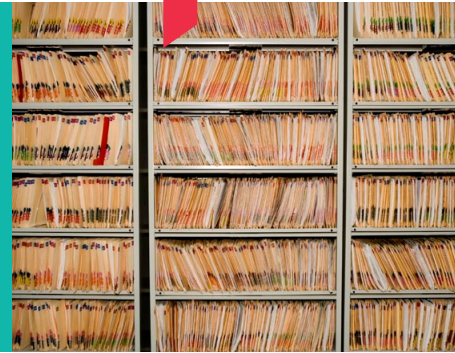


INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/07

CESR'S SEVENTH 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 16 December 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, 2010/05 and 2010/06.

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

Additional guidance for the application of IFRSs

Transactions and related IFRSs covered by the extracts

- (1) Restructuring of financial obligations (IAS 39)
- (2) Reclassification of a loan (IAS 1)
- (3) Presentation of financial instruments (IFRS 7)
- (4) Classification of cash and cash equivalents (IAS 7)
- (5) Revenue recognition (IAS 18)
- (6) Customer loyalty programme (IFRIC 13)
- (7) Segmental reporting (IFRS 8)
- (8) Provisions and contingent liabilities (IAS 37)
- (9) Correction of an error (IAS 8)
- (10) Half-year consolidated cash-flow statement (IAS 34)
- (11) Related party disclosures (IAS 24)
- (12) Business combinations (IFRS 3 and IAS 8)
- (13) Collective assessment for impairment of loans (IAS 39)

Summary of extracts**1) Restructuring of financial obligations (IAS 39)**

The issuer implemented a comprehensive restructuring of its financial obligations, the effect of which was to provide new cash resources to the Group, to reduce or defer cash payment obligations and to provide flexibility for investment and development.

The issuer considered the changes to be "substantial modifications of the terms of the existing financial liabilities" and accounted for them as an extinguishment of the original debt and the recognition of new debt in accordance with IAS 39.40 and recognised a gain in profit or loss as the difference between the carrying amount of the original debt that was extinguished and the fair value of the new debt. The issuer also charged profit and loss for the issue and renegotiation costs. After initial recognition, the Issuer subsequently measured the new debt at amortised cost using the effective interest method.

The enforcer accepted this accounting treatment by satisfying itself that the terms of the debt were substantially different from the initial terms in accordance with IAS 39.40.

IAS 39.40 provides that an exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original debt and the recognition of a new financial liability. IAS 39.AG 62 states that, for this purpose, terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original liability.

The enforcer also agreed with the inclusion of the issue and renegotiation costs as part of the gain since IAS 39.AG 62 states that where an exchange of debt instruments is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain.

2) Classification of loan (IAS 1)

In November 2008 the issuer defaulted on an interest payment on an issued bond loan. The loan agreement stipulated that such default could lead to an obligation to repay the whole loan immediately (including incurred interest and expenses). The bondholders, however, issued a waiver postponing the interest payment until 19 December 2008. Subsequently, on 6 January 2009, the issuer summoned the bondholders to a meeting and asked for, and obtained from the bondholders, a further waiver of the interest payment until 5 February 2009.

The issuer classified the loan as long-term debt in its 31 December 2008 (issued 26 February 2009) balance sheet on the basis that it was not in default and the bondholders had issued waivers and not sought redemption.

The enforcer concluded the loan should have been classified as short-term debt as the issuer did not have an unconditional right to defer payment for at least twelve months after the balance sheet date as required by paragraphs 65 and 66 of IAS 1.

IAS 1.60(d) states that a liability should be classified as current if it is due to be settled within twelve months after the balance sheet date. IAS 1.65 clarifies, that, if an issuer breaches an undertaking under a long-term loan agreement on or before the balance sheet date, such that the debt becomes due and payable on demand, the loan is classified as current even if the lender agrees, after the balance sheet date, not to demand payment as a consequence of the breach. IAS 1.66 states that a liability should be classified as current if a waiver is issued before the balance sheet date, but does not give the issuer a period of grace ending at least twelve months after the balance sheet date.

As the waiver was issued after the balance sheet date, and only for a short period, the issuer did not have an unconditional right to defer the payment for at least twelve months after the balance sheet date as required by the standard.

3) Presentation of financial instruments (IFRS 7)

The issuer was a financial institution with significant US sub-prime related investments classified as available-for-sale.

The issuer's financial statements disclosed how much of the whole amount of the fair value of the available-for-sale investments was determined, in whole or in part, directly by reference to price quotations in active markets or was estimated using a valuation technique supported by (i) observable market data or (ii) non observable market data as required by paragraph 27 of IFRS 7.

In a subsequent analysts' presentation, this same information was presented in respect of the US sub-prime related investments (which formed a component of the AFS investments) which was not disclosed in the accounts. The issuer did not consider there to be any requirement to disclose this information on a product basis in the accounts but provided it voluntarily to analysts believing there to be an interest in information that went beyond the specific disclosure requirements of IFRS 7.

The enforcer concluded that the US sub-prime investment information disclosed to analysts should have been disclosed in the accounts because the objective of IFRS 7 is to provide disclosures that enable users to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of an entity's risk exposure arising from the financial instruments held. Therefore, even though IFRS 7.6 and IFRS 7.27 did not specifically require the issuer to provide information on a product basis, in this case, the additional detail was necessary in order for users to evaluate the significance of US sub-prime investments to the issuer's position and performance and to meet the objective of the standard.

4) Classification of cash and cash equivalents (IAS 7)

The issuer, a private equity and venture capital provider, presented in its 2008 accounts an amount of €538 million as cash and cash equivalents on the face of its balance sheet as required by IAS 1.68. The issuer's accounting policy stated cash and cash equivalents comprised cash on hand, cash with banks and short-term deposits, explaining that cash and cash equivalents were carried at nominal value but that the carrying amount approximated their fair value, given their short-term nature.

The notes disclosed the €538 million as €456 million in marketable securities and other instruments, €18 million of short-term bank deposits and cash and other equivalents of €64 million. The note explained that the marketable securities were invested in "immediately realizable instruments like bonds, CDOs and investment funds".

The enforcer concluded that, contrary to its stated accounting policy, the amounts included in cash and cash equivalents on the issuer's balance sheet comprised amounts, the nature of which did not satisfy the definition of cash and cash equivalents as set out in IAS 7.

IAS 7.6 defines cash as cash on hand and demand deposits and cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.

The enforcer noted that the amount reported on the balance sheet comprised certain investments that did not meet this definition. Contrary to the stated accounting policy, the financial statements showed significant value reductions through profit and loss in respect of certain investments included in cash and cash equivalents. In addition, it appeared that some of the investments were neither short-term nor liquid.

5) Revenue recognition (IAS 18)

The issuer, which designed, realised and managed business solutions and IT infrastructures, entered into contracts with both customers and suppliers. Suppliers produced bug fixes, new releases and updates. Client complaints and requests were channelled through the issuer's service department which had maintenance contracts with the customers. The terms of the contract supported accruals accounting by the issuer.

Prior to 2007 the issuer recognised the whole amount of revenue (and related costs) on standard software maintenance contracts when the customer was invoiced, which was at the beginning of the contract. From 2007 onwards, the issuer recognised revenue (and related costs) on a straight-line basis over the contract term.

The issuer presented this change as a change in accounting estimate. The issuer argued that in December 2006, it had acquired company X which recognised revenue from a similar type of maintenance contract as the issuer, on a straight-line basis over the term of the contract. The issuer considered both policies to comply with IAS 18.20 but, on advice, and in response to analyst comments, adopted the practice of company X for the group. The issuer concluded that the two recognition methodologies were not, in substance, two different accounting policies and therefore, did not consider the adoption of the new practice to be a change in accounting policy.

The enforcer found that the change in accounting treatment should have been presented as a correction of an error in accordance with IAS 8, as the previous policy applied was not in accordance with paragraph 20 of IAS 18. IAS 18.20 requires that revenue associated with the rendering of a service should be recognised by reference to the stage of completion of the transaction at the end of the reporting period, providing that the outcome of the transaction can be estimated reliably. IAS 18.26 states that when the outcome cannot be estimated reliably, revenue should be recognised on to the extent that the expenses are recoverable.

The enforcer concluded that, given that the maintenance contract with the customer involved rendering of service over a period, the previous accounting policy of recognising revenue in full when invoiced at commencement of the contract did not comply with IAS 18. The subsequent change was therefore a correction of an error rather than a change in estimate and should have been presented retrospectively in accordance with IAS 8.

6) Customer loyalty programme (IFRIC 13)

The issuer, an airline, operated a customer loyalty programme in which members were granted loyalty points when they bought airline tickets. The points could be redeemed for air travel or other services with either the issuer or partner companies participating in the programme including airline companies, credit card companies, hotel chains and car rental companies.

In its previous financial statements, the points had been accounted for as follows:

- The estimated value of all points outstanding was calculated as the estimated value of a point multiplied by the number of points granted, not yet redeemed;
- The estimated value of a point was not the fair value but was an estimate based on the specific terms and conditions of the programme;
- The estimated value of all points was recognised as a deduction against revenue (not as an expense) and recognised as a liability on the balance sheet and described as 'deferred revenue'; and
- The revenue for these points was recognised when the points were redeemed.

Up to 31 March 2008, the value of a point had been calculated as a weighted average (weighting based on issuer's historic data of point redemption) of the following three components:

- Those points which were going to be redeemed with the issuer (these were valued based on the discounted incremental cost of the passenger carried);
- Those points which were going to be redeemed with a partner (these were valued based on the billing from the issuer's partners in the programme); and
- Those points which were never going to be redeemed (no value was attributed to these points).

As of 1 April 2008, the issuer applied IFRIC 13 and as a result, the points were now valued at fair value. The three components were retained, but the method used to measure the component reflecting those points redeemed with the issuer was changed to fair value, the fair value being the average fare charged by the issuer.

The enforcer found that the accounting treatment adopted by the issuer complied with the requirements of IFRIC 13 because the points were accounted for at fair value. IFRIC 13.6 requires the consideration allocated to the award credits to be measured by reference to fair value (the amount for which the award credits could be sold separately). Paragraph AG 2 clarifies that the fair value of the points should be reduced to account for the awards that are not expected to be redeemed.

7) Segmental reporting (IFRS 8)

The issuer, publicly listed and traded on an unregulated market, applied IFRS 8 early in its December 2007 financial statements as part of its transition to IFRS.

The accounts did not disclose the segmental analysis of revenues from external customers; the operating segments from which revenue from major customers was derived, and the measure of profit or loss reported to the chief operating decision maker, as required by IFRS 8. The issuer argued that making the specific disclosures of IFRS 8 might affect its competitive position (i.e. the issuer argued that the disclosure should be omitted due to commercial sensitivity).

The enforcer found that the accounts did not comply with certain aspects of the requirements of IFRS 8 because IFRS does not provide for a 'competitive harm' exemption. Paragraph 44 of the basis of conclusions to IFRS 8 explains that the IASB concluded that such an exemption would be inappropriate because it would provide a means for broad non-compliance with the IFRS.

8) Provisions and contingent liabilities (IAS 37)

The issuer built, developed and managed airports. In July 2007, the National Council of State (the Council), responding to a complaint from several airlines, cancelled the issuer's tariff decisions (airport fees) for 2006 (the period May 2006 to March 2007). These airlines also submitted a motion to the Council to cancel the issuer's 2007 (April 2007 to March 2008) airport fees.

Using the conclusions of the July 2007 ruling on the 2006 tariff procedures, the issuer issued a new 2006 tariff procedure and, as a precautionary measure, a new 2007 tariff procedure. Both new tariff procedures were approved by the Government with retrospective effect and were, in fact, at the same level as those originally proposed.

Since the Council did not require the issuer to refund any amounts received under the original tariff, the issuer interpreted the Council ruling to mean that it did not question the tariffs but rather the procedure by which they had been originally determined. Nonetheless, the air transport operators lodged an appeal with the Commercial Court in January 2008 for reimbursement of a portion of the amounts paid in 2006 and 2007 as they felt the amounts charged were not justified in view of the decision by the Council of State.

The issuer had not recorded a provision nor referred to any contingent liability in respect of this matter in its 2007 financial statements on the basis that the conditions for recognising a contingent liability had not been met as set out in paragraphs 14 and 28 of IAS 37.

The enforcer considered the conditions set out for recognising a provision (IAS 37.14) and the reporting of contingent liabilities (IAS 37.28) and accepted the accounting treatment of the issuer because at the date the financial statements were published, it was not probable that an outflow of resources would be required as set out in IAS 37.14(b) since the Government had approved both the 2006 and 2007 fees. In consequence, there was no reliable estimate of the amounts that might have had to be paid by the issuer, if any, in accordance with IAS 37.14(c). For the same reasons, there was no reason for the issuer to disclose a contingent liability as the outflow of resources, if any, was still very remote (IAS 37.28).

9) Correction of an error (IAS 8)

The issuer made a public announcement in November 2007 that its 2006 accounts, which were reviewed by the enforcer, contained a consolidated cash flow statement that did not comply with IAS 7 in all material respects.

In its 2007 annual accounts, the issuer corrected the 2006 consolidated cash flow figures as the comparative amounts to the 2007 consolidated cash flow statements but did not, however, include any reference to the fact that the 2006 comparative cash flow statement amounts had been restated. The issuer argued that the correction to the 2006 cash flow statement had been adequately communicated to the market through the November 2007 announcement and that no other disclosures were necessary in 2007.

The enforcer did not accept the issuer's argument and concluded that the changes to the comparative figures were material and should have been adjusted in accordance with IAS 8.42 and supported by the relevant disclosures, including the disclosure of the nature of the prior period errors. IAS 1.14 and .15 state that in virtually all circumstances a fair presentation is achieved by compliance with applicable IFRSs. The fact that relevant information had already been communicated to the market did not release the issuer from the obligation to apply IFRS standards when preparing its annual accounts.

10) Half-year consolidated cash flow statement (IAS 34)

The issuer's half-year consolidated condensed cash flow statement did not include the headings 'Cash flow from operating activities' and 'Changes in operating assets and liabilities' which were included in its prior year annual cash flow statements. There was however, a sub-total for 'net cash flows from operating activities'. Furthermore, there was no note to explain either the nature or amounts comprising the cash flows from operating activities.

The issuer argued that IAS 7.10 states that 'the cash flow statement shall report cash flows during the period classified as operating, investing and financing activities'. Since the cash flow statement was entitled 'condensed' and included subtotals for operating, investing and financing activities, the issuer claimed that the minimum requirements of IAS 7 had been met.

The enforcer did not agree with this position. IAS 34.10 requires that condensed financial statements should include, at a minimum, each of the headings and subtotals that were included in an entity's most recent annual financial statements. Therefore by omitting the headings and subtotals 'cash flows from operating activities' and 'changes in operating assets and liabilities', the issuer did not comply with IAS 34.10.

11) Related party disclosures (IAS 24)

The issuer had a two-tier board structure consisting of a management board and a supervisory board. Some members of the supervisory and management boards were of a particular EU nationality, where there was some sensitivity about the disclosure of information about remuneration that could be traced back to individuals.

In the related parties note in the consolidated accounts, the issuer disclosed the total remuneration paid to directors and non-executive directors and a total for these two groups. However, the remuneration for the supervisory group was not included in the key management disclosures because this could enable readers of the financial statements to trace amounts paid to individuals from the particular EU country noted above. The issuer noted that because of the sensitivity around these disclosures, it did not provide information about remuneration that could be traced back to individuals, instead provided the information in the annual accounts in an ambiguous way to prevent users of the financial statements from tracing remuneration to specific individuals.

The enforcer did not accept this explanation and found that the exclusion of the remuneration of the supervisory board from the key management disclosures and the lack of an analysis of the total remuneration into categories did not comply with IAS 24, in particular IAS 24.9 and IAS 24.16. IAS 24.9 defines key management personnel as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly. IAS 24.16 states that an entity should disclose key management personnel compensation in total and for each of the following categories: (a) short-term employee benefits; (b) post-employment benefits; (c) other long-term benefits; (d) termination benefits; and (e) share-based payment.

12) Business combinations (IFRS 3 and IAS 8)

The seventh extract included a number of issues in respect of business combinations including two issues in respect of the purchase price allocation of a business combination, two issues in respect of the identification of the acquirer in a business combination, and one issue in respect of a business combination under common control.

Purchase price allocation:

In the first case, the issuer, an alternative provider of electricity and gas, had acquired an entity in June 2007. As at 31 December 2007, the purchase price allocation (PPA) was not finalised and so the issuer booked goodwill on a provisional basis. No explanation was provided in the notes to the financial statements to explain the provisional PPA nor the nature of the information needed to finalise it.

During the first half of 2008, the issuer finalised the fair values of the acquiree's identifiable assets and liabilities including the fair value of internally generated intangible assets. As a result, the issuer booked an adjustment in the half-yearly financial statements which resulted in negative goodwill and a large gain in the income statement. Subsequent to the publication of these half-yearly statements, the issuer realised it had made an error and the adjustment for the negative goodwill should not have been booked as a gain in 2008 but should have been booked retrospectively at the date of acquisition (June 2007) in accordance with IFRS 3.62.

The enforcer agreed that the error should be corrected because IFRS 3.62 states that in respect of business combinations, "the acquirer shall recognise any adjustments to the provisional values as a result of completing the initial accounting (a) within 12 months of the acquisition date and (b) from the acquisition date".

In the second case, the issuer previously acquired several international oil services entities which led to significant goodwill being recorded in the issuer's financial statements at 30 June 2007. None of the acquired companies had many fixed assets and were acquired by the issuer for 'human capital' and the opportunity for synergies and cross-selling opportunities.

The issuer estimated the fair value of the assets based on what it was prepared to pay for them and clarified that what it was prepared to pay was influenced by its future plans for the acquired businesses. As a result, the issuer estimated the fair value of the customer relationships in the acquired companies to be zero because the issuer already enjoyed relationships with the majority of these same customers.

The enforcer did not agree with the issuer's allocations for these acquisitions as they were not based on "fair value" as defined in IAS 38.40 or IFRS 3.B16(g). IFRS 3.B16(g) states that the fair value of intangible assets not traded in an active market are determined at the amount that would be paid in an arm's length transaction between knowledgeable and willing parties. The fair value is not an amount specific to the acquirer nor should it take into account the acquirer's future intentions of the acquired businesses. Since the valuations had taken the issuer's own circumstances and future plans into consideration, the allocations of the costs to the assets were not in compliance with IFRS.

The enforcer considered that the acquired companies had identifiable contract-based customer relationships at the date of acquisition which were identifiable in accordance with IAS 38.12(b). To be recognised separately, the identified assets would have to satisfy the probability and reliable measurement criteria of IFRS 3. Intangible assets acquired in a business combination meet the probability criterion by virtue of IAS 38.33 and IAS 38.35 notes that the fair value of intangible assets acquired in a business combination can normally be measured with sufficient reliability to be recognised separately from goodwill. As a result, part of the cost of the business combinations should have been allocated by the issuer to these customer relationships.

Business combination under common control:

The issuer reorganised certain of its subsidiaries and decided to spin-out (transfer) to a separate legal entity (entity B) all of its water and waste treatment activities in exchange for 100% of the shares and voting rights of entity B. Immediately after the spin-out, the issuer distributed 65% of the shares in entity B to its own shareholders, in proportion to their holdings in the issuer's capital. After the distribution the issuer held 35% of entity B and had a signed shareholder's agreement, under the terms of which it still controlled B.

The issuer did not account for this transaction in accordance with IFRS 3 as it considered the transaction to be under common control as defined in IFRS 3.3 and instead followed the requirements of paragraphs 8-10 of IAS 8. Following this approach, the issuer concluded that an appropriate approach would be to account for the transaction as a pooling of interests. This resulted in the issuer recognising the effect of the distribution of the shares at net book value against equity with a proportionate increase in minority interest.

The enforcer accepted this accounting treatment because, in the absence of specific guidance in IFRS setting out how to account for a business combination under common control, the application of the pooling of interest method was acceptable. It was also noted that paragraph 30 of IAS 27 (revised 2008) states that changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Identification of the acquirer:

In the first case the issuer (a listed company) and entity A (a non-listed company) entered into a business combination whereby the issuer acquired 100% of entity A.

Before the transaction the issuer's capital and voting rights was 46% held by entity B and 54% was held by the public, and entity A was wholly owned by entity C. After the transaction 17% of the issuer's capital and voting rights were held by entity B, 63% by entity C and 20% by the public. There was no link between the issuer and C before the transaction and the fair value of A was significantly greater than the issuer.

The terms of the agreement for the transaction included the following (references to the Board are in respect of the Board of the issuer):

- the issuer was the legal acquirer;
- the Board would comprise the Chairman (appointed by entity B) and 10 other members (5 appointed by entity B and 5 by entity C);
- the Board would seek to make decisions unanimously;
- Board members appointed by entity C would have veto rights on certain important decisions including annual budget, appointment/dismissal of auditor, payment of exceptional distributions and mergers and acquisitions; and
- A CEO and vice-CEO would be appointed by the issuer on an annual basis

The issuer considered itself the acquirer through reference to IFRS 3.19(b) because it had the power to govern the financial and operating policies of entity A by virtue of the agreement under which it appointed the majority of the Board.

The enforcer disagreed. IFRS 3.17 notes that the acquirer is the entity that obtains control over the other combining entities or businesses. Guidance on how to determine the acquirer in a business combination is provided in paragraphs 19 to 21 of IFRS 3.

Control is defined as the power to govern the operating and financial policies of an entity or business so as to obtain benefits from its activities. There is a presumption that control exists when one entity acquires more than one half of the voting rights of another entity unless it can demonstrate that such ownership does not constitute control. For the purposes of this transaction, there was a strong presumption that the former shareholders of entity A (entity C) had obtained control since they had 63% of the voting rights after the transaction.

IFRS 3.19 considers circumstances where a combining entity might obtain control over another even if it does not acquire more than half of the voting rights. IFRS 3.20 sets out, by way of example, certain factors which might help in determining the identification of the acquirer. IFRS 3.21 states that "... all pertinent facts and circumstances shall be considered to determine which of the combining entities has the power to govern the financial and operating policies of the other entity (or entities) ...".

Taking into account all the specific facts and circumstances of this case, the enforcer concluded that the transaction was a reverse acquisition and that entity A was the acquirer having entered into the transaction to obtain a stock exchange listing. To support this position the enforcer concluded that:

- Entity C (the former 100% shareholder in entity A) owned more than 50% of the voting rights of the new combined entity;
- The fair value of entity A was significantly greater than the fair value of the issuer, therefore entity A was likely to be the acquirer (IFRS 3.20(a));
- In contrast to the issuer's view, it is not clear whether the issuer had the power (by law or agreement) to govern the financial and operating policies of entity A;
- In theory, the issuer (and its former shareholders) had the ability to elect the majority of the Board (the Chairman and 5 of the 10 other members) which might indicate the issuer had control. However, because the agreement required decision, where possible, to be taken with unanimous Board approval, in practice the board members appointed by entity B did not have the power to govern the financial and operating policies of the combined entity. Also the Board members appointed by entity C had the right to veto major decisions; and
- In theory, the issuer (and its former shareholders) had the power to cast the majority of the votes at the Board meetings. However, the requirement in the agreement for decisions, where possible, to be taken with unanimous Board approval, negated that power.

In the second case, the issuer, a listed entity which was in a very weak financial position and had a business that was towards the end of its lifecycle, entered into an arrangement with three parties (group B, a private group with various businesses, financier C and entity D, a small private entity) to refinance the issuer through a transfer of control to group B and form a new group with an improved business proposition.

Before the transaction, group B had no ownership interest in the issuer, financier C (the main financier of the issuer) had a 5% ownership interest and held a significant amount of the issuer's convertible bonds, entity D (which operated as a subcontractor of the issuer), had a 25% ownership interest and other shareholders held the remaining 70%. After the transaction the issuer's ownership interests were 63% held by group B, 0% held by financier C, 10 % held by entity D and 27% held by other shareholders.

The transaction was completed in several phases that were contingent on each other and which were carried out within a very short time frame of each other. In the first phase, group B purchased 11% of the shares from other shareholders, and financier C and entity D entered into an agreement whereby they would support the board nominees and other proposals of group B. In the next phase, the issuer acquired a small business from group B (entity B). The aim of this acquisition was to improve the business proposition of the issuer by combining its business with that of entity B. In the final phase, group B acquired the majority of the share capital of the issuer from financier C (which first converted all of its convertible bonds into shares of the issuer).

The issuer intended to account for the acquisition of entity B as a transaction under common control on the basis that entity B was controlled immediately before and after the transaction and the control was not intended to be transitory post acquisition.

The enforcer did not agree as the transaction did not meet the definition criteria of IFRS 3.10 which defines a common control transaction as one in which all of the combining entities are controlled by the same party or parties both before and after the business combination and control is not transitory. Critical to the enforcer's decision was whether the phases of the agreement were to be treated as a single or as separate transactions. The enforcer concluded that the arrangement should be treated as a single transaction because it was negotiated as a single transaction and the separate phases, on their own, could not have been justified economically. In the end, the criteria of IFRS 3 were not fulfilled by the arrangement because the issuer and entity B were not controlled by the same party or parties before the arrangement.

13) Collective assessment for impairment of loans (IAS 39)

This enforcement decision dealt with a bank's collective assessment of loans and consisted of a number of sub decisions dealing with different aspects of the assessment.

a) Calculation of collective impairment based solely on customers with low credit quality:

The bank's collective impairment assessment was based only on customers with very low credit quality. Customers which had initially been of better credit quality but had subsequently moved to poorer credit classes were not added to the collective impairment calculation on the basis that these customers were still expected to be able to service their loans.

The enforcer did not accept this approach because paragraph AG 85 of IAS 39 states that the process for estimating impairment should consider all credit exposures not simply those of a poor quality. All downward migrations from one credit grade to another should be considered, not only those reflecting a severe deterioration in credit.

b) No explicit adjustment of Basel II parameters

The bank used a rating model based on Basel II parameters ($PD \times LGD \times AE = EL$, where PD is probability of default, LGD is loss given default, AE is actual exposure and EL is expect loss) for capital adequacy purposes. These parameters were not adjusted for financial reporting purposes although the bank claimed the differences were taken into account when making an overall management judgement at the end of the process.

The Enforcer did not accept this accounting treatment because there are many differences between a Basel II calculation of expected losses and the calculation of collective impairment according to IFRS which is based on incurred losses (IAS 39.63). Given these differences Basel parameters cannot be applied for financial reporting purposes without adjustment and there was no convincing evidence that this was done when management applied its judgement.

c) Inadequate consideration for loss identification period (LIP)

LIP is an important element in calculating impairment losses and is defined as the period from when a loss event occurs to the point to which it is identified as an individual impairment. As part of its impairment calculation, the bank had assumed that LIP could not exceed 12 months as all business exposures were renegotiated at least annually.

The enforcer did not accept this assumption because the bank's assumption was not supported by experience as required by IAS 39.AG89 which provides guidance for the collective evaluation of a group of assets for impairment. The condition for using a maximum LIP period of 12 months was that all losses would have been identified at an individual level by then. The bank was not able to produce convincing evidence that all loss events were known merely because the loans were renegotiated at least annually.

d) Collective impairment was not based on the decrease in expected future cash flows since initial recognition

By using the Basel parameters for the collective evaluation of the groups assets for impairment, the expected future cash flows also included the initial expected losses as they are not deducted for the purposes of the capital adequacy calculation.

The enforcer did not agree that this aspect of the impairment loss calculation complied with IFRS. IAS 39.59 notes that impairment losses are only incurred when loss events occur after initial recognition. Recognition of impairment losses at initial recognition, as was the bank's approach, was not permitted.

e) Systematic override of the calculation based on the model

In addition to calculation based on the Basel model, the bank also calculated a "maximum loss interval" based on a probability of default (PD) of 1. The impairment losses to be recognised in the financial statements were then calculated to be an amount between the interval and the result provided by the model but at a level that was systematically much higher than calculated using the bank's own rating model.

The enforcer concluded this approach was not in accordance with IAS 39. IAS 39.AG89 requires future cash flows to be based on historical loss experience, which was reflected in the bank's own rating model. The bank was disregarding its own loss experience by systematically overriding the output from its model resulting in much higher impairment losses.

f) Management judgement included loss events already considered by the model

When applying judgement the bank considered a number of loss events that occurred in the last 1 – 2 years.

The enforcer found this accounting treatment to be inappropriate because it appeared to lead to double-counting because the bank rated its customers on a quarterly basis. Consequently, the effect of the loss events would already be reflected in the quarterly ratings.

g) The collective assessment of a group of loans was not based on that group's own characteristics

The bank used the same loss percentages for business customers with significantly small loan amounts as for larger customers, with an adjustment factor to reflect additional administrative overheads and that less information was available about the financial position of these smaller customers. The bank argued that smaller customers were affected by the same loss events as larger customers, and the additional administrative overhead was justified by the fact that case officers dealing with smaller customers have more customers.

The enforcer concluded this approach was not in accordance with IAS 39.AG 89 which requires the assessment of future cash flows from a group to be based on historical loss experience for assets with similar credit characteristics. Merely assuming that smaller customers have similar credit characteristics as the larger ones does not comply with the requirements of IAS 39.AG89.

h) For private customers the bank relied on experienced judgement only

The bank had no impairment assessment model for loans to private customers. The bank relied solely on management judgement to make the assessment and the assessment was based solely on changes in interest rates and the assumption that all customers belonged to the same group.

The enforcer did not consider this accounting treatment to be in accordance with IAS 39. It follows from paragraphs 59, 62-63, AG87 and AG 91-92 of IAS 39 that a model should be in place in order to make a collective impairment assessment and management judgement, irrespective of experience, is not sufficient.

IAS 39.AG87 states that customers should be grouped on the basis of shared credit risk characteristics that give an indication of their ability to pay amounts due. As there were many customers in different geographic areas, it was very unlikely that they would all share similar credit risk characteristics.

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