

ESMA's FOURTEENTH EXTRACT FROM ITS DATABASE OF ENFORCEMENT DECISIONS TAKEN BY EU NATIONAL ENFORCERS OF FINANCIAL INFORMATION (IFRS) INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/21



Background

The European Securities and Markets Authority (ESMA) have, 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). 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 the 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.

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.

On 29 October 2013, ESMA published its fourteenth extract from the database. The full report can be found on the ESMA website at the following address:

<http://www.esma.europa.eu/content/14th-Extract-EECS-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, and 2013/11.

STATUS

Final

EFFECTIVE DATE

Immediate

ACCOUNTING IMPACT

Additional guidance for the application of IFRSs.

Transactions and related IFRSs covered by the extracts

1. Derecognition of financial assets and liabilities (IAS 39)
2. Classification of financial assets as loans and receivables (IAS 39)
3. Hedge accounting for an embedded floor in a loan portfolio (IAS 39)
4. Nature and extent of risks arising from financial instruments (IFRS 7)
5. Cash flow classification of amounts paid to vary the notional amount of a commodity contract (IAS 7)
6. Presentation of cost of inventories in cost of goods sold (IAS 1)
7. Scope of consolidation (IAS 27)
8. Identification of intangible assets in a business combination (IFRS 3 and IAS 38)
9. Contingent payments to acquire a non-controlling interest (IAS 32)
10. Deferred tax asset arising from tax losses carried forward (IAS 12)
11. Segment disclosures (IFRS 8)
12. Disclosure of new standards that have been issued but are not yet effective (IAS 8).

Summary of extracts

1. Derecognition of financial assets and liabilities (IAS 39)

The issuer entered into two transactions:

- 1) The grant of a loan to its ultimate parent, through a facility agreement
- 2) The issue of preferred securities, through an offer document and a support agreement.

The issuer believed that these two transactions should be viewed as a single transaction as they had both been entered into with intention of the issuer being a 'pass-through' and had no commercial substance from the issuer's perspective. This was because:

- The income generated from the loan was used to pay amounts due to the preferred security holders
- The terms of the loan advanced to the ultimate parent and the terms attached to the preferred securities were matched (i.e. cash received from the ultimate parent in respect of the loan was equal to the cash obligations related to the preferred securities).

Because of this, the issuer believed that at inception both the loan to the ultimate parent (financial asset) and the preferential shares (financial liability) should be derecognised.

In respect of the financial asset, the issuer believed that, in principle and in consideration of the commercial substance of the transaction as a whole, the financial asset should be derecognised as it had been transferred in accordance with the criteria of IAS 39.19:

- (a) There was no obligation for the issuer to pay amounts to the preferred security holders unless it received amounts in respect of the loan issued to its ultimate parent (the issuer believed the condition was met due to the fact the terms of the financial asset and financial liability matched exactly, and that the financial asset was the only asset held by the issuer that could realistically be used to settle the obligation to the preferred security holders).
- (b) The financial asset was prohibited from being sold or pledged as security, other than as security to the preferred security holders. Although this was only true of the support agreement, which required the express agreement of preferred security holders to be sold or pledged, the issuer believed that both agreements should be considered as one overall unit of account and therefore considered that this condition was met.
- (c) Cash flows were passed on without material delay (the issuer believed the condition was met due to the fact that the contractual terms of the financial asset and financial liability were matched).

In respect of the financial liability, the issuer believed that because the contracts were entered into concurrently and in contemplation of each other, the assessment of the derecognition of the financial liability should be considered concurrently with the derecognition of the related financial asset. The issuer believed (refer above) that the risks and rewards of the financial asset (the loan) had been transferred (to the preferred security holders), because the issuer was now only obliged to pass-on any amounts received in respect of the loan to the preferred security holders. Consequently, the issuer believed that the financial liability had been extinguished in accordance with IAS 39.39.

The enforcer's decision

The enforcer did not agree with the issuer's treatment and considered that the loan and the preferred securities should have been recognised in the issuer's financial statements.

The enforcer noted that there was a lack of a contractual link between the contract related to the loan to the ultimate parent and the contract related to the preferred securities. As a result the enforcer concluded that the issuer was party to two separate contracts, rather than a single combined contract, and that the issuer should have recognised:

- A financial asset, in respect of the loan to the ultimate parent
- A financial liability, in respect of the preferred securities.

The enforcer noted the following conflicts of the issuer's treatment with IAS 39:

- The contract did not state that the preferred security holders would be paid only if cash flows were received from the ultimate parent in respect of the inter-company loan. Instead, the preferred security holders had first recourse to the issuer in the event of default (IAS 39.19(a)).
- The contractual documentation did not prohibit the issuer from selling or pledging the financial asset (the loan), other than as security to the preferred security holders for the obligation to pay them cash flows (IAS 39.19(b)).
- There was no contractual obligation binding the two agreements, and therefore even though the timing and amount of cash flows matched exactly there was no contractual obligation for the issuer to remit the cash received from the financial asset to the preferred security holders (IAS 39.19(c)).
- Because the financial asset did not meet the conditions for transfer (and therefore did not qualify for derecognition under IAS 39.19), the contracts did not give rise to a pass-through arrangement. Consequently, the financial liability had not been extinguished and therefore did not qualify for derecognition in accordance with IAS 39.39.

2. Classification of financial assets as loans and receivables (IAS 39)

The issuer issued bonds to third parties and used the proceeds to make an onward investment in its parent company through a 'silent contribution' arrangement with the following terms:

- The silent contribution has a right to profit participation on the nominal contribution amount at a rate of 7.25%
- Profit participation does not accrue if the parent company has or will have an annual loss
- The silent contribution will share in a loss in the parent company that shall be subsequently replenished if it does not cause or increase a loss of the parent company
- The silent contribution may only be terminated by the parent company with a two year's notice period and only if the book value of the silent contribution at the time of the notification is equal to the nominal contribution amount and the parent company's solvency ratio exceeds 9%. Profit or loss participation continues during those two years.

The issuer classified the silent contribution arrangement in the category 'loans and receivables' in accordance with IAS 39.9, and subsequently measured it at amortised cost less impairment.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that condition (c) in the definition of loans and receivables in IAS 39.9 states that if the holder of a financial asset may not recover substantially all of its investment, other than because of credit deterioration, it is prohibited from classifying the instrument in the loans and receivables category, and must instead classify it as available for sale.

The enforcer noted that, in accordance with the contractual terms of the arrangement, there were circumstances in which the issuer might not recover all of its investment for reasons other than credit deterioration:

- If the repaid amount was lower than the nominal contribution amount, the parent company was not required to repay the full nominal amount of the investment to the issuer (holder of the silent participation) and was instead fully discharged
- A partial repayment could arise as follows:
 - i. A reduction of the silent contribution could occur within the two year's notice period (due to the parent company recording losses) in which case the parent company would be required to repay an amount which is the lower than the nominal contribution amount; or
 - ii. The book value of the silent contribution could be reduced in the event of the parent company's bankruptcy. In that case the note holders would have a reduced claim.

However, the issuer argued that credit deterioration should not be linked to the definition of credit risk in IFRS 7 Appendix A (i.e. the risk that one party to a financial instrument causes a financial loss for the other party by failing to discharge an obligation). Specifically the issuer believed that:

- Credit risk relates to a certain point in time
- Credit deterioration occurs over time.

The enforcer rejected this argument, and noted that credit risk is not a static notion but an integral aspect of any loan that may develop over time, and therefore credit risk and credit deterioration refer to the same issue (a loss caused by failure to discharge an obligation).

Consequently, the silent contribution arrangement should have been classified in the available for sale category and measured after initial recognition at fair value through other comprehensive income (except impairment which would be recorded in profit or loss).

3. *Hedge accounting for an embedded floor in a loan portfolio (IAS 39)*

The issuer, a financial institution, held a mortgage loan portfolio with variable interest rates and embedded floors. Key points were:

- The embedded floors were not separated at initial recognition as the economic characteristics and risks of the embedded floor were closely related to the economic characteristics and risks of the host contract (IAS 39 paragraph 11(a)). This is because, at the date of issue of the mortgages, the floors were at or below market rates of interest and were not leveraged
- Due to subsequent changes in interest rates, the embedded floors were now significantly 'in the money' from the issuer's perspective.

To realise and record the gain from the existing 'in the money' embedded floors, the issuer planned to issue new floors at a price equal to the fair value of the existing embedded floors. Because the new floors would be stand alone derivatives, they would be required to be measured initially and subsequently at fair value through profit or loss (IAS 39.43 and 47(b)). This contrasted with the accounting treatment for the existing embedded floors which had not been accounted for separately from the host contract (and so were not measured at fair value through profit or loss).

The issuer considered that this measurement mismatch would create artificial volatility to comprehensive income after the initial recognition of the new floors. To avoid this, the issuer designed a fair value hedge in which the new floors were designated as a hedging instrument, with the existing embedded floors designated as the hedged item, which resulted in:

- The existing embedded floors being measured at fair value
- Recognition of an immediate gain in profit or loss in relation to the existing embedded floors, which suggested they had been separated from the host contract
- The premiums collected on the new floors being recognised as a financial liability
- Subsequent changes in the fair values of the existing embedded floors and the new floors would be symmetrically recorded.

Alongside this, the issuer was in the process of acquiring an entity which also held a mortgage loan portfolio with embedded floors. The issuer proposed to apply the same accounting treatment as if it had applied to its existing embedded floors.

The enforcer's decision

The enforcer did not agree with the issuer's treatment of separating the existing embedded floors.

The enforcer noted that at initial recognition, the economic characteristics and risks of the embedded floor were closely related to the economic characteristics and risks of the host contract, and therefore IAS 39 paragraph 11(a) is clear that the embedded floor should not be separated at this point.

Subsequently to initial recognition, IFRIC 9 required that separation was not reconsidered as there was neither:

- A significant modification of the terms of the contract, nor
- A business combination.

The fact that the embedded floor had been designated as a hedged item did not alter this assessment.

The enforcer noted that only changes in the fair value of the existing embedded floors that arose after the designation of the hedging relationship would be permitted to be recognised in profit or loss (IAS 39.89(b)).

In respect of the treatment of the embedded floors within the entity about to be purchased by the issuer, the enforcer noted that IFRS 3 *Business Combinations* applies:

- Identifiable assets acquired and liabilities assumed are measured at their acquisition-date fair values (IFRS 3.18)
- At the acquisition date, the acquirer makes an assessment based on conditions that exist at that date as to whether any embedded derivatives should be separated from their host contracts in accordance with IAS 39 (in this case whether the embedded floor was above or below the market rate of interest – IAS 39.AG33(b))
- Any separated embedded derivatives are subsequently measured at fair value through profit or loss
- Any host contracts that have had embedded derivatives separated from them are accounted as stand-alone financial assets in accordance with IAS 39.

4. Nature and extent of risks arising from financial instruments (IFRS 7)

The extracts highlighted three cases. In each of them, the issuer's main business activity was as follows:

- The issue of multiple series of limited-recourse notes
- The acquisition of investment assets with the proceeds from each series of notes
- The investment assets acquired were held as collateral separately from the investment assets acquired with the proceeds of any other series of notes
- The performance of the underlying investment assets determined the return on each related series of the notes
- Risks and rewards arising from exposure to the underlying investment assets lay with the noteholders
- The issuers hedged some of the risks arising from some series of the notes by entering into derivatives (such as interest rate swaps, currency swaps and credit default swaps).

Each issuer had only a nominal amount of equity capital. Equity shareholders did not participate in the profits.

Case 1 – Credit risk disclosures

Each series of the issuer's notes were linked to one of the following investment categories:

- 1) Total return swaps (linked to a portfolio of debt issuers)
- 2) Special investment funds
- 3) Hedge funds in alternative investments
- 4) Equity linked swaps
- 5) Inflation or interest linked investments.

In the financial statements, the issuer stated there was no net exposure to the underlying investments. Consequently, the associated risk disclosures were minimised and appeared to be boilerplate.

With reference to credit risk, the issuer disclosed the following information:

- Quantitative: Credit quality of all assets in aggregate
- Qualitative: That the responsibility of monitoring credit risk was outsourced to an external service provider. Also due to the limited recourse structure there was no net exposure to credit risk.

The enforcer's decision

The enforcer considered that the issuer's disclosures in respect of credit risk arising from financial instruments did not meet the requirements of IFRS 7.

The general qualitative and quantitative requirements of IFRS 7.33 and 34 require an entity to disclose (for each risk):

- The exposures to the risk including concentration
- How the risk arises
- The entity's objectives, policies and processes for managing the risk
- Methods used to measure the risk and changes compared to the previous period.

In addition IAS 1.112(c) requires additional information to be provided that is relevant to the understanding of the financial statements.

In relation to the entity's credit risk disclosures, the enforcer noted the following:

- More disaggregation was required, as disclosures should not be aggregated to the extent that important differences between individual transactions or associated risks are obscured (IFRS 7.B3)
- The nature of the assets relating to each series of notes issued suggested that there were significant differences in the credit risk associated with those assets.

Case 2 – Other price risk disclosures

The issuer's notes were a combination of asset backed notes and credit/derivative linked notes.

Each note series was secured by different combinations of financial instruments:

- Corporate bonds
- Loans
- Derivatives.

The nature of those financial instruments that underpin the notes were differentiated further by being:

- Listed or unlisted
- Combinations of corporate bonds and loans
- Derivative investments (such as credit default swaps).

In the financial statements, the issuer stated that the ultimate amount repaid to noteholders was dependent on the proceeds from the sale of investments and derivatives held as collateral.

Other than providing the definition of other price risk, the issuer did not disclose how the exposure to other price risk arose or how it changed.

The enforcer's decision

The enforcer considered that the issuer's disclosures in respect of other price risk arising from financial instruments did not meet the requirements of IFRS 7.

The general qualitative and quantitative requirements of IFRS 7.33 and 34 require an entity to disclose (for each risk):

- The exposures to the risk, including concentration
- How the risk arises
- The entity's objectives, policies and processes for managing the risk
- Methods used to measure the risk and changes compared to the previous period.

In addition, IAS 1.112(c) requires additional information to be provided that is relevant to the understanding of the financial statements.

The enforcer noted that the issuer should have disclosed:

- A description of the nature of the exposure to other price risk by type, concentration of investment, issuer, currency, geographic location, listed or unlisted investments
- Changes in other price risk during the period
- Concentrations of other price risk
- Sensitivity analysis (IFRS 7.40).

Case 3 – Concentration risk disclosures

The issuer invested in:

- Corporate bonds (asset-backed notes)
- Derivative backed notes.

Each series of derivative backed notes was secured by the purchase of derivatives.

In the financial statements, the issuer stated that:

- Asset swap agreements were entered into for selected notes
- The return to noteholders was dependent on proceeds from the total return swaps and any payment the swap counterparty was obliged to make
- The issuer dealt with counterparties with a credit rating defined in external documentation.

Also, the issuer identified that it dealt with only one derivative counterparty, and disclosed its name and credit rating (which had declined in the period) but provided no qualitative counterparty risk disclosure, including:

- The exposure to derivative counterparty risk
- The objectives, policies and processes for managing derivative counterparty risk
- Changes in derivative counterparty risk from the previous period.

The enforcer's decision

The enforcer considered that the issuer's disclosures in respect of concentration risk arising from financial instruments did not meet the requirements of IFRS 7, particularly as the issuer had issued derivative backed notes and used only a single derivative counterparty for all of its derivative transactions.

The general qualitative and quantitative requirements of IFRS 7.33 and 34 requires an entity to disclose (for each risk):

- The exposures to the risk, including concentration
- How the risk arises
- The entity's objectives, policies and processes for managing the risk
- Methods used to measure the risk and changes compared to the previous period.

In addition, IAS 1.112(c) requires additional information to be provided that is relevant to the understanding of the financial statements.

The enforcer noted that while in general the use of derivatives may mitigate some risks, credit risk arose in this instance as the issuer dealt with only a single derivative counterparty, which resulted in increased exposure to counterparty risk for holders of derivative backed notes or credit linked notes (because the noteholders were increasingly reliant on the sole counterparty's ability to honour its commitments in order for the issuer to provide a return).

The enforcer noted that the issuer should have disclosed:

- Qualitative information regarding risk (i.e. the credit risk) arising from derivative counterparties
- Objectives, policies and procedures for managing risk arising from derivative counterparties
- Changes in risk arising from derivative counterparties
- Reasons for changes in risk arising from derivative counterparties
- A description of the nature of risk arising from derivative counterparties
- How risk arising from derivative counterparties arises with regard to the particular circumstances of the issuer
- An analysis of total derivative financial instruments per counterparty (as necessary)
- Impact of a credit downgrade of the credit quality of the derivative counterparty
- Mitigation of the note holders' risk exposure to a derivative counterparty risk (i.e. actions that are triggered due to counterparty default).

5. Cash flow classification of amounts paid to vary the notional amount of a commodity contract (IAS 7)

The issuer, a mining entity, obtained bank funding to develop its mines. A condition to obtaining this funding was that the issuer enter into a separate fixed-price forward contract to sell the bank a specific quantity of output from the mine.

However, funding repayment amounts were independent from both:

- The level of production
- The spot price of the commodity produced.

The issuer applied the own use exemption in IAS 39.5 and therefore did not recognise the forward contract as a derivative. Instead it recognised sales under the contract in accordance with IAS 18 *Revenue*.

Due to the issuer closing some of its operations, and the risk that this posed to the ability of the issuer to fulfil its obligations under forward contract (at which point it would have to buy the commodity at market rates), the issuer made a one-off payment to the bank to reduce the notional amount of the forward contract.

The issuer classified the one-off payment as an outflow from financing activities, as:

- It did not consider the payment to be part of its operating activities
- Payment was to a bank that provides the issuer with financing.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that IAS 7.6 defines financing activities as those that result in changes in the size and composition of the contributed equity and borrowings of the entity.

As the forward contract was neither directly linked to the loan contract, nor recognised as part of borrowings, the payment did not affect the issuer's equity or borrowings.

In addition the enforcer noted that the cash inflows from the forward contract (i.e. sales of the commodity to the bank) were recorded as cash inflows from operating activities. The one-off payment amounted to an adjustment of those cash inflows from operating activities in the future, and so the one-off payment should have been classified in the same way (i.e. as an operating activity).

6. Presentation of cost of inventories in cost of goods sold (IAS 1)

The issuer entered into a business combination during the period and as a result was required to recognise an upward fair value adjustment to the carrying amount of inventory acquired, as required by IFRS 3.18.

At reporting date, the issuer disaggregated (within operating income) the value of the cost of inventories sold during the period that related to the inventory acquired in the business combination ('acquired inventory sold during the period'), between:

- Cost of goods sold – being the business combination fair value of the acquired inventory sold during the period, less the fair value adjustment (recorded in cost of goods sold)
- A non-recurring item – being the amount of the fair value adjustment (recorded in operating costs).

The value of the non-recurring item above was material (30% of EBIT), and had been adequately explained in the notes to the financial statements.

The issuer believed that the presentation adopted provided the users of the financial statements with transparent information in respect of the non-recurring fair value adjustment and its effect on the issuer's gross profit.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that IAS 2.34 and 38 are clear in requiring that:

- Inventories are recognised as an expense when sold
- The cost of inventories sold includes the measurement (i.e. carrying amount) of inventory at the point it is sold.

The enforcer therefore noted that the issuer should have presented the carrying amount of the acquired inventory that was sold during the period in cost of goods sold in its entirety (and therefore within gross profit).

The enforcer did note that IAS 1.101 requires entities to sub-classify expenses in order to highlight items that may differ in terms of frequency, potential for gain or loss and predictability. The enforcer noted that it would have been appropriate for the issuer to present both disaggregated line items relating to the value/cost of acquired inventory sold during the period within cost of goods sold.

7. Scope of consolidation (IAS 27)

The issuer, a dormant publicly listed company with no subsidiaries, acquired 100% of the outstanding shares in entity B.

In accordance with the applicable section of the national law derived from article 13 sub 3(c) of the Seventh Council Directive, the issuer considered that entity B was held exclusively for resale.

The issuer proceeded to prepare separate financial statements as it believed entity B was excluded from the scope of consolidation under IFRS. In coming to this determination, the issuer did not refer to, nor consider any, comments issued by the European Commission (EC) in relation to any relative Articles or Directives, as the issuer believed that comments issued by the EC do not amount to endorsed legislation which can be imposed on entities.

The consolidation of entity B would have had a material impact.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that although the EC Comments are not endorsed legislation, they do provide guidance in determining whether or not an entity is required to prepare consolidated financial statements. Specifically, paragraph 2.2.2 of the EC Comments states:

"The determination of whether or not a company is required to prepare consolidated accounts will continue to be made by reference to national law transposed from the Seventh Council Directive" and that "Certain exclusions from the scope of the consolidation are provided for in Articles 13 to 15 of the Seventh Directive.

As noted above, it is the national law derived from the Accounting Directives that determines whether or not consolidated accounts are required.

However, if consolidated accounts are so required, it is the requirements of endorsed IASs that will dictate the scope of consolidation and, therefore, which entities should be included in those consolidated accounts and how they should be included.

Accordingly, the exclusions from the scope of the consolidation derived from the Accounting Directives are not relevant – the consolidated accounts are prepared in accordance with endorsed IASs.'

The enforcer noted:

- When a company is of a type specified in Article 4 of the Seventh Council Directive (as was the case here), the determination of whether consolidated financial statements are required is made in reference to the national law (as transposed from the Seventh Council Directive). Relevant Articles include 1, 2, 3(1), 4, 5-9, 11, 12 and 13(2a)
- In instances where consolidated financial statements are required:
 - IFRS is applied in determining which entities are to be consolidated
 - The exclusions from the scope of consolidation provided for in Articles 13 to 15 (except Article 13(2a)) of the Seventh Council Directive are not relevant.

Therefore, the enforcer noted that the Article the issuer had referred to in its argument (Article 13 sub 3(c) of the Seventh Council Directive) was not relevant in determining whether consolidated financial statements were required and that, as a result, the issuer was required to prepare IFRS consolidated financial statements (i.e. the issuer was required to consolidate entity B).

8. Identification of intangible assets in a business combination (IFRS 3 and IAS 38)

In 2011 the issuer, a commercial bank, acquired the operations of a distressed bank as part of a business combination resulting in goodwill totalling 15% of issuer's total equity.

The issuer disclosed in its financial statements that the goodwill represented:

- The expected return from the acquired activities
- Synergies from combining operating activities
- The deposit surplus (i.e. the difference between the amounts of deposits and loans acquired).

The issuer believed that the majority of the goodwill was related to the deposit surplus, as the acquired deposits were substantially larger than the acquired loans and the customers were expected to continue to have deposits in the bank in future.

Goodwill equal to the expected value of the deposit surplus was allocated to the related cash generating unit (CGU), being the existing business that the issuer expected to benefit from the deposit surplus.

The remaining goodwill was allocated to another cash-generating unit related to the acquired business.

The interest rates of the acquired deposits were substantially lower than the interest rates of the issuer's existing bonds, resulting in an expected linear decrease in annual funding costs of CU3.5 m over 10 years, with a net present value representing 80% of total goodwill.

The issuer believed that the benefit derived from the deposit surplus was linked to the synergies in combining the two banks businesses, and should therefore form part of goodwill.

The enforcer's decision

The enforcer did not agree with the issuer's treatment, and considered that the deposit surplus was not a synergy from combining the two companies subsumed within goodwill, but instead was a separate intangible asset.

The enforcer noted that the separability criteria for the deposit surplus in IFRS 3.B34 had been met as:

- The deposit surplus could be separated in combination with the customers' deposits and loans
- Another bank could benefit from the deposit surplus
- The deposits relating to the deposit surplus had a low interest rate compared to the market.

The enforcer noted that the value of the deposit surplus recognised in accordance with IAS 38.33 should incorporate the liquidity benefit received that arose from the potential use of the deposits (such as to grant loans, or as an alternative source of funding).

9. *Contingent payments to acquire a non-controlling interest (IAS 32)*

The issuer exercised an option that it held from a previous business combination to acquire the non-controlling interest (NCI) in the subsidiary.

The consideration payable to the NCI on exercise of the option was split into:

- A fixed initial payment
- Contingent amounts based on future EBITDA payable over the following three years (up to a ceiling).

In respect of the treatment of the consideration payable, the issuer:

- Recognised the fixed amount within equity in accordance with IAS 27(2008).30 (changes in a parent's ownership interest that do not result in a loss of control)
- Treated the contingent amounts as a contingent liability under IAS 37, making disclosures in respect of the estimate timing and amounts to be settled.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that IAS 27(2008) does not contain guidance when accounting for contingent consideration payable in relation to changes in a parent's ownership interest that do not result in a loss of control.

However, the enforcer noted that the contingent payments met the definition of a financial liability in accordance with IAS 32, as:

- The issuer had a contractual obligation to pay cash to the NCI
- The issuer's was unable to avoid this obligation.

Therefore the enforcer noted that the issuer should have recognised a financial liability in respect of the contingent payments in accordance with IAS 32, rather than simply disclosing a contingent liability in accordance with IAS 37.

The enforcer further noted that IAS 32.25 states that the fact the contingent payments are based on variables outside of both the issuer's and NCI's control (i.e. the parameters which contribute to EBITDA) did not change the determination that a financial liability needed to be recognised.

The enforcer noted that, as with the fixed payment, the offsetting entry to the initial recognition of the contingent payment liability would be recognised in equity.

10. Deferred tax asset arising from tax losses carried forward (IAS 12)

The issuer, a commercial bank, had net deferred taxes equal to 19% of its total equity which included:

- A significant deferred tax asset (CU26m), relating to carried-forward tax losses
- A small amount of deferred tax liabilities (CU4m) relating to taxable temporary differences.

In relation to the recognition of the deferred tax asset:

- There was no limit to the utilisation of the unused tax losses in the issuer's jurisdiction
- Based on its budget forecasts, the issuer expected future taxable profits would be available within the next 7 years as a result of:
 - An expected substantial reduction in impairments of loans
 - Low expected rates of impairment on loans compared to other banks in the industry.

Other relevant points were:

- The issuer had a history of material pre-tax losses over the previous 4 years (averaging CU12m per year, including the current period)
- Budget forecasts versus actual results in the previous two years were materially different, predominately due to an underestimate of the level of impairment losses. The issuer argued that this was due to industry wide variances in expectations and was not reflective of an inability accurately to forecast its future operating results
- The issuer disclosed a material uncertainty regarding its ability to continue as a going concern.

The enforcer's decision

The enforcer did not agree with the issuer's treatment, and noted that it did not agree with the issuer's assumption that it was probable that future taxable profits would be available to offset the carried forward tax losses, due to the combination of:

- The existence of carried forward losses in the first place (IAS 12.35)
- The magnitude and prolonged nature of the issuer's most recent pre-tax losses
- The magnitude of the pre-tax profit that would be required in the future to offset the deferred tax asset (CU87m), compared with its recent pre-tax loss history
- Insufficient deferred tax liabilities relating to taxable temporary differences
- The inaccuracy of the issuer's budget forecasts when compared to its actual results raised questions to the degree to which the issuer's forecasts were reliable in predicting whether future taxable profits would be probable
- The material uncertainty regarding the issuer's ability to continue as a going concern.

Given these facts and circumstances, the enforcer noted that the issuer should have only recognised a deferred tax asset to the extent of its taxable temporary differences (i.e. CU4m) as there was no conclusive evidence to support an assertion that it was probable there would be future taxable profits.

11. Segment disclosures (IFRS 8)

The issuer, a multi-national entity, held a significant amount of goodwill recognised in its financial statements.

The issuer presented the following information in its segment reporting note:

- A geographical analysis of revenues and non-current assets (IFRS 8.33)
- Information about the country of domicile
- Information relating to two other countries considered to be material
- Remaining amounts of revenue and non-current assets were categorised as 'other'.

In presenting its geographical analysis of non-current assets, the issuer:

- Included customer related intangible assets
- Excluded goodwill.

For the purposes of impairment testing, the issuer identified two operating segments based geographical areas as its cash-generating-units, and allocated goodwill to each of these segments accordingly. In terms of the make-up of the CGUs, each was based on either:

- A single country, or
- A limited group of countries.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that IFRS 8.33(b), relating to information about geographic areas, requires disclosure of non-current assets other than a number of exempt items (which does not include goodwill) – except in instances where those assets relate to a material individual foreign country, in which case they are disclosed separately.

Based on the mechanics of the issuer's goodwill impairment testing, the enforcer noted that it was possible for the issuer to disclose the amounts of goodwill identified and allocated to the country of domicile and the two material countries.

12. Disclosure of new standards that have been issued but are not yet effective (IAS 8)

The issuer prepared its financial statements in accordance with IFRS as endorsed in the EU.

In respect of the disclosure requirements of IAS 8.30, which requires disclosures relating to the effects of IFRSs issued but not yet effective, the issuer only disclosed information regarding IFRSs that had been endorsed for use in the EU as at the date the financial statements were approved.

Examples of significant IFRSs that had been issued but had not been endorsed for use in the EU included:

- IAS 19 (2011) *Employee Benefits*
- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*
- IFRS 13 *Fair Value Measurement*.

In particular, it was likely that IAS 19 (2011) would have a significant effect on the issuer's financial statements.

The enforcer's decision

The enforcer did not agree with the issuer's treatment.

The enforcer noted that the EU had previously endorsed IAS 8 and in doing so had not amended paragraph 30 to stipulate that an entity applying IFRSs endorsed in the EU should make disclosures about only those IFRSs that had been issued but were not yet effective that had been endorsed in the EU.

In addition, the enforcer noted that IAS 1.112(c) requires an entity to present information that is not required elsewhere if that information is relevant to an understanding of the financial statements. Given the likely significant future impact of IAS 19 (2011) the enforcer noted that disclosures relating to the effect of that standard were necessary in the issuer's case.

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