



# International Financial Reporting Bulletin

25 June 2007

**Status:** Final

**Effective date:** Immediate

**Accounting impact:**  
Additional guidance for the  
application of IFRSs

CESR publishes key information from its database of enforcement decisions taken by EU National Enforcers of financial information (IFRS)

## Background

The Committee of European Securities Regulators (CESR) has, as a source of information to foster appropriate application of IFRSs, developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS).

CESR intends regularly to publish extracts from this database with the intention of informing market participants about which accounting treatments EU National Enforcers (such as the UK's Financial Reporting Review Panel) may consider as complying with IFRSs and thus contribute to a consistent application of IFRSs in the European Union.

The extracts that CESR intend to publish will not normally deal with simple or obvious accounting matters, or oversight of IFRS requirements, even if they were material breaches leading to sanctions. The published decisions will generally include a description of the accounting treatment or presentation at issue, the decision taken by the National Enforcer and a summary of the Enforcer's underlying rationale.

CESR published the first extracts on 16 April 2007. The full report can be found on the [CESR web-site](#). Set out below is a summary of the conclusions reached, which are in the same order as they have been presented in the report.

## Summary of extracts

### 1 Identification of the acquirer in a business combination (IFRS 3)

In the combination of two entities, A and B, entity B was presented as the acquirer as it was significantly larger than entity A in terms of market value and revenues, notwithstanding that entity A was the legal parent.

The Enforcer disagreed with this treatment on the basis that other characteristics of the combination suggested that entity A was the acquirer both in substance and legal form. The rationale for this decision was that, when analysing a business combination, all of the characteristics of the combination must be considered in the context of the guidance set out in IFRS 3.19-21. It is not appropriate to base the decision on a single condition (such as the relative sizes of the combining entities) in isolation.

2. *Control of a subsidiary when the holding is passive (IAS 27)*

Company A consolidated Company B because it had control over the appointment of four out of seven board members. However, one of the four directors appointed by Company A rarely attended Company B's board meetings and consequently, Company A did not *actively* control Company B.

The Enforcer agreed that Company A should consolidate Company B. The rationale for this decision was that it is the *power* to govern Company B's financial and operating policies that constituted control not the actual exercise of this power.

3. *Capitalisation of borrowing costs relating to a construction pending approval (IAS 23)*

A company purchased some agricultural land on which it intended to build a new factory. The company elected to capitalise the interest on the loan used to finance the land purchase even though its application to change the classification of the land from agricultural to industrial use had been delayed for six months by objections from local residents.

The Enforcer agreed with this treatment. The rationale for this decision was that IAS 23.22 prohibits the capitalisation of borrowing costs incurred by an entity while land acquired for building purposes is held without any associated development activity. However, where the entity is carrying out substantial technical and administrative work, for example activities associated with obtaining permits, borrowing costs may be capitalised prior to the commencement of construction. IAS 23.24 states that capitalisation of borrowing costs is not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use, and in consequence a temporary delay in obtaining permits would not result in the need to suspend capitalisation.

4. *Restructuring plans (IAS 37)*

An entity recognised two restructuring provisions, one in respect of redundancies that were part of a contractual arrangement to sell a factory in three years time (the 'Factory Provision') and another in respect of redundancies resulting from a headquarters reorganisation planned to commence at an unspecified time within the next two years (the 'Headquarters Provision').

The Enforcer agreed with the recognition of the Factory Provision but disagreed with the recognition of the Headquarters Provision. The rationale for this decision was that, for a restructuring plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely (IAS 37.74). In the absence of any additional evidence to the contrary (such as the binding contractual arrangement seen in the Factory Provision), where there is a long delay before the restructuring plan is expected to be implemented, it is unlikely to raise valid expectations among the parties affected by it that the company is committed to restructuring since the timeframe allows opportunities for the company to change its initial plans.

5. *Carrying value of a trade receivable (IAS 39)*

A company provided services to a number of clients who were unable to settle their debts. An arrangement was negotiated whereby 35% of the debt would be payable, attracting a special interest rate and including the possibility of being converted into share capital of the debtor's associated companies, and the remaining 65% would be written off. At the balance sheet date, the company had not finally accepted the terms of the agreement but had not impaired the debt on the basis that the amount due under the proposed agreement would be equal to the carrying value of the financial asset. Management saw no requirement to recalculate the carrying value of the asset.

The auditor issued a qualified audit report, indicating that the accounting treatment adopted was not in accordance IAS 39.58 and 59.

The Enforcer agreed that the treatment adopted by the company was inappropriate. The rationale for this decision was that IAS 39.59 states that a financial asset is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of events that occurred after initial recognition of the asset that have an impact on the estimated future cash flows of that asset. The existence of the draft agreement in this case indicated that such circumstances existed.

The loss is measured as the difference between the carrying amount of the asset and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate. The resulting loss, which cannot be offset by any compensating asset (e.g. interest receivable), is recognised in the income statement. In calculating the present value of the estimated cash flows, the company had set the losses incurred against the anticipated future payments which were equivalent to the principal and potential interest receivable from the revised, expected, agreement.

6. *Individual assessment of impairment of loans (IAS 39)*

When calculating the present value of a loan in order to determine whether or not it had been impaired, a company (a bank) adjusted an absolute estimate of cash flows only if a broad estimate indicated that discounting would have an effect. In the event that an adjustment was deemed necessary, that adjustment was based on the broad estimate rather than precisely determined cash flows.

The Enforcer did not consider this treatment to be in accordance with IAS 39; in its opinion broad estimates were not sufficient for use in the calculations required by IAS 39.63.

7. *Individual assessment of impairment of loans (IAS 39)*

When calculating impairment losses on individual loans, a company (a bank) used a fixed average percentage (the value of which was based on the type of evidence indicating impairment) of the unsecured part of the individual loan instead of determining the best estimate of the future expected cash flows from the individual loan as is required by IAS 39.63.

The Enforcer did not consider this treatment to be in accordance with IAS 39; in its opinion a fixed average percentage is not necessarily the best estimate of future expected cash flows that is required by IAS 39.63.

8. *Individual assessment of impairment of loans (IAS 39)*

When calculating impairment losses on individually assessed loans in accordance with the requirements of IAS 39.63, a company (a bank) determined a number of different cash flow scenarios, assessed the probability of each and calculated a weighted average.

The Enforcer did not challenge this treatment. The rationale for this decision was that IAS 39.AG86 states that the process for estimating the amount of an impairment loss may result in either a single amount or in a range of possible amounts and that in the latter case, the company should recognise an impairment loss equal to the best estimate within a range taking into account all relevant information available.

9. *Individual assessment of impairment of loans (IAS 39)*

When grouping loans for the purpose of a collective assessment of impairment, a company (a bank) only took credit rating grades into consideration and did not make any other segmentation of the loans (e.g. by industry type). By using this method, loans in the same group were considered equally sensitive to changes in the same economic conditions notwithstanding that they might be subject to different primary economic conditions.

The Enforcer did not challenge this treatment. The rationale for this decision was that IAS 39.AG87 states that, for the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (e.g. on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location and other relevant factors). In addition, IAS 39.BC122 states that assets may be grouped on the basis of one or more characteristics including estimated default probabilities or credit risk grades, asset type, counterparty type and geographical location. Finally, IAS 39.BC123 states that the IASB decided that for the purpose of assessing impairment on a portfolio basis, the method employed for grouping assets should, as a minimum, ensure that individual assets are allocated to groups of assets with similar credit risk characteristics.

10. *Individual assessment of  
impairment of loans (IAS  
39)*

On the basis of these provisions, the enforcer found that the company's method for grouping loans – according to which loans in the same groups are equally sensitive but not necessarily sensitive to changes in the same economic conditions – cannot be challenged, as the minimum requirements of paragraphs AG87 and BC122 are met.

When calculating impairment losses on individual loans a company (a bank) generally took no account of cash flows from probable liquidation dividends. The company argued that cash flows from liquidation dividends could not be assessed with the necessary degree of reliability as the dividend amount and the exact settlement date were normally not known.

The Enforcer did not consider this treatment to be appropriate. It was the Enforcer's view that a best estimate of the future cash flows from dividends in general satisfies the reliability criterion and that only in exceptional circumstances would probable cash flows from dividends not be taken into consideration because of unreliability of measurement.

11. *Accounting for biological  
assets (IAS 41)*

A company measured live farmed salmon with a weight exceeding 4kg at their fair value, while more immature salmon were measured at cost. The fair value of mature salmon exceeding 4kg was determined by using the observed prices in an active market of slaughtered salmon, classified as a similar asset according to IAS 41.18b. Based on an overall assessment, the company considered alternative estimates (including the present value of future net cash flows) of the fair value of live immature farmed salmon (<4kg) to be clearly unreliable, and hence accounted for these biological assets at cost according to IAS 41.30.

The Enforcer found that there existed observable market prices for slaughtered salmon weighing less than 4kg (also considered a similar asset under IAS 41.18b) and thus concluded that immature farmed salmon assets should be accounted for at fair value and not cost.

The decision was appealed to the Ministry of Finance. The Ministry of Finance upheld the decision of the Enforcer, with some adjustments and additions. Most significantly, the final ruling upholds the Enforcer's decision that slaughtered salmon is, in an accounting sense, to be considered as an asset similar to live salmon, according to IAS 41.18b and that this also applies to so-called immature farmed salmon. Hence, the observable prices of slaughtered salmon shall be used as a basis for determining the fair value of live immature salmon. The key amendment to the decision made by the Ministry of Finance is that it added certain comments relating to how the term "adjustments to reflect differences" in IAS 41.18b was to be applied. The adjustments should reflect the differences between the price of slaughtered immature salmon and the hypothetical market price in an active market for live immature salmon. These adjustments should be consistent with the assessments that would be expected to be made by market participants to set the price of live salmon in an arms length transaction, given its present location and condition.

## 12. *Business combination* (IFRS 3)

A listed company, Company A, presented its interim report for the period to 30 June 2005 in accordance with the recognition and measurement principles of IFRSs.

During the period, the company had acquired a much larger non-listed company, Company B. The acquisition was accounted for as follows:

- (a) Prior to the business acquisition, the principal shareholder in Company B (Company C) had only a minority interest in Company A.
- (b) Company C contributed its shares in Company B as a non-cash contribution in Company A. The transaction represented an exchange of equity interests as, in effect, the shareholder exchanged his shares in one company for shares in another company.
- (c) By virtue of this transaction Company C became the parent company of Company A which in turn became the parent of Company B. The business combination was recognised in the interim financial statements as Company A having acquired Company B.

The Enforcer disagreed with this treatment; in its opinion Company A should have treated the combination as a reverse acquisition. The rationale for this decision was as follows: Under IFRS 3.17 the acquirer is the combining entity that obtains control of the other entity in a business combination. When the combination is effected through an exchange of equity instruments the acquirer is normally the entity that issues the equity interests. However, all facts and circumstances should be considered to determine which of the combining entities has the power to govern the financial and operating policies of the other(s). In reverse acquisitions, where a private company is acquired by a smaller public company to obtain a stock exchange listing, the acquirer may be the entity whose equity interests have been acquired.

The Enforcer found that Company B was the acquirer and Company A the acquiree in this case as Company B had the power to govern the financial and operating policies of the legal parent, so as to obtain benefits from its activities. The business combination was a reverse acquisition under IFRS 3, being an exchange of equity instruments under which Company B achieved a Stock Exchange listing through the significantly smaller listed company. The exchange of instruments also had the effect that the principal shareholder in Company B (Company C) became the principal shareholder in Company A.

**13.** *Recognition of costs related to an acquisition and an issue of equity instruments (IFRS 3, IAS 32)*

A company entered into a business combination funded by cash and non-cash consideration, including refinanced and converted debt. In its financial statements, the company recognised consultancy fees in respect of this combination in its income statement together with other costs for the capital increases relating to the issue of equity instruments. The costs in question included lawyers' and accountants' fees, consultants' fees, bank commission, and a prospectus fee payable to the stock exchange.

The Enforcer was of the opinion that the treatment of costs relating to the acquisition and related issue of equity instruments did not comply with the requirements of IFRS 3.29 and IAS 32.37 respectively. Its rationale for this decision was as follows: In accordance with IFRS 3.29, all costs that can be attributed directly to the business combination (such as the consultancy fees) are to be regarded as part of the overall costs of the business combination and capitalised as part of the cost of investment. Additionally, under IFRS 3.31, the costs of a business combination that relate to the issue of equity instruments are not to be recognised as part of the business combination, but are to be treated in accordance with IAS 32.37 and set against the proceeds of the issue of the equity instruments; these are accounted for as a deduction from equity.

**14.** *Forward purchases and sales of non-financial assets to be settled through physical delivery (IAS 2, IAS 39)*

A company, which operates in the electricity generation business, entered into several forward contracts to buy gas for consumption in its production process. These contracts guaranteed a part of the company's future production process and ensured that, once acquired, the gas is not resold in the market. The contracts were to be settled through the physical delivery of gas; cash settlement was not anticipated. Included in the contract terms was a penalty (take or pay) clause should the company not want the gas at the end of the contract. In recent similar contracts, the company had taken the gas – and it intended to do so in respect of the contracts in question. The company had introduced appropriate internal controls to ensure that the contracts were executed in accordance with its expected usage requirements which were determined at the commencement of each contract.

The company believed that contracts to be settled through physical receipt of non-financial items (gas) where they are planned to be used or consumed in the production process should be accounted for as forward purchases in accordance with IAS 2, rather than IAS 39. Accordingly, payments of brokers' commissions, guarantee margins and other items typical of futures markets were treated as advance payments and included in the cost of acquisition of the gas.

The Enforcer agreed that these contracts fell outside of the scope of IAS 39 by virtue of paragraph 5 that excludes contracts that are entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in

15. *Redenomination of a foreign  
currency loan (IAS 21)*

accordance with the company's expected purchase, sale or usage requirements. The Enforcer also agreed that as IAS 2 is applicable, broker's commissions, guarantees and other payments typical of forward purchase contracts should be treated as prepayments and be included in the cost of the gas.

In accordance with IAS 21.15, a parent company recognised certain foreign exchange loans granted to its subsidiaries as part of its investment in them. Following changes in tax regulations and exchange rate performance, management converted these loans from US Dollars into Euros. The loans were converted using a Dollar-Euro spot exchange rate at the date of redenomination. The company took the view that exchange differences prior to the loan redenomination should remain in equity, as there had been no disposal of the net investment in the foreign operation (IAS 21.32).

The Enforcer agreed that a conversion or redenomination of such a foreign currency loan affects the form but not the substance of the investment as it does not involve a disposal. Therefore, exchange differences prior to the redenomination of the loan should remain in equity.

16. *Accounting treatment of a  
written puttable instrument  
on a minority interest (IAS 32,  
IFRS 3)*

In 2001 Company A, acquired 75% of the shares of Company C. Company B retained the remaining 25% of Company C's shares but had the right to put these shares, at any time, to Company A for an amount equal to their fair value at the time the option is exercised. Company A had the choice either to settle in cash or an equivalent value of its own shares. The option could be exercised without cause.

Up to and including its 2004 financial year, Company A recognised Company B's 25% share in Company C as minority interest in its consolidated financial statements. The written put option was not recognised.

As of 1 January 2005, the Company A applied revised IAS 32 retrospectively. This revised standard provides modified guidance on whether a minority interest in an entity shall be classified as equity or as a financial liability. IAS 32.23 states that a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability.

Due to the retrospective application of revised IAS 32, Company A reported the following in its 2005 financial statements:

- As at the date of the business combination: The recognition, at fair value, of the liability for puttable instruments (the 'Liability') and the derecognition of Company B's minority interest (IAS 32.23).

- During the periods between 2001 and 2005: Dividend payments made to Company B have been treated as partial repayments (i.e. reductions) of the Liability. In addition, increases in the fair value of the Liability due, for example, to higher sales volumes and profits, were treated as an adjustment of the contingent purchase consideration under IFRS 3.32 and 33 (these fair value movements affected only 2004 and 2005).

The Enforcer decided that the treatment did not constitute an infringement. The rationale for this decision was as follows:

*Presentation of the minority interest in the consolidated financial statements*

IAS 32.AG29 states that, when classifying a financial instrument in the consolidated financial statements, an entity should consider all terms and conditions agreed between members of the group and holders of the financial instruments in determining whether the group as a whole has an obligation to settle it in a manner that results in liability classification. Consequently IAS 32.23, rather than IAS 1 and IAS 27, is applicable to Company B's minority interest in Company C.

*Derecognition of the minority interest and initial recognition and measurement of the liability*

IAS 32.23 does not state clearly whether the contra to the Liability requires that the minority interest be derecognised or whether the general reduction in equity is sufficient. However, in the Enforcers opinion, it seemed logical to derecognise the minority interest and this approach is not forbidden by IAS 32.23. As a consequence of the derecognition of the minority interest, the Enforcer agreed that the dividend paid to Company B should be regarded as a repayment of the Liability.

IAS 32.23 requires the Liability to be measured at the present value of its redemption amount. As the put option is exercisable at any time the Enforcer accepted the judgement that the present value of the redemption amount was equal to the fair value of the 25% stake.

*Accrual of interest*

IAS 39.47 requires that financial liabilities are measured at amortised cost using the effective interest method after initial recognition. The Enforcer also accepted that, because of the current liability classification, interest costs were negligible.

*Goodwill recognised*

The Enforcer accepted that the liability could represent contingent purchase consideration for the future acquisition of the 25% stake. Under IAS 32.4(c) and IAS 39.2(f), contingent consideration is measured in accordance with IFRS 3 (except for cumulative amortisation under the effective interest method and dividends). IFRS 3.32 requires the recognition of contingent consideration to the extent that payment is probable and can be reliably measured and IFRS 3.33 requires that the cost of the combination (and consequently goodwill) is adjusted to reflect revised estimates in respect of contingent consideration.