mainly related to acquired players' registration rights comprising registration and agents fees in its financial statements. They were amortised using the straight line method over the life of the contracts.

Agent fees, which are common in the football business, are paid by clubs to player's agents when a player is transferred or extends his contract. The club believed that the fees met the criteria for capitalisation as intangibles because they are directly attributable to the costs of a player's contract.

The enforcer accepted the accounting treatment for payments relating to transfers as well as for payments for contract extensions.

For payments relating to new transfers the enforcer agreed that payments met the example set out IAS 38 paragraph 28: "professional fees arising directly from bringing the asset to its working condition".

For payments relating to extended contracts the enforcer based its conclusion on IAS 38 paragraphs 68 (a) and 18 which applies "to costs ... incurred subsequently to add to, replace part of, or service it". Noting that agents fees paid on the extension of contracts can be considered cost incurred to service the registration rights.

7. Revenue recognition (IAS 18)

In 2004 the issuer launched an on-line video game with the following characteristics:

- In order to be able to play, the player has to buy an initial pack and a monthly subscription.
- It is impossible to play without an on-line subscription.
- The initial pack is sold with a free subscription for one month. The price of the initial pack is equivalent to the price of a one-month subscription.
- It is a "multi-player" game, which means that the issuer has an implicit obligation to maintain its IT capacity in order to enable players around the world to play with each other.
- The player may also buy expansion packs. An expansion pack is more expensive than the initial pack and does not include a free subscription. It provides players with new options (new characters, new battlegrounds, additional outdoors, rated matches, etc.) that are not available with the initial pack. Whether or not a player buys the expansion pack, the price of the monthly subscription remains the same. New expansion packs generate new customers. They also encourage former customers to re-subscribe to the game.
- The initial pack is necessary in order to use the expansion pack.

The licence agreement explicitly states that there is no legal obligation to maintain the online game for the issuer. Based on the products success it would however make no sense for the issuer to stop maintaining the IT-platform.

Until 30 September 2008 the sale of the initial or the extension pack was recognised when a player bought the pack. The monthly subscription was spread over the subscription period.

The issuer launched a second extension pack in October 2008 following the success of the product.

The vast majority of players subscribe for an average of ten month. The issuer reconsidered its revenue recognition policy and concluded that that the different elements of the game were so inter-linked that considering the sale of the expansion pack and the monthly subscription as two separate transactions did not reflect the substance of the sale. Indeed the commercial effect of the sale of the expansion packs cannot be understood without reference to the monthly subscription. These elements of the sale should, therefore, be considered together in accordance with paragraph 13 of IAS 18.

Therefore, as of 30 September 2008, the issuer changed its accounting policy for revenue, and recognised the sale of the expansion packs over a 10-month period. The change in accounting policy was applied retrospectively in accordance with IAS 8.

The Enforcer accepted the accounting treatment of the issuer.

IAS 18 paragraph 13 states the in certain circumstances it is necessary to apply recognition criteria to two or more transaction together in order to reflect the substance of the transaction.

The enforcer accepted the issuer's argument that the sale of the extension pack and the monthly subscription should be dealt together in accordance with the above paragraph. Recognising the revenue from the sale of the extension pack immediately would also not reflect the issuer's implicit obligation to maintain its IT capacity.

The enforcer also accepted that the new accounting treatment met the criteria of paragraph 14(b) of IAS 18 to be treated as a change in accounting policy to be applied retrospectively.

8. Impairment of trade receivables (IAS 39)

An issuer stated in the notes that trade receivables were initially recognised at fair value and subsequently at amortized cost based on the effective interest method less provisions for impairment. The provision being calculated as the difference between the carrying amount and the present value of the estimated future cash flows discounted at the original estimated interest rate.

At year end the group's and the issuer's trade and other receivables overdue between 170 and 1031 days were as follows:

Group			
Name (debtor)	Outstanding amount	Debt overdue in days	Invoice payment deadlines (in days)
Entity A	42,270	394	60/90
Entity B	324,690	450	60
Entity C	34,110	245	15
Entity D	20,000	170	60
Entity E	15,680	452	60/90
Entity F	99,000	256	15
Total	535,750		

Group's trade and other amounts receivable from unrelated entities			
Name (debtor)	Outstanding amount	Debt overdue in days	Invoice payment deadlines (in days)
Entity A-F	535,750 (see above)	(see above)	(see above)
Issuer's subsidiary H	11,865,000	1,031	30/60
Total	12,400,750		

The issuer expected to receive all the amounts due and had therefore not discounted any amounts with the original effective interest rate. However it had recognised an impairment of 535,750 for the amounts due from Entities A-F.

The enforcer concluded that the accounting treatment did not comply with IAS 39 in a number of respects relating to the measurement of the receivables.

Paragraph 59 (b) in IAS 39 states that evidence for impairment of financial assets includes default in principal payment. In the view of the enforcer the fact that receivables were overdue is objective evidence for impairment.

According to IAS 39 paragraph 63 the issuer should have measured its receivables by discounting future cash flows with the original effective interest rate. The enforcer did not accept the issuer's argument that it was not in the position to measure its receivables from subsidiary H due to uncertainties in the property market.

9. Disclosure of financial instruments – liquidity risk (IFRS 7)

A fund management company (the issuer) holds portfolios of investments that are measured at fair value. At year end the issuer revalued its investment to fair value. The fair values of certain hedge funds held, were based on net asset values published by the hedge fund managers.

The issuer confirmed that expected requests for additional funding from funds are taken into consideration in monitoring cash flow requirements. These calls were not disclosed in the liquidity risk disclosure because the correspondence was regarded as confidential by the issuer.

The enforcer found that the disclosures of the issuer's liquidity risk did not comply with IFRS 7 paragraph 34 (a) which requires summary quantitative information based on information provided to key management personnel.

The enforcer also noted that there is no exemption in IFRS 7 regarding confidentiality.

10. Earnings per share (IAS 33)

An entity A was founded in March 2006. Its 0.5 million shares were held by listed entity B. On 29 June 2006 new shares in tranches of 14.5 and 60 million were issued and transferred to entity B in exchange for its demerged assets and liabilities. Entity B offered 15 millions of the shares to the public and the issuer was listed on 30 June 2006.

The demerger was accounted for using the pooling of interest method. The financial statements for 2006 were based on company B's historical (book) values. Entity A's profit and loss statement covered the entire year ending 31 December 2006.

Earnings per share (EPS) were calculated by dividing the loss for the year by the weighted average number of shares outstanding, which was calculated as 75 million. The number of 75 million was equal to the amount of outstanding shares as at year end did not appear to be the average number of shares outstanding during the year.

Disclosure was not provided on how entity A had accounted for the demerger, or the method adopted to determine the average number of shares.

The enforcer accepted the issuer's accounting for the demerger and concluded that the calculation of EPS complied with IAS 33.

The calculation of EPS in a business combination accounted for using the pooling of interest method is not covered in IAS 33. The principles of the standard however imply that there should be a consistency between earnings and the capital involved to generate those earnings. It is in accordance with that principle that the shares issued in connection with the demerged assets are included as if they were outstanding at the beginning of the period presented.

11. Related party disclosures (IAS 24)

The issuer's financial statements included a note on related party transactions that stated that key management personnel comprised the Board of Directors. A cross-reference was provided to the Report of Directors' Remuneration section which was outside the audited financial statements. The report did also not provide all information requested by IAS 24 (2003) paragraph 16 (IAS 24 (2009) paragraph 17).

The enforcer found that the issuer had not complied with IAS 24 (2003) because the information provided was not within the consolidated financial statements, was not subject to audit and also missed disclosures required by paragraph 16.

12. Presentation of the income statement (IAS 1)

A group who is primarily engaged in the insurance business split its return on investment income between two separate line items:

- A gain for item "investment income - longer term rate of return" and
- A loss for item "investment income - fluctuation" (the loss being the difference between the actual short term and the expected longer term investments returns during the period).

The gain was included within "Operating profit" while the loss was presented below that subtotal.

The enforcer found that the presentation did not comply with the requirements of IAS 1 relating to the presentation of the income statement.

While IAS 1 neither requires nor precludes disclosure of results of operating activities on the face of the income statement, paragraph BC 56, IAS 1 states that where an entity discloses such an amount it should be representative of activities that would normally be considered to be "operating", even if the exclusion of such items from operating profit had been industry practice.

The enforcer believed that the actual return for a period would seem to be of a clear operating nature. Notwithstanding that it may reflect actual short term, rather than expected longer term performance.

13. Impairment of assets (IAS 36)

In 2008 to test its goodwill for impairment an issuer used the cost of debt as an input to the determination of the WACC used as discount rate. The issuer used the risk free rate adjusted by the company specific average credit spread of its outstanding debt.

The banks had not recently increased the credit spreads or made an indication that they had the intention to do so. The issuer did also not have any need for additional funding and did not need to repay its outstanding loans before 2010. The issuer did therefore not see a need to use a higher credit spread notwithstanding that it was aware that its current credit spread would have been higher for new funds due to the financial crisis.

The enforcer concluded that the calculation of the discount rate was not wholly in accordance with the requirements of IAS 36 because the discount rate applied did not reflect the market assessment of the contributing factors.

IAS 36 paragraphs 55 and 56 specify that a rate that reflects the current market assessment should be used for impairment testing. The inputs to the determination of the discount rates should be based on current credit spread levels in order to reflect the current market assessment of the time value of the money and asset specific risks.

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