# ESMA's 22nd EXTRACT FROM THE EECS's DATABASE OF ENFORCEMENT

## INTERNATIONAL FINANCIAL REPORTING BULLETIN 2018/04

**STATUS**
Final

**EFFECTIVE DATE**
Immediate

**ACCOUNTING IMPACT**
Additional guidance for the application of IFRSs.

### Background

The European Securities and Markets Authority (ESMA) has, as a source of information to assist in the appropriate application of International Financial Reporting Standards (IFRSs), developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). This forum involves 41 European enforcers from the 28 member states and two countries in the European Economic Area (EEA) who have responsibilities in the area of supervision and enforcement of financial information. The EECS is a forum in which European enforcers of financial information meet to exchange views and discuss practical experiences of enforcement of IFRS financial information provided by companies which have, or are in the process of having, securities admitted to trading on a regulated market in Europe.

European national enforcers apply their judgement, knowledge and experience to the particular circumstances of the cases that they consider. 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. Situations which seem similar may in substance be different, and consistent application of IFRS means consistent with the principles and treatments permitted by IFRS.

ESMA 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. However, decisions taken by enforcers do not constitute generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee.

On 19 April 2018, ESMA published its 22nd extract from the database. The full report can be found on the ESMA website at the following address:

https://www.esma.europa.eu/press-news/esma-news/esma-publishes-22nd-extract-eecs-database

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 ESMA are summarised in IFRBs 2007/06, 2008/07, 2008/17, 2009/04, 2010/05, 2010/06, 2010/07, 2012/01, 2012/02, 2012/03, 2012/04, 2012/14, 2013/11, 2013/21, 2014/04, 2014/25, 2015/11, 2016/08, 2017/02 and 2017/12.

## Transactions and related IFRSs covered by the extracts

1. Classification of an asset that is not expected to be sold within one year
2. Presentation and disclosure of restricted cash balances
3. Perpetual notes classified as liabilities
4. Disclosure of quantitative commodity price assumptions that have significant risk of resulting in material adjustments to carrying amounts
5. Purchase price allocation of a group of acquired assets
6. Demerger and distribution of a segment to the issuer's shareholders
7. Presentation of revaluation losses of assets used in operating activities
8. Obtaining power over an investee following a tender offer
9. Lack of foreign currency exchangeability and hyperinflation
10. Amortisation of content rights for film and television programmes

## Summary of extracts

### *1. Classification of an asset that is not expected to be sold within one year (IFRS 5 Non-current Assets Held for Sale and Discontinued Operations)*

The issue concerns the accounting for the sale of a grandstand by a football club to a third party which already owned the rest of the stadium. The commitment to sell the grandstand was entered into in 2015 with the sale completing in 2017 (being when the football club would locate to a new stadium).

In its financial statements for 2015, the football club classified the grandstand as a non-current asset held for sale in accordance with IFRS 5 on the basis that its carrying amount would be recovered principally through a sale transaction rather than continuing use.

#### *The enforcer's decision*

The enforcer did not agree with the football club's presentation of the grandstand as a non-current asset held for sale because paragraph 8 of IFRS 5 requires the sale should be expected to complete within a year for such classification to apply. The exceptions in paragraph 9 of IFRS 5 setting out when the one year period should be extended did not apply.

### *2. Presentation and disclosure of restricted cash balances (IAS 7 Statement of Cash Flows)*

A subsidiary of the reporting (parent) entity raised funds by issuing perpetual notes. The terms of the financing agreement included a requirement for the subsidiary to maintain a minimum cash balance of CU 30 million with an authorised deposit taking institution until the notes are fully redeemed. If the balance on deposit falls below CU 30 million, the subsidiary is required to notify a breach of contract, which triggers certain penalties (e.g. that it is prevented from issuing further notes and separate enforcement actions including penalties and claims). Moreover, if the balance is below CU 30 million at the end of any given month, this constitutes an early redemption event subject to the situation being remedied within 7 days.

In its consolidated financial statements, the reporting (parent) entity:

- presented the minimum cash balance within the line item 'cash and cash equivalents'; and
- did not disclose any restrictions associated with the minimum cash balance.

#### *The enforcer's decision*

The enforcer did not agree with either of these accounting treatments:

- Paragraph 7 of IAS 7 states that cash equivalents are held for the purposes of meeting short-term cash commitments, but in this case the contractual provisions of the perpetual notes require a minimum cash balance to be maintained continuously until redemption. Consequently the CU 30 million is not available to meet short-term cash commitments and therefore cannot be included in the line 'cash and cash equivalents'. Instead they should have been presented on a separate line or within another line of similar nature (e.g. other financial assets'). Although not included in the Extract, on the same basis (that the CU 30m is not available), the balance does not meet the definition of cash as it is not permitted to be withdrawn on demand without an associated requirement immediately to put equivalent funds on deposit.
- Paragraph 31 of IFRS 7 *Financial Instruments: Disclosure* requires an entity to disclose information that enables an evaluation of the nature and risks arising from financial instruments. In this respect about liquidity restrictions imposed by the obligation to maintain a minimum cash balance should have been provided. Further, had

presentation of the amount on deposit as 'cash and cash equivalents' been warranted, paragraph 48 of IAS 7 would also have required disclosure of any significant amount not available for use.

### *3. Perpetual notes classified as liabilities (IAS 32 Financial Instruments: Presentation)*

Following on from the previous enforcement decision, the perpetual notes have a notional repayment schedule, according to which they should be repaid by 2021. However, the subsidiary has the ability to defer any and all of those payments, with unpaid amounts being capitalised and added to the amount payable on redemption. The contractual provisions contain a number of clauses to guarantee that subsidiary A is funded to meet its obligations under the terms of the perpetual notes.

In addition to the requirement to keep a CU 30 million cash balance, the terms of the perpetual notes:

- Enable the holders of the notes to trigger a liquidity facility requiring the reporting (parent) entity to transfer cash to the subsidiary each time the subsidiary defers a scheduled payment. The amount to transfer is equal to the accumulated deferred payments capped at CU75 million. If the subsidiary uses the amount received under the facility for a purpose other than making a scheduled payment on the perpetual notes, the holders of the notes can trigger the facility again on the next scheduled payment date (6 months later) in relation to any remaining accumulated deferred payment at that date.
- Require the reporting (parent) to further fund the subsidiary if the subsidiary incurs unbudgeted payment obligations, such as a liability to pay unforeseen tax liabilities.
- Include a number of early redemption events which enable the holders of the notes to require the subsidiary to redeem the notes. These include the failure of the reporting (parent) entity or other group companies to make the above payments to the subsidiary.

The reporting entity classified the perpetual notes as equity and provided very limited disclosures about their terms.

#### *The enforcer's decision*

The enforcer disagreed with this accounting treatment. In the enforcer's view the reporting (parent) entity is not fully in control of events and circumstances to enable its subsidiary to avoid early redemption of the loan notes and, therefore, application of paragraph 25 of IAS 32 results in the perpetual notes being classified as a financial liability and not equity in the reporting (parent) entity's consolidated financial statements.

This is because:

- the reporting (parent) entity does not fully control the occurrence of events that could trigger a need to make payments to its subsidiary (e.g. as the result of an unbudgeted tax liability crystallising in the subsidiary or the subsidiary failing to make scheduled payments) that could result in it having to make liquidity payments to the subsidiary.
- the reporting (parent) entity cannot control the future availability of sufficient liquidity that can be transferred to subsidiary A. This is especially the case considering the liquidity problems of the issuer.

### *4. Disclosure of quantitative commodity price assumptions that have significant risk of resulting in material adjustments to carrying amounts (IAS 1 Presentation of Financial Statements and IAS 36 Impairment of Assets)*

The issuer recognised material impairment losses on certain production and development assets in cash generating units (CGUs). The CGUs impaired did not contain any goodwill and, therefore, the issuer concluded it did not need to disclose the key assumptions (including in this case long-term commodity price forecasts) used in calculating value in use for each CGU. This was because paragraph 132 of IAS 36 only encourages, but does not require, disclosure assumptions used to determine the recoverable amount of CGUs that do not contain goodwill or intangibles with indefinite useful economic lives.

#### *The enforcer's decision*

The enforcer disagreed with the issuer, concluding that the issuer should also have considered paragraph 125 of IAS 1. This requires an entity to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

As the value in use of the assets in question is highly sensitive to long-term price assumptions, with different market participants using different assumptions, a reasonable change to such assumptions could result in material additional impairments or reversal of previous impairments during the subsequent year.

Therefore, the issuer should have provided quantitative information about the long-term price assumptions used in its impairment models, to enable users of its financial statements to assess the impairments that had been recognised and the risks associated with the remaining recoverable amounts of the assets.

### 5. *Purchase price allocation of a group of acquired assets (IFRS 3 Business Combinations, IFRS 13 Fair Value Measurement and IAS 38 Intangible Assets*

The issuer is a gambling solutions and entertainment provider which entered into separate transactions for the purchase of a group of assets related to 'affiliate marketing'. This is a form of online performance marketing in which the service provider receives a commission for referring new customers to online gaming websites, receiving either an upfront payment for every customer referred or a share of the customer's future gambling revenue.

The group of assets purchased in each transaction did not constitute a business, and therefore the purchase consideration was allocated to the individual assets on the basis of their relative fair values as required by paragraph 2(b) of IFRS 3.

In each of the transactions the issuer identified two intangible assets – internet domains and customer databases. It also applied a rule of thumb to allocate 95% and 5% of the transaction price respectively the to the two intangibles. The internet domains were deemed to have indefinite lives and so the allocated purchase price was not subject to amortisation, while the amounts allocated to the customer databases were amortised over 3 years

#### *The enforcer's decision*

The enforcer did not agree with the purchase price allocation.

Firstly, it considered the issuer should have identified additional intangibles. In each case, the issuer also :

- acquired a present right to receive future cash flows under affiliate contracts and, in accordance with paragraphs 21 and 25 of IAS 38, an intangible asset should have been recognised for these contractual rights
- acquired (i) website content on the acquired affiliate websites programmed in HTML code and (ii) the keyword and network architecture created by the developer related to the individual sites as well as their interrelation in the network hierarchy for the search engine optimisation. As it is possible to copy both from one domain address to another, both satisfy the separability criterion for separate recognition in paragraph 12(a) of IAS 38 and should therefore similarly have been recognised as intangible assets.

Taking into account the factors included in paragraph 90 of IAS 38 the enforcer concluded that both the website content and the intangible asset related to search engine optimisation do not have an indefinite useful economic life, with the following being of particular relevance:

- the potential for technical, technological, commercial or other types of obsolescence (paragraph 90(c));
- the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset (paragraph 90(d)); and
- expected actions by competitors or potential competitors; (paragraph 90(e)).

Secondly, the enforcer did not agree with 95% of the transaction price being allocated to domains. Such intangibles tend only to have significant value when the domain address itself is the brand or trademark of the business, which was not the case here.

The enforcer required the issuer to perform new comprehensive purchase price allocations for each of the transactions, with amounts allocated to the additional intangibles identified using fair values determined in accordance with paragraph 61 of IFRS 13 instead of the rule of thumb approach previously used.

### 6. *Demerger and distribution of a segment to the issuer's shareholders (IFRIC 17 Distributions of Non-cash Assets to Owners)*

The issuer planned to:

- carry out a demerger in which one of its segments would be transferred to a new company, with the shares in the new company then being transferred to the issuer's shareholders. Consequently, there would be no change in the ultimate ownership of the segment.
- account for the transfer by derecognising the segment's assets and liabilities and recording the carrying amounts of those assets and liabilities directly in equity. No gains or losses would be recognised on the demerger.

#### *The enforcer's decision*

The enforcer disagreed with this proposed accounting treatment because:

- the transaction is a non-reciprocal distribution of non-cash assets to the entity's owners acting in their capacity as such and, therefore, the transaction was within the scope of IFRIC 17 (see paragraphs 3 to 5 of IFRIC 17);
- paragraph 11 of IFRIC 17 requires the issuer to measure a liability for the distribution of non-cash assets to its owners at fair value;
- when the liability for the distribution is settled, the difference between (i) the book value of assets and liabilities derecognised and (ii) the liability for the distribution is, in accordance with paragraph 14 of IFRIC 17, recognised in profit or loss; and
- paragraph BC34 of IFRIC 17 is clear that there are no exceptions to the requirement that the fair value of assets to be distributed is used when measuring the liability for the dividend payable.

In this case, the segment constitutes a business and therefore the fair value of the business being distributed could include unrecognised goodwill and intangible assets as set out in paragraph BC57 of IFRIC 17.

### 7. *Presentation of revaluation losses of assets used in operating activities (IAS 1 Presentation of Financial Statements)*

The issuer uses the revaluation model in IAS 16 *Property, Plant and Equipment* and, due to a reduction in the fair value of certain assets, was required to recognise a revaluation loss which it presented as a separate line item after the 'net result'.

#### *The enforcer's decision*

The enforcer did not agree with this presentation, concluding that the revaluation loss should have been presented within operating activities. This is on the basis that the assets in question were of an operating nature (i.e. being used in the issuer's operations) and, as set out in paragraph BC 56 of IAS 1, it would be misleading if items of an operating nature were excluded from the results of operating activities.

## 8. *Obtaining power over an investee following a tender offer (IFRS 10 Consolidated Financial Statements)*

The issue was the date on which Entity X obtained control over Entity Y for the purposes of deciding from which date Entity X should consolidate Entity Y. The following facts are relevant:

- Entity X offered, by way of tender, 0.55 of its own shares for each share of Entity Y. The offer was opened in two countries in November 2015 with the offer period closing on 23 December 2015.
- Shareholders of Entity Y had the right to withdraw tendered shares prior, but not subsequent, to 23 December and the Directors of Entity X were required to authorise the exchange if a minimum of 50% of Entity Y's shares had been tendered by this date.
- On 30 December, the final results of the tender in country A were communicated confidentially to the management of Entity X. Although not stated in the Extract, it would appear that the number of shares acquired in country A fell below a controlling interest. Although there were preliminary results from the tender in Country B (similarly communicated in confidence to the management of Entity X), the final results were not available until 4 January.
- In total, across both Country A and Country B, more than 70% of Entity Y's shares were tendered, with the exchange taking place on 7 January.

Although the settlement of shares did not occur until 7 January, Entity X's right became irrevocable with the closing of the tender on 23 December (subject to meeting the minimum threshold of 50%). However, the issuer concluded that it did not have sufficient evidence to determine that it had power over, and hence controlled, Entity Y until 4 January. Although paragraph B53 states that an entity's (in this case Entity X's) right to exchange shares can give it power by way of potential voting rights, this only applied if more than 50% of the shares in Entity Y were tendered (giving Entity X substantive rights that were effectively equivalent to a majority shareholder).

Consequently, Entity X determined that it only obtained control on 4 January once the final tender results were available. It argued that the unofficial aggregate position of shares tendered in both countries prior to this date had no legal standing and, therefore, it did not have sufficient evidence that it controlled Entity X prior to this date.

### *The enforcer's decision*

Regarding the determination of the point in time Entity X obtained power, the enforcer noted careful judgement is required when attaching weight to preliminary and confidential notifications and so did not object to the argument that prior to 4 January it was not clear that the tender was successful and that the exchange of shares would take place. Consequently it was not clear whether Entity X had power over Entity Y until that date.

The enforcer also noted that on 4 January, Entity X had rights to variable returns and was able to exercise its power to affect those variable returns and therefore, in accordance with paragraph 18 of IFRS 10, Entity X controlled Entity Y from that date.

Therefore, the enforcer did not object to the issuer's conclusion that control was obtained on 4 January.

## 9. *Lack of foreign currency exchangeability and hyperinflation (IAS 8 Accounting Policies, Changes in Estimates and Errors, IAS 21 The Effects of Changes in Foreign Exchange Rates and IAS 29 Financial Reporting in Hyperinflationary Economies*

The issuer has a subsidiary in Venezuela, a hyperinflationary economy, and needed to determine the appropriate exchange rate to translate the subsidiary's results and net assets into the group's presentation currency for the purposes of inclusion in the group's consolidated financial statements as required by paragraphs 42 of IAS 21. Prior to effecting the retranslation, paragraph 43 requires an entity to apply IAS 29 to the subsidiary's results and net assets.

During the financial year in question, and at the balance sheet date, determining an appropriate rate of exchange was complicated by the fact that:

- the exchange regime was in constant flux with several legal exchange rates at any one time, and exchange mechanisms being withdrawn, replaced, suspended or merged; and
- official exchange rates did not fluctuate freely, and although reflected a significant weakening of the Venezuelan Bolivar relative to the Euro, were set in way that failed to reflect accurately the very high levels of inflation experienced in Venezuela. This lack of sufficient fluctuation in rates indicated a lack of liquidity, meaning that settlement of exchanges of the local currency at official rates was not possible.

Were the issuer to apply IAS 29 to restate the subsidiary's accounts in local currency for the effects of inflation (as required by paragraph 43 of IAS 21), and then restate those current cost amounts into the group's presentation currency (as required by paragraph 42 of IAS 21) at the official exchange rate, the restatement required by paragraph 43 would not be sufficiently compensated by the restatement required by paragraph 42.

When several exchange rates are available, paragraph 26 of IAS 21 states that the rate used should be one that reflects the rate at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. Further, that if exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made. However, IAS 21 does not provide guidance when (as was the case here) exchangeability is lacking on a longer-term basis.

Therefore, the issuer deemed it necessary to estimate an exchange rate. The main input used was the evolution of the inflation rate in Venezuela compared to more stable currencies.

### *The enforcer's decision*

The underlying assumption expressed in Paragraph 17 of IAS 29 is that it may be necessary to estimate inflation rates based on movements in exchange rates. However, in Venezuela this link was broken. Although, the issuer's methodology of estimating exchange rates from inflation rates is not expressly included in IAS 29 or IAS 21, the enforcer was of the view that if the general price index can be estimated using movements in exchange rates (as permitted by paragraph 17 of IAS 29), then it may also be possible to estimate the exchange rate from movements in the general price index (being the methodology applied by the issuer).

Further, when there is a lack of exchangeability for longer than a 'temporary period', it can be argued that the definition of 'closing rate' in paragraph 8 of IAS 21 is not met.

Therefore, given the very specific circumstances in Venezuela, the enforcer did not object to the issuer's accounting treatment However, it underlined that the issuer should provide additional disclosure to allow users to assess the impact of using an estimated, synthetic rate instead of applying the official rate

### *10. Amortisation of Content Rights for film and television programmes (IAS 38 Intangible Assets)*

The company's principal activity is the production or purchase and distribution of films and television programmes across numerous channels (cinema, television, DVD, internet, etc.). The company holds material intangible assets for its content rights.

Paragraph 98A of IAS 38 sets out a rebuttable presumption that an amortisation method for intangible assets based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate. That presumption can be overcome only in limited circumstances including when it can be demonstrated that revenue and consumption of the economic benefits are highly correlated.

The company concluded than in its circumstances it was appropriate to rebut the presumption and amortised the intangible assets related to content rights on a revenue forecast basis. Amortisation of the intangible asset for content rights was based on a ratio of the current period revenue derived from the content rights to the total estimated revenues for those rights, arguing that:

- The future economic benefits decrease over time, e.g. for films, the value of the right is highest when the film is broadcast for the first time in theatres because the film has not yet been released to the public and revenues are much higher during the first showing. The value of the content rights decreases with showings on the later stage media (e.g. e.g. when it is available later on as DVD), as does the revenue.
- The underlying intellectual property rights purchased or created can be considered to be consumed as customers view the related film or television programme, which is also the basis on which revenues are generated. The sales prices are not normally linked to the quality or the success of the film or television programme, with the price of a cinema ticket or DVD being comparable across different films. Thus, the revenue generated is highly correlated with the number of units sold. While there is a somewhat more indirect link between the number of viewers watching content through the television and internet, they are still highly correlated with the revenue the issuer can expect. Therefore, revenue can be considered a proxy for the pattern of consumption from the multiple activities in which the film or television programme can be used.
- Although content was consumed by the end user through a unique medium, regardless of the medium, in all cases the economic benefit derived by the company was the revenue received. Therefore, the receipt of revenue was not just a proxy for the consumption of the intangible assets' economic benefits, but rather represents it directly.
- The estimated revenues for a given film or television programme determine the costs of production to which the issuer is prepared to commit and thus the cost of the intangible asset.

### *The enforcer's decision*

The enforcer did not object to the company's policy based on the above arguments.

The enforcer also considered whether the company should have componentised the intangible asset into amounts to reflect the fact that revenue is derived for content through numerous mediums (film, television, theatre, DVD, internet, etc.) as suggested in paragraph BC 72I of IAS 38. However, the enforcer accepted the company's argument that:

- this would be difficult and arbitrary because there would be no basis for allocating the value of the intangible to those various channels and, from a legal perspective, it owns a multi-use right without any decomposition for the various channels; and
- the amortisation pattern for each channel would also be based on revenue meaning that the timing of amortisation expense would not be significantly different whether or not those rights were componentised.

The enforcer therefore concluded that the amortisation method used, which results in higher charges in the early periods compared with those in later periods, seems to reflect the deterioration of the content rights' economic benefits.

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