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

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Status: Final

Effective date: Immediate

Accounting impact: Additional guidance for the application of IFRSs

Background

The Committee of European Securities Regulators (CESR) 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 UK National Enforcer is the Financial Reporting Review Panel (FRRP). 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.

CESR intends regularly to publish extracts from its database, with the intention of informing market participants about which accounting treatments EU National Enforcers (the Enforcers), such as the FRRP, may consider as complying with IFRSs and thus contribute to a consistent application of IFRSs in the European Union.

The extracts that CESR intends to publish will not normally deal with simple or obvious accounting matters, or oversight of the requirements of IFRSs, even if there 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 Enforcer and a summary of the Enforcer's underlying rationale.

On 17 December 2007, CESR published its second extracts from the database. The full report can be found on the CESR web-site at the following address: http://www.cesr-eu.org/. Set out below is a summary of the conclusions reached, which are in the same order as they have been presented in the report.

CESR published its first extracts from the database on 16 April 2007. BDO's IFR Bulletin Issue 6, 2007 summarises that publication.

Transactions and related IFRSs covered by the December 2007 extracts

1. Amortisation of intangible assets with finite useful lives included in goodwill (IAS 36 / IAS 38 / IFRS 1)
2. Excise tax on fuel (IAS 1 / IAS 2 / IAS 18)
3. Recognition of negative goodwill (IFRS 3)
4. Deferred tax asset (IAS 12)
5. Valuation of offshore rigs at the transition date (IFRS 1)
6. Use of the Fair Value option (IAS 39)
7. Segmental reporting (IAS 14)
8. Method of amortising intangible assets (IAS 38)
9. Change in accounting for employee benefits (IAS 19)
10. Identification of the acquirer in a business combination (IFRS 3)
11. Real estate projects (IAS 11 / IAS 18)

Summary of extracts

1. Amortisation of intangible assets with finite useful lives included in goodwill

(IAS 36 / IAS 38 / IFRS 1)

When accounting for a business combination effected prior to its date of transition to IFRSs, an issuer included in goodwill a separately identifiable intangible asset (rights to operate a mine for a specified period of time) because it could not be recognised on the date of the business combination under the GAAP previously applied.

Subsequently, on transition from local GAAP to IFRSs the issuer elected not to apply IFRS 3 retrospectively and, in consequence, the intangible asset was included in goodwill and not separately identified because it did not meet the qualifying criteria for separate recognition which are set out in IFRS 1.B2(f) and (g), even though it was known that the asset had a finite life and would be fully impaired or amortised over the period specified by the rights.

The issuer asked its Enforcer whether goodwill impairment should be calculated taking into account the useful life of the intangible asset that is subsumed within it or whether the impairment provision should be calculated in accordance with IAS 36 'Impairment of Assets'. The former approach would give rise to a systematic allocation to the income statement similar to the process of amortisation set out in IAS 38 'Intangible assets' whereas the latter approach would mean that most of the expense allocation is made at the end of the useful life of intangible asset subsumed within goodwill.

The Enforcer found that goodwill which included a subsumed intangible asset with a finite life should be subject to annual impairment testing in accordance with IAS 36.90 and that no part of the goodwill balance should be systematically amortised through the income statement.

2. Excise tax on fuel
(IAS 1 / IAS 2 / IFRS 18)

In accordance with IAS 18.8, excise tax imposed by national law on the consumption of fuels as they leave bonded warehouses qualify as an expense when a distributor withdraws the product from the bonded warehouse and as revenue when the distributor recovers its incurred cost through sale to the end customer; they cannot generally be classified as "amounts collected on behalf of third parties" and treated net. Among other features that distinguish excise tax from, for example, Value Added Tax, is the fact that the tax cannot be recovered in the event of default by the end customer.

In this case, the issuer asked its Enforcer whether such costs (which represented approximately 15% of the total revenues and total expenses) truly qualify as purchase costs and whether these amounts should be disclosed in notes to the income statement.

The Enforcer found that, as the issuer has no right to recover the tax from the authorities or offset it against other taxes and bears the entire risk of its recovery, the tax should be treated as part of the costs of inventories, in accordance with IAS 2.11. In addition, as is the case with all other inventory-related costs, the portion of the sales price relating to this tax qualifies as revenue in accordance with IAS 18.8.

The Enforcer also concluded that IAS 1.103(c) would require the separate identification and disclosure of these material costs.

3. Recognition of negative goodwill
(IFRS 3)

When accounting for a December 2004 business combination under its previous GAAP, an issuer recognised negative goodwill as a current liability. On adopting IFRSs for its accounting period ended 31 December 2005, the issuer continued to recognise the negative goodwill in its comparative balance sheet but indicated in its first quarterly consolidated financial statements of 2005 (that were published under IFRSs in accordance with the local legislation) that the balance would be written off during that year.

The Enforcer disagreed with this treatment because IFRS 1 does not allow an issuer to elect not to restate business combinations that are effected after the date of transition (which in this case was 1 January 2004). IFRS 3.56 requires that negative goodwill be written off immediately. In consequence, the negative goodwill which resulted from the 2004 acquisition should have been recognised in the income statement in 2004, not in 2005.

4. Deferred tax asset
(IAS 12)

An issuer incurred substantial annual losses in each year since 2000 except for 2003 and 2004, when it made a minimal profit before tax resulting mainly from income recognised in respect of a deferred tax asset. The issuer also expected a substantial loss would be incurred in 2005. The issuer had a history of reporting considerable negative variances from its budgeted results.

The issuer's recognised deferred tax assets (consisting primarily of unused tax losses that could be carried forward but against which there were virtually no taxable temporary differences to offset) had been increasing year on year and, at 30 June 2005, they were approximately 34% of equity.

The Enforcer disagreed with the treatment adopted as the recognition of deferred tax assets on losses carried forward was not in accordance with IAS 12.34. The issuer was not able to provide convincing evidence to persuade the Enforcer that the issuer would be able to generate sufficient taxable profits against which the unused tax losses could be offset.

In reaching its decision, the Enforcer attached particular importance to the fact that, historically, substantial negative variances arose between the issuer's budgeted and realised results and also that, in 2005, the issuer had announced that it would record a substantial loss. The enforcer was also influenced by the fact that the losses were not of a type that could clearly be attributed to external events that might not be expected to recur.

5. Valuation of offshore rigs at the transition date
(IFRS 1)

In its opening IFRS balance sheet, an issuer in the offshore drilling business elected to measure its rigs at fair value and use that fair value as deemed cost in accordance with IFRS 1.16. Fair value was calculated on the basis of two brokers' estimates, both of which provided a range of values within which the valuation might be considered acceptable but neither of which was supported by a full description of the method adopted or the assumptions underlying the calculation. The valuations were principally based on discussions with various players in an illiquid market.

The Enforcer questioned whether the brokers' estimates were a reliable form of evidence on which to base the fair value calculation of tangible assets to be then adopted as deemed cost.

The Enforcer indicated that, it is generally advantageous to use independent estimates when determining fair value but an issuer should ensure that the valuation is prepared in accordance with the requirements of the relevant IFRS. In this case the broker estimates included so little information about the valuation methods and underlying assumptions that they could not, of themselves, be relied upon for determining fair value in accordance with for example IAS 16 *Property, Plant and Equipment* or IAS 36 *Impairment of Assets*.

However, as IFRS 1.16 does not set out detailed requirements under which fair value should be determined, the Enforcer considered the method adopted acceptable. In addition, it indicated that issuers who adopt fair value as deemed cost have only to provide the limited disclosures required by IFRS 1.44; methods and assumptions for determining fair value do not have to be disclosed.

6. Use of the Fair Value option
(IAS 39)

The issuer applied the fair value option rules to debt related to investment property that was measured at fair value in accordance with the provisions of IAS 40 (using a discounted cash flow model). The issuer argued that the recognition of gains and losses on its investment properties and the related debt would otherwise be inconsistent and that there is a specific financial correlation between the factors that form the basis for determining the fair value of both the investment properties and the related debt.

The case raises the question of whether an issuer may apply the fair value option rules laid down in IAS 39.9b(i) to measurement inconsistencies between investment properties and related debt.

The Enforcer supported this use of the fair value option. It concluded that there was no reason why the option should be restricted only for the use of financial services entities or on financial assets and financial liabilities and that applying the option resulted, in this case, in more relevant information because the recognition inconsistency, in this particular case, would be significantly reduced. The Enforcer agreed with the argument that there is a specific financial correlation between the factors that form the basis of the measurement of the fair value of the investment properties and the related debt. Particular importance was placed on the role played by interest rates, although it was acknowledged that the value of investment properties will also depend, to some extent, on other factors.

7. Segmental reporting
(IAS 14)

An issuer gave IAS 14 segmental disclosures for a division notwithstanding that the two business units of which it comprised each contributed 10-20% of the issuer's consolidated net revenues, were separately discussed in the narrative sections of the issuer's Annual Report, and were dissimilar in terms of risks, management, activities, expertise, markets and customers.

The Enforcer disagreed with this treatment and indicated that it was the business units and not the division that should be identified as separate segments under IAS 14.

8. Method of amortising intangible assets
(IAS 38)

An issuer won, through public tender, licences to provide telephony services in a specific area for a specified period of time. The licences related to a geographical area where the company had no previous experience and where its forecasts were subject to a degree of uncertainty. The price paid for the licence did not vary with the number customers won by the issuer.

The issuer argued that this was one of the very rare situations envisaged by IAS 38.98 where it would be appropriate to use an amortisation method that would result in a lower amount of accumulated amortisation than under the straight-line method.

The Enforcer disagreed with the treatment adopted by the issuer.

In order to adopt a method other than straight-line amortisation in respect of an intangible asset with a finite useful life, it is necessary to prove that the pattern in which the entity expects the future economic benefits embodied in the licence to be consumed is that based on production or demand and not the length of the licence. This could be the case, for example, for a licence that explicitly refers to the number of items produced (i.e. number of telephony lines) but was not the case for the type of licence acquired by the issuer. In addition, with no previous experience in this area, the issuer could not demonstrate that demand was the most representative pattern of consumption, nor could the issuer determine reliably the expected demand or volume as the non-linear methodology would require. Consequently, as neither of the conditions set out above were met, straight-line was deemed to be the only appropriate method of amortisation.

9. Change in accounting for employee benefits
(IAS 19)

In its 2006 Financial Statements, an issuer changed its accounting treatment for a pension plan from Defined Benefit (DB) to Defined Contribution (DC) and restated the comparative 2005 financial information. The effect of the restatement for 2005 was significant.

The issuer explained that, since the pension liabilities were fully insured and indexation of future liabilities was limited up to and including the funds available in escrow, where the escrow was not at disposal of the issuer, the plan qualified as a defined contribution plan under IAS 19 rather than a defined benefit plan. Furthermore, it was noted that the escrow was built up by the insurance company from the surplus yield on investments. The pension plan was an average pay plan in respect of which the entity paid insurance premiums to a third party insurance company to fund the plan.

The Enforcer concluded that the issuer's pension arrangement did not meet the criteria as outlined in IAS 19.25 and 39 for Defined Contribution accounting on the grounds that the risks, although potentially limited, remained with the issuer. Among the factors considered by the Enforcer in coming to this decision were:

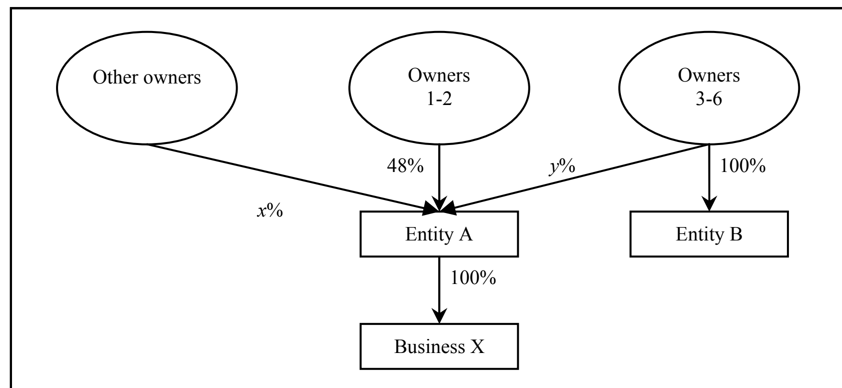
- The employees pay a fixed premium of 7.04% of their salary and the issuer paid the balance of the insurance premium.
- The insurance contract was between the issuer and the insurance company, not between the employee and the insurer.
- The insurance contract was renewed every year and, as the premium for the employee was fixed, the issuer was exposed to changes in premiums depending on the return on the investments and changes in actuarial assumptions.
- The agreement between the issuer and the employees did not include any indication that, in the case of a shortfall in the funded status of the plan, the entitlement of the employees may be reduced. This indicated that the issuer had a legal or constructive obligation to pay further amounts if the insurer did not pay all future employee benefits relating to employee service in the current and prior periods.

10. Identification of the acquirer in a business combination

(IFRS 3)

The issuer (Entity A) is a publicly listed company that divested one of its largest segments (Business X) to a group of shareholders (Owners 1-2) and dissolved the centralised ownership structure of the company. The overall arrangement was carried out in accordance with a pre-determined plan involving the establishment of a separate entity (Entity B), by another group of shareholders (Owners 3-6) to facilitate certain stages of the arrangement.

Figure 1: Original structure

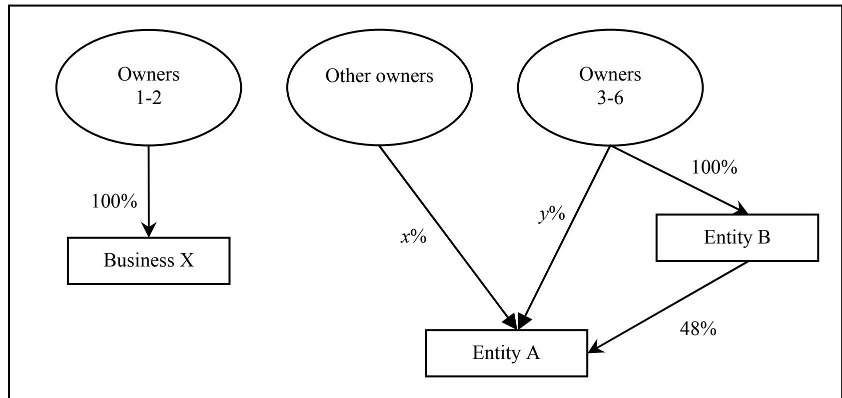


The arrangement included four steps that were, for the most part, contingent upon each other. The sequence of events was as follows:

a) The Entity A sold Business X to Owners 1-2. The sales price was satisfied by a debt note.

b) Simultaneously, Entity B purchased all of the shares held by Owners 1-2 in Entity A (48 % of the voting rights). This purchase was also satisfied by a debt note. The two notes were settled in the subsequent merger of Entities A and B.

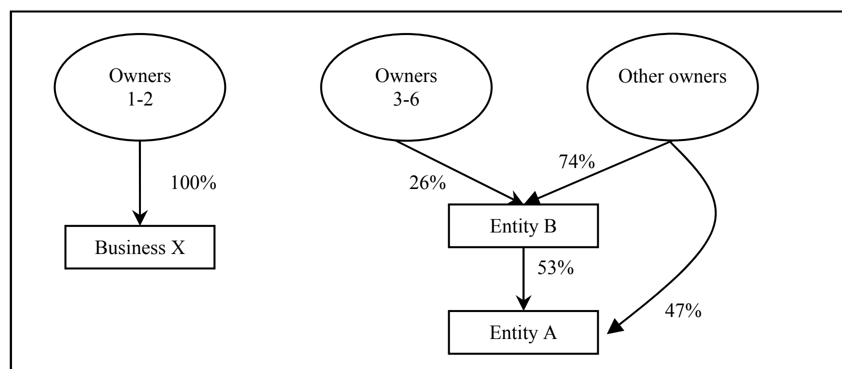
Figure 2: After steps (a) and (b)



c) A few days later, Entity B made an exchange tender offer to Owners 3-6 and the other shareholders for their shares in Entity A, mainly for shares in entity B but also including a non-material cash element. After the offer, Entity B had controlling ownership (53% of the voting rights) of Entity A's former operations, excluding Business X. With the closing of the public tender offer, Entity B's shares were listed on the stock exchange.

d) Simultaneously with the offer, the Entity A and Entity B signed and entered into a merger agreement following which Owners 3-6 had 26% of the voting rights of the combined entity.

Figure 3: After steps (c) and (d)



After completion of the arrangement, the new publicly listed Entity B had the same business as was formerly operated by Entity A excluding Business X.

After the transaction was completed, the founders of Entity B, whose control over Entity A was only intended to be temporary, have less than one third of the voting rights of the merged company. The members of Entity A's Board (except for members representing Owners 1-2) were elected to the Board of the merged entity.

The issuer asked the Enforcer whether Entity A or Entity B should be considered the acquirer.

The Enforcer concluded that Entity A was the acquirer. It maintained that the terms, conditions and commercial effects of individual steps in the arrangement could not be understood without reference to the whole. As such, the accounting treatment should reflect the overall substance of the arrangement rather than the legal form of each individual step. Among the factors considered by the Enforcer in coming to this decision were:

- As Entity B was formed to issue equity instruments to effect a business combination it cannot, according to IFRS 3.22, be the acquirer; Entity A must, therefore, be the acquirer.
- Because members of Entity A's Board (except for members representing Owners 1-2) were elected to the Board of the merged entity, Entity A had control over the new combined entity after completion of all the stages to the arrangement and, in accordance with IFRS 3.21, is deemed the acquirer.
- Entity B had no operating activities, or personnel and its existence as a separate entity was intended to be temporary and was formed only after the arrangement was proposed at a meeting of Entity A's shareholders.
- The decision is further supported by consideration of the other indicators set out in paragraph 20 of the standard.

11. Real estate projects
(IAS 11 / IAS 18)

An issuer that develops and sells property applied IAS 11 to all of its construction contracts, recognising revenue in accordance with the percentage of completion method. The three kinds of contracts entered in to by the issuer were as follows:

- Commercial property – The issuer acquires a commercial property that has development potential and enters into a lease with a tenant. Conversion of the property, in accordance with the issuer's plans and the tenants' requirements and wishes, is agreed at the time of entering into the leases, and the conversion work is then commenced. Until the date of completion the issuer receives income in the form of rent. On completion of the conversion work, the selling price for the property is calculated on the basis of the expected cash flow from its operation. A contract of sale is entered into with a third party investor, and the investor takes possession of the property. The investor only acquires legal title to the property at the date of completion.
- Construction projects for cooperative dwellings – In these contracts, the "resident" does not own the dwelling unit, instead they have a right to use that unit and also benefit from a share in the cooperative housing society (the Cooperative). The Cooperative is the owner of the property and is the party with whom any contract is entered into.

- Apartments for sale – In substance, buyers of a completed apartment have only limited influence on the design and the construction of the apartment.

The Enforcer disagreed with the issuer's accounting approach; it considered the appropriate treatment to be the postponement of revenue recognition until the transfer of the property takes place (i.e. for IAS 18 to be applied, not IAS 11).

IAS 11.3 defines a construction contract as a contract specifically negotiated for the construction of an asset. The Enforcer considered it insufficient that the contract has been negotiated with a specific customer; it insisted that there must be a negotiation of the contractual terms (design of the building project, the choice of materials, layout and arrangement, etc.) between the seller and the buyer prior to commencement of the work. For the majority of the issuer's contracts, the substance is that the entity sells a completed building to a buyer, who has only limited influence on the design and construction of the building. In consequence, the Enforcer concluded that it was not appropriate to account for the arrangement under IAS 11.

As IAS 11 is not applicable to any of the contracts in question, IAS 18 should be applied to the issuer's deliverables. IAS 18.14 contains five conditions which must be met before revenue from the sale of goods can be recognised. In each case, the Enforcer found that the issuer retained significant risks, effective control and the right to a return attached to the property sold until the final transfer. This means that the condition in IAS 18.14(a), had not been met and the point at which revenue could be recognised was required to be postponed until the transfer of the property took place.

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