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**Decision ref.EECS/0508-01: Consolidation of subsidiary**

**Financial year end:** 31 December 2005 / Annual Financial Statements

**Category of issue:** Consolidated Financial Statements, Accounting Estimates, Errors, Disclosures

**Standard involved:** IFRS 1 - IAS 1 – IAS 8 – IAS 27

**Date of the decision:** 12 December 2006

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

IAS 27 paragraph 12 requires that consolidated financial statements should include all subsidiaries of the parent entity.

The issuer's consolidated financial statements for 31 December 2005 stated that its Guinean subsidiary was excluded from consolidation because its inclusion would conflict with the objective of financial statements set out in the IAS Framework.

The financial statements did not however provide any of the disclosures in IAS 1, paragraph 18, which are required in the extremely rare circumstance that an issuer departs from a requirement of a standard or interpretation.

**The enforcement decision**

The enforcer found that the Guinean subsidiary should have been included in the issuer's consolidated financial statements as required by IAS 27, paragraph 12.

**Rationale for the enforcement decision**

In extremely rare circumstances, where management concludes that compliance with a requirement in an IFRS standard would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the issuer is required to depart from the IFRS requirement as prescribed by IAS 1, paragraph 18. In such circumstances a raft of disclosures is required including an explanation why the treatment required by the standard would be so misleading as to conflict with the objective of financial statements as set out in the Framework and the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

No such disclosures were provided.

When challenged, the issuer explained that:

- a. The consolidation of the overseas subsidiary would be inconsistent with its historical treatment and would introduce an element of volatility into the accounts;
- b. The book value of investments in the subsidiary, even if adjusted for hyperinflation, is only indicative of value and is established in a non-transferable currency.
- c. As the subsidiary operates under severe long-term restrictions, its ability to transfer funds to the parent is significantly impaired. The issuer was aware that this previous exemption from consolidation had been withdrawn from the standard in the 2003 revision of IAS 27 but referred to it to underline the difficulty of its position.

The enforcer did not accept the issuer's argument for the following reasons:

- a. The impact of first time application of IFRS is not a valid reason for failing to apply international standards. IFRS 1 requires entities to explain how the transition from previous GAAP to IFRS affected its reported financial position, financial performance and cash flows to help users understand the effect and implications of the transition to IFRS (paragraph 38).
- b. IAS 29, 'Financial Reporting in Hyperinflationary Economies' applies to the financial statement of any entity whose functional currency is that of a hyperinflationary economy. There is no exemption from consolidation for such entities.
- c. The enforcer confirmed the removal of the exemption from consolidation of a subsidiary operating under long-term restrictions. Although companies should consider restrictions on the transfer of funds when assessing their ability to control a subsidiary, such restrictions in themselves do not preclude control. In this case, the restrictions were not, of themselves, sufficient to preclude control on the part of the issuer.

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**Decision ref.EECS/0508-02: Step acquisition**

**Financial year end:** 31 December 2007 / Prospectus

**Category of issue:** Business Combination

**Standard involved:** IFRS 3

**Date of the decision:** 30 November 2007

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

The issuer holds 50% of the equity in entity B, an unlisted company, the remaining 50% being held by entity C. The issuer consolidates B under the equity method as permitted by IAS 31.

In September 2007, the issuer and entity C signed an agreement under which:

- a. Entity B will buy back its own shares from C for m.u. 188, and reduce its capital by the same amount. On completion of these transactions, the issuer will hold 57.5% of entity B.
- b. Entity C will then exchange its remaining shares in B for newly issued shares in the issuer. The issuer will then hold 100% of entity B.

The first step in the transaction took place in November 2007. The second step will be subject to shareholder approval in January 2008.

The issuer accounted for the two steps in the arrangement as separate transactions as follows:

- a. As the issuer has control of B once the investee company has bought back its shares, all assets and liabilities acquired are accounted for at fair value and the residual amount of m.u. 50 is recognised as goodwill;
- b. The second step represents an acquisition of a minority interest which, in accordance with the issuer's accounting policy, is taken to equity leading to a reduction of m.u. 130.

**The enforcement decision**

The enforcer considered the arrangement in the context of IFRS 3, paragraph 25 which notes that when a business combination involves more than one exchange transaction, for example, when it is achieved in stages, the cost of the combination is the aggregate cost of the individual transactions.

The enforcer concluded that the exchange transactions had been properly accounted for as separate stages.

**Rationale for the enforcement decision**

The rationale for the enforcer's decision was as follows:

- a. The first step is irreversible in that, whatever the decision taken by the shareholders in January 2008, the issuer had control of entity B once the shares owned by C were bought back in November 2007;
- b. The completion of the second step depends on several administrative approvals, most significantly, the approval by the issuer's shareholders with a majority of 2/3 of the voting rights. The parties to the agreement, the issuer and entity C, represent only 47% of the voting rights. Historically, between 53% and 74% of the issuer's shareholders are represented at general meetings. It is possible, although not necessarily probable, that the second leg of the operation will not win shareholder approval.

In coming to its decision, the enforcer took account of the fact that a significant shareholder in entity C does not participate in step 2, entity C having bought back this particular shareholder's capital with the funds generated at step 1 of the arrangement.

\* \* \*



**Decision ref.EECS/0508-03: Consolidation of special purpose entities**

**Financial year end:** 31 December 2006 / Annual Financial Statements

**Category of issue:** Consolidation, Special Purpose Entities

**Standard involved:** SIC 12

**Date of the decision:** 11 October 2007

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

In December 2003, an issuer entered into a securitization of its current trade receivables (on average, due in less than 6 months), maturing in December 2011, and with a roll-over period ending in 2010. Certain of the issuer's subsidiaries ('originators') transferred their receivables to a special purpose entity (SPE) created for this purpose, 'X' Receivables Funding PLC, ('the Fund'). In some cases, intermediaries were involved in order to satisfy the legal requirements of each jurisdiction in respect of securitization.

The SPE financed the operation through the issue of 1,400 senior notes (140 million euros), subscribed by third parties, and junior notes (7,628 thousand euros), owned by the issuer and recognized in its financial statements as at December 31, 2006.

The originators provided information about the quality and the amounts receivable calculated as prescribed by the terms of the agreement. The purchase price was calculated as the face amount of the receivables less a discount related to the interest rate. However, the Fund actually paid an initial price of the purchase price less a percentage that was deferred and payable only to the extent that funds were available after meeting all senior debt obligations. The maximum amount to be paid under the agreement is 140 million euros.

Each originator sells its receivables to the Fund, absolutely and without recourse against the originator in case of non-payment by the end customer. The rolling period is available until any receivable is in default as, in accordance with the agreement, the Fund accepts offers only if, on the proposed purchase dates, sufficient funds are retained in its operating account

However, on notification by an originator to the Fund that a purchased receivable is in default, the originator (Issuer) may offer to buy back from the Fund such defaulted receivable for its outstanding face amount. The issuer then has a call option allowing it to maintain the financing line of 140 million euros associated with the senior notes and without disturbing the roll-over of the new receivables.

The issuer did not consolidate the SPE associated with the senior notes in the financial statements as at December 31, 2006, as it considered that the receivables and associated credit risk were transferred by the subsidiaries definitely and without recourse.

However, in its management report (MD&A) the issuer took account of the amount securitised when determining total remunerated (interest bearing) financial liabilities and when performing an impairment review on the goodwill attaching to the parent company's holding in its subsidiaries.

**The enforcement decision**

Based on the additional information presented by the issuer, the enforcer concluded that the SPE should have been included in the consolidated financial statements for the year ended December 31 2006.

**Rationale for enforcement decision**

The enforcer asked the issuer to explain the apparent reporting inconsistencies in the context of SIC 12 'Consolidation – Special Purpose Entities'.

Under this Interpretation, a beneficial interest in a SPE may take the form of a "debt instrument, an equity instrument, a participation right, a residual interest or a lease". Some beneficial interests may "simply provide the holder with a fixed or stated rate of return, while others give the holder rights or access to other future economic benefits of the SPE's activities. In most cases, the creator or sponsor (or the entity on whose behalf the SPE was created) retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity."

SIC 12 paragraph 8 requires an SPE to be consolidated when the substance of its relationship with an issuer is that the SPE is controlled by that entity, even where the arrangements are very well defined and where they work on so-called 'autopilot', as the enforcer considered to be the case in this instance.

The enforcer also considered that paragraph 10 of the Interpretation was also applicable in this case in that:

- a. The activities of the SPE are conducted on behalf of the issuer according to its specific business needs so that the entity obtains benefits from the SPE's operation;
- b. The SPE is an "auto-pilot" and all the management decisions are clearly established in the contract with the issuer;
- c. The issuer has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE; or
- d. The entity retains the majority of the residual risks related to the SPE or its assets in order to obtain benefits from its activities.

Further support for consolidation of the SPE was also provided by consideration of the factors listed in the Appendix to the Interpretation; specifically the fact that the SPE's activities are, in substance, being conducted on behalf of the reporting entity as the SPE is principally engaged in providing a source of long term capital to an entity to support the issuer's major or central operations and the SPE supplies goods or services consistent with an entity's ongoing major or central operations which, without the existence of the SPE, would have to be provided by the entity itself.

The enforcer considered that the transfer of current trade receivables arising from the core business provides the necessary liquidity to support the issuer's ongoing central operations.

The fund is over collateralized by the transfer of receivables with a nominal value of approximately 170 million euros, when the finance line is just 140 million. The difference between the payment of senior notes (interest rate of EURIBOR for one month deposits plus a spread, plus the amortization of 140 million) and the residual amount existing in the fund is returned to the issuer through (i) the payment of the deferred price under the receivables agreement and (ii) through the payment of the nominal value of the junior notes, plus a 5% interest.

In substance, the issuer is exposed to the majority of the risks and rewards of the SPE's assets once the following factors are viewed together:

- a. The receivables are of short maturity;
- b. The issuer would like to retain the 140 million euros as a finance line until 2011 and, for that reason, will use the option to replace any defaulted receivables, if they exist (call option), and
- c. The probability of default of payment on the senior notes is very low.

\* \* \*

<b>Decision ref.EECS/0508-04: Application of the pooling of interest method in a business combination under common control</b>
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**Period end:** 31 December 2007 /Prospectus

**Category of issue:** Business Combination

**Standard involved:** IFRS 3

**Date of the decision:** 10 May 2007

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

In December 2007, M (a parent company) reorganized its subsidiaries. M transferred to A (the issuer) its ownership interests in B and C as well as part of its own activities. In exchange, M received additional shares from A, leaving the existing minority interests unchanged (but reducing their significance).

As the companies and activities transferred to the issuer were under common control, as defined in paragraph 3 of IFRS 3, the issuer was not required to apply that standard to the accounting for the business combination. In the absence of any specific standard prescribing how to account for this kind of transaction, the issuer followed the requirements of IAS 8. This standard, at paragraphs 8-10, allows management to consider the applicability of pronouncements of other standard-setting bodies when developing and applying an accounting policy in respect of areas not covered by a specific requirement within IFRS. The issuer decided to apply the accounting treatment required by the US Statement of Financial Accounting Standard (SFAS) 141 as set out below.

FAS 141 requires the transfer of net assets or exchanges of shares between entities under common control to be treated as follows:

- The entity that receives the net assets should initially recognize the assets and liabilities transferred at their carrying amounts (in practice, many entities use a method similar to that of the pooling method).



In terms of reporting requirements, FAS 141 also provides that:

- The financial statements of the receiving entity should report the results of operations for the period in which the transfer occurs as though the transfer had occurred at the beginning of the period;
- Financial statements and financial information presented for prior years should also be restated to provide appropriate comparative information.

#### **The enforcement decision**

The enforcer concluded that, as the combination was one of companies under common control, the accounting treatment required by SFAS 141 was acceptable.

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

In the absence of a specific standard prescribing how to account for business combinations under common control, the enforcer considered that application of the US standard SFAS 141 was acceptable, although not required, in the circumstances. The enforcer noted that the issuer had, voluntarily, also adopted the reporting requirements of the standard.

The enforcer concluded that the presentation of financial statements restated as if the transaction had occurred at the beginning of the periods presented in the prospectus was acceptable.

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<b>Decision ref.EECS/0508-05: Identification of the acquirer in a business combination</b>
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**Financial year end:** 31 December 2007 / Prospectus

**Category of issue:** Business Combination, Reverse Acquisition

**Standard involved:** IFRS 3

**Date of the decision:** 5 October 2007

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

Entity A, a listed issuer, and entity B, a private company, entered into a business combination that took place in two stages that were contingent upon each other. In the first phase entity A acquired 45% of the share capital and voting rights of entity B for cash. In the second stage, entity B merged with entity A with entity A issuing new shares to B's shareholders for their 55 % interest in entity B.

Prior to the transaction, entity A had a market value of EUR 49 million and entity B, based on commonly used valuation methods, a value of EUR 74 million. As a result of negotiations entity A's business represents 45% and entity B's business 55% of the total value of the combined businesses.

Before the transaction, entity B was the largest shareholder in entity A with an ownership interest of 17.5% and with the balance of other holdings widely dispersed. Entity B was owned by the founder who owned 76% of the shares with the remainder owned by some 40 key personnel.

B's ownership interest of 17.5% corresponded to over 50% of the votes represented at entity A's 2007 general meeting.

After the transaction, the former shareholders of entity A (excluding B) own 50.2% and the former shareholders of entity B, 49.8% of the votes of the combined entity. The founder and CEO of B is the biggest individual owner of the combined entity with 35.9% interest. The financial supervision authority granted an order to the CEO exempting him from the general requirement to make an offer for the remaining shares when he had acquired 30% on the basis that his interest would reduce to 30% or under within twelve months.

The purchase agreement provides for a board of six directors for the combined entity, five of which will be former board members of A with one seat reserved to a former board member of B. The next board of directors is decided at the first general meeting of the combined entity.

Under the terms of the purchase agreement, the founder of B is nominated as the CEO of the combined entity. The management comprised the CEO and four other members, two from A and two from B. The board of directors nominates the members of the management team.

The issuer proposed to account for the transaction as a business combination and identified A as the acquirer.

### **The enforcement decision**

The enforcer was of the view that the arguments supporting A or B as the acquirer were finely balanced and therefore it was difficult to identify an acquirer in the case. In accepting the issuer's proposal that A be identified as the acquirer, the enforcer was influenced by the facts that:

- A issued the equity interest (IFRS 3, paragraph 21);
- A was the entity giving up the cash or other assets (IFRS 3, paragraph 20b); and
- A had the marginal controlling interest (50.2%)

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

IFRS 3 requires an acquirer to be identified in all business combinations, the acquirer being the combining entity that obtains control of the other combined entity. Guidance to be applied in determining the acquirer is provided in paragraphs 19 to 21 of the standard.

Control is defined as the power to govern the operating and financial policies of an entity or business so as to obtain benefits from its activities. There is a presumption that an entity achieves control over another entity by acquiring more than one half of the voting rights, unless it can be demonstrated that such ownership does not constitute control.

When there is an exchange of equity interests in a business combination, the entity that issues the equity interests is normally the acquirer (paragraph 21). In this case, as the majority of the purchase consideration is settled in equity instruments, entity A would appear to be the acquirer. Yet, as the paragraph states, all pertinent facts and circumstances should be considered to determine which of the combining entities has the power to govern the financial and operating policies of the other entity.

The shareholders of entity A, the smaller of the two combining entities, appear to have obtained control since, in terms of voting rights, their share amounts to 50.2% after the transaction. A controlling ownership however does not necessarily mean that the entity has the power to govern the combined entity's financial and operating policies so as to obtain benefits from its activities as is explained in IFRS 3 paragraphs BC 57 - 58.

Given the finely balanced distribution of the voting rights – 50.2% and 49.8% - and the existence of a significant individual shareholder, the enforcer was of the view that the identification of the acquirer should take account of the criteria set out in paragraphs 19 to 21 of the standard.

IFRS 3, subparagraphs a to d of paragraph 19 consider circumstances where a combining entity might obtain control over another even if it does not acquire more than one half of the voting rights. IFRS 3, paragraph 19(c) states that an entity might have obtained control of the other entity if, as a result of the combination, it obtains power to appoint or remove the majority of the members of the board of directors.

The former members of A's board represent the majority of the board of directors of the combined entity. However, at A's general meeting preceding the transaction, the large minority shareholder, entity B, had opportunity to influence the nomination of the Board. Therefore, it is not clear which of the combining entities, A or B, is represented by the majority of the Board. The same reasoning applies to the criteria introduced in paragraph 19(d), being the power to cast the majority of votes at meeting of the board.

As it was difficult to identify the acquirer through application of the criteria in paragraph 19, the enforcer considered whether other indications implying control existed as set out in paragraph 20. As the fair value of B was significantly greater than A, paragraph 20 (a) would point towards B as the acquirer. IFRS 3, paragraph 20(b) however would indicate A, as it is the entity giving up a cash amount corresponding to 45% of the purchase price. This represents a significant share of the total purchase consideration. On the other hand, the acquisition price was affected by other factors, including the possible utilisation of tax losses. Furthermore, the cash element was financed by a bank loan that was given on the basis of the pro forma financial information of the combined entity.

As it is not evident which of the combining entities, A or B, was able to dominate the selection of the management team, IFRS 3, paragraph 20(c) does not provide a clear indication of the acquirer. Although the board nominates the management team, the CEO (the founder of B) had significant influence on the business and on the selection of the team.

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**Decision ref.EECS/0508-06: Partial reimbursement and modifications of the term of the contract of a borrowing**

**Financial year end:** 31 December 2006 / Annual Financial Statements

**Category of issue:** Financial Liabilities

**Standard involved:** IAS 39

**Date of the decision:** 31 October 2007

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

At December 31, 2005, the issuer had a financial liability of m.u. 88 in respect of an original borrowing from 2001. The underlying contract stipulated that covenants will be subject to review on a quarterly basis, and provided for partial reimbursement of the residual debt on an increase in capital.

In January 2006, following an increase in capital, the contract was renegotiated and resulted in the following:

- A modification of the terms of the financial contract
- A reimbursement of m.u. 50.

The enforcer identified two related issues:

- Whether the partial reimbursement and the modification of some of the terms of the initial contract should be considered as separate transactions
- Whether the modification of the terms should be accounted for as extinguishing the original and initiating a new liability.

**The enforcement decision**

The enforcer accepted the accounting treatment adopted and as set out below.

**Rationale for the enforcement decision**

The issuer had considered the two transactions separately as a reimbursement followed by a second transaction consisting in a modification to certain terms of the contract.

The reimbursement was considered a distinct transaction because it was a contractual obligation according to the terms of the 2001 agreement.

The reimbursement was accounted for in accordance with IAS 39, paragraph AG 8, under which the issuer recalculated the carrying amount of the initial debt by calculating the present value of estimated future cash flows (including the m.u. 50 repayment) at the original effective interest rate of the debt. This resulted in an insignificant amount being recognised in the income statement.

The modification to the financial terms of the financial debt was not considered substantive, as the discounted present value of the change in the cash flows, considered in accordance with IAS 39, paragraph AG 62, amounted only to a 3.96% change. Therefore, the modification was not considered as extinguishing the original financial liability.

The enforcer accepted the accounting treatment adopted on the grounds that the partial reimbursement complied with the initial terms of the financial debt and because the change in cash flows following the modification of the contractual terms of the financial liability was not significant.

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**Decision ref.EECS/0508-07: Impairment of an investment**

**Period end:** 31 December 2005 / Annual Financial Statements

**Category of issue:** Associates, Impairment

**Standard involved:** IAS 28 – IAS 36

**Date of the decision:** 6 November 2006

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

As of 31st December 2005 the issuer, by virtue of shareholder agreements, had joint control of entity A. Through its interest in A, the issuer also had a significant influence over entity B, a listed company, shares in which was A's only asset.

The issuer considered whether there was any impairment in respect of its investment in accordance with the procedures prescribed in IAS 36, 'Impairment of assets' and which ensures that assets are not carried at above their recoverable amount. IAS 36, paragraph 18, defines recoverable amount as the higher of an asset's fair value less costs to sell and its value in use.

The issuer argued that fair value was the only measure applicable in this case as value in use was not determinable as expected cash flow estimates were not evident from business plans. The issuer also argued that an active market did not exist for the investment in entity B, and hence, that its quoted share price was not an appropriate measure when considering the fair value of its significant influence on that entity. Therefore, the issuer estimated the fair value of its interest in entity B through application of measurement techniques; one based on earnings multiples and the other on an option-pricing model.

Neither estimate supported the existence of an impairment loss as of 31st December 2005.

**The enforcement decision**

The enforcer found that the issuer's approach to the determination of impairment did not comply with IAS 36, 'Impairment of assets' nor IAS 28, 'Investments in Associates'.

**Rationale for the enforcement decision**

The enforcer challenged the issuer's position regarding the non-existence of an active market for an investment where the investor has significant influence and its method of calculating fair value.

In particular, the enforcer challenged the issuer's view that market price cannot reflect the fair value of significant holdings of equity such as an investment in an associate. The enforcer pointed out that IAS 36 prescribes the method of conducting the impairment test in such circumstances. IAS 36, paragraph 26 stipulates:

"If there is no binding sale agreement but an asset is traded in an activity market, fair value less costs to sell is the asset's market price less the costs of disposal. The appropriate market price is usually the current bid price".

The enforcer also questioned compliance with IAS 28, 'Investments in associates'. The enforcer did not agree with the issuer's statement regarding the non-applicability of value in use when considering impairment in this particular case. IAS 28 paragraph 33 explains that, "In determining the value in use of the investments, an entity estimates:

- a. Its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or
- b. The present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal."

The standard is clear that, under appropriate assumptions, both methods give the same result.

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**Decision ref.EECS/0508-08: Disclosure of the effect of discontinued operations**

**Financial year end:** 31 December 2006 / Annual Financial Statements

**Category of issue:** Discontinued Operations

**Standard involved:** IFRS 5

**Date of the decision:** 7 December 2007

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

The issuer disposed of a part of its business at the end of 2006. In order to comply with IFRS 5 in its 2006 accounts, it adjusts the comparative figures for the 2005 financial year, eliminating approximately 30% of its revenues and a comparable amount of costs in the income statement and adjusting the 2005 cash-flow statement accordingly.

The issuer does not, however, disclose the effects of discontinued operations on its cash-flows in 2006, nor is there any indication of the effect on 2006 income. The adjustments to the 2005 figures are only apparent when comparing these figures with the original 2005 financial statements.

**The enforcement decision**

The enforcer concluded that not eliminating the effects of discontinued operations in the 2006 income and cash-flow statement was in breach of IFRS 5. In addition, the issuer failed to disclose the effects of the disposal on the cash-flow statement as required by IAS 7, paragraph 40.

**Rationale for the enforcement decision**

The enforcer requested relevant disclosure requirements relating to the cash-flow statement as required by IAS 7, paragraph 40. The issuer conceded that the 2006 figures had, mistakenly, not been adjusted for discontinued operations, and reported that the effect on revenues and costs would be approximately 30%. The business itself had reported breakeven results; therefore, no effect was expected on profit before discontinued operations.

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**Decision ref.EECS/0508-09: Definition of key management personnel**

**Period end:** 31 December 2006 / Annual Financial Statements

**Category of issue:** Related Party

**Standard involved:** IAS 24

**Date of the decision:** 2 October 2007

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

The issuer designated the 4 members of the parent company Executive Board as key management personnel in its financial statements. Hence, in accordance with IAS 24, these persons were considered related parties. The 4 members included the CEO and CFO of the parent company as well as the CEOs of the two main subsidiaries.

The issuer also identified a number of key corporate officers in its prospectus prepared in connection with an issue of shares in March 2006.

The issuer scoped its understanding of key corporate officers more broadly than the definition of key management personnel in IAS 24.

Key corporate officers include the 4 Executive Board members (including the CEOs of the two main subsidiaries) as well as the other members of the Executive Boards of the two main subsidiaries. These other members were not considered key management personnel and hence were not considered related parties.

The board of each main subsidiary is responsible for planning, directing and controlling one of the two main activities of the group.

**The enforcement decision**

The enforcer concluded that all Executive Board members of the two main subsidiaries meet the definition of key management personnel as set out in IAS 24 and hence should be considered related parties.

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

The enforcer questioned whether the non – CEO members of the Executive Board of the two main subsidiaries should also be considered as key management personnel and hence be treated as related parties, in accordance with IAS 24.

The issuer explained that the reason for identifying key corporate officers lay solely in the provisions of the prospectus directive which require an entity to demonstrate that management is capable of running the business. The issuer felt it could only satisfy the requirement by providing the required information for both the members of the Executive Board of the parent and all Executive Board members of the two main subsidiaries. The Issuer has clarified that this does not mean that the non – CEO Executive Board members of the main subsidiaries are also key management personnel and hence meet the definition of a related party; these other individuals do not participate in the board meetings of the parent company and hence, do not have the authority or responsibility for planning, directing and controlling the activities of the parent, either directly or indirectly. However, the Company has confirmed that they do have authority and responsibility for planning, directing and controlling the activities of the two main subsidiary companies.

The issuer also indicated that it had looked at how its peers define key management personnel and that they usually appear to restrict this to the members of the Executive Board of the parent company.

IAS 24 paragraph 9 states that a party is related to an entity if the party is a member of the key management personnel of the entity or its parent. Key management personnel is further defined as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, either directly or indirectly, including any director (ie executive or non-executive) of that entity.

In reaching its conclusion the regulator took account of the following:

- a. The issuer's confirmation that the non-CEO Executive Board members of the main subsidiaries have the authority and responsibility for planning, directing and controlling one of the two main activities of the group at subsidiary level. This is also supported by the description of their roles and responsibilities as included in the prospectus. Consequently they have authority and responsibility for planning, directing and controlling the activities of the entity;
- b. The fact that key corporate officers do not participate in the parent company's board meetings does not mean that they cannot be considered key management personnel. An entity may have more than one level of key management.
- c. That other companies appear to restrict key management personnel to members of the executive boards of parent entities does not preclude other individuals from satisfying the definition of key management personnel. Designation is determined by the particular facts and circumstances of the individual case.

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<b>Decision ref.EECS/0508-10: Internally generated intangible assets</b>
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**Financial year end:** 31 December 2006 / Annual Financial Statements

**Category of issue:** Intangible Assets, Research and Development

**Standard involved:** IAS 38

**Date of the decision:** 12 October 2007

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

As at 31 December 2006, 51% of the issuer's total assets were represented by mainly internally developed intangible assets comprising the capitalised expenses of the acquisition and production of electronic map data. The intangible assets generate 100% of the issuer's revenue.

The issuer had constructed a database of electronic maps. On a worldwide level the data is sufficiently detailed for routable purposes (i.e. calculation of distances for planning purposes). At national level, the information is more specific, allowing customers to use the information for satellite navigation purposes (i.e. to plot the optimum route from A to B). The issuer modifies electronic maps from its database to match customer specifications, so that the maps run on their own devices.

The costs incurred in bringing the information about a certain region to a higher standard of performance are capitalised. The costs related to maintaining the information about a certain region at that same standard of performance are expensed to the income statement.

The issuer's accounting policy states that intangible assets are valued at historical cost. The issuer considers the database to have an indefinite useful life which is reconsidered annually when it is tested for impairment. The reasons supporting the assessment of an indefinite useful life were not however disclosed in the financial statements as required by IAS 38 paragraph 122.a. Nor did the issuer disclose how it satisfied the criteria for recognising an intangible asset arising from development as set out in IAS 38 paragraph 57.

#### **The enforcement decision**

Based on the additional information provided by the issuer, the enforcer considered the requirements of IAS 38 paragraphs 88, 90 and 91 to be met in determining the useful life of the intangible asset as indefinite at the balance sheet date. The disclosure requirements of IAS 38 paragraph 122.a however were not satisfied.

IAS 38, paragraph 57, specifies the criteria that an entity must be able to satisfy in order to recognise an intangible asset arising from development. There is no specific requirement that this be disclosed. However, IAS 1 paragraph 108 requires that an entity disclose accounting policies relevant to an understanding of its financial statements. Given that the internally generated intangible assets comprised 51% of the issuer's total assets as at 31 December 2006 the enforcer concluded that this information should also have been disclosed.

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

IAS 38 paragraph 88 requires an entity to assess whether the useful life of an intangible asset is finite or indefinite. An intangible asset is regarded by an entity as having an indefinite life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. IAS 38 paragraph 90 sets out the factors which should be considered in determining the useful life of an intangible asset.

The issuer provided the following information with respect to the intangible asset:

- The value of the database is directly related to its content which is universal and can be used indefinitely (IAS 38 paragraph 90.a, b and c)
- The content of the database is independent from the technology used (IAS 38 paragraph 90.a and c)
- Changes in technology can be utilised to add additional features to the content of the database (IAS 38 paragraph 90.e)
- The issuer is engaged in a rapidly expanding market where increasing demand is expected for database which will be able to be used in more and more electronic devices (IAS 38 paragraph 90.b, c and d)
- The costs related to entering the market are relatively high (IAS 38 paragraph 90.e)
- Typical product life cycles and information about estimates of useful lives of similar assets are not available (IAS 38 paragraph 90.a and b)
- The level of maintenance expenditure required to obtain the expected future economic benefits from the database are considered cost efficient compared to the competition. The issuer is able and willing to maintain this level of expenditure (IAS 38 paragraph 90.f)
- Usage of the intangible asset is unrelated to any other assets of the issuer (IAS 38 paragraph 90.a and h)

IAS 38 paragraph 91 states that the useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life and the entity's ability and intention to reach such a level. The issuer considers that, given the present status of the market and technology, it can expect to generate revenue for an indefinite period, provided that there is adequate maintenance. The issuer explained that annual maintenance activities are performed to retain the same level of accuracy i.e.: the same standard of performance in respect of information about geographical regions.

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**Decision ref.EECS/0508-11: allocation of the costs of an acquisition**

**Period end:** 31 December 2006 / Annual Financial Statements

**Category of issue:** Business Combination, Intangible Assets, Goodwill

**Standard involved:** IFRS 3 - IAS 38

**Date of the decision:** 12 October 2007

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

Halfway through December 2006, the issuer acquired 100% of the shares of company X from company X's shareholders, mainly in exchange for newly issued (un-listed) shares and cash. The transaction is a significant transaction for the Issuer.

The issuer and company X design, realise and manage business solutions and IT infrastructures.

At 31 December 2006, the issuer consolidated the balance sheet of Company X in its annual financial statements. The results of Company X related to two weeks in December and were not consolidated as they were not considered significant.

Accounting for the business combination was not provisional at the year end. As intangible assets were not separately recognised, 79% of the cost of the business combination was represented by goodwill. The Issuer had identified the customer list as an intangible asset but was not able to value it.

Disclosures relating to the business combination including cash flow related disclosures were not included in the financial statements. Additionally, investing and financing transactions that did not require the use of cash or cash equivalents were included in the cash flow statement.

**The enforcement decision**

Based on additional information provided by the issuer, the enforcer concluded that the issuer should have identified and measured customer related intangible assets separately from goodwill. The issuer should also have provided relevant business combination disclosures as required by IFRS 3, paragraph 67 and IAS 7, paragraph 40, and investing and financing transactions that do not require the use of cash or cash equivalents should have been excluded from the cash-flow statement as required by IAS 7, paragraph 43.

**Rationale for the enforcement decision**

According to IFRS 3 paragraphs 36, 37 and 45, an acquirer should allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in IFRS 3, paragraph 37. The acquirer should recognise separately an intangible asset of the acquiree at the acquisition date if it meets the definition of an intangible asset in IAS 38 and its fair value can be measured reliably.

A non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset (IFRS 3 paragraph 46). In accordance with IAS 38, an asset meets the identifiability criterion of an intangible asset only if it (a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability, or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

IFRS 3 Illustrative Examples B includes a number of items acquired in a business combination that meet the definition of an intangible asset, including four types of customer-related intangible asset: customer lists; order or production backlog; customer contracts and the related customer relationships; and non-contractual customer relationships. Order or production backlog, and customer contracts and related customer relationships acquired in a business combination meet the contractual-legal criterion for identification as intangible assets. Customer relationships also meet the contractual-legal criterion for identification as intangible assets when an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the date of acquisition. As noted, an order or a production backlog arises from contracts such as purchase or sales orders, and is therefore also considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, those relationships also arise from contractual rights and therefore meet the contractual-legal criterion for identification as intangible assets.

The issuer argued that its intangible assets could not be measured reliably. The issuer had not however engaged an external valuer. The issuer claimed that both recurrent and non-recurrent projects could not be



measured reliably. This seemed to contradict both the way in which the issuer had valued company X on acquisition and how it had determined value in use when subsequently performing the impairment test at the year end.

According to IAS 38 and IFRS 3 paragraph BC 102(a), the fair value of intangible fixed assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill. When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, that uncertainty is reflected in the measurement of the asset's fair value, rather than demonstrate an inability to measure fair value reliably. If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably.

Information included in the issuer's Merger Shareholder Circular, its 2006 Annual Report and the minutes of its annual shareholders' meeting indicated that an increase in customer base was one of the underlying reasons for the acquisition.

Other companies in the software sector seem able to allocate the cost of business combinations between client contracts, software, trade names and customer relationships.

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#### Decision ref.EECS/0508-12: Scope of IAS 11

**Period end:** 31 December 2005 / Annual Financial Statements

**Category of issue:** Construction Contracts

**Standard involved:** IAS 11

**Date of the decision:** 10 May 2007

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

The issuer is a global supplier of night vision and laser products. The issuer's total revenue and gross margin in 2005 included amounts recognised in accordance with IAS 18 'Revenue' and accrued revenues from construction contracts accounted for in accordance with IAS 11 'Construction Contracts'. Contract revenue and contract costs associated with construction contracts are recognised by reference to the stage of completion of contract activity and each contract's stage of completion is determined by reference to recognised costs.

In its 2005 annual report the company described three major contracts which were recognised in the accounts in accordance with IAS 11. The contracts concerned delivery of a considerable number of night goggles, night sights and sniper night sights to three different countries.

#### **The enforcement decision**

The enforcer found that none of the three contracts referred to in the issuer's financial statements fell within the scope of IAS 11.

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

The enforcer questioned whether these three contracts were within the scope of IAS 11. According to IAS 11 paragraph 3 a construction contract is "a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use."

The company had prepared a checklist to be used when considering a contract is within the scope of IAS 11. The following criteria were required to be met:

- The contract is binding and individually negotiated
- The contract takes account of customer requirements
- The contract is for customer specific or custom designed items
- The contract is for a period of more than three months
- There are penalty clauses should the customer cancel the contract
- Items are produced to contract
- The items to be delivered under the contract are seen as one package

The products to be delivered under the terms of the three contracts are presented in brochures as standard models with some choice of technical specification.

The products are largely constructed by assembling components that are available on the commercial market. An image intensifying tube is an important part of each of the three products; the issuer however needs to make some adjustments to the construction of the night goggles in order for the specified light tube to fit. These adjustments are primarily electronic and generate start-up and/or development costs. The image intensifying tube represents a significant proportion of the total cost of the final product.

The contract for the production of night goggles also includes specifications relating to the helmet brackets and the supply of user manuals training and maintenance equipment. In the case of sniper sights, the main adjustment is to the design of the brackets needed to mount the sight onto the specific type of hand held weapon specified in the contract.

Two of the three contracts require the products to be delivered within a fixed time-frame. There is no such time-frame specified in the third contract. After customer acceptance of a number of pilot products, further deliveries are required at fixed points of between one to three months.

One of the contracts states that the customer can cancel the contract without penalty. Irrespective of how few units have been delivered under the contract, the customer only has to pay the unit price agreed in the contract multiplied by the number of units received. In such a case the seller would risk not recovering the initial development cost, nor realizing economies of scale. Under the other two contracts, if the customer cancels, the issuer will be compensated for losses incurred, but this will not include compensation for loss of prospective profits

A construction contract is defined in IAS 11 paragraph 3 as “a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. “Among the illustrative examples in IAS 11 paragraph 4 are a contract for the construction of a single asset like a ship and a contract for the construction of a number of interrelated and interdependent assets in a refinery.

The enforcer found that the assets to be produced under the contracts were not closely interrelated or independent in terms of their function, purpose or use. Night goggles are worn by individual soldiers and are not interrelated to or dependent on those worn by others. The same is true of night sights and sniper sights. Furthermore, the contracts were for the production of relatively large numbers of identical products of which standard components constitute a significant proportion of the total costs. Based on these considerations it was the enforcer’s opinion that none of the three contracts fell within the scope of IAS 11.

The enforcer also considered whether the construction of one unit, for example, one single set of night goggles, fell within the scope of IAS 11. However, given that a standard component comprises a substantial proportion of the total costs of the product, which was not customised to a significant extent, the enforcer did not support application of the standard in this respect.

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<b>Decision ref.EECS/0508-13: Barter transaction</b>
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**Financial year end:** 31 December 2005 / Annual Financial Statements/ Pre-clearance

**Category of issue:** Advertising Services, Barter Transaction

**Standard involved:** IAS 18 – SIC 31

**Date of the decision:** 13 July 2005

**Description of the issuer’s accounting treatment**

An issuer, whose core businesses do not include the provision of advertising services, supplies a football club with advertising space on its website. In exchange, the club promotes the issuer on its footballers’ shirts. No cash is exchanged between the issuer and the football club. The issuer estimates that the fair value of the exchanged advertising amounts to 50,000 m.u., based on earlier rates applied for other ad hoc advertising banners on its website.

The issuer asked whether it should recognise any revenue from this barter transaction.

**The enforcement decision**

The enforcer concluded that no revenue should be recognised in respect of this barter transaction.



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

IAS 18 paragraph 12 establishes that, when goods or services are exchanged or swapped for goods or services of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. Under the same standard, a seller who provides advertising services in the ordinary course of business recognises revenue from a barter transaction involving advertising when the services exchanged are dissimilar and the qualifying conditions in SIC 31 are met.

SIC 31, paragraph 5 concludes that the revenue from a barter transaction involving advertising cannot be measured reliably at the fair value of the services received. However, a seller who provides advertising services in the course of its ordinary activities can measure revenue at the fair value of the advertising services it provides by reference to its non-barter transactions that involve advertising similar to that of the barter transaction. SIC 31 further stipulates that the non-barter transactions must be frequent; they must represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction; they must involve cash and/or another form of consideration that has a reliably measurable fair value and cannot involve the same counterparty as in the barter transaction.

As the issuer does not provide advertising services in the ordinary course of business and does not meet the conditions of SIC 31 that support revenue recognition for barter transactions, no revenue should be recognised in respect of this transaction.

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#### **Decision ref.EECS/0508- 14: Half-yearly Financial Statements**

**Period end:** Half-yearly Financial Statements

**Category of issue:** Retirement Benefit

**Standard involved:** IAS 19

**Date of the decision:** 3 March 2008

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

The issuer prepared its first half yearly financial report in accordance with IAS 34 as required by the Transparency Directive. Included in assets was a retirement benefit asset which, in the comparative half-yearly and annual balance sheet, had been a liability representing approximately 6% and 5.7% of total assets respectively. The half yearly financial report did not include a note providing information on these amounts nor, more specifically, on the movement in the retirement benefit figure appearing as an asset in the condensed balance sheet.

From figures disclosed elsewhere in the financial report it appeared that approximately 30% of the movement in the retirement benefit balance had arisen as a result of a retirement benefit liability disposed of as part of the sale of a business during the period and the bulk of the balance of the movement arose as a result of an actuarial gain on the group's defined benefit pension schemes, which was included in the Group Condensed Statement of Recognised Income and Expenditure for the period. It was further noted that the corresponding actuarial gain for the prior half-yearly period and financial year respectively had been substantially lower.

#### **The enforcement decision**

While the enforcer had no reason to dispute the rationale underpinning the explanations (and associated calculations) provided as to the reasons for the movement, the enforcer was nevertheless of the view that, in accordance with IAS 34, paragraph 16, the issuer should have disclosed additional information in order to aid users' understanding of the half-yearly financial report.

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

In addition to disclosing the minimum information required by paragraph 16 of IAS 34 in the notes to its half yearly financial statements an issuer is also required to "...disclose any events or transactions that are material to an understanding of the current interim period" (IAS 34 paragraph.16).

Paragraph 15 of IAS 34 also states that ".....At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date is more useful." Sub paragraph (c) of paragraph 16 is also relevant in this context, where an issuer is required to disclose by way of note "...the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence."



By virtue of paragraph 3 of IAS, paragraph 15(c) of IAS 1 also applies to half yearly financial statements and states that a fair presentation also requires an entity “...to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.”

The enforcer felt that the relevant provisions of IAS 34 as outlined above indicate that when amounts in half-yearly financial reports have changed materially, an issuer should disclose information over and above the minimal requirements listed in IAS 34 paragraph 16 and in sufficient detail to explain the nature of the change and any estimates made in their determination.

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