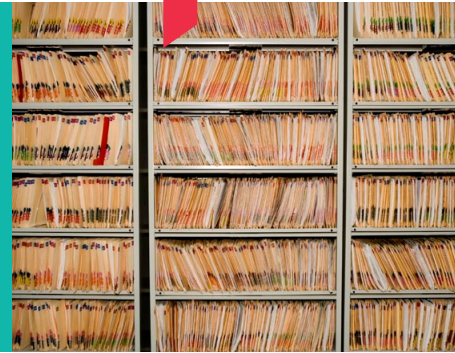


INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/06

CESR'S SIXTH 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 26 August 2009, CESR published its sixth 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, 2008/17, 2009/04 and 2010/05.

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

Additional guidance for the application of IFRSs

Transactions and related IFRSs covered by the extracts

- (1) Impairment of available for sale equity instruments (IAS 39)
- (2) Cash flow statements (IAS 7)
- (3) Classification and valuation of written puts on minority interests (IAS 32 and IAS 39)
- (4) Disclosure of key management personnel compensation and related party transactions with key management (IAS 24)
- (5) Contingent liabilities (IAS 37)
- (6) Disclosures regarding share capital (IAS 32)

Summary of extracts**1) Impairment of available for sale equity instruments (IAS 39)**

The sixth extract included three similar issues in respect of the impairment of equity instruments classified as Available for Sale. The summary below combines these three decisions.

In each case, the Issuers held significant investments in equity instruments which were classified as available for sale under IAS 39. The wording of the accounting policies in respect of the impairment of these assets or inconsistencies between the accounting policies and other disclosures within the financial statements resulted in the Enforcers identifying the inappropriate accounting treatments adopted.

In the first case, the Issuer's accounting policy stated that a significant or prolonged decline in the fair value of an equity instrument classified as available for sale was considered to be objective evidence of impairment and that, where an impairment resulted in the valuation of these instruments below their original cost, that loss would always be recognised in the income statement. However, in the notes to the financial statements, the Issuer noted that, where the loss was unrealised at the balance sheet date, if documentation was available supporting a recovery in the fair value of the instrument in the short term, no charge to the income statement would be recognised.

In the second case, the Issuer's accounting policy stated that a significant and prolonged decline in the fair value of an equity instrument classified as available for sale was required before an income statement charge would be recognised.

Finally, in the third case, the Issuer claimed that a significant or prolonged decline in the fair value of an equity instrument classified as available for sale triggered the need for a further analysis of estimated future cash flows before it could be concluded that an impairment should be recognised.

The Enforcer disagreed with the treatment adopted in all cases.

IAS 39.61 provides examples of objective evidence of impairment for an investment in an equity instrument, including a clear reference to a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost. No further evaluation is required to establish whether the investment is impaired in such circumstances. Although management must use their judgement to determine what constitutes a significant or prolonged decline in the fair value (IAS 39 does not indicate quantitative thresholds that may satisfy those criteria), that judgement should be unaffected by the existence or otherwise of documentation supporting the recovery of the fair value in the short term.

2) Cash flow statements (IAS 7)

The Issuer disposed of a subsidiary during the year. In its cash flow statement the sale of the subsidiary was reflected as follows:

- The Issuer had granted a loan to a subsidiary. As a result of the sale of the subsidiary to a third party, the loan was no longer eliminated on consolidation but recorded on the balance sheet. The movement in the book value of the loan (i.e. its recognition in the consolidated balance sheet), a non-cash transaction, was classified as a cash outflow from investing activities in the cash flow statement.
- The aggregate amount of cash received as consideration for the sale of the subsidiary was reported as an incoming cash flow from investing activities and was not recorded net of the cash and cash equivalents disposed of with the subsidiary. Furthermore, disposal costs were not taken into account.

The Enforcer found that, as a result of the non-compliance with IAS 7, cash flows from operating activities and investing activities were materially misstated.

The cash receipt from investing activities was incorrect as it was not reported net of cash and cash equivalents disposed of as required by IAS 7.16 and IAS 7.42. In addition, the issuer had not disclosed, in aggregate, the amount of the assets and liabilities other than cash or cash equivalents in the subsidiary over which control was lost as required by IAS 7.40(d).

3) Classification and valuation of written puts on minority interests (IAS 32 and IAS 39)

The Issuer's strategy, when acquiring a new subsidiary, was to acquire the majority of the acquiree's shares but to leave a minority interest outstanding for a limited amount of time, after which it acquired those interests too. To this end, the Issuer assumed an unconditional liability to purchase the remaining outstanding shares for an amount determined by the results achieved by the acquired companies.

Under the terms of the contract, the Issuer could choose to pay for these minority shares in cash or in its own shares. However, if the Issuer opted for payment by way of its own shares, the number of shares to be paid was calculated at the time of the purchase of the minority interests using the share price at that point, not at the date of the original purchase transaction.

In its financial statements, the issuer classified the minority interests as part of group equity, disclosing the existence of unconditional liabilities in a note to the accounts.

The Enforcer found that, in accordance with IAS 32.23, the minority interests should have been classified in the balance sheet as a financial liability as the shares were to be paid for either in cash or through the issue of a variable number of the issuer's own equity instruments.

IAS 32.23 stipulates that a contract which contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. This is the case even if the contract itself is an equity instrument. When the financial liability is recognised initially under IAS 39, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with IAS 39.

4) Disclosure of key management personnel compensation and related party transactions with key management (IAS 24)

The Issuer granted shares to key management as part of their remuneration package. The related costs were not included in the total of the compensation disclosed for key management personnel but were noted separately. The Issuer subsequently bought back some of the shares from key management but did not disclose either the number of shares involved or the amount for which they were repurchased.

Both the issue and the subsequent repurchase of the shares were significant in relation to the total remuneration package for key management personnel.

The Enforcer concluded that the issuer should have disclosed the information as required by IAS 24.16 and 17(a).

IAS 24.16(e) requires disclosure of key management personnel compensation in total for a number of identified categories, including share-based payments. Compensation for share-based payment, although provided elsewhere, was not included in the total compensation disclosed and was significant in relation to that amount (20%).

IAS 24.17 also requires information about transactions and balances that is necessary for an understanding of the potential effect of the relationship with related parties on the financial statements. Disclosure should include the amount of the transactions. The Enforcer concluded that both the number of shares bought back and the amount for which they were purchased should also have been disclosed.

5) Contingent liabilities (IAS 37)

In 2004, an accident at one of the Issuer's facilities caused a number of deaths and injuries. The accident resulted in the temporary closure of the facility and led to legal action against the Issuer.

Both the investigation and the reconstruction were still in progress when the 2007 accounts were published and no action had yet been brought in connection with the accident. Experts were continuing with their appraisals, mainly in connection with the expert report that was to be presented to the civil courts, determining the cause of the accident and assessing the respective responsibilities of the various parties involved. The report was expected in the summer 2008. In consequence, the nature and extent of any damages and who might be liable to pay them had yet to be established.

Although liability was yet to be established, compensation agreements had been agreed with victims, all of which were covered by the Issuer's insurance policy. In each case, compensation paid by the insurers was subject to a waiver of any judicial proceedings or appeals against the Issuer and its insurers. In addition, if compensation was determined ultimately also to be payable to other parties, such payments were expected to be covered by the insurance policies taken out by the Issuer.

The Issuer considered that the conditions for recognising a provision or disclosing a contingent liability, particularly the conditions set out in IAS 37.14 and IAS 37.28, had not been fulfilled. In consequence, the Issuer did not recognise any provision in respect of the accident in its 2007 accounts nor did it disclose any related contingent liability. Furthermore, the issuer did not disclose its underlying analysis of the situation in the notes to its 2007 financial statements.

The Enforcer agreed that, in accordance with IAS 37.14, the conditions for establishing a liability were not fulfilled. IAS 37.14 requires a provision to be recognised when an entity has a present obligation as a result of a past event; it is probable that an outflow of resources embodying benefits will be required to settle the obligation and a reliable estimate of the obligation can be made. At the date of the 2007 financial statements, there was no current obligation for the Issuer. In particular, no action had been brought in connection with the accident. It was not yet probable that an outflow of resources would be required to settle the obligation.

The Enforcer was, however, of the opinion that IAS 37.28 applied to the case and that the Issuer should have disclosed a contingent liability. The fact that the identity of the responsible parties was yet to be determined and that the nature and extent of the damages remained to be established indicated the level of uncertainty attaching to the issue. In the view of the Enforcer, however, the degree of uncertainty was not such that the possibility of an outflow of resource could be considered remote. Only had this been the case would it have been appropriate to omit the disclosures required under IAS 37.28.

6) Disclosures regarding share capital (IAS 32)

The Issuer, a closed-ended fund, had share capital comprising two subscriber shares of €1 each which did not participate in the profits of the Issuer, and in excess of 50 million participating preference shares of no par value, which were classified on the face of the balance sheet as a component of equity. The issuer's financial statements stated that its participating and subscriber shares were classified as equity in accordance with the issuer's articles of association. The participating preference shares were to be redeemed when the Issuer's 15-year life span expired.

The Issuer argued that the participating preference shares should be presented as equity on the basis that this was the legal form of these instruments.

IAS 32.18 notes that "the substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet". Similarly, IAS 32.15 requires that an issuer of a financial instrument "shall classify the instrument ... on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument". The Enforcer concluded that the shares should have been shown as a financial liability as they were mandatorily redeemable at the end of the Issuer's limited life of 15 years.

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