



European Securities and  
Markets Authority

# Report

15<sup>th</sup> Extract from the EECS's Database of Enforcement



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## List of abbreviations and acronyms used in this report

CCIRS	Cross-Currency Interest Rate Swap
CGU	Cash-Generating Unit
CU	Currency Units
EEA	European Economic Area
EC	European Commission
EECS	European Enforcers Coordination Sessions
EU	European Union
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards (as adopted by the EU)
IFRS IC	International Financial Reporting Standards Interpretation Committee



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## Introduction

The European Securities and Markets Authority (ESMA) is publishing extracts from its confidential database of enforcement decisions on financial statements, with the aim of providing issuers and users of financial statements with relevant information on the appropriate application of the International Financial Reporting Standards (IFRS).

According to its founding regulation (European Regulation no 1095/2010), ESMA shall act in the field of financial reporting, to ensure the effective and consistent application of European Securities and Markets legislation. In order to fulfil these responsibilities, ESMA organises the European Enforcers Coordination Sessions (EECS), a forum gathering 39 European enforcers from the 28 Member States and the 2 countries in the European Economic Area (EEA) who have responsibilities in the area of supervision and enforcement of financial information.

European enforcers monitor and review IFRS financial statements and consider whether they comply with IFRS and other applicable reporting requirements, including relevant national law. Through the EECS, European enforcers are able to share and compare their practical experiences on the enforcement of IFRS financial information provided by companies who have, or who are in the process of having, securities admitted to trading on a regulated market in Europe. It provides a forum to discuss enforcement cases before or after decisions are taken by the European enforcers. As a forum of technical experts, this group provides technical advice for the preparation of ESMA statements and/or opinions on accounting matters. In addition, the EECS enables ESMA to review accounting practices applied by European issuers and monitors market developments and changes in those practices.

In taking enforcement decisions, European national enforcers apply their judgement, knowledge and experience to the particular circumstances of the cases that they consider. Relevant factors may include other areas of national law beyond the accounting requirements. Interested parties should therefore consider carefully the individual circumstances when reading the cases. As IFRS are principles based, there can be no one particular way of dealing with numerous situations which may seem similar but in substance are different. Consistent application of IFRS means consistent with the principles and treatments permitted by the standards.

Decisions taken by enforcers do not provide generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee (IFRS IC).

ESMA has developed a confidential database of enforcement decisions taken by individual European enforcers as a source of information to foster appropriate application of IFRS. Decisions that deal with simple or obvious accounting matters are normally not published, even if they related to material breaches leading to sanctions. The selection criteria are based on the above stated objectives, and accordingly, only decisions providing market participants with useful guidance are published.

Publication of enforcement decisions will inform market participants about which accounting treatments European national enforcers may consider as complying with IFRS; that is, whether the treatments are considered as being within the accepted range of those permitted by IFRS. Such publication, together with the rationale behind these decisions, will contribute to a consistent application of IFRS in the EEA.

On this basis, all cases submitted to the enforcement database are considered as appropriate for publication, unless:

- similar decisions have already been published by ESMA, and publication of a new one would not add any substantial value to the fostering of consistent application;
- the decision deals with a simple accounting issue;
- there is no agreement between European enforcers to support the submitted decision; and
- a particular European national enforcer, on a grounded and justified basis, believes that the decision should not be published.

Decisions included in this extract were taken by national enforcers in the period from December 2012 to November 2013. ESMA will continue publishing further extracts from the database on a regular basis, with the next extract expected to be published in the second half of 2014.



## **I Decision ref EECS/0114-01 – Classification of Contingent Consideration Based on Continuing Employment**

**Financial year end:** 31 December 2012

**Category of issue:** Contingent consideration

**Standards or requirements involved:** IFRS 3 – *Business Combinations*

### *Description of the issuer's accounting treatment*

1. The issuer is in the marketing and advertising industry and made a business acquisition where part of the consideration was contingent on the future performance of the acquired business. The amount of additional consideration payable was to be calculated at the end of an 'earn-out' period. The vendor had to remain an employee of the group during the earn-out period in order to be eligible for the contingent payments, otherwise the amounts would be forfeited.
2. The issuer treated the contingent amounts arising from the acquisitions as contingent consideration, regardless of whether they were dependent on continued employment or not. The contingent consideration was initially recognised on the statement of financial position at fair value, with a corresponding amount in goodwill.
3. The introductory sentence to paragraph B55 of IFRS 3 requests the issuer to consider eight indicators in determining whether payments are contingent consideration or separate transaction. The issuer explained that it considered all eight indicators, assumed that continuing employment should be considered together with the other seven indicators, and concluded that the contingent payments were additional consideration rather than remuneration for the employment.

### *The enforcement decision*

4. The enforcer disagreed with the classification of the contingent payments as contingent consideration for the business combination in the situation where the vendor was required to be employed over the earn-out period and the service condition was substantive. It required the contingent consideration to be expensed over the earn-out period as remuneration for services provided.

### *Rationale for the enforcement decision*

5. According to paragraph B55 (a) of IFRS 3, a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates, is remuneration for post-combination services.
6. In its January 2013 agenda decision<sup>1</sup>, the IFRS IC considered the case of an arrangement in which contingent payments are automatically forfeited if employment terminates. IFRS IC concluded that the arrangement was compensation for post-combination services rather than additional consideration for an acquisition, unless the service condition was not substantive. This conclusion was not dependent on the company's assessment of the other indicators in paragraph B55 of IFRS 3.
7. In this particular case, the contingent payments were to be forfeited on termination of the employment contract. The enforcer considered that in light of the paragraph B 55 (a) of IFRS 3 and January 2013 IFRS agenda decision, the continuing employment condition specified in the contract was conclusive on its own to determine that the contingent payments were consideration for post-combination services and had to be expensed over the earn-out period.

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<sup>1</sup> IFRIC Update, IFRS Interpretation Committee, January 2013



## II Decision ref EECS/0114-02 – Allocation of Goodwill on Sale of an Operation

**Financial year end:** 31 December 2011

**Category of issue:** Allocation of goodwill to cash-generating units (CGU)

**Standards or requirements involved:** IAS 36 – *Impairment of Assets*

### *Description of the issuer's accounting treatment*

8. The issuer is active in the oil and gas industry and has development and production operations in various countries. In 2011 it sold seven licenses, four of which were originally acquired in the acquisition of the listed Company A in 2007. As part of the purchase price allocation, the issuer identified significant fair value adjustments related to exploration and evaluation assets (including licenses) and production facilities with a corresponding recognition of deferred taxes and adjustment to goodwill. In accordance with paragraph 80 of IAS 36, goodwill was allocated to the following groups of CGUs: Company A in country 1 (A 1), Company A in country 2 (A 2) and Company A in country 3 (A 3).
9. As part of the disposal of licences in 2011, goodwill was allocated to the groups of CGUs that included the sold licenses. Paragraph 86 of IAS 36 prescribes that the goodwill associated with the operation disposed of should be included in the carrying amount of the operation when determining the gain or loss on disposal. Paragraph 86(b) of IAS 36 specifies that the goodwill associated with the operation disposed of should be measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.
10. The issuer allocated a portion of goodwill in the determination of the result from disposal of the four licenses in 2011 initially acquired in 2007. The issuer did not use the general method defined in IAS 36, but its own method involving a hypothetical price and purchase allocation analysis where the difference between the recoverable amount and the net book value (*the excess value*) of the licenses was calculated. Subsequently, the portion of goodwill to be included in the determination of the result was calculated on the basis of the relative value of the excess value of the sold licenses over the sum of the corresponding excess value for all the licenses calculated at the time of the sale.
11. Goodwill identified was mainly related to deferred tax on fair value adjustment related to licenses. Of the total original fair value adjustments to all the licenses transferred to A 1 and A 2 in 2007, approximately 80% and 50% was related to the four licenses disposed of. Although the consideration for the licenses disposed of was substantial compared to the estimated recoverable amounts of the unsold licenses in 2011, the issuer's new hypothetical purchase price allocation implied that the main part of the total excess value rested with the unsold licenses. The issuer's alternative method thus led to the inclusion of only a small portion of goodwill in the determination of gains and losses on disposal.
12. As goodwill is related to the difference between the current value and the book value of the licences, the issuer considered that the alternative method was a more correct way of allocating the goodwill to the CGUs. As such the issuer considered this method acceptable under paragraph 86(b) of IAS 36.



13. The following example illustrates the issuer's accounting treatment related to licences acquired in a business acquisition. Goodwill identified in 2007 was 40.

	2007 <sup>2</sup>	2011
<b>Licences disposed in 2011</b>		
Net book value of licenses	100	100
Market value of licenses	150	110
'Excess value' of licenses	50	10
Goodwill allocation	20	
<b>Licences retained</b>		
Net book value	100	100
Market value	150	150
'Excess value'	50	50
Goodwill allocation	20	
Total goodwill	40	40

Calculation of the goodwill associated with the licences disposed in 2011 according to the general method in paragraph 86(b) of IAS 36 (relative values):  $40 \times 110 / (110 + 150) = 16,9$ .

Calculation of the goodwill associated with the licences disposed in 2011 according to the issuer (relative value based on excess values):  $40 \times 10 / (10 + 50) = 6,7$ .

*The enforcement decision*

14. The enforcer disagreed with the issuer on the allocation of the goodwill related to the operation disposed of and considered that the issuer should have used the general method prescribed by paragraph 86 of IAS 36.

*Rationale for the enforcement decision*

15. According to paragraph 86 of IAS 36, whenever goodwill has been allocated to a CGU and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be included in the carrying amount of the operation when determining the gain or loss.
16. In some cases, issuers are able to demonstrate that an alternative method better reflects the goodwill associated with the operation disposed of. Paragraphs BC 153 to BC 156 of IAS 36 provide some cases dealing with special circumstances relating to the disposed operation. Those cases objectively demonstrate that using the general rule would lead to an inappropriate evaluation of the related goodwill.
17. However, the issuer has not been able to associate its situation with any of the cases mentioned in the Basis for Conclusions to IAS 36, or to demonstrate that any other objective criteria adequately support the use of the alternative method. It was unable to demonstrate why it was more relevant to allocate a higher proportion of goodwill to the retained operations. Therefore, in the opinion of the enforcer, the issuer should have used the general method in paragraph 86 of IAS 36.

<sup>2</sup> Calculation at the time of acquisition as part of the purchase price allocation



### III Decision ref EECS/0114-03 – Sale of single licences presented as discontinued operations

**Financial year end:** 31 December 2011

**Category of issue:** Discontinued operations

**Standards or requirements involved:** IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations*

#### *Description of the issuer's accounting treatment*

18. The issuer has oil and gas exploration, development and production operations in various countries. The issuer classified licenses as: producing fields, fields under development, or discovery. In 2011 the issuer sold seven licenses (three producing fields, three fields under development and one discovery licence). The sale of the licences was not a strategic decision to end a specific line of business. All, except one, of the licenses were considered to be separate CGUs.
19. The issuer defined each of the producing fields and fields under development as a major line of business, regardless of their size and relative importance. Consequently, all sales of licenses in producing fields and in fields under development were presented as discontinued operations. For licenses in the discovery phase, the issuer defined the major line of business criterion as a fixed CU limit related to the size of the sales consideration. The issuer considered the presentation of the license sales as discontinued operations to provide more relevant and better information to users of financial statements. Accordingly, the issuer presented net income from discontinued operations on a single line in the entity's Statement of Comprehensive Income.

#### *The enforcement decision*

20. The enforcer disagreed with the issuer's treatment and considered that the presentation of the license sales as discontinued operations was inappropriate. It concluded that a component of the entity is usually identified on a level higher than a single CGU.

#### *Rationale for the enforcement decision*

21. According to paragraph 31 of IFRS 5, the term "component of an entity" comprises operations and cash flows that can be clearly distinguished from the rest of the entity.
22. According to paragraph 32 of IFRS 5, a discontinued operation is an entity's component that either has been disposed of or is classified as held for sale, and
  - represents a separate major line of business or geographical area of operations, or
  - is part of a single coordinated plan to dispose of separate major line of business or a separate major geographical area of operations, or
  - a subsidiary acquired exclusively with a view to resale.
23. The enforcer concluded that the assessment of the issuer was not sufficient to conclude whether or not each sale constituted a component of an entity that represented a separate major line of business. For licenses in the discovery phase, the enforcer's opinion was that assessment of separate major line is related to the magnitude and relative importance of the business and that a numerical determination alone cannot be considered a sufficient and appropriate operationalization of the guidance in IFRS 5.



24. In the opinion of the enforcer, paragraphs 31 and 32 of IFRS 5 suggest that the term 'component of an entity' as a threshold for presentation of discontinued operations, represents a level which is normally higher than the individual CGU but lower than a segment.
25. Furthermore, the sales of seven licences included in the portfolio in 2011 was not due to a coordinated strategic decision to end a specific line of business but clearly appeared to be part of the normal course of business for the issuer that includes continuous change to the composition of the portfolio of licences. As the issuer defined each license as a CGU, and did not engage in the sale of all licences of a certain type or all licences in a specific geographical area, the enforcer believed that the sale of one of many individual licenses in the portfolio constituted a "component of an entity" only in exceptional cases and therefore none of the criteria in paragraph 32 of IFRS 5 were fulfilled.

#### **IV Decision ref EECS/0114-04 – Identification of a CGU**

**Financial year end:** 31 December 2011

**Category of issue:** Cash-generating unit

**Standards or requirements involved:** IAS 36 – *Impairment of Assets*

##### *Description of the issuer's accounting treatment*

26. The issuer is in the retail industry and has a significant network of branches of merchants and retailers. In its financial statements, the issuer determined its CGUs for the impairment testing at the level of each branded business under which it operated, rather than at each individual branch. At 31 December 2011 the net book value of the issuer's property, plant and equipment was CU 560 million and its net assets were CU 4,200 million.
27. The determination of CGUs was based on the fact that each of its individual branches did not operate on a standalone basis as some income, such as volume rebates, and costs were dependent on the whole branded business rather than on individual branches. The issuer considered that cash inflows and outflows for individual branches did not provide an accurate assessment of the actual cash generated by those branches. Volume rebate income was approximately CU 70 million compared with gross revenue of approximately CU 1,000 million.
28. However, the issuer has daily sales information and monthly income statements produced for each individual branch and this information was used to make decisions about continuing to operate individual branches.

##### *The enforcement decision*

29. The enforcer disagreed with the issuer's determination of CGUs and considered that each branch should be identified as a separate CGU.

##### *Rationale for the enforcement decision*

30. According to paragraph 6 of IAS 36, a CGU is defined as the smallest identifiable group of assets generating cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
31. In accordance with paragraph 69 of IAS 36, one factor to be considered is the monitoring of the entity's operations. The issuer used the daily sales information and monthly income statements of each individual





branch to monitor its operations and to make decisions about continuing or disposing of its assets and operations.

32. In the enforcer's view, each individual branch generated cash inflows that were largely independent of those generated by the other individual branches. Therefore, each branch should be identified as a separate CGU because rebate income was insignificant compared to gross revenues and because the issuer monitored and made decisions about its assets and operations at the individual branch level.

## V Decision ref EECS/0114-05 – Determination of the fair value of land

**Financial year end:** 31 December 2011

**Category of issue:** Investment property under construction, Fair value measurement

**Standards or requirements involved:** IAS 40 – *Investment Property*

### *Description of the issuer's accounting treatment*

33. The issuer operates in the commercial and agricultural industry and owns a large plot of land, which had been used in its normal operations and is classified as property, plant and equipment. Furthermore, the issuer has acquired additional land for agricultural use on a continuing basis.
34. In July 2011, as the production on the land had stopped and no further production was planned, the issuer transferred the land from owner-occupied property to investment property, as it intended to sell or lease it. The change in the use of the land was caused by difficulties in transporting the harvest from this location to the markets. While transferring an investment property, the issuer chose to account for the land under the fair value model in IAS 40.
35. At the time of the transfer, the issuer claimed that it was not possible to determine the fair value of the land reliably, due to the unclear legal structure related to the ownership of the land. According to paragraph 53 of IAS 40, the issuer treated the land as '*property under construction*' and measured it at cost.
36. In the second half of 2011, the issuer incurred costs regarding clearing the land and making it more attractive to potential buyers or lessees as well as legal costs. These costs were expensed in the income statement.
37. On 31 December 2011 the issuer clarified the legal status of the land, considering that its fair value could be reliably measured. The issuer reported a fair value gain, determined as the difference between the fair value at that time and its previous carrying amount which was recognized in the income statement according to paragraph 65 of IAS 40.

### *The enforcement decision*

38. The enforcer disagreed with the accounting treatment of the issuer and considered that land with unclear legal status cannot be treated as an investment property under construction and required it to be measured at fair value from the time of the transfer to investment property. Any difference between the book value and the fair value at the time of the transfer should be accounted for in accordance with IAS 16 – *Property, Plant and Equipment*.

### *Rationale for the enforcement decision*



39. The enforcer concluded that the work performed on the land related mainly to legal assistance, and that does not constitute construction costs, as it is not part of a process that would result in physical changes to the property. Accordingly, in light of the requirements of paragraph 53 of IAS 40, the land cannot be treated as an investment property under construction as some physical changes must be made to the asset in order for the investment property to be under construction.
40. According to paragraph 48 of IAS 40, it is only in exceptional cases that the fair value of an investment property cannot be measured reliably. The enforcer assumed that the issuer had a good understanding of how to determine the fair value of the land as it was able to determine the fair value of the land each time it acquired additional piece of land. Accordingly, it concluded that the issuer should be able to do the same on a continuous basis.
41. According to paragraph 61 of IAS 40, if an owner-occupied property becomes an investment property carried at fair value, the issuer should record any difference at that date between the carrying amount of the property and its fair value in the same way as a revaluation in accordance with IAS 16.

## **VI Decision ref EECS/0114-06 – Change of Presentation of the Share in the Profit or Loss of Associates and Joint Ventures Accounted for Using the Equity Method**

**Financial year end:** 31 December 2013

**Category of issue:** Equity method, Presentation of Financial Statements

**Standards or requirements involved:** IAS 1 – *Presentation of Financial Statements*, IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors*, IFRS 11 - *Joint Arrangements*

### *Description of the issuer's accounting treatment*

42. Prior to the adoption of IFRS 11, the issuer presented in its income statement the line: '*share in the profit or loss of associates and joint ventures accounted for using the equity method*' as part of its operating result. In presenting its income statement the issuer distinguishes between its operating and non-operating results. Following the publication of IFRS 11 and the elimination of proportionate consolidation, the issuer reviewed the presentation of its income statement. The presentation of the share in the profit or loss of *operating* associates and joint ventures accounted for using the equity method would not have changed, however, the issuer intended to present the result on *non-operating* associates and joint ventures separately.
43. The issuer intended to adopt as its accounting policy that an investment accounted for using the equity method would be classified as 'operating' if it met the following conditions:
- The activity of the entity is related to the operating activities of the group;
  - The elements in the income statement have primarily an operating nature: results that are primarily financial suggest that the nature of the entity is not operating;
  - In case of an industrial entity, the entity has started production.
44. On the above basis, the issuer intended to change the presentation of the share in the profit or loss of a joint venture in its start-up phase as the assets of the joint venture consisted mainly of a factory under construction and the functional currency was different from the functional currency of the issuer. The issuer argued that the results of this start-up company were significantly different from the results of operating entities, since they contained important financial results that are not of an operating nature (e.g. the impact of changes in foreign exchange rate that are not regarded as an adjustment to interest costs



according to paragraph 6(e)<sup>3</sup> of IAS 23 – *Borrowing Costs* and other charges that cannot be capitalised as part of factory under construction). The issuer also argued that these results are different from the usual type of charges the issuer faces in its subsidiaries in a start-up/developing phase because the joint ventures are operating in other regions and have a different functional currency.

45. The issuer considered that IFRS do not provide sufficient guidance on the presentation of this type of result. Paragraph 82 (c) of IAS 1 requires at least a separate line in the income statements for the share of the profit or loss of associates and joint ventures accounted for using the equity method. However, this paragraph does not indicate where this line should be presented nor does it prohibit using two lines.
46. Overall, the issuer considered that this change in accounting policy would increase transparency and provide reliable and more relevant information.

#### *The enforcement decision*

47. The enforcer disagreed with the issuer and concluded that a change in the presentation of the share in the profit or loss of a joint venture in a start-up phase to non-operating result would not provide more relevant information to the users of financial statements.

#### *Rationale for the enforcement decision*

48. The enforcer agreed that the issuer has the possibility of including additional lines in the statement of comprehensive income or income statement to present its share in the profit or loss in associates and joint ventures.
49. According to paragraph BC56 of IAS 1, an entity may choose to disclose the results of operating activities, even though the term ‘operating’ is not defined. In such cases, the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as ‘operating’. IASB considered it would be misleading and impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities and noted that it would be inappropriate to exclude items related to operations because they occur irregularly, are unusual in amount or do not involve cash flows, such as depreciation and amortisation expenses.
50. Some components of the finance result depend on the way a company is financed, whereas others depend on the geographical location and the way how an issuer is operating. The activities of the start-up subsidiary were of the same nature as some core activities of the issuer and were part of the normal business of the group in new regions. Once an issuer decided to present its share in the profit or loss in associates and joint ventures in its income statement as part of its operating result it should present start-up associates and joint ventures in the same way as mature operations. Considering a company to be in a start-up phase is not a valid reason to consider that its results are not of an operating nature because start-up companies are normally regarded as part of the normal business of a group.
51. Finally, according to paragraph 14 of IAS 8, an entity shall change an accounting policy only if the changes result in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows. The change in the presentation from one category to another should be treated as a change in an accounting policy in accordance with IAS 8 and needs to be justified by providing reliable and more relevant information.

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<sup>3</sup> Paragraph 6 (e) of IAS 23 defines borrowing costs as including exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.



## VII Decision ref EECS/0114-07 – Cost of listing

**Financial year end:** 31 December 2010

**Category of issue:** Cost of issuing equity instruments

**Standards or requirements involved:** IAS 32 – *Financial Instruments: Presentation*

### *Description of the issuer's accounting treatment*

52. The issuer is a pharmaceutical company which was listed for the first time on the stock exchange in 2010. On that occasion it issued new shares for which it incurred issuance and listing costs. Certain listing costs were included in the income statement and others in the statement of changes in equity, whereas all costs of the capital increase were recognized in equity.
53. The issuer allocated expenses to the capital increase and to the listing based on their nature. The costs that related to both the capital increase and the listing were allocated on a rational basis, that is, the proportion of newly issued shares in relation to the total share capital.
54. The lawyer's fees were allocated between the listing and the capital increase, according to their nature. The success fee paid to investment banks was directly attributable to the capital increase and recognised directly in equity. The cost of the preparation of the prospectus in accordance with foreign rules for the subscription of new shares by foreign market investors was attributed to sales promotion and expensed accordingly. If the company did not want to attract investors from those foreign markets, this cost would not have been incurred.
55. Approximately two-thirds of the costs relating to the capital increase concerned success fees and fees paid to lawyers for the preparation of the prospectus as the issuer wanted a prospectus prepared in accordance with foreign market regulations in order to have access to foreign investors on other markets than Europe.

### *The enforcement decision*

56. The enforcer concluded that the issuer's allocation of costs to the capital increase and the stock exchange listing did not conflict with the requirements of IAS 32.

### *Rationale for the enforcement decision*

57. According to paragraph 35 of IAS 32, transaction costs of an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit.
58. According to paragraph 37 of IAS 32, the costs incurred by an entity when issuing equity instruments might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided.
59. According to paragraph 38 of IAS 32, transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.



## VIII Decision ref EECS/0114-08 – Conditions for hedge accounting

**Financial year end:** 31 December 2011

**Category of issue:** Hedge Accounting

**Standards or requirements involved:** IAS 39 – *Financial Instruments: Recognition and Measurement*

### *Description of the issuer's accounting treatment*

60. The issuer is a manufacturer selling its products through selected distributors all over the world. Revenues and costs are earned in different currencies. The issuer uses forward exchange contracts to hedge forecast transactions, and accounts for them as cash flow hedges according to IAS 39.
61. The issuer designated the first part of expected cash receipts in each period (month) as the cash flows being hedged. Forward exchange contracts existed for a maximum of 80 % of the expected cash receipts in the transaction currencies. In the hedging documentation, there is no clear reference to the relationship between the forward exchange contracts and the forecast transactions. Furthermore, the documentation does not state whether it was the forward price or the spot price that was hedged.
62. When assessing effectiveness, the issuer compared the actual receipts with the cash flows from the settlement of the forward contracts. This showed that the actual receipts exceeded the forward contract amounts in most months in 2011, with some exceptions. The issuer explained that, in these cases, the cash had been received in the prior month.
63. The issuer did not recognize any portion of gain or loss in the income statement arguing that the forward price was designated for hedging purpose. According to Guidance on Implementing IAS 39, Question F.5.6 – *Cash flow hedges: firm commitment to purchase inventory in a foreign currency*, the issuer believed that the forward price could be designated for hedging purposes in a cash flow hedge. The issuer argued that it was fully effective, because gross cash receipts in each period were greater than amounts paid to settle the forward exchange contracts.

### *The enforcement decision*

64. The enforcer disagreed with the issuer and considered that not all the conditions set in paragraph 88 of IAS 39 for hedge accounting were met.

### *Rationale for the enforcement decision*

65. According to paragraph 88 of IAS 39, hedge accounting can only be used if all the following conditions are met:
  - At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness;
  - The hedge is expected to be highly effective;
  - The forecast transaction that is subject of the hedge must be highly probable;
  - The effectiveness of the hedge can be reliably measured, and
  - The hedge is assessed on an on-going basis and determined to have been highly effective.



66. The enforcer considered that there was no clear reference between the forward exchange contract and the forecast transaction, from the inception of the hedge relationship and throughout the whole hedging period. At the inception of the forward exchange contract, there was no identification of forecast payments; the relationship between the forward exchange contract and the payment was documented only retrospectively.
67. Furthermore, according to Question F.5.6 of the Guidance on Implementing IAS 39, the forward price can be designated for hedging purposes, when the hedged item does not fall due before the hedging instrument. However, in this case, the cash receipt could occur before the hedging instrument fell due, because it was the first part of the cash receipts during the month that was hedged, while the hedging instrument fell due later in the month. The issuer did not document how it would assess the effectiveness of the hedging instrument and thus should not have assumed full effectiveness.

## **IX Decision ref EECS/0114-09 – Hedging of the Presentation Currency**

**Financial year end:** 31 December 2012

**Category of issue:** Hedge accounting of the presentation currency

**Standards or requirements involved:** IAS 39 – *Financial Instruments: Recognition and Measurement*, IFRIC 16 - *Hedges of a Net Investment in a Foreign Operation*

### *Description of the issuer's accounting treatment*

68. The issuer is a commodity producer and its financial statements are presented using the presentation currency CU1. At the end of the reporting period, a CU2 functional currency subsidiary of the issuer borrowed in CU2 from a party external to the group and lent the proceeds as a CU2 denominated loan to its fellow subsidiary whose functional currency was CU1. In order to hedge its foreign currency exposure, the subsidiary with the functional currency CU1 entered into a CU1/CU2 cross-currency interest rate swap (CCIRS).
69. In the separate financial statements of the subsidiary with the functional currency CU1, the CCIRS was designated as the hedging instrument in a cash flow hedge of that subsidiary's foreign currency exposure on its intra group CU2 denominated borrowings.
70. In the issuer's consolidated financial statements, the CCIRS was designated as the hedging instrument in a cash flow hedge of the Group's foreign currency exposure on its external CU2 denominated borrowings that were designed as the hedge item. The issuer did not identify the intragroup borrowings between the CU2 and CU1 subsidiaries as the hedged item in its hedging documentation.

### *The enforcement decision*

71. The enforcer did not agree with the issuer's rationale for hedge accounting and considered it had been incorrectly using hedge accounting solely for hedging its presentation currency.

### *Rationale for the enforcement decision*

72. According to paragraph 80 of IAS 39, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. Consequently, hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group, unless specific conditions are met.



73. The hedging documentation showed that the issuer designated external CU2 borrowings as the hedged item in a cash flow hedge in the consolidated financial statements. According to paragraph BC14 of IFRIC 16, a presentation currency does not create an exposure to which an entity may apply hedge accounting as only functional currencies could create an economic exposure to changes in cash flows or fair values. Accordingly, in these circumstances, presentation of the issuer's group accounts in CU1 does not create a CU1/CU2 foreign exchange exposure to which hedge accounting could be applied.

## **X Decision ref EECS/0114-10 – Minimum funding requirements**

**Financial year end:** 31 August 2012

**Category of issue:** Post-employment benefits

**Standards or requirements involved:** IAS 19 – *Employee Benefits*, IFRIC 14 - *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*

### *Description of the issuer's accounting treatment*

74. The issuer is in the retail industry. The issuer's pension scheme was in deficit at the date of the actuarial valuation on 31 March 2012 with respect to the statutory minimum funding basis. In order to eliminate this deficit, the issuer and the pension scheme trustee put in place a schedule of contributions.
75. In the issuer's jurisdiction, the schedule of contributions is governed by national law and sets out the contributions due from the employer and active members of the scheme. Any amount under a schedule of contributions that is not paid by the employer or the members of the scheme is a debt of the employer. At 31 August 2012, the amount payable under the schedule of contributions was determined at CU 13 million per annum subject to indexation over a six and half year period.
76. At the same date, on the basis of the use of IAS 19 provisions, the issuer's pension scheme was in surplus. The difference between the IFRS and the statutory minimum funding basis was due to different assumptions and calculation methodologies.
77. The issuer had not recognised a liability for its statutory obligation to fund the pension scheme under the schedule of contributions as it did not consider the schedule of contributions to be a minimum funding requirement to be accounted for in accordance with IFRIC 14.

### *The enforcement decision*

78. The enforcer disagreed with the issuer as it had not provided for an additional liability in its financial statements in accordance with IFRIC 14.

### *Rationale for the enforcement decision*

79. Paragraphs 23 and 24 of IFRIC 14 require an additional liability to be recognised in respect of a minimum funding requirement if an entity does not have an unconditional right to a refund or the ability to reduce future contributions.
80. As the issuer had an obligation under the minimum funding requirement to cover an existing shortfall on the minimum funding basis defined in the national law and did not have an unconditional right to a refund or the ability to reduce future contributions, it should have recorded a liability on the basis of the minimum funding requirement.