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Table of contents

Decision ref.EECS/1207-01: Amortisation of intangible assets with finite useful lives included in goodwill

Financial year end: 31 December 2005 /Annual Financial Statements/ Pre-clearance
Category of issue: Goodwill, Intangible assets, Amortisation
Standard involved: IFRS 1 – IAS 36 – IAS 38
Date of the decision: 30 September 2004

Description of the issuer's accounting treatment
An issuer elected not to apply IFRS 3 retrospectively to past business combinations, for reasons which included the fact that there was no duly supported purchase price allocation available for a key business combination.

A separately identifiable intangible asset was included in the goodwill arising on that transaction because it could not be recognized on the date of the business combination under the GAAP previously applied. Under local GAAP, the criteria for separate recognition was very rigorous and was only the practice if there was certainty that the asset could be identified and measured as an intangible asset. The intangible asset in question related to rights to operate a mine for a specified period of time.

Subsequently, on transition from local GAAP to IFRS, the intangible asset was included in goodwill and not separately identified because it did not meet the qualifying criteria set out in appendix B2 (paragraphs f and g) of IFRS 1, even though it was known that the asset had a finite life and would be fully impaired or amortised over the period specified by the rights.

The issuer questioned which of the following two alternative accounting treatments was most appropriate in respect of the impairment calculation of goodwill:

1. Should goodwill impairment be calculated taking into account the useful life of the intangible asset that is subsumed within it? This approach would suggest systematic allocation to the income statement, through impairment, of that part of the goodwill attributed to the intangible asset throughout its useful life similar to the process of systematic amortization as set in IAS 38 paragraph 97.
2. Should the goodwill impairment provision be calculated in accordance with IAS 36 paragraph 90 ? This alternative could lead to an expense pattern, through an impairment provision, for that part of the goodwill attributed to the intangible asset. This approach might mean, in practice, that most of the expense allocation is not made until the end of the useful life of that asset.

The enforcement decision
The enforcer found that the impairment of goodwill should be accounted for in accordance with IAS 36 paragraph 90, i.e. there should be no systematic amortisation of any identifiable element within goodwill but rather an annual impairment test as required by the standard.

Rationale for the enforcement decision
In accordance with IFRS 1 Appendix B1, an issuer who, during the transition process to IFRS, decides to retroactively apply IFRS 3 to a certain business combination must apply that decision consistently to all business combinations occurring between the date on which it decides to adopt IFRS 3 and the date of transition.

a. The decision to apply IFRS 3 cannot be made selectively. The entity must consider all similar transactions carried out in that period; and
b. When allocating values to the various assets (including intangibles) and liabilities of the entity acquired in a business combination to which IFRS 3 is applied, an entity must necessarily have a specific documented base to support its purchase price allocation to justify the decisions and valuations (IFRS 3, Appendix B16g).

If there is no such basis, alternative or intuitive methods of price allocation cannot be used unless they are based on the strict application of the standards referred to above. The requirements of IFRS 1 apply in respect of an entity's first IFRS financial statements and cannot be extended or applied to other similar situations.

As no purchase price allocation was available, i.e., the issuer was unable to obtain a reliable value for the rights, it was not possible to separate the intangible asset within goodwill as established in the regime envisaged by IFRS 1 Appendix B2 f) and g). As this was a pre-clearance decision, the enforcer did not challenge this fact, although whether or not it was possible to obtain a reliable valuation of the rights would be a matter for separate consideration. Because the issuer was unable to satisfy the recognition and revaluation criteria of IAS 38, he was also not able to elect to use the fair value of the mining rights as its deemed cost as permitted by IFRS 1 paragraphs 16-18. Consequently, the goodwill presented in the first financial statements under IFRS, insofar as it did not require a write-down under IFRS 1, Appendix B2g (iii) due to loss of value at the date of transition to IFRS, will be the same as its net carrying amount at the date of transition. The intangible asset with a finite useful life, subsumed within goodwill, cannot be separately identified, amortised and presented as another item.

Given the circumstances, the enforcer found that goodwill which included a subsumed intangible asset with a finite life should be subject to annual impairment testing in accordance with IAS 36 and that no part of the goodwill balance should be systematically amortised through the income statement.

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Decision ref.EECS/1207-02: Excise tax on fuel

Financial year end: 31 December 2005 / Annual Financial Statements/ Pre-clearance
Category of issue: Costs of sales, Revenues
Standard involved: IAS 1 – IAS 2 – IAS 18
Date of the decision: 2 December 2004

Description of the issuer's accounting treatment
An issuer operating in the oil sector understands that, in accordance with IAS 18, paragraph 8, excise tax imposed by national law on the consumption of fuels as they leave bonded warehouses cannot be classified as "amounts collected on behalf of third parties". Rather they qualify as an expense when the distributor withdraws the product from the bonded warehouse and as revenue when the distributor recovers its incurred cost through sale to the end customer. The relevant amounts therefore should not be excluded from revenue. Among other features that distinguish this duty from, for example, value added tax or electricity tax, is the fact that the tax cannot be recovered in the event of default by the end customer.

In this case, the excise tax on fuel represents 13.7% of the total revenue and 15.5% of the total expenses of the company. The issuer questioned whether such costs truly qualify as purchase costs and whether these amounts should be disclosed in notes to the income statement.

The enforcement decision
According to IAS 2 paragraph 11, the excise tax is part of the costs of purchase and should not be classified as accounts receivable from tax authorities.

Rationale for the enforcement decision
This is a special tax that is imposed on purchases and which is accrued and settled at the time of purchase or when the distributor withdraws the product from the bonded warehouse. The buyer has no right to recover the tax from the authorities or offset it against other taxes and bears the entire risk of its recovery. Therefore, the tax should be treated as part of the costs of inventories, in accordance with IAS 2 paragraph 11.

The tax is an expense forming part of the inventory cost and should not be classified as an amount receivable from the tax authorities or from a hypothetical end customer since it does not represent a monetary asset.

The special tax borne on purchases is passed on to customers to recover the cost borne by the issuer, as is also the case with all other inventory-related costs. Consequently, the sales price paid by the customer includes a portion relating to this tax, which then qualifies as revenue in accordance with IAS 18 paragraph 8. It should not be recorded as an amount payable to the tax authorities as, amongst other reasons, the entity is not a collecting agent of that special tax on behalf of the tax authorities. The issuer, itself, is liable for the tax.

In light of the amounts involved, and consistent with the principle of transparency and IAS 1, paragraph

103(c), the enforcer considered it appropriate in this case to identify and disclose, in the notes to the financial statements, the relevant amounts relating to the excise tax and included in the purchases and sales figures.

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Decision ref.EECS/1207-03: Recognition of negative goodwill

Financial year end: 31 March 2005 / Interim Financial Statements
Category of issue: Negative goodwill
Standard involved: IFRS 3
Date of the decision: 5 January 2006

Description of the issuer's accounting treatment
In its financial statements for 2004, which were presented in accordance with national law, the issuer disclosed an acquisition in December 2004 which resulted in the recognition of negative goodwill. The amount was recognized as a short-term liability in the consolidated financial statements as at 31 December 2004 in accordance with local regulation.

In accordance with national law, the issuer prepared its quarterly consolidated financial statements for the first quarter of 2005 in accordance with IFRS recognition and measurement principles and national rules for presentation and disclosure.

In respect of expectations for 2005 the issuer reported that equity would increase due to the recognition in the income statement of the negative consolidated goodwill.

The enforcement decision
The enforcer decided that, in accordance with IFRS 3, paragraph 56, the negative goodwill which resulted from the 2004 acquisition should have been recognized in the comparative figures for 2004 and not in 2005.

Rationale for the enforcement decision
Under IFRS 1, when a company uses IFRS for the first time, it should use the standards that apply on the balance sheet date in the financial year in which IFRS financial statements are first presented. The same versions of standards are to be applied to the comparative information presented (IFRS 1, paragraph 8).

IFRS 1, paragraph 36, requires companies to provide at least one year of comparative information in accordance with IFRS in their first financial statements prepared under IFRS.

IFRS 1 relaxes the requirement to apply IFRS recognition and measurement principles retroactively in some areas, including the provisions contained in IFRS 3 relating to business combinations. The issuer can opt to treat business combinations either retroactively or in accordance with the exemption clause in IFRS 1, paragraph 15 and as set out in detail in Appendix B.

Appendix B can only be applied to business combinations recognised before the company's date of transition to IFRS.

IFRS 3, paragraph 56, states that:
"If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized in accordance with paragraph 36 exceeds the cost of the business combination, the acquirer shall:

a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination, and
b) recognise immediately in profit or loss any excess remaining after that reassessment."

When the issuer prepared its interim report as at 31 March 2005, it applied IFRS recognition and measurement principles. Therefore, the issuer should present the information in its quarterly consolidated financial statements in accordance with IFRS from the date of the issuer's transition to IFRS. As the interim report is for 2005 and comparative figures are provided for the equivalent period in 2004, the date of transition is 1 January 2004 and the figures as at 1 January 2004 and onwards should therefore also have been calculated in accordance with IFRS.

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Decision ref.EECS/1207-04: Deferred tax asset

Financial year end: 30 June 2005 / Interim Financial Statements
Category of issue: Deferred Tax
Standard involved: IAS 12
Date of the decision: 24 October 2005

Description of the issuer's accounting treatment

In accordance with national regulation, the issuer applied IFRS recognition and measurement principles in its interim consolidated financial statements for the first six months of 2005 and local GAAP for presentation and disclosure.

The issuer develops and sells technological solutions including software etc.

Since 2000 the issuer has incurred substantial annual losses except for 2003 and 2004, when it made a minimal profit before tax. In those two years, most of the profit consisted of income recognized on revaluation of the deferred tax asset.

The issuer had announced early in 2005 that it anticipated substantial growth and profit. Later in the year however, the issuer announced that the expected profit would not be achieved and that, instead, a substantial loss would be incurred. The issuer had a history of reporting considerable negative variances from its budgeted results.

The issuer's recognized deferred tax assets have been increasing year on year. In 2004, they represented approximately 20% of turnover and 26% of equity at the year end; at 30 June 2005 they were approximately 34% of equity. Furthermore, pre-tax profit for 2004 represented approximately 9% of the recognized deferred tax asset. The issuer's deferred tax assets consist primarily of unused tax losses that can be carried forward but against which there are virtually no taxable temporary differences to offset.

The enforcement decision
The enforcer found that the recognition of deferred tax assets on losses carried forward was not in accordance with IAS 12 paragraph 34. The issuer was not able to provide convincing evidence to persuade the enforcer that the issuer would be able to generate sufficient taxable profits against which the unused tax losses could be offset.

Rationale for enforcement decision
The issuer does not have sufficient taxable temporary differences against which the unused tax losses can be offset. Historically, the issuer's activities have generated either significant losses or very minimal profits; they have never produced large pre-tax profits. Therefore, in accordance with IAS 12, paragraph 35, the enforcer required convincing evidence from the issuer that it would be able to generate future taxable profits equivalent to the value of the deferred tax asset recognized in the interim consolidated financial statements

The enforcer assessed the documentation provided by the issuer's management. The view of the enforcer was that the documentation did not provide convincing evidence in accordance with the provisions of IAS 12 to substantiate the probability that the issuer will be able to generate enough future taxable profits to be able to use the deferred tax assets recognized in the interim consolidated financial statements for the first six months of 2005.

The enforcer's decision was based mainly on the following:

1. history of the issuer's pre-tax profits;
2. previously published budget expectations and realized results in the past;
3. the issuer's expectations for the next few years; and
4. announcements of new contracts.

The enforcer attached particular importance to the fact that, historically, substantial negative variances arose between the issuer's budgeted and realised results. Also, in 2005, the issuer had announced that it would not achieve the expected profit, but rather would record a substantial loss. The enforcer was also influenced by the fact that the losses were not of a type that could clearly be attributed to external events that might not be expected to recur.

* * *

Decision ref.EECS/1207-05: Valuation of offshore rigs at the transition date

Financial year end: 31 January 2005 /Annual Financial Statements
Category of issue: First time application
Standard involved: IFRS 1
Date of the decision: 9 December 2005

Description of the issuer's accounting treatment
In its IFRS opening balance as of January 1st, 2004, an issuer in the offshore drilling business elected to measure its rigs at fair value and use that fair value as deemed cost in accordance with IFRS 1 (paragraph 16). The fair value was an estimate based on valuations provided by two independent brokers.

There was a question whether brokers' estimates were a reliable form of evidence on which to base the fair value calculation of tangible assets to be then adopted as deemed cost.

The fair value was calculated on the basis of two brokers' estimates, both of which provided a range of values within which the valuation might be considered acceptable. The issuer calculated fair value at the average of the highest amounts in the two ranges provided.

One of the broker valuations was not supported by any description of the method adopted or the assumptions underlying the calculation.

Although not giving a clear description of the method or assumptions applied, the other broker's estimate did provide additional information about the valuation. The broker had considered three methods: the "Market Approach", the "Income Approach" or "Cost Approach". Traditionally, however, valuation methodologies were difficult to apply, mainly due to extreme volatility in the offshore market and thin trading in the second hand market. Valuations therefore were principally based on discussions with various market players. In the broker's estimate, the rig market at the end of 2003 was described as a "bear market" as there was a substantial gap between sellers' and buyers' perceptions of the fair market value.

The enforcement decision
The enforcer concluded that the issuer was not in breach of IFRS 1 paragraph 16 and could determine fair value on the basis of broker estimates.

Rationale for the enforcement decision
The enforcer focused on whether the broker estimates could be used to calculate fair value in accordance with IFRS 1 paragraph 16.

In the enforcer's opinion, it is generally advantageous to use independent estimates when determining fair value, but the issuer should ensure that the valuation is prepared in accordance with the requirements of the relevant IFRS standard. An independent valuation should generally, as a minimum, include enough information for the issuer to assess whether or not this is the case.

The broker estimates in this case included so little information about the valuation methods and underlying assumptions that they could not, of themselves, be relied upon for determining fair value in accordance with for example IAS 16 'Property, Plant and Equipment' or IAS 36, 'Impairment of Assets'.

IFRS 1 paragraph 16, however, does not set out detailed requirements under which fair value should be determined. Issuers who adopt fair value as deemed cost have only to provide the limited disclosures required by paragraph 44 of the standard. Methods and assumptions for determining the fair value, for example, do not have to be disclosed.

Paragraph 16 of IFRS 1 provides a cost-effective alternative to full retrospective application of IAS 16. Use of fair value as deemed cost is an alternative approach for issuers who do not perform a full retrospective application of the requirements of IAS 16 to their property, plant and equipment. This indicates that the requirements inherent in the process of determining fair value as required by other IFRS standards, for example, IAS 16 and IAS 36, cannot, by analogy, be used when determining the fair value of property, plant and equipment in accordance with IFRS 1 paragraph 16 where it will be used as deemed cost at the date of transition to IFRS.

This understanding is also supported by IFRS 1 paragraph 17 which states that a previous GAAP revaluation of an item can be used as deemed cost at the date of the revaluation if the revaluation was broadly comparable to fair value or cost or depreciated cost at the date of revaluation. The Basis for Conclusions adds further that: "*It may not always be clear whether a previous revaluation was intended as a measure of fair value or differs materially from fair value. The flexibility in this area permits a cost-effective solution for the unique problem of transition to IFRS*" (BC 47).

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Decision ref.EECS/1207-06: Use of the Fair Value option

Financial year end: 30 September 2005 / Annual Financial Statements
Category of issue: Fair value, loans
Standard involved: IAS 39
Date of the decision: 30 October 2006

Description of the issuer's accounting treatment
The issuer applied the fair value option rules to debt related to the issuer's investment property. The investment property was measured at fair value in accordance with the provisions of IAS 40.

The issuer's argument for applying the fair value option was rooted in the fact that the recognition of gains and losses on its investment properties and the related debt would otherwise be inconsistent. The issuer argued that there is a specific financial correlation between the factors that form the basis for determining the fair value of both the issuer's investment properties and the related debt.

The issuer measures the investment properties using a discounted cash flow model.

The case raises the question of whether an issuer may apply the fair value option rules laid down in IAS 39, paragraph 9b (i) to measurement inconsistencies between investment properties and related debt.

The enforcement decision
The enforcer accepted that the issuer can apply the fair value option in IAS 39 paragraph 9b (i) as such application would eliminate or significantly reduce a measurement or recognition inconsistency ('an accounting mismatch') between the debt liabilities and the investment properties to which they are related and which are measured at fair value.

Rationale for the enforcement decision
The fair value option was initiated to address recognition and measurement inconsistencies in the financial statements of financial service entities and their presentation of financial assets and financial liabilities.

The fair value option in IAS 39, paragraph 9b (i), is not restricted to financial service entities. Any issuer with a measurement or recognition inconsistency between a financial instrument and another asset or liability can use the option subject to satisfying the qualifying criteria.

The provision only requires there to be a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. The option is not restricted to financial assets and liabilities. This view is also supported by example AG 4E (b) of IAS 39 regarding a company's liabilities under insurance contracts, providing that the principle of IAS 39 9 b(i) is met.

The option can however only be applied under this provision where it results in more relevant information by eliminating or significantly reducing an accounting mismatch. In IAS 39, BC 75B, the IASB records its conclusion that accounting mismatches may occur in a wide variety of circumstances and that financial reporting is best served by providing entities with the opportunity of eliminating such mismatches where that results in more relevant information. The IASB also concluded that entities may validly apply the fair value option instead of hedge accounting for hedges of fair value exposures. Hence, the IASB decided not to develop detailed prescriptive guidance about when the fair value option could be applied, as it has done, for example, with requirements for efficiency testing on application of the hedging provisions in IAS 39. The IASB decided that the companies were instead to provide relevant disclosures required by IAS 32.

The issuer supported his application of the fair value option with the argument that there is a specific financial correlation between the factors that form the basis of the measurement of the fair value of the investment properties and the related debt. Particular importance was placed on the role played by interest rates, although it was acknowledged that the value of investment properties will also depend, to some extent, on rent, location and maintenance and other factors. For some investment properties, however, the value of the properties will, to a great extent, be dependent on the movement in interest rates. The issuer believes that applying the option to value the debt at fair value resulted in more relevant information because the recognition inconsistency would be significantly reduced.

On the basis of the information provided, the enforcer found that there was a clear correlation between the measurement of the investment properties and the related debt such that the principle of IAS 39 (b) (i) was met.

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Decision ref.EECS/1207-07: Segment reporting

Financial year end: 31 December 2006 / Annual Financial Statements
Category of issue: Segment reporting
Standard involved: IAS 14
Date of the decision: 26 July 2007

Description of the issuer's accounting treatment
The issuer has several divisions operating in separate markets. In its 2006 financial statements, the issuer identified its divisions as business segments under IAS 14. One of the issuer's divisions (hereafter referred to as "Division I") comprises two business units (hereafter referred to as "BU1" and "BU2"), BU1 operating in the manufacturing sector and BU2 operating in the services sector.

The activities of the divisions are discussed separately in the issuer's 2006 Report of the Management Board (MD&A/OFR). The section covering Division I includes subsections discussing BU1 and BU2, identifying dissimilarities in risks, management, activities, expertise, markets and customers. The investor relations area of the issuer's website also discusses all divisions, including Division I, while dealing with BU1 and BU2 separately.

In 2005 and 2006, BU1 and BU2 each generated net sales of 10–20% of total consolidated net sales.

The issuer put forward various arguments for not identifying BU1 and BU2 as separate reportable business segments which included the following:

- consistency in disclosure since 2000;
- similar long-term financial performance for BU 1 and BU 2;
- the management and management reporting structure of the Division below that of business unit level;

- the interdependency of BU1's and BU2's activities (some of BU2's services are dependent on BU1 having had some involvement in the manufacture of the product in question);
- some similarities between certain of BU1's and BU2's activities in terms of their customer base (according to the customer lists included in the issuer's Report of the Management Board a few companies are customers of both BU1 and BU2);
- consistency with segmental reporting adopted by foreign companies operating in similar markets;
- confidentiality considerations arising from the political sensitivity of the activities of BU1.

The enforcement decision
The enforcer found that the issuer's presentation did not comply with IAS 14.

Rationale for the enforcement decision
The enforcer concluded that BU1 and BU2 were business segments for 2006 financial reporting purposes under IAS 14 paragraph 31. The decision was based on the information provided in the Report of the Management Board regarding risks, activities, expertise, markets and customers and the management structure as demonstrated by the issuer's organisation chart and which showed that BU1 and BU2 each have their own director reporting to the issuer's Management Board.

The Report of the Management Board regarding risks, activities, expertise, markets and customers and the management structure as demonstrated by the issuer's organisation chart shows that BU1 and BU2 each have their own director reporting to the issuer's Management Board. Based on this information, the enforcer concluded that BU1 and BU2 were business segments for 2006 financial reporting purposes under IAS 14 paragraph 31.

The enforcer also considered whether BU1 and BU2 were reportable segments under IAS 14 paragraphs 34 and 35.

Paragraph 34 sets out the circumstances under which internally reported segments that are substantially similar may be combined as a single business segment. Such segments must exhibit similar long-term financial performance and be shown to be similar in all of the factors referred to in the definition of a business segment in paragraph 9 of the standard. A business or geographical segment is a reportable segment if a majority of its revenue is earned from sales to external customers and it meets one of the additional thresholds in terms of revenue, segment result or assets as specified in paragraph 35.

Based on the return on sales graph provided by the issuer, the enforcer concluded that BU1 and BU2 were not substantially similar as they did not exhibit similar long-term financial performance within the meaning of IAS 14 paragraph 34(a). In 2001 and 2002, BU1's return on sales exceeded BU2's, while from 2004, BU2 outperformed BU1 in terms of return on sales. In 2006, BU1's return was negative while BU2's return was positive, approximately 15% higher than BU1's return. Nor, based on its assessment of the products and services provided by BU1 and BU2, and considering the factors in IAS 14 paragraph 9, did the enforcer conclude that BU1 and BU2 were similar within the meaning of IAS 14 paragraph 34(b), given dissimilarities in terms of the nature of the products and services (BU1: manufacturing; BU2: services), the nature of the production processes (BU1: technical transformation; BU2: non-transformation) and the type of customer for the products and services (BU1: manufacturers; BU2: operators). The issuer did not explicitly address all of the relevant factors referred to in IAS 14 paragraph 9.

As both BU1 and BU2 each generated net sales of 10–20% of total consolidated net sales in 2005 and 2006, the two segments were identified as reportable segments under IAS 14 paragraph 35 for financial reporting purposes

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Decision ref.EECS/1207-08: Method of amortising intangible assets

Period end: 31 December 2005 /Annual Financial Statements
Category of issue: Intangible assets
Standard involved: IAS 38
Date of the decision: 31 October 2005

Description of the issuer's accounting treatment
A telecommunications provider questioned the method under which it should amortise licences acquired to provide telephony services.

The licences in question were won through public tender and allow the issuer to operate services in a specific area for a specified period of time. The price paid for the licence is not a variable dependant on the number of potential customers, but was the best offer presented that fulfilled the technical specifications of the tender. The telephony licences relate to a geographical area where the company has no previous experience and where its forecasts will be subject to a degree of uncertainty.

IAS 38 states that the amortisation method in respect of an intangible asset with a finite useful life must reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method must be used (IAS 38, paragraph 97). The standard also states that, in the case of such intangibles, there is rarely, if ever, persuasive evidence to support an amortisation method that results in a lower amount of accumulated amortisation than under the straight-line method (IAS 38, paragraph 98).

The issuer contends that, in the case of telephony licences, the benefits inherent in the asset are the capacity to generate revenues by providing the services to which the licences grant entitlement. As the price paid for a licence reflects the value of the right to provide the service, the service provision itself should determine the amortisation method. The economic benefits of the assets either materialise or are consumed as the service is provided.

Therefore, according to the issuer, it would appear reasonable to amortise the licences on the basis of the revenues obtained as a proportion of the total estimated revenues over the licence period, since this would reflect the consumption of the asset's future economic benefits.

This approach would be reliant on estimates which would need to be updated and revised each year in line with actual data, changes in the environment and other factors that lead to variations from the initial estimates.

Because of the nature of the telephone business, this method could lead to a form of rising-balance amortisation as the revenues generated by such services also increase progressively.

The issuer considers that this method of amortising licences is valid under IAS 38 on the basis that it constitutes one of those very rare cases recognised by the standard where an amortisation method that results in a lower amount of accumulated amortisation than under the straight-line method may be applied.

The enforcement decision
The enforcer found that the method of amortisation proposed was not acceptable in the circumstances and that the straight-line method should be applied.

Rationale for the enforcement decision
IAS 38, paragraph 97, establishes that the amortisation method used for an intangible asset with a finite useful life must reflect the pattern in which the future economic benefits embodied in the asset are expected to be consumed. If that pattern cannot be determined reliably, the entity must use the straight-line method.

In the enforcer's view, it was not acceptable for the company to adopt a method of amortisation based on the attainment of revenue as the sales price component was unrelated to the pattern of consumption or use of the asset.

IAS 38, paragraph 98, accepts that a variety of amortisation methods can be used. It expressly mentions the straight-line method, the diminishing balance method and the unit of production method, adding, however, that there is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method.

As envisaged by paragraph 98, there may be certain specific cases in which a system of non-linear amortisation such as the pattern based on the amount of demand or units of production would be applicable. In this present case, the conditions required in order to support a method of amortisation other than straight-line would include the following:

a) The demand or volume of units to be produced must be the truest and most representative pattern of the asset's economic utility and;
b) It must be possible in advance to determine reliably the expected volume or amount of demand to be met, or units of production to be served, by the intangible asset.

If these two conditions are met, then an amortisation method based on units of demand or production, from the time the intangible asset is operational, would be more appropriate than straight-line amortisation. This would be the case even if that method resulted in to rising-balance amortisation that, in some periods, could result in a lower amount of accumulated amortisation than under the straight-line method.

In order to adopt a method other than straight-line amortisation in respect of an intangible asset with a finite useful life, it is necessary to prove that the pattern in which the entity expects the future economic benefits embodied in the licence to be consumed is that based on production or demand and not the length of the licence. This could be the case, for example, for a licence that explicitly refers to the number of items produced (i.e. number of telephony lines).

The issuer was not able to meet the high standard of proof required by paragraph 98 of the standard when considering an amortisation method other than straight-line for intangible assets with finite useful lives which results in a lower amount of accumulated amortisation. With no previous experience in this area, the issuer could not demonstrate that demand was the most representative pattern of consumption. Nor was the enforcer persuaded that the issuer could determine reliably the expected demand or volume as the non-linear methodology would require. Consequently, as neither of the conditions set out above were met, straight-line was deemed to be the appropriate method of amortisation.

* * *

Decision ref.EECS/1207-09: Change in accounting for employee benefits

Period end: 31 December 2006 /Annual Financial Statements
Category of issue: Employee benefits
Standard involved: IAS 19
Date of the decision: 3 July 2007

Description of the issuer's accounting treatment
The issuer's pension plan was accounted for as a Defined Benefit (DB) Plan in 2005. In 2006 the issuer changed its accounting to a Defined Contribution (DC) Plan and restated the comparative 2005 financial information. The effect of the restatement for 2005 was significant.

In the 2006 Financial Statements, the issuer explained that, during the year, the arrangements underlying the retirement benefit plan, which were based on average pay, had been subject to detailed review. Since the pension liabilities are fully insured and indexation of future liabilities is limited up to and including the funds available in escrow, where the escrow is not at disposal of the issuer, the plan qualifies as a defined contribution plan under IAS 19 rather than a defined benefit plan. Furthermore, it was noted that the escrow is built up by the insurance company from the surplus yield on investments.

The pension plan is an average pay plan in respect of which the entity pays insurance premiums to a third party insurance company to fund the plan.

The enforcement decision
The enforcer concluded that the issuer's pension arrangement did not meet the criteria as outlined in IAS 19 paragraphs 25 and 39 for DC accounting on the grounds that the risks, although potentially limited, remained with the issuer.

Rationale for the enforcement decision

Information provided by the issuer was analysed as follows:

- The collective labor agreement which sets out the agreement between the issuer and its employees states that the issuer has to provide for an average pay pension plan with limited indexation, the indexation being limited to the escrow available in the pension fund.
- Every year 1.75% of the pension is built up (the plan benefit formula), meaning that for every year of service employees build up 1.75% of their entitlement so that after 40 years of service they receive 70% of the average pay they received during their service. Together with the tax benefits for retired employees, this leaves employees with approximately the same net income as, on average, they enjoyed during their working lives.
- Employees pay a premium of 7.04% of their salary, the employer paying the balance of the premium.

Based on the above information, the enforcer concluded that the pension plan qualifies as a DB Plan under paragraphs 24-27 of IAS 19.

As the pension plan is insured with a third party insurance company, an analysis was made as to whether the plan should be treated as a DC plan or a DB plan in accordance with IAS 19, paragraph 39.

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

- The insurance contract is between the issuer and the insurance company, not between the employee and the insurer;
- The insurance contract is renewed every year. The insurance company determines the insurance premium payable by the issuer annually. As noted above, the premium for the employee is fixed and the balance of the required premium rests with the issuer, exposing him to changes in premiums depending on the return on the investments by the insurer and changes in actuarial assumptions (i.e. changes in mortality tables);
- The insurance contract states that when an employee leaves the issuer and transfers his pension to another fund, the issuer is liable for or is refunded the difference between the benefits the employee is entitled to base on the pension formula and the entitlement based on the insurance premiums paid. In these cases then, the issuer is exposed to actuarial risks, i.e. a shortfall or over funding as a consequence of differences between returns compared to assumptions or other actuarial differences ;
- During the annual shareholders' meeting, when a question was asked about the change in accounting for the employee benefit plan; management indicated that limited risks associated with the pension agreements remained with the issuer.
- The issuer's actuary highlighted the following risks associated with the pension plan:
    - Investment risk: the insurance company insures against this risk for the issuer. The enforcer is of the view that as the insurance premium is determined every year, part of this risk can be transferred by the insurance company to the issuer to cover shortfalls. Therefore, the risk is not wholly transferred to the insurance company.
    - Individual transfer of funds: On transfer of funds, any surplus is refunded to the issuer while unfunded amounts have to be paid; a risk that can preclude DC accounting. The issuer noted that this risk is not material as very few employees have left the issuer lately; the issuer also indicated that in making the IAS 19 calculations the actuary values this risk at nil. The enforcer does not believe the issuer's view of materiality to be relevant in making the distinction between a DC and DB plan in accordance with IAS 19. This risk, currently perceived to be low, will be taken into account in the valuation of pension obligations and can change from year to year.
    - The agreement between the issuer and the employees in the collective labor agreement does not include any indication that, in the case of a shortfall in the funded status of the plan, the entitlement of the employees may be reduced. Consequently, the enforcer concluded that the issuer had a legal or constructive obligation to pay further amounts if the insurer did not pay all future employee benefits relating to employee service in the current and prior periods.

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Decision ref.EECS/1207-10: Identification of the acquirer in a business combination

Financial year end: 31 December 2005 / Annual Financial Statements / Pre-clearance
Category of issue: Acquisition accounting, Business combination, Reverse acquisition
Standard involved: IFRS 3
Date of the decision: 25 January 2006

Description of the issuer's accounting treatment

The issuer A is a publicly listed company that divested one of its largest segments to a group of shareholders (Owners 1-2) and dissolved the centralised ownership structure of the company. The overall arrangement was carried out in accordance with a pre-determined plan involving the establishment of a separate entity, entity B, by another group of shareholders (Owners 3-6) to facilitate certain stages of the arrangement.

The arrangement included four steps that were, for the most part, contingent upon each other. The sequence of events was as follows:

1. The issuer sold Business X to Owners 1-2. The sales price was satisfied by a debt note.
2. Simultaneously, entity B signed an agreement to purchase all of the issuer's shares owned by Owners 1-2 (48 % of the voting rights). The purchase was also satisfied by a debt note. The two notes were settled in the subsequent merger of entities A and B.
3. A few days later, entity B made an exchange tender offer to Owners 3-6 and the other shareholders for their shares in the issuer mainly for shares in entity B but also including a non-material cash element. After the offer, entity B had controlling ownership (53% of the voting rights) of issuer A's former operations, excluding Business X. With the closing of the public tender offer, entity B's shares were listed on the stock exchange.
4. Simultaneously with the offer, the issuer and entity B signed and entered into a merger agreement following which Owners 3-6 had 26 % of the voting rights of the combined entity.

After completion of the arrangement the new publicly listed entity B had the same business operations as the former issuer A excluding Business X. The new ownership structure was less centralized, as Owners 1-2 no longer had an interest in the entity.

After the transaction was completed, the founders of entity B, whose control over the issuer was only intended to be temporary have less than one third of the voting rights of the merged company. The members of issuer A's Board (except for members representing Owners 1-2) were elected to the Board of the merged entity.

The enforcement decision
The enforcer found that the issuer A was the acquirer.

Rationale for the enforcement decision
The transactions presented above were part of single arrangement, the purpose of which was to divest the issuer A of a significant part of its business, thereby dissolving the centralised ownership structure of the issuer. The transactions were negotiated at the same time and took place either concurrently or in a continuous sequence. The transactions were, for the most part, conditional upon the occurrence of each other and the financing of the transactions was linked. Therefore, the terms, conditions and commercial effects of individual steps in the arrangement cannot be understood without reference to the whole.

The nature of entity B also indicates that the transactions the entity carried out were part of a wider arrangement. Entity B was formed to participate in the ownership structuring of the issuer by facilitating the acquisition of the issuer's shares; it had no operating activity and its existence as a separate entity was always intended to be temporary.

<u>Applying IFRS 3 Business Combinations</u>
IFRS 3 paragraph 4 defines a business combination as the bringing together of separate entities or businesses into one reporting entity. As the issuer and entity B are brought together into one reporting entity, IFRS 3 applies to the arrangement in this case.

IFRS 3 paragraph 17 requires that an acquirer be identified for all business combinations, being the combining entity that obtains control of the other combining entities or businesses.

<u>Identifying the acquirer in a business combination effected through an exchange of equity interests (paragraph 21)</u>
When a business combination is effected through an exchange of equity interests, as in the arrangement under consideration, the entity that issues the equity interests is normally the acquirer (entity B). However, all pertinent facts and circumstances are required to be considered to determine which of the combining entities has the power to govern the financial and operating policies of the other entities so as to obtain benefits from their activities. Commonly the acquirer is the larger entity (the issuer); however, the facts and circumstances surrounding a combination sometimes indicate that the smaller entity acquires the larger entity.

In some business combinations, commonly referred to as reverse acquisitions, the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree. In such cases, the legal subsidiary has the power to govern the financial and operating policies of the combined entity so as to obtain benefits from its activities and therefore should be identified as the acquirer. Paragraphs BC 57-61 of IFRS 3 supplement paragraph 21 and give more guidance on how the acquirer may be identified.

In the case under discussion the controlling party can only be determined after completion of the various stages of the arrangement, as reference must be had to the arrangement as a whole. On completion, the issuer has the power to control the activities of the combined entity. The founders of entity B, whose control over the issuer was only intended to be temporary now have less than one third of the voting rights of the merged company. The issuer's control is demonstrated by the fact that members of entity A's Board (except for members representing Owners 1-2) were elected to the Board of the merged entity.

<u>Identifying an acquirer when a new entity is formed to effect a business combination (paragraphs 22)</u>
Additional guidance is given for situations where a new entity is formed to issue equity instruments to effect a business combination. In these situations, one of the combining entities that existed before the combination should be identified as the acquirer on the basis of the evidence available (the issuer A). Paragraphs BC 62-66 provide further guidance on this matter.

Entity B can be regarded as a vehicle that was formed to facilitate the arrangement of the issuer. This interpretation is supported by the fact that entity B was formed only after the arrangement was proposed at an extraordinary meeting of issuer A's shareholders. The fact that entity B had no operating activities, or personnel and its existence as a separate entity was intended to be temporary also support this view.

In the tender offer, entity B acquired control of issuer A through a combination of an issue of shares and a small cash payment. Obtaining control was a prerequisite to the subsequent merger. In the merger entity B issued shares as consideration to other shareholders of the issuer. The share capital of entity B was almost entirely issued during the arrangement. The cash consideration paid in the tender offer, and which was not considered material, does not preclude application of IFRS 3 paragraph 22 to the arrangement which, in such circumstances, requires one of the combining entities that existed before the combination to be identified as the acquirer. This therefore, cannot be entity B.

Before the merger, entity B had control, albeit temporarily, over the issuer, presenting a situation where the economic reality was not consistent with the legal relationship between the two entities. This inconsistency is clarified by applying paragraph IFRS 3 Paragraph 22.

<u>Other indications that can be considered when identifying the acquirer (paragraph 20)</u>
Paragraph 20 lists factors that may help indicate the identity of the acquirer. First, if the fair value of one of the combining entities is significantly greater than that of the other combining entity, the entity with the greater fair value is likely to be the acquirer. In the case in question, this points towards the issuer being the acquirer.

Second, if the business combination is effected through an exchange of equity instruments for cash or other assets, the entity giving up cash or other assets is likely to be the acquirer. This indication does not provide a clear signal towards either party to the transaction in this case as the debt note given by entity B in exchange for shares from Owners 1-2 was not paid in cash but settled during the merger.

Thirdly, if the business combination results in the management of one of the combining entities being able to dominate the selection of the management team of the resulting combined entity, the entity whose management is able to do so is likely to be the acquirer. This is a clear indication that the issuer A is the acquirer.

Conclusion
The purpose of the arrangement was to divest business X and dissolve the centralised ownership structure of the issuer. The accounting treatment should reflect the substance of the arrangement.

Based on the above rationale, the enforcer concluded that entity B was formed to issue equity instruments to effect a business combination, and according to IFRS 3 paragraph 22, cannot be the acquirer. Therefore, issuer A is the acquirer. This conclusion is supported by the principle stated in IFRS 3 paragraph 21, as the issuer has control over the new combined entity after completion of all the stages to the arrangement. The decision is further supported by consideration of the other indicators set out in paragraph 20 of the standard.

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Decision ref.EECS/1207-11: Real estate projects

Period end: 30 September 2005 /Annual Financial Statements
Category of issue: Construction contracts
Standard involved: IAS 11
Date of the decision: 30 October 2006

Description of the issuer's accounting treatment
An issuer that develops and sells property applied IAS 11 to its construction contracts, recognising revenue in accordance with the percentage of completion method.

The enforcer examined the accounting treatment adopted in respect of three different types of contracts entered into by the issuer. The enforcer considered especially whether a specifically negotiated contract of sale had been entered into with the buyer (investor) of the building project. For contracts where this condition was not met, the enforcer then considered whether revenue could be recognised on the basis of the rendering of services (as argued by the issuer) in accordance with IAS 18.

The three different kinds of contracts; commercial property for third parties, cooperative dwellings and apartments for sale had the following characteristics.

For contracts relating to commercial property, the general process is that the issuer acquires a commercial property that has development potential. The issuer may enter into leases with new tenants or existing tenants may be replaced. Conversion of the property, in accordance with the issuer's plans and the tenants' requirements and wishes, is agreed at the time of entering into the leases, and the conversion work is then commenced. Until the date of completion the issuer receives income in the form of rent. At that point, the selling price for the property is calculated on the basis of the expected cash flow from its operation. A contract of sale is entered into with the investor, and the investor takes possession of the property when the conversion work has been completed. The investor only acquires legal title to the property at the date of completion.

Regarding contracts on housing construction projects for cooperative dwellings the individual owner does not own the dwelling unit, but has a right to use of that unit as well as a share in the cooperative. The cooperative housing society is the owner of the property and is the party with whom any specifically negotiated contract is entered into. Hence, the cooperative housing society must be established before the building project is commenced if it is to have a significant influence on the building project.

The substance of the contracts in relation to apartments is that the buyer of a completed apartment has only limited influence on the design and the construction of the apartment or on the course of the construction project. In substance, he is only responsible for meeting his obligations in accordance with a concluded contract of sale (ie to take delivery and pay for it).

The matter at issue relates to whether the issuer's different types of real estate projects can be defined as specifically negotiated contracts in relation to the construction of buildings in terms of design, technology or function, as defined in IAS 11, paragraph 3, and whether, if IAS 11 is not applicable, revenue should be recognised as revenue from services or delivered goods.

The enforcement decision

The enforcer concluded that IAS 11 is not applicable to any of the three types of contracts referred to above, as the issuer does not enter into specifically negotiated contracts prior to commencement of construction work. Furthermore, as the enforcer decided that the issuer delivers goods not services, the conditions required to be satisfied before revenue from the sale of goods is to be considered are those of IAS 18, paragraph 14. As not all the conditions specified are met, the appropriate accounting treatment, in respect of all three types of contracts, are the "completed contract" rather than "percentage of completion method" for all three types of contracts i.e. when the risks and rewards of ownership are transferred.

Rationale for the enforcement decision

IAS 11

In the enforcer's opinion, the issuer should either apply IAS 11 or IAS 18 to determine the recognition of revenue from real estate development projects. The enforcer considered the issuer's different types of contracts in relation to the two standards.

Under IAS 11 a construction contract is a contract specifically negotiated for the construction of an asset (IAS 11, paragraph 3). According to the issuer, a central factor in this definition is whether the contract is negotiated with a specific customer.

Whilst IFRS does not define the term "specifically negotiated", the enforcer finds that it is not sufficient that the contract has been negotiated with a specific customer. There must be a negotiation of the contractual terms between the seller and the buyer prior to commencement of the work.

The enforcer is of the opinion that the individual distinguishing feature of such a contract should be seen in connection with the terms that normally characterise the work performed under construction contracts. The most common procedure for such contracts is that a landowner, possibly following an invitation to tender for a ready-designed construction assignment, engages a contractor to perform the work in accordance with detailed specifications and drawings. In such a case, the landowner exercises a decisive influence on the design of the building project, the choice of materials, layout and arrangement, etc.

In a "specifically negotiated" contract, the buyer has a right to change the original plans for the project to suspend or discontinue the building work or to engage another contractor to complete the work (possibly against payment of compensation) throughout the course of the building project.

The substance of the majority of the issuer's contracts is that the entity sells a completed building to an investor, who has but limited influence on the design and construction of the building or on the course of the building project, and who is therefore, essentially only responsible for meeting his obligations in accordance with a concluded contract of sale (ie to take delivery and pay for the property).

In the enforcer's opinion, a specifically negotiated contract can be characterised by the fact that the buyer must have a decisive influence on the design, construction, choice of materials, layout and arrangement, etc. of the building project. The buyer is also usually is entitled to:

- make changes to the original plans for the building project,
- suspend or discontinue the building project, and
- let another contractor complete the work on the building project.

As far as contracts on commercial property are concerned, the enforcer is of the opinion that the consideration for the tenants' requirements and wishes in connection with the conversion work supersedes the buyers' requirements because the performance affects the size of the rent, the cash flow of the property and consequently the selling price. The total selling price for the property is based on the price of the original building acquired by the entity and the additional costs for the conversion work done on the building. The investor becomes involved at a late stage of the development process and, thus, has very little influence on the development of the property. Added to this, the investor's interest first and foremost concerns the cash flows from the operation of the property, as the cash flow determines the price. On these grounds, the enforcer found that this type of contract does not constitute a specifically negotiated contract and that IAS 11 is, therefore, not applicable.

Further, the construction and sale of cooperative dwellings begins before the cooperative society is set up. Consequently, no contract is entered into on the construction of an individual dwelling. Hence, the contracts are not covered by the definition of a construction contract and IAS 11 is not applicable.

The reason why the enforcer considered the contracts on apartments for sale not to be specifically negotiated contracts is that the construction of the apartments is performed as a turnkey construction contract. As the apartments are essentially homogenous in terms of design, choice of materials etc., the individual buyer has little influence on the building project. No contract is entered into on the construction of a single apartment and IAS 11, therefore, is not applicable.

IAS 18

As IAS 11 is not applicable to any of the contracts in question, IAS 18 is to be applied to the issuer's deliverables. It must however be decided whether the entity delivers a product, a service or makes a composite delivery (consisting of one or several components and including both the delivery of goods and the rendering of services).

The enforcer's assessment of this matter is based on the issuer's own information about the nature of the deliveries that are made. The information provided shows that the issuer develops real estate projects, handles the construction of properties under these projects and sells the completed properties to the investor. On this understanding, the enforcer's conclusion is that the entity delivers goods (property) to investors. This view is supported by the definition of deliveries of goods, in IAS 18, paragraph 3 and which includes:

"… land and other property held for resale".

Regarding the recognition of revenue generated from the three different types of contracts, the five conditions listed in paragraph 14 must be met before such revenue can be recognised (LIST?).

It should be noted in this connection generally that the issuer has stated that it does not retain any managerial involvement in building projects and that it takes out insurance to cover the financial risk that still attaches to building projects in those situations where the entity enters into a sales contract for the sale of a non-completed building project to a buyer. Therefore, subject to satisfying the other criteria of paragraph 14, the issuer has sold the real estate project and can recognise the revenue generated from this sale at the time at which the "binding contract of sale" is entered into.

As far as commercial properties are concerned, the issuer retains a right to a return on the projects, which are treated as having been sold under a binding sales contract. The issuer receives income in the form of rent throughout the period up to the date of completion. In the enforcer's opinion, the issuer retains significant risks, effective control and the right to a return attached to the property sold in each of the projects for which revenue has been recognised in accordance with the percentage of completion method before the final transfer. This means that the condition in IAS 18, paragraph 14 (a), has not been met and the point at which revenue can be recognised must be postponed until the transfer of the property takes place.

With respect to cooperative dwellings, the enforcer found that a similar rationale was relevant as for commercial property above. The property cannot be delivered until the cooperative housing society is established. Therefore, until this event and the transfer of the property, the issuer retains the significant risk and effective control over the property sold. This indicates that the condition in IAS 18, paragraph 14(a) is not met and recognition of revenue should be postponed until the transfer of the property takes place.

In connection with apartments for sale, the enforcer did not find that the conditions of IAS 18, paragraph 14 had been met when the issuer recorded the sales. The key reason for this was that the issuer continues to bear financial risk (even though it is covered through insurance) for the completion of the project.