ESMA's 21st EXTRACT FROM THE EECS's DATABASE OF ENFORCEMENT

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2017/12

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 31 October 2017, ESMA published its 21st 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-21st-extract-eecs%E2%80%99s-database-enforcement

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 and 2017/02

Transactions and related IFRSs covered by the extracts

1. Country risk premium in the impairment test of oil and gas assets
2. Assessment of joint control
3. Valuation and use of the equity method for participating interests with restrictions
4. Assessment of joint control
5. Restatement of comparative amounts
6. Disclosures on a reverse factoring transaction
7. Assessment of control over investment funds
8. Disclosure of unobservable inputs in fair value measurement
9. Recognition and measurement of the proceeds from an arbitration agreement
10. Impairment test of trademarks
11. Recognition of deferred tax assets for carry forward of unused tax losses
12. Definition of 'economic environment' and separation of foreign currency embedded derivatives in a power contract.

Summary of extracts

1. Country risk premium in the impairment test of oil and gas assets (IAS 36 Impairment of Assets)

The issuer holds oil and gas assets in a third country subject to significant political turmoil and increasing political uncertainty. In its financial statements, the discount rate adopted by the issuer for value-in-use calculations, which was based on the company's weighted-average cost of capital (WACC), had significantly decreased over several years to 2015. The issuer had factored country specific risk into the discount rate used rather than in the expected cash flows to be generated by the assets (as permitted by IAS 36 *Impairment of Assets*).

According to the issuer, the rate used in 2015 was in line with those used by peers (as disclosed in their annual reports), external analysts and valuation reports.

The enforcer's decision

The enforcer noted that the decline in the rates used over several years to 2015 was not supported by any improvements in observed risk factors in the third country where the assets were located. Indeed, the enforcer highlighted that the market prices of traded bonds for that area indicated that the current cost of debt was higher than the discount rate used by the issuer. As the WACC takes into account the cost of both debt and equity, and the cost of debt cannot be higher than the cost of equity, the enforcer concluded the discount rate was not acceptable. In addition, the issuer had not taken into account updated external sources that provided explicit estimates of country risk premium and had not provided a rationale as to why the discount rate adopted had decreased over time

Although the discount rate used may have been in line with those used by others, it is inappropriate to rely on those rates without having specific information on how and if these analyses take into account country risk in the cash flows rather than in the discount rate, i.e. unlike the issuer, others might have factored the country specific risks into the expected future cash flows instead of adjusting the discount rate (also permitted by IAS 36).

Therefore, the enforcer did not agree with the issuer's determination of the discount rate used as it was not based on an assessment of all available sources of information, in particular dealing with country risk premium.

2. *Assessment of joint control (IFRS 11 Joint Arrangements)*

The issuer holds a 42% interest in an investee, which it created with eight other investors each holding between 1.6% and 14.5%. All significant decisions of the investee are taken by its board of directors, with the issuer able to nominate 5 of the 12 board members. Some decisions, such as the approval of budget, annual review of the business plan, significant investments or divestments, financial debt issuance or merger or transfer of assets require a 2/3 majority and cannot, therefore, be taken against the will of entity A. No shareholder has any specific right and no shareholder agreement was signed.

The issuer accounted for its 42% interest as a joint arrangement because its 42% interest meant it had a veto right on some decisions.

The enforcer's decision

The issuer did not agree with the assessment. As illustrated in examples 2 and 3 in paragraph B8 of IFRS 11 *Joint Arrangements*, to be a joint arrangement it must be clear which combination of parties is required to agree unanimously to decisions about the relevant activities. However, in this case, there is more than one combination of parties possible to reach the required majority

The enforcer also considered whether the issuer controlled the investee, concluding that it did not because, as clarified in paragraph B14 of IFRS 10 *Consolidated Financial Statements*, in order to have power over an investee the investor must have existing rights that give it the ability to direct the relevant activities. In this case, the issuer did not have such an ability; it could block decisions, but could not unilaterally make decisions.

Therefore the issuer was correct not to classify the investment as a subsidiary, but should also not have classified its interest as a joint arrangement. Instead it should have been classified as an associate.

3. *Valuation and equity method for participation with restrictions (IFRS 13 Fair Value Measurement and IAS 28 Investments in Associates and Joint Ventures))*

The issuer holds 90% of the share capital of a public welfare housing company with the other 10% held by the issuer's parent. According to local law, the investee must provide affordable housing to the public in return for which all profits are tax exempt as well as the entity being eligible for various subsidies. To be granted public company status, an application needs to be made to, and accepted by, the local government. If the application is accepted, a public welfare housing company is subject to the following restrictions:

- The total annual profit available for distribution is restricted to 3.5% of the total paid-in capital. There is no way for shareholders to legally extract profits above this cap;
- Profits which cannot be distributed accrue in a special equity account which can be used to cover future losses; and
- On a liquidation, or on revocation of public welfare status, the balance on the special equity account is payable to the local government or other public welfare company as nominated by the local government, after repaying the paid-in capital contributed by investors.

In 2013, the issuer transferred all voting rights to its parent while retaining the 90% interest and a minority representation in the managing bodies of the public welfare housing company.

The issuer accounted for the transfer of voting rights by deconsolidating the subsidiary and accounting for it instead as an associate to which it applied the equity method. In applying this accounting treatment the issuer:

- Initially measured its interest in the public welfare housing company from the date of reclassification to an associate at fair value, but ignored the above restrictions; and
- When using the equity method thereafter, recognised a 90% share of the public housing company's total profits, resulting is a share of profits of over CU 100 million in the three years to 2015 when the profits available for distribution to the issuer approximated only CU 4 million.

The enforcer's decision

The enforcer disagreed with this accounting treatment, noting that

- Paragraph 11 of IFRS 13 *Fair Value Measurement* requires an entity to factor in to valuations the characteristics that market participants would take into account, including restrictions on the sale or use of the asset. As the restrictions on the distribution of profit by an entity operating as an approved public housing welfare company would be taken into account by potential buyers, this should have been factored in to the valuation
- Paragraph 3 of IAS 28 *Investments in Associates* requires an investor to include, in its financial statements, its share of an investee's profit or loss and other comprehensive income. When the economic interest does not correspond to its nominal shareholding, the investor should account for its economic interest, which in this case was the amount of paid in capital and its share of the 3.5% cap on profits. As the issuer had no claim on the special equity account in which remaining profits are accumulated, it should have excluded amounts in this account when determining its share of profit or loss and net assets.

4. *Assessment of Joint Control (IFRS 11 Joint Arrangements)*

The issuer acquired 49.5% of the shares in Entity X from Entity Y, with Entity Y continuing to own the other 50.5%. The relevant terms of the sale and purchase agreement were as follows:

- Entity X had a board of 5 directors, three of which (including the right to designate chairman) were appointed by Entity Y and two of which were appointed by the issuer;
- The issuer's consent was required for the following 'restricted matters':
  - altering constitutional documents;
  - changing or varying the share capital;
  - modifying, varying or abrogating any rights attaching to any shares;
  - material changes in the nature or scope of the business;
  - acquisitions and disposals or partnerships and joint ventures (other than as contemplated in the business plan);
  - appointing or removing the Chief Executive or Chief Financial Officer;
  - adopting or amending the business plan or annual budget;
  - entering into any contract outside the ordinary course of business; appointing or removing the auditors;
  - approving the statutory accounts and/or any change in the accounting principles or tax policies and/or any change in the end of the financial year
  - declaring or paying any dividend or distribution other than as contemplated by the business plan or annual budget; and
  - entering into, renewing or amending any transaction, contract or arrangement with any investor or member of its investor group;
- A call option was granted by Entity Y in favour of the issuer exercisable during specific periods in 2018, 2019 and 2020 for all of Entity Y's shares; and
- A 'drag-along' provision, which applied in the event that the issuer did not exercise its call option, required the issuer to sell its 49.5% holding as part of a joint exit with Entity Y.

The issuer accounted for its interest in Entity X as an associate for a number of reasons including:

- The issuer only held 2 out of 5 seats;
- All matters other than the 'restricted matters' required only a majority vote of the board
- The restricted matters only provided the issuer with protective rights to influence relevant activities, but did not allow it to direct those activities
- Entity Y continued to control primary operating decisions, as well as selecting recruiting firms and the lists of individuals proposed for key roles.

The enforcer's decision

The enforcer disagreed with the issuer, noting that Appendix A of IFRS 11 *Joint* Arrangements defines joint control as 'the contractually agreed sharing of control of an arrangement which exists when decisions about the relevant activities require unanimous consent'. It further considered that the restricted matters referred to above over which the issuer had a veto related to strategic decisions over the operation and governance of Entity X, and therefore related to activities which were capable of significantly affecting Entity X's returns, i.e. they met the definition of 'relevant activities' in IFRS 10

The enforcer did not agree that the issuer's rights were only protective. Paragraph B27 of IFRS 10 states that "…an investor that holds only protective rights cannot… prevent another party from having power over an investee', yet the issuer's veto over the restricted matters did prevent Entity Y from having such power

Finally, the fact that Entity X did not participate in the day-to-day management of Entity X did not mean it could not be involved in directing the relevant activities.

Therefore, the enforcer concluded that the issuer had joint control over Entity X and should not, therefore, have classified it as an associate.

5. *Restatement of comparative amounts (IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and IAS 34 Interim Financial Statements)*

In its financial statements for the year ended 31 December 2014, the issuer (a financial institution) restated the comparatives of its maturity analysis of financial liabilities required by IFRS 7 *Financial Instruments: Disclosure*, with balances related to deposits made by banks being restated by more than €3 billion and derivatives by €90 million, with the total amount of undiscounted cash flows being restated by more than €250 million.

In the notes to the 2014 financial statements, the issuer indicated that it had made some reclassifications of the amounts in the maturity analysis to enhance comparability, but provided no information on the nature of the reclassifications.

The issuer had also restated its 2013 comparatives in its 2014 half-yearly interim financial statements.

The enforcer's decision

The enforcer noted that the restatement of comparatives in both the 2014 annual and interim financial statements related to the correction of a prior period error and that the associated disclosure required by paragraph 42 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* had not been complied with adequately in either the annual or interim financial statements because:

- The disclosures had not been explicitly identified as 'restated';
- Did not explicitly identify the amount of the restatement or the line items affected; and
- No description of the nature of the prior period error was provided.

Further, in the enforcer's view, although the restatements did not relate to amounts presented on the face of the primary statements, they were material because, due to their nature and magnitude, they could have influenced the economic decisions of users.

6. *Disclosures on a reverse factoring transaction (IAS 1 Presentation of Financial Statements and IAS 39 Financial Instruments: Recognition and Measurement)*

The issuer entered into a reverse factoring transaction whereby a financial institution undertakes to settle the issuer's trade payables (and which also requires the agreement of the supplier). The issuer repays the financial institution within 360 days of the supplier issuing an invoice.

The issuer accounted for the reverse factoring transaction by recognising a financial liability instead of a trade payable.

The enforcer's decision

The enforcer agreed with the issuer's assessment that the liability owed to the financial institution, arising from the reverse factoring agreement, should be classified as a financial liability under paragraph 54 of IAS 1 *Presentation of Financial Statements* rather than a trade payable. It was noted that a number of substantial modifications are made to the original liability owed to the supplier:

- The maturity extension is significant;
- Once a supplier enters the agreement all its invoices are automatically processed as part of the factoring scheme;
- Compensation is paid to extend the maturity; and
- The creditor has changed, i.e. it is no longer the supplier, but a financial institution

These modifications indicated that substantial changes had been made to the financial liability, meaning that it should be treated as giving rise to a new financial liability. This was consistent with paragraph 40 of IAS 39, which requires an exchange of debt instruments with substantially different terms to be accounted for as an extinguishment of the original financial liability and the recognition of a new one.

7. *Assessment of control over investment funds (IFRS 10 Consolidated Financial Statements)*

The issuer, an insurance company, had an investment in an umbrella fund and also a direct interest in certain sub-funds of the umbrella fund. Although the issuer only had a small interest in the umbrella fund its interests in some of the sub-funds were significant and in one case was a majority holding.

The issuer determined that the sub-funds fulfilled the conditions in paragraph B77 of IFRS 10 *Consolidated Financial Statements* to be considered as separate entities (silos) and concluded that it did not have control over the sub-funds because:

- the board of directors of the umbrella fund had extensive decision making powers over the sub-funds and determined the investment objectives and policies;
- the investment manager, which along with the board of the umbrella fund was part of the group which designed the umbrella fund, had discretion to make investments within the investment policies
- the issuer (and other investors in the sub-funds) only had a right to object to material changes in investment policy, and did not have substantive rights to remove the board of the umbrella fund, remove the investment manager or to restrict the decision-maker's discretion

The enforcer's decision

The enforcer agreed that the sub-funds were separate silos.

The enforcer also considered whether the silos were controlled, concluding that the umbrella fund board were acting as agents rather than principal for the investors of the fund. This was because the management fee (based on a percentage of each sub-funds' net assets and a performance fee) seemed commensurate with the services provided and there was no indication the fee level was not determined on an arm's length basis. Consequently, although having power over, and exposure to variable returns of, the sub-funds, the board of the umbrella fund were not exercising that power to affect their variable returns.

Further, as the holdings in the umbrella fund were widely dispersed, no individual investor in the umbrella fund (including the issuer) controlled the umbrella fund and, by extension, did not control any of the sub-funds.

8. *Fair value measurement disclosures of unobservable inputs (IFRS 13 Fair Value Measurement)*

The issuer, a real estate investment trust (REIT), was engaged in property investment with four classes of properties:

- commercial / office;
- industrial;
- residential;
- development

All classes of investment properties were classified in Level 3 of the fair value hierarchy. The financial statements disclosed the following unobservable inputs for the first three of the above categories

- annual rent per square meter (lowest and highest in range)
- estimated rental value (ERV) per square metre; and
- the equivalent yield (%).

However, unobservable inputs disclosed for development assets was limited to a quantification of the equivalent yield. ERV data for those assets was only disclosed outside the audited financial statements in the management commentary

The enforcer's decision

The fair value of development assets was measured by means of a residual value method which uses the yield and the ERV as key inputs. Paragraph 93 of IFRS 13 requires, for Level 3 fair value measurements, various disclosures including quantitative information about significant unobservable inputs and a narrative description of sensitivity of fair value measurements if a change in unobservable inputs could result in a significant change in fair value measurement.

Consequently the ERV data for development assets should also have been disclosed for development property assets in the audited part of the financial statements. In addition, although it was acknowledged that ERV data for development assets was disclosed in the narrative accompanying the financial statements, the narrative disclosures were not sufficient to comply with the requirements of IFRS 13.

9. *Recognition and measurement of the proceeds from an arbitration agreement (IAS 39 Financial Instruments: Recognition and Measurement, IAS 37 Provisions, Contingent Liabilities and Contingent Assets, and IAS 18 Revenue)*

The issuer had been pursuing another company in the courts, Entity X, for the infringement of the issuer's patents.

Following a period of arbitration, and by the issuer's balance sheet (the end of an interim period) date, Entity X had agreed to pay damages to the issuer, with Entity X having no ability to appeal the ruling.

Shortly after the end of the interim period and before the interim financial statements were issued, the issuer received a first tranche of payment from Entity X. Although it provided disclosure about the successful arbitration outcome in the relevant interim financial statements and the receipt of the first tranche, the issuer did not recognise any income for the interim period. This was on the basis that, at that date, there was uncertainty around whether the court decision (which was taken in a third country that was neither the country of the issuer or of Entity X) would be enforced in the event that Entity X did not comply with the decision as well as doubts about whether Entity X had the financial ability to pay the settlement amount. Consequently, the requirements in IAS 18 *Revenue* for the recognition of revenue were not met, and the proceeds from winning the court case were considered to be a contingent asset in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The enforcer's decision

The enforcer disagreed with the issuers accounting treatment because it had won the case prior to its reporting date and that, in accordance with paragraphs14 and AG 35(a) of IAS 39 *Financial Instruments: Recognition and Measurement* it had a financial asset that should have been recognised in its interim financial statements. This financial asset should have been initially recorded at fair value and subsequently classified as a receivable and measured at amortised cost. After initial recognition, if there was a change in the estimate of receipts, the carrying amount of the financial asset would be adjusted to reflect the revised estimates.

The enforcer also noted that IAS 18 did not apply although, if its requirements had been applied by analogy, income would have been recognised as it was probable that the issuer would receive economic benefits from the agreement. Further, as the issuer had already received the first tranche of payment by the reporting date, there was no objective evidence of any impairment of the receivable.

10. *Impairment test of trademarks (IAS 36 Impairment of Assets)*

The issuer recognised trademarks as part of its intangible assets, which were tested individually for impairment rather than being allocated to cash generating units (CGUs). The issuer calculated the value-in-use (VIU) of each trademark by applying the 'relief from royalty' method.

The enforcer's decision

The enforcer considered whether the trademarks could be tested individually for impairment, instead of being tested as part of a CGU.

Paragraph 67 of IAS 36 *Impairment of Assets* explains that the recoverable amount of an individual asset cannot be determined independently of the CGUs to which they belong if:

- The asset's value in use cannot be estimated to be close to its fair value less costs of disposal; and
- The asset does not generate cash flows that are largely independent of those from other assets.

The 'relief from royalty' method is widely used to estimate the fair value of a trademark and therefore value in use is close to, or in this case the same as, fair value less costs of disposal. Therefore, the enforcer agreed with the issuer that the trademarks can be tested for impairment individually rather than as part of the CGU to which they belong.

11. *Recognition of deferred tax assets for carry forward of unused tax losses (IAS 12 Income Taxes*

The issuer recognised deferred tax assets of CU 1.1 million arising from the carry-forward of unused tax losses in its 2015 financial statements. Overall, the issuer recognised total deferred tax assets of CU 9.8 million, of which CU 4.1 million arose from the carry-forward of tax losses at the year end. The deferred tax assets were recognised even though

- The issuer had suffered losses in 2015 and the previous two financial years;
- The economic situation of the issuer had worsened over the previous few years;
- There were doubts about the existence of future profits and whether the issuer could continue as a going concern; and
- After the balance sheet date, and before the financial statements were authorised for issue, the issuer's strained economic situation resulted in the failure to make contractual interest payments on a bond.

The issuer argued that recognition of a deferred tax asset from carry-forward of tax losses was appropriate based on

- an expectation that the bondholders would agree to forgive a portion of the debt; and
- its business plan which forecast a significant improvement in the issuer's financial situation

The enforcer's decision

The enforcer disagreed with issuer's accounting treatment as

- paragraph 34 of IAS 12 only permits deferred tax to be recognised for the carry-forward of unused tax losses to the extent it is probable there will be future profits available against which the tax loses can be utilised;
- paragraph 35 of IAS 12 states that the existence of tax losses is strong evidence that future profit may not be available;
- an expectation that bondholders would agree to a restructuring of their debt was not convincing evidence as it depended on the future decision of the debt holders, the outcome of which was uncertain; and
- the uncertainty over whether the issuer was a going concern cast doubt on its ability to fulfil its business plan.

It was also noted that, as at its reporting date, the issuer was negotiating the main features of future restructuring with local authorities, and that the outcome was highly uncertain.

Consequently the issuer did not have sufficient convincing evidence that sufficient future taxable profit would be available in future against which the tax losses could be utilised.

12. *Definition of 'economic environment' and separation of foreign-currency embedded derivatives in a power contract (IAS 39 Financial Instruments: Recognition and Measurement))*

The issuer is a power producing company that enters into long-term power contracts. These contracts are usually denominated in Euros, even if both parties have a non-Euro functional currency.

Paragraph AG33(d)(iii) of IAS 39 *Financial Instruments: Recognition and Measurement* states the foreign currency component of a contract which is not denominated in the functional currency of either party to the contract to be accounted is an embedded derivative that is closely related to the host contract if the currency is commonly used to purchase or sell non-financial items in the economic environment in which the transaction takes place. Consequently, such an embedded derivative would not be accounted for separately from the host contract.

The issuer considered that 'economic environment' referred to is not necessarily limited to the national economy and that the references in the standard to a currency commonly used in local business transactions or external trade is not exhaustive. Rather, the issuer believed that economic environment refers to the set of factors or circumstances that influence the transaction and therefore it may refer to a broader geographical area, such as the 'regional power market' as a whole, in which the Euro is a widely spread currency for regional power transactions. B As the Euro is a commonly used currency in the regional power market the issuer argued that the power contracts in question meet the condition in AG33(d)(iii) such that the foreign currency embedded derivative is closely related to the host contract.

The enforcer's decision

The enforcer disagreed with the issuer. It noted that the relevant economic environment of the embedded derivatives is the country, i.e. an area where transactions for non-financial items in general take place and where only one currency is commonly used.

Since the regional power market deals with only one specific good, it cannot be seen as the economic environment of reference. On this basis, the enforcer concluded that the economic environment is the country of the issuer.

Therefore the enforcer decided the issuer should have concluded that the embedded derivative was not closely related, and consequently, in accordance with paragraph 11 of IAS 39, should have accounted for it separately from the host contract at fair value through profit or loss, or otherwise designated the entire sales contract at fair value through profit or loss in accordance with paragraph 11A.

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