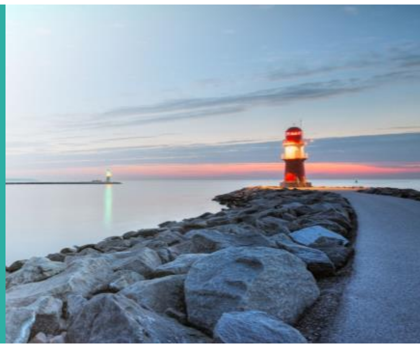
ESMA's 17th EXTRACT FROM THE EECS's DATABASE OF ENFORCEMENT



INTERNATIONAL FINANCIAL REPORTING BULLETIN 2015/11

Background

The European Securities and Markets Authority (ESMA) has, as a source of information to assist in the appropriate application of International Financial Reporting Standards (IFRSs), developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). This forum involves 38 European enforcers from the 28 member states and the two countries in the European Economic Area (EEA) who have responsibilities in the area of supervision and enforcement of financial information. The EECS is a forum in which European enforcers of financial information meet to exchange views and discuss practical experiences of enforcement of IFRS financial information provided by companies which have, or are in the process of having, securities admitted to trading on a regulated market in Europe.

European national enforcers apply their judgement, knowledge and experience to the particular circumstances of the cases that they consider. 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. Situations which seem similar may in substance be different, and consistent application of IFRS means consistent with the principles and treatments permitted by IFRS.

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. However, decisions taken by enforcers do not constitute generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee.

On 21 July 2015, ESMA published its seventeenth extract from the database. The full report can be found on the ESMA website at the following address:

https://www.esma.europa.eu/news/ESMA-publishes-17th-extract-EECS%E2%80%99-enforcement-decisions?t=326&o=home

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, 2010/07, 2012/01, 2012/02, 2012/03, 2012/04, 2012/14, and 2013/11, 2013/21, 2014/04, 2014/25.

STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Additional guidance for the application of IFRSs.

Transactions and related IFRSs covered by the extracts

1. Extinguishment of debt (IAS 27, IAS 39, IFRS 10, IFRIC 19)
2. Impairment charge for a decline in the fair value of available for sale financial assets (IAS 39)
3. Measurement of financial instruments at fair value (IFRS 13)
4. Fair value measurement in a business combination (IFRS 3, IFRS 13)
5. Presentation of financial statements (IAS 1, IAS 28)
6. Accounting for claims in construction contracts (IAS 11)
7. Impairment testing (IAS 36, IFRS 6).

Summary of extracts

1. Extinguishment of debt (IAS 27, IAS 39, IFRS 10, IFRIC 19)

The issuer, a company providing financial services to institutional investors, issued bonds redeemable after five years. Before maturity, the issuer negotiated an alternative to cash repayment with the bondholders. The issuer would give 33% of the shares of its fully owned and consolidated subsidiary in exchange for the redemption of the bonds.

At the date of settlement the carrying amount of the liability was CU8,000. The book value of the 33% stake in the subsidiary was CU5,000 and its fair value amounted to CU8,500 on the basis of an independent expert evaluation.

Due to the fact that the transaction did not involve the issuer's own equity instruments, the issuer considered that the transaction was not directly within the scope of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*.

However, the issuer applied IFRIC 19 by analogy and recognised a loss of CU500 in profit or loss, increased the non-controlling interests (NCI) by CU5,000 and attributed the remaining difference of CU3,500 to equity on the basis of paragraphs 30 and 31 of IAS 27 *Separate Financial Statements*.

The enforcer's decision

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

According to IAS 27.30 and 31, changes in ownership interest that do not result in a loss of control are equity transactions. Any difference between the amount by which NCI's are adjusted and the fair value of the consideration received is recognised in equity.

The application of IFRIC 19 results in a loss, which reflects the economic substance of the transaction which is that the issuer paid a premium to extinguish its debt because it could not repay the bonds in cash.

This is also consistent with a decision by the IFRS Interpretations Committee about a potential conflict between IAS 27.30 and 31 and IFRIC 17 *Distribution of Non-cash Assets to Owners* on the issue of a non-cash acquisition of non-controlling interests. Based on the decision, it was noted that IAS 27.31 deals solely with the difference between the carrying amount of NCI and the fair value of the consideration given which should be recognised in equity. It does not deal with the difference between the fair value of the consideration given and its carrying amount which should be recognised in profit or loss.

2. Impairment charge for a decline in the fair value of available for sale financial assets (IAS 39)

The issuer accounted for its investment in shares of unlisted companies as available for sale financial assets and measured them at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. The issuer developed the following accounting policy for a significant or prolonged decline in value of the instruments, being:

- ***Significant*** – 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.
- ***Prolonged*** – A decline in the fair value over a period of 3 to 5 years.

Based on the above policies, the issuer did not recognise impairment charges even when the absolute reduction in the fair value was 60-70% of the original cost. When the significant or prolonged thresholds have been reached, the issuer considered additional facts and circumstances and did not necessarily recognise a change for impairment in profit or loss.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

IAS 39.67 requires a significant or prolonged decline in the fair value of an available for sale financial instrument to be recognised in profit or loss. As no bright lines for a significant or prolonged decline exist, an entity is required to determine appropriate thresholds considering other available guidance and market practices.

The issuer's judgement was outside the range of thresholds that the enforcer has seen previously. A policy that allows a decline in fair value of 60-70% below cost is not acceptable.

It was noted, that according to findings of the European Securities and Markets Authority (ESMA) that were published as part of the *Review of Accounting Practices – Comparability of IFRS Financial Statements of Financial Institutions in Europe*, significant decreases ranged from 20% to 50% of the original cost and a prolonged decline exists when lasting from 6 months to 3 years. In its assessment, ESMA expressed doubt about whether thresholds at the higher end of those ranges were reasonable.

3. Measurement of financial instruments at fair value (IFRS 13)

The issuer invested in shares of listed and unlisted entities and accounted for these as available for sale financial assets which represented more than half of its total assets. The shares were measured based on the stock exchange prices when shares were listed in an active market and based on valuation techniques when there was no active market. An active market was assessed by the issuer based on the following benchmarks:

- daily % of average value of trades / capitalisation below 0.05%
- daily equivalent value of trades below CU50,000
- daily bid-ask spread above or equal to 3%
- maximum number of consecutive days with unvaried prices higher than 3
- % of trading days lower than 100%.

On the basis of the above, the issuer considered its investments in listed companies A, B and C as not traded in active markets and measured them at fair value using a valuation technique on the basis of level 3 inputs.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

IFRS 13 *Fair Value Measurement* is based on the concept of the 'fair value hierarchy' giving highest priority to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs.

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

The indicators used by the issuer, to determine a significant decrease in the volume or level of activity of traded instruments did not comply with IFRS 13.B37 and were insufficient. Furthermore, IFRS 13.B43 lists circumstances that may indicate that transactions are not orderly, and note specifically that a significant decrease in the volume or level of activity is not by itself sufficient to conclude that all transactions are not orderly. In this case, the enforcer considered that the issuer had not obtained sufficient information to enable a conclusion to be reached that the markets were not active.

In addition, the valuations used to measure the fair value of the instruments were far above the quoted prices which raised additional concerns with the enforcer.

4. Fair value measurement in a business combination (IFRS 3, IFRS 13)

The issuer acquired three businesses that were mainly composed of fixed tangible assets, with a low value being attributed to customer contracts/relationships, brand name or workforce. The value of the acquired assets and liabilities assumed exceeded the purchase price for each acquisition which gave rise to a gain on a bargain purchase for each acquisition.

In accordance with paragraph 36 of IFRS 3 *Business Combinations* the issuer reassessed the measurement of the assets acquired and liabilities assumed.

The issuer stated that the bargain purchase occurred due to:

- the economic environment
- the willingness of each of the sellers to dispose of non-core assets after unsuccessful selling attempts and no competition for the acquired businesses
- the issuer's strong liquidity and access to financial markets led to a better negotiating position
- prospects of higher benefits in the long term due to operational knowledge and a large customer base.

The fair value of the net assets was based on the current state of the assets. The issuer also considered that anticipated future capital expenditure lowered the prices and that the bargain purchase gain would compensate for expected future losses or investments to be recognised in future.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The purchase price allocation carried out was not in accordance with the requirements of IFRS 3, meaning that the bargain purchase gain reported by the issuer was mainly due to measurement errors.

The assessment of the fair value of the tangible assets was inadequate and should have considered expectations of future cash outflows to reflect the current status of the assets. According to paragraph B39 of IFRS 13 *Fair Value Measurement*, the exit price of an asset embodies expectations about future cash inflows and outflows associated with the asset. Expectations of future expenses reduce the fair value of acquired net assets. In accordance with the requirements in IFRS 13.B8 and B9, economic obsolescence should have been taken into account given the fact that acquired businesses faced environmental or regulatory requirements and reduced demand.

Market inactivity, in the form of the absence of other market participants, did not indicate that the transaction price did not represent fair value but required further assessment by the issuer (IFRS 13.BC134). Furthermore, the fair value is set from a market participant's view and own use (or entity specific considerations) do not represent rationale or argument for recognition of a bargain purchase gain (IFRS 13.B43).

Finally, the use of independent valuation experts did not relieve management from its responsibility to ensure the use of appropriate valuation techniques and assumptions to estimate the fair value of the acquired net assets.

5. Presentation of financial statements (IAS 1, IAS 28)

The issuer presented a separate line item in its statement of comprehensive income for its '*share of the profit or loss of associates and joint ventures accounted for using the equity method*'.

One component of the result from associates and joint ventures was a material impairment for property, plant and equipment. The issuer intended to present an adjusted measure of share of profit or loss from associates and joint ventures and with the impairment charge being included as a second separate line item in the statement of comprehensive income. The issuer justified the separate presentation with reference to the dissimilar nature of the items (see paragraph 29 of IAS 1 *Presentation of Financial Statements*).

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

IAS 1.82(c) requires the separate presentation of the '*share of the profit or loss of associates and joint ventures accounted for using the equity method*'. The example in IAS 1.IG6 describes this line item 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 charge was part of the share of the profit or loss, the enforcer concluded that it could not be presented separately. The separate presentation of elements related to profit or loss of a single associate or joint venture leading to an adjusted measure of profit or loss, without presentation of the total amount, was not in accordance with IAS 1.

6. Accounting for claims in construction contracts (IAS 11)

The issuer was an engineering company and accounted for its fixed price contracts by applying the percentage of completion method.

Some of the contracts were delayed and gave rise to additional costs and contract penalties. As the issuer considered making claims against customers those additional costs and penalties were not included in the total costs used to calculate percentage of completion (this was based on a comparison of costs to date and costs to completion excluding the additional costs and penalties).

Subsequent to the year end, the penalties were recognised as costs associated with the contract.

The enforcer's decision

The enforcer did not agree with the issuer's treatment and stated that all costs attributable to a contract until its final completion should be considered when they occur. The penalties should have been included in the total costs. Offsetting penalties by submitting claims was not in compliance with IAS 11 *Construction Contracts*.

The percentage of completion method requires contract revenues to be matched with contract costs incurred in reaching completion (IAS 11.25). According to IAS 11.21, contract costs should include all costs attributable to a contract until its final completion.

Contract revenues may vary from one period to another (e.g. due to delays) as they are measured at the fair value of the consideration received or receivable and is revised when events occur and uncertainties are resolved (IAS 11.12). Any submission of a modification to the contract should only have been included in total revenues if it was likely that the client would approve the claim on the additional cost. As the negotiations about such a modification had not reached an advanced stage, the claims submitted could not be included in total revenues.

7. Impairment testing (IAS 36, IFRS 6)

The issuer operated in the extractive industry and accounted for its exploration and evaluation costs based on the successful efforts method. The issuer owned an interest in a gas discovery licence, whose ownership was regulated through a joint operating agreement between the owners.

In 2001, a contingent plan for the development of the licence was submitted to the authorities stating that the reserves were too small to justify development by themselves, and additional drilling results and changes to the extractive industry were necessary. No subsequent drilling was performed.

The exploration and evaluation assets were tested for impairment by the issuer on an annual basis irrespective of the impairment indicators in paragraph 6 of IFRS 6 *Exploration for and Evaluation of Mineral Resources*. The impairment test carried out in 2011 stated that the value in use of the licence was 50% higher than its carrying amount and therefore no charge for impairment was recognised.

The enforcer's decision

The enforcer did not agree with the issuer's treatment and stated that the issuer had not applied reasonable and supportable assumptions in measuring the value in use and that the licence was materially impaired.

IFRS 6.18 requires that exploration and evaluation assets are tested for impairment when facts and circumstances indicate that the carrying amount of the asset exceeds its recoverable amount. Impairment indicators listed in IFRS 6.20 were present, being:

- Little activity performed to conclude on the commercial viability of the discovery since 2007
- Substantive future exploration and evaluation expenditures for the licence were neither budgeted nor planned.

Paragraph 33(a) of IAS 36 *Impairment of Assets* requires cash flow projections to be based on reasonable and supportable assumptions.

Divergent views on commerciality existed between the issuer and the other owners of the joint agreement and further increased over the years. Based on a feasibility study in 2011, a working group which included representatives from all licence owners advised not to further develop the discovery.

Although differences in the views between licence owners are common, these differences and the results of the feasibility study should have been considered by the issuer in its estimation of the value in use of the licence.

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