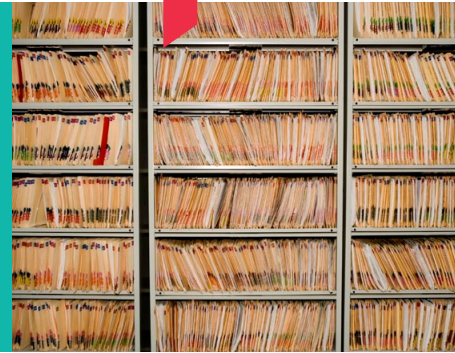


INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/05

CESR'S FIFTH EXTRACT 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 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.

CESR 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 24 March 2009 CESR published its fifth extract from the database. The full report can be found on the CESR web-site at the following address: <http://www.cesr-eu.org/>, following the links on that page to Operational Groups/CESR-Fin/EECS. 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 CESR are summarised in IFRBs 2007/06, 2008/07, 2008/15 and 2009/04.

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

Additional guidance for the application of IFRSs

Transactions and related IFRSs covered by the extracts

- (1) Reclassification of available for sale financial instruments (IAS 39)
- (2) Share based payment (IFRS 2)
- (3) Loss of Control of a subsidiary (IFRS 5, IAS 8)
- (4) Control of a subsidiary (IAS 27)
- (5) Reverse acquisition accounting in a business combination (IFRS 3)
- (6) Put options over minority interests (IAS 32)
- (7) Treatment of preference shares (IAS 32)

Summary of extracts**1) Reclassification of available for sale financial instruments (IAS 39)**

On 1 December 2008 the issuer, a listed holding company with interests in banking and private equity published its half-yearly financial statements for the period to 30 September 2008.

In the light of the deterioration of the markets, the issuer sought to apply IAS 39 (amended October 2008) to reclassify, in its half-yearly financial statements, its available for sale financial instruments into the category "loans and receivables" on the basis that it had the intention and the ability to hold those financial instruments for the foreseeable future.

The assessment of whether these available for sale financial instruments met the conditions to be classified as loans and receivables was to be made at the date of reclassification.

The issuer asked the enforcer to confirm whether this treatment was compliant with the amendments to IAS 39.

The enforcer did confirm that the treatment was compliant with the amendment to IAS 39. The enforcer also indicated to the issuer that it should apply the amendments to IFRS 7 and make thorough disclosures of the reclassification.

The revised IAS 39.50E states:

"A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available for sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity."

The paragraph does not state explicitly on which date the assessment of whether an available for sale financial instrument meets the definition of a loan and receivable has to be made (as indicated in IAS 39.9, "loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market").

In particular, it does not explicitly state that the assessment has to be made at initial recognition of the financial instrument (in contrast to the requirements of IAS 39.50D).

Therefore, in this case, the enforcer considered that it could accept the decision of the issuer to assess the conditions at the date of classification.

2) Share based payment (IFRS 2)

The issuer had three different employee share purchase plans (ESPP).

Under plans 1 and 3, all employees were invited to participate in a savings plan whereby a certain amount was withdrawn from their net monthly salaries during a year and transferred into a separate account. The balance of this account was used to purchase shares after a one year service period at a 15% discount to the fair value at the start of the plan or the fair value at the end of the plan.

Under plan 2 eligible employees were invited to participate in a savings plan whereby they could contribute a limited amount of cash up front into a separate account, which was used to purchase shares after a one year service period at a 30% discount to the fair value at the start of the plan or the fair value at the end of the plan.

The issuer was of the opinion that the ESPP plans were share based payments within the scope of IFRS 2.11 and that in principle, they should be measured at fair value in accordance with IFRS 2.11.

However, as the issuer was of the opinion that the fair value of the ESPP programs could not be reliably measured the issuer accounted for the plans using the intrinsic value method in accordance with IFRS 2.24.

The issuer had argued that it had no basis on which to estimate a reliable fair value at the inception of the plan as there was uncertainty about how many shares the employees would be entitled to buy and what the future market prices of those shares would be.

In the enforcer's opinion, the ESPP plans could be reliably measured, and the plans, therefore, should have been measured at fair value in accordance with IFRS 2.11.

IFRS 2.24 notes that an entity may, in rare cases, be unable to estimate reliably the fair value of the equity instruments granted at the measurement date. In these rare cases only, the entity is required to measure the option to employees at intrinsic value.

IFRS 2.BC144 provides unlisted or newly listed companies as being examples of entities that might not be able to estimate reliably the fair value of share options at the grant date.

The issuer's ESPP plans were similar to those described in US GAAP, specifically, FAS 123 R appendix A and FASB Technical Bulletin 97-1 "Accounting for Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back option".

In the enforcer's opinion as there were valuation methods that could be used reliably to measure the issuer's ESPP plans, they should have been measured at fair value in accordance with IFRS 2.11.

3) Loss of control of a subsidiary (IFRS 5, IAS 8)

At the beginning of 2007 the issuer had a direct holding of a 67% (interest) in entity B. In September 2007, entity B issued new shares which were wholly subscribed for by a new investor (entity C).

As a consequence, after the increase in capital, the issuer retained an interest of 44% (30% of voting rights) in its former subsidiary, entity B.

At the same time, the shareholders of the entity B signed an agreement providing new governance rules for entity B. Based on this new agreement, the issuer was no longer to be represented on entity B's board or participate in its management. The issuer, therefore, considered that it had lost control of entity B.

The issuer also considered that its decision not to subscribe to the issue of new shares was equivalent to a decision to disinvest in entity B, and was a change in strategy.

Consequently, from October 2007, the issuer stopped consolidating entity B on a line by line basis and adopted the equity method of accounting to reflect its interest in entity B.

Due to the fact that entity B was a separate line of business (with separate cash flows, management and customers), the issuer considered the results of entity B for the period beginning on 1 January 2007 and ending on 30 September 2007 should be presented based on principles provided by IFRS 5 (including restatement of the 2006 comparative figures).

The issue was whether, in these circumstances, the issuer could present the results of entity B for the period ended 30 September 2007 based on the principles of IFRS 5.

The enforcer concluded that the issuer's presentation, based on IFRS 5 principles (specifically IFRS 5.2 and IFRS 5.4) was acceptable.

The enforcer decided that the presentation was acceptable for the following reasons:

- The issue of dilution is not addressed by IFRS (neither IFRS 3, IFRS 5 or IAS 27);
- The decision not to subscribe to the issue of new shares of entity B was clearly a change in the strategy of the issuer;
- By deciding not to subscribe to the issue of new shares of entity B, the issuer agreed to the dilution and the loss of control (which, in economic terms, was similar to a decision to sell shares while retaining a continuing interest in the entity);
- Entity B represented a separate line of business (separate cash flows, management and customers) (IFRS 5.31 and IFRS 5.32);
- Information disclosed in accordance with the principles of IFRS 5 highlighted the effects of entity B on the issuer's 2007 financial statements (for the 9 month period) and 2006 (for the 12 month period) profit and loss statements (IFRS 5.33 and IFRS 5.34); and
- An agreement between entity B's shareholders confirmed that the issuer had lost control over its former subsidiary.

Therefore, in the absence of a specific Standard or Interpretation applying to this situation, the enforcer considered, based on IAS 8.10 and IAS 8.11(a), that IFRS 5 could be used by analogy.

In coming to its decision, the enforcer also considered the requirements of paragraphs 32 to 37 of IAS 27 (amended January 2008), and reached the conclusion that the presentation based on IFRS 5 principles selected by the issuer was consistent with the accounting treatment required by the amended standard when a parent loses control of a subsidiary.

4) Control of a subsidiary (IAS 27)

The issuer, a significant industrial and services group, owned 35.4% of entity B, a newly listed company.

The capital of the entity B was distributed as follows:

- The issuer: 35%;
- Institutional investors: 12%; and
- Public: 35%.

When entity B was admitted to trading in June 2008, a 5-year renewable shareholders' agreement was signed between the issuer and the Institutional Investors ("the parties"), the objective being to ensure the development of entity B by:

- Establishing the governance policy; and
- Guaranteeing a stable ownership.

According to the agreement:

- The board of directors would be comprised of 18 members: 9 members appointed by the issuer, 5 members appointed by the Institutional Investors, and 4 members appointed by "the parties" (both the issuer and the Institutional Investors) and the Chairman of the Board of Directors;
- The Chairman of the board of directors, who would have a casting vote where votes were otherwise equal, would be appointed by the issuer;
- The Chairman of the board of directors would appoint the Chief Executive Officer;
- All current decisions of the board of directors would be made by simple majority;
- A qualified majority would be necessary for decisions relating to capital, statutory requirements and extraordinary distributions of dividends; and
- The parties would have pre-emption rights if one party wished to sell its shares in the issuer.

The prospectus issued by entity B for admission to trading clearly stated that it was the objective of the issuer to retain control.

Prior to listing, the issuer had transferred to a separate entity (entity B) all water and waste activities in the group (the "spin out"). After the spin-out, the issuer still owned almost 100% of the capital and voting rights of entity B.

The issuer then distributed – and therefore admitted to trading – 65% of the shares of entity B to its own shareholders (other than itself), proportionately to their holdings in the issuer's capital (the "distribution").

The issuer was of the opinion that it had control over entity B at 31 December 2008.

The enforcer agreed.

Control is defined in IAS 27 as the power to govern the operating and financial policies of an entity or business so as to obtain benefits from its activities.

IAS 27.13 notes that there is a presumption that an entity controls another entity if it owns, directly or indirectly through subsidiaries, more than half of the voting power of that entity unless it can be clearly demonstrated that such ownership does not constitute control.

However, IAS 27.13 also notes that control exists when the parent owns half or less of the voting power of an entity when there is, *inter alia*:

- Power to govern the financial and operating policies of the other entity under a statute or an agreement;
- Power to appoint or remove the majority of the members of the board of directors or equivalent governing body of the entity; or
- Power to cast the majority of votes at meetings of the board of directors or equivalent governing body of the entity.

Under the shareholders' agreement, the issuer had the power to appoint more than half of the board members, including the Chairman, and therefore, had the power to govern the financial and operating policies of entity B, since all current decisions of the board of directors were to be made by way of a simple majority.

5) Reverse acquisition accounting in a business combination (IFRS 3)

The issuer and entity B, another listed company, entered into a business combination in July 2008 that took the form of a merger. According to the merger agreement, the issuer was the legal acquirer. The issuer issued around 1.2 million new shares in exchange for shares in entity B. There was no cash consideration.

Before the transaction, the capital of both entities was distributed as follows:

The issuer

- Controlling Shareholder A: 80%
- Public: 20%

Entity B

- Public: 66.7%
- Institutional investors: 33.3%

Prior to the transaction, the fair value of entity B was significantly greater than the fair value of the issuer.

After the transaction, the former shareholders of the issuer had 44.5% of the voting rights of the combined entity and the former shareholders of entity B had a stake of 55.5%.

The participation of the controlling shareholder A in the combined entity ("the golden share") was regulated by national decree. Under this decree, shareholder A could oppose any decision by the issuer which could be considered contrary to the national vital interest in the energy sector, in particular regarding the continuity and security of the energy supply. However, this decree did not give any right to shareholder A to govern the financial and operating policies of the issuer as such although it did give A the right to appoint 7 members out of a 25 person board.

Under the terms of the purchase agreement, the CEO of entity B was appointed as the CEO of the combined entity. The CEO had a casting vote in the event of other votes being equal. The Board of Directors comprised the CEO and 24 other members: 10 members appointed by the issuer (including the 7 members appointed by shareholder A), 10 members appointed by Entity B, 3 members appointed by employees and 1 member representing the other shareholders.

The issuer proposed to account for the transaction as a business combination and identified B as the acquirer.

The enforcer accepted the accounting treatment of the issuer.

IFRS 3 requires an acquirer to be identified in all business combinations, the acquirer being the combining entity that obtains control so as to obtain the benefits from its activities. There is a presumption that control exists when an entity owns, either directly, or indirectly, more than half of the voting rights, unless it can be clearly demonstrated that such ownership does not constitute control.

In this case, it was presumed that the shareholders of entity B had obtained control since, in terms of voting rights, their stake amounted to 55.5% after the transaction. The existence of a significant individual shareholder (shareholder A) was, nevertheless carefully considered by both the issuer and the enforcer.

Subparagraphs (a) to (d) of IFRS 3.19 consider circumstances where a combining entity might obtain control over another even if it does not acquire more than half of the voting rights. The facts of the case were compared with these circumstances. It was noted that shareholder A did not

- hold more than half of the voting rights in the combined entity;
- have the power over half of the voting rights by virtue of an agreement (IFRS3.19(a))
- have the power to govern the financial and operating policies of the other entity under a statute or an agreement (IFRS3.19(b))
- have the power to appoint or remove a majority of the members of the board of directors or equivalent governing body of the combined entity (IFRS 3.19(c)). Shareholder A only appoints 7 members out of 24.
- have the power to cast the majority of votes at meetings of the board of directors or equivalent governing body of the other entity (IFRS3.19(d))

The enforcer agreed that shareholder A, with 35.7 of the voting rights, did not have control over the combined entity.

In coming to their decision, the issuer and the enforcer also considered the criteria set out in IFRS 3.20 and IFRS 3.21 which provide further guidance on how to identify the acquirer in a business combination. As the fair value of B was significantly greater than the issuer, IFRS 3.20(a) confirmed entity B was the acquirer. However, the issuance of 1.2 million new shares could have pointed towards the issuer as the acquirer.

6) Put options over minority interests (IAS 32)

The issuer had written put options each of which contained an obligation on the issuer to purchase the minority holdings in a subsidiary.

Each option was written as part of a business combination and was exercisable during specified periods at prices determined by reference to the performance of the relevant subsidiary.

In its 2007 accounts the company disclosed a contingent liability for the best estimate of the value of the redemption amount of the minority put options using current levels of profitability.

The enforcer concluded that the company's treatment of minority put options as contingent liabilities was not in accordance with IAS 32.23 which requires a liability to be recorded for all contracts that contain an obligation to purchase own equity instruments for cash.

Minority put options are contracts that contain an obligation for an entity to purchase its own equity instruments for cash or another financial asset. Under IAS 32.23, these contracts give rise to a financial liability for the present value of the redemption amount, which is required to be recognised in the balance sheet rather than as a contingent liability in the notes to the accounts.

While IAS 32 is clear as to the recognition of the liability, the enforcer was aware that, at the time, there were divergent accounting practices in respect of the corresponding accounting (debit) entry when the liability is first recognised and when the amount of the liability is revised.

7) Treatment of preference shares (IAS 32)

The issuer presented non-redeemable preference shares as equity instruments in its balance sheet date.

The terms of the issue of the instruments give the holders a contractual right to an annual fixed net cash dividend and the entitlement to a participating dividend based on any dividends paid on ordinary shares. Both the fixed and participating dividends were presented as dividends, below profit after taxation, in the income statement.

The issuer had invoked IAS 1.17, explaining that presentation of the preference shares with a liability component in compliance with IAS 32 would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the IASB's Framework for the Preparation and Presentation of Financial Statements. The enforcer did not agree that the departure from IAS 32 was warranted.

Compliance with IAS 32 (as revised in 2003) would have required the preference shares to be treated as compound financial instruments with both equity and liability components. Under the requirements of IAS 32.31, the value of the equity component is the residual after deducting the separately determined liability component from the fair value of the instrument as a whole.

By following the requirements of IAS 32, substantially all of the carrying value of the issuer's preference shares would have been allocated to the liability component and the fixed net cash dividend would have been treated as a finance cost.

IAS 1.17 requires the departure from a requirement of a standard only in the extremely rare circumstances where management conclude that compliance would be so misleading that it would conflict with the objective of financial statements set out in the Framework.

The issuer argued that presentation of the preference shares in accordance with IAS 32 would have been misleading because it would not reflect the nature of the instruments as having characteristics of permanent capital providing participation in future gains and losses.

IAS 1.15(c) requires additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable a user to understand the impact of particular transactions or conditions on financial position and financial performance.

In the enforcer's view, a fair presentation would have been achieved by complying with IAS 32 and providing additional disclosures to explain the characteristics of the preference shares.

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