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Decision ref.EECS/0407-01: Identification of the acquirer in a business combination
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Financial year end: 31 December 2005 / Annual Financial Statements / Prospectus / Pre-clearance

Category of issue: Acquisition accounting, business combination, reverse acquisition

Standard involved: IFRS 3

Date of the decision: 15 January 2005

Description of the issuer's accounting treatment

Issuer A proposes a business combination in the form of a mixed offer (equity and cash) issued in consideration to the shareholders of issuer B. A legal merger is contemplated after the completion of the take-over bid. Both issuers are listed on a regulated equity market. The volume of shares traded daily is such that for both issuers it can be assumed the published price at the date of exchange provides the best evidence of the fair value of their shares.

The details of the mixed offer for 100% of the shares of the target (B) are:

- Equity issued by A: 77% of fair value of B
- Cash paid by A: 23% of fair value of B

The cash payment will be financed by debt instruments of A. The corresponding new debt will represent roughly 70% of issuer A's total equity before the bid (and 15% of the equity of the combined entity (A+B)). Issuer B is significantly larger than issuer A. In terms of fair value before the bid, issuer A had a market value of 600 while issuer B's market value was 1,000. In terms of revenue, the sales of issuer A represent 35% of the sales of the combined entity.

As a consequence of the bid, it is expected that the former shareholders of issuer B will hold 57% of the economic interest of the combined entity. Due to the existence of double voting rights existing before the take-over, issuer A's original shareholders will control 50.2% of the combined voting rights after the combination.

In terms of control over financing and operational policies, there are no specific contractual agreements or other arrangements between the shareholders that limit their voting rights.

The combined entity will have both a supervisory board and an executive board. The supervisory board will include 5 members from each entity, with its chairman (the former chairman of the supervisory board of issuer A) holding a casting vote. The executive board will comprise 3 members. Its chairman will be the former Chairman and CEO of issuer B. The other two members are the former CEO of issuer A, and a Deputy Chairman of issuer B.

In the pro forma information included in the prospectus, issuer B was presented as the acquirer of A.

The enforcement decision

The enforcer found that issuer A was the acquiring entity.

Rationale for the enforcement decision

IFRS 3 requires that an acquirer be identified for all business combinations. Paragraph 17 sets out the principle that the acquirer is the combining entity that obtains control of the other combining entity.

In the present situation, the balance reached between both parties in terms of management of the combined entity and the very small advantage of A's shareholders in terms of control over the voting rights make it necessary to analyze all the characteristics of the combination. All the more so as BC 57, which explains why IFRS 3 did not carry forward paragraph 12 of the previous standard IAS 22 "Business Combinations" dealing with reverse acquisitions, underlines that the IASB considered that controlling ownership does not necessarily mean that governing of financial and operating policies is reached.

In reaching its conclusion, the enforcer considered that although application of the fair value criteria might indicate that issuer B is the acquirer, consideration of other significant criteria set out in paragraphs 19 to 21 of IFRS 3 indicated that issuer A is the acquirer. These other criteria, apart from the control of 50.2% of the voting rights, were the fact that issuer A is "the entity giving up cash or other assets" (as mentioned in paragraph 20(b)), and that A is also the entity that issues the equity interest (see paragraph 21).

Decision ref.EECS/0407-02: Control of a subsidiary when the holding is passive

Financial year end: 31 December 2005 / Annual Financial Statements / Pre-clearance

Category of issue: Consolidated financial statements, parent, subsidiaries

Standards involved: IAS 27

Date of the decision: 31 January 2005

Description of the issuer's accounting treatment

The issuer has control over the composition of the board of directors of entity C which is composed of seven members. Of the seven directors, four were appointed by the issuer and three by another entity (B). However, given that one of the directors appointed by the issuer rarely attends board meetings, decisions are taken by majority vote among the remaining directors.

The enforcement decision

The enforcer found that the issuer controlled entity C.

Rationale for the enforcement decision

Control is presumed to exist, inter alia, where an issuer has the power to cast the majority of votes at meetings of the board of directors and control of the issuer is by that board or body (IAS 27 paragraph 13 (d)). Accordingly, regardless of whether the issuer rarely exercises control over entity C (one of the directors appointed by the issuer rarely attends board meetings), the fact remains that, if the issuer wishes to exercise said control, it has the power to do so.

Therefore, even though the holding is supposedly passive, as a result of non attendance at the majority of board meetings by a director, that implies control, i.e. the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities (IAS 27 paragraph 4), independently of whether this power is exercised or not.

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Decision ref.EECS/0407-03: Capitalisation of borrowing costs relating to a construction pending approval

Financial year end: 31 December 2005 / Annual Financial Statements/ Pre-clearance

Category of issue: Borrowing costs

Standard involved: IAS 23

Date of the decision: 31 March 2005

Description of the issuer's accounting treatment

An issuer buys land on which to build a new factory. The land is classified as agricultural land upon purchase. The issuer's management has applied to the local authorities for permission to change the classification of the land from agricultural to industrial use but permission has been blocked for six months due to opposition from local residents.

The issuer's management has arranged a bank loan to finance the purchase of the land. The loan has a 7-year maturity from the date of entry into operation of the factory. The issuer's accounting policy is to capitalise borrowing costs as permitted by paragraph 11 of IAS 23 and it has commenced the capitalisation of the borrowing costs of the loan in accordance with paragraphs 20 and 22 of the standard.

It is management's opinion that the local authority will approve the change of use since the new factory will create substantial employment in the area. The issuer is actively pursuing the request for the permission to change the current classification of the land, and has been doing so since the land was purchased. The issuer's management is very confident that the permission will be obtained: a short delay in obtaining permission is common under local legislation.

It is the issuer's judgment that the borrowing costs should be capitalised in accordance with IAS 23.

The enforcement decision

The enforcer found that the capitalisation of borrowing costs was acceptable and did not consider that capitalisation should be suspended for a period of temporary delay.

Rationale for the enforcement decision

Borrowing costs incurred by the entity while land acquired for building purposes is held without any associated development activity, do not qualify for capitalisation (IAS 23 paragraph 22). However, where the entity is carrying out substantial technical and administrative work for example activities associated with obtaining permits, borrowing costs may be capitalised prior to the commencement of construction. Capitalisation of borrowing costs is not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use (IAS 23 paragraph 24). As a temporary delay in obtaining the permission (due to the opposition from local residents) is an unavoidable part of the reclassification process in this case, the capitalisation need not be suspended.

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Decision ref.EECS/0407-04: Restructuring plans

Financial year end: 31 December 2005 / Annual Financial Statements/ Pre-clearance

Category of issue: Restructuring

Standard involved: IAS 37

Date of the decision: 31 March 2005

Description of the issuer's accounting treatment

An issuer has announced two restructuring plans:

- a) The sale of 50% of the cotton group business in three years from now, which involves the laying off of 15% of employees and 10% of middle management in each factory. A purchaser has been sourced and a sales agreement entered into which is binding on both parties.
- b) The reorganisation of the headquarters over one year (commencing within two years), which involves the laying off of 20% of the headquarter's workforce.

Management proposes recognising a provision in respect of each restructuring plan.

The enforcement decision

The enforcer found that a provision should be made in respect of plan (a), but not in respect of plan (b).

Rationale for the enforcement decision

The restructuring plans should be considered separately as they relate to separate events.

According to IAS 37 paragraph 72, a constructive obligation to restructure arises only when an entity:

- a) Has a detailed formal restructuring plan identifying at least:
 - (i) the business activities, or part of the business activities, concerned;
 - (ii) the principal locations affected;
 - (iii) the location, function and approximate number of employees who will be compensated for terminating their services;
 - (iv) the expenditure that will be undertaken;
 - (v) the implementation date of the plan; and, in addition,
- b) Has raised a valid expectation among the affected parties that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely (IAS 37 paragraph 74).

Even when an issuer has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. (IAS 37 paragraph 79).

Plan a)

The enforcer considered it appropriate for the issuer to recognise a provision for the restructuring, as a binding sale agreement, from which neither party can withdraw is in place and as long as the requirements of IAS 37 paragraph 72 are met. Were it not for the binding sale being in place, the conditions would not arise in which the plan raised a valid expectation among the parties affected.

Plan b)

The enforcer found that the issuer should not recognise a provision because the long delay before the restructuring begins (potentially two years) means that the plan is unlikely to raise valid expectations among the parties affected by it that the issuer is committed to restructuring since the timeframe allows opportunities for the issuer to change its initial plans (IAS 37 paragraph 74).

* * *

Decision ref.EECS/0407-05: Carrying value of a trade receivable
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Financial year end: 30 June 2005 / Interim Financial Statements

Category of issue: Impairment, trade receivables

Standard involved: IAS 39

Date of the decision: 18 November 2005

Description of the issuer's accounting treatment

An issuer in the construction industry had provided services to a number of clients who were unable to settle their debts. To resolve the matter, a protocol was arranged in 2002 between the issuer, his debtors and other lenders under which it was agreed that 65% of the debt would be waived. The remaining amount was payable under certain conditions, which included the application of a special interest rate and the possibility of converting the debt into share capital of the debtors' associated companies. The issuer had the option of accepting the terms of the protocol and receiving the 35% immediately or of continuing to negotiate for different terms. The issuer had not yet accepted the terms of the protocol.

In its half yearly financial report to 30 June 2005, the issuer did not impair the debt on the basis that the amount due under the protocol would be equal to the current carrying value of the financial asset. Management saw no requirement to recalculate the carrying value of the asset.

The auditor issued a qualified report, indicating that the issuer's accounting treatment was not in accordance with paragraphs §58 and §59 of IAS39.

The enforcement decision

The interim report was found not to have complied with the measurement principles of IFRS, in particular IAS 39 with respect to the accounting treatment of the trade receivable.

Rationale for the enforcement decision

Under IAS 39 an issuer is required to assess at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired (paragraph 58). A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a loss event) and that loss event (or events) has an impact on the estimated future cash-flows of the financial asset or group of financial assets that can be reliably estimated (paragraph 59). Objective evidence includes observable data about, for example a lender who, for economic or legal reasons relating to a borrower's financial difficulty, grants the borrower a concession that he would otherwise not consider. The existence of the protocol in this case indicated circumstances that met this condition.

The loss is measured as the difference between the carrying amount of the asset and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest). The resulting loss, which cannot be offset by any compensating asset, for example, interest receivable, is recognised in the income statement.

The issuer had, however, in considering the present value of the estimated cash flows, set the losses against the anticipated future payments equivalent to the principal and the potential interest receivable.

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Decision ref.EECS/0407-06: Individual assessment of impairment of loans
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Financial year end: 31 December 2005 / Annual Financial Statements

Category of issue: Impairment, loans

Standard involved: IAS 39

Date of the decision: 14 December 2005

Description of the issuer's accounting treatment

When calculating the present value of a loan in order to find out whether or not it had been impaired, the issuer (a bank) did not determine exact cash flows, including all in- and outflows from the loan and thereby taking into account the effect of discounting. The bank calculated the value of the loan simply by deducting the estimated value of the collateral, estimated future payments etc. from the amount of the loan outstanding. This value was adjusted if and only if a broad estimate indicated that discounting would have an effect. The final adjustment was based on the broad estimate rather than precisely determined cash flows.

The enforcement decision

The accounting treatment was considered not to be in accordance with IAS 39.

Rationale for enforcement decision

According to IAS 39, paragraph 63, the amount of an impairment loss on a loan is measured as the difference between a loan's carrying amount and the present value of the estimated future cash flows of the loan discounted at the loan's original (before impairment) effective interest rate. IAS 39, paragraph AG84, states however that cash flows relating to short-term receivables should not necessarily be discounted if the effect of discounting is immaterial.

It was the enforcer's assessment that the bank's system for calculating the present value of estimated future cash flows of a loan was not in accordance with IAS 39, paragraph 63. The enforcer was of the opinion that it is not sufficient to only take into account the effect of discounting, when a broad estimate indicates that discounting has an effect. Equally, it is not sufficient to base a final adjustment on such a broad estimate without taking into account the estimated cash flows.

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Decision ref.EECS/0407-07: Individual assessment of impairment of loans
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Financial year end: 31 January 2005 / Annual Financial Statements

Category of issue: Impairment, loans

Standard involved: IAS 39

Date of the decision: 14 December 2005

Description of the issuer's accounting treatment

When calculating impairment losses on individual loans an issuer (a bank) used a fixed average percentage of the unsecured part of the individual loan instead of determining the best estimate of the future expected cash flows from the individual loan (IAS 39, paragraph 63).

The fixed percentage used was linked to different types of objective evidence indicating impairment (IAS 39 paragraph 59). If, for instance a significant financial difficulty of an issuer (IAS 39 paragraph 59(a)), was identified, the impairment loss would always amount to 40 % of the unsecured part of the loan whereas a breach of contract (IAS 39 paragraph 59(b)), would always result in an impairment loss of 100 % of the unsecured part.

The fixed percentages used were average numbers based on the bank's statistics and historical experience of its total loan portfolio.

The enforcement decision

The issuer's method for calculating the impairment of loans was considered not to be in accordance with IAS 39.

Rationale for the enforcement decision

According to IAS 39, paragraph 63, the amount of an impairment loss on a loan is measured as the difference between the carrying amount of a loan and the present value of the estimated future cash flows of the loan discounted at the loan's original effective interest rate, pre impairment.

The enforcer found that the bank's system for calculating impairment losses on individual loans was not in accordance with IAS 39, paragraph 63. The enforcer was of the view that a fixed percentage of the unsecured part of a loan is not necessarily the best estimate of the future expected cash flows from the loan. The issuer should assess whether impairment loss generated by application of fixed percentages represents the best estimate of the future expected cash flows – and if that is not the case make the necessary corrections of the calculated impairment loss.

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Decision ref.EECS/0407-08: Individual assessment of impairment of loans
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Financial year end: 31 December 2005 / Annual Financial Statements

Category of issue: Impairment, loans

Standard involved: IAS 39

Date of the decision: 14 December 2005

Description of the issuer's accounting treatment

Calculating impairment losses on individually assessed loans (IAS 39, paragraph 63) an issuer (a bank) determined a number of different cash flow scenarios (typically 3-5), assessed the probability of each and then calculated a weighted average. The bank believed that this method of calculating the best estimate of the future expected cash flows from a loan was in accordance with IAS 39, section AG86, and that the best estimate required by the standard is not necessarily defined as the "most likely" cash flow.

The enforcement decision

The method for calculating the impairment losses was not challenged by the enforcer as it was considered to be in accordance with IAS 39.

Rationale for the enforcement decision

According to IAS 39, section AG86, the process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the issuer should recognise an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date.

It was the enforcer's opinion that the bank's method for calculating impairment losses on individually assessed loans could not be challenged, as IAS 39, section AG86, states that the assessment process can result in both a range of possible amounts and one single amount. Compliant with the standard, the issuer had determined the weighting of possible outcomes on the basis of probability of outcome.

Decision ref.EECS/0407-09: Individual assessment of impairment of loans
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Financial year end: 31 December 2005 / Annual Financial Statements

Category of issue: Impairment, loans

Standard involved: IAS 39

Date of the decision: 14 December 2005

Description of the issuer's accounting treatment

When grouping loans for the purpose of a collective assessment of impairment, an issuer (a bank) only took credit rating grades into consideration and did not make any other segmentation of the loans. By using this method, loans in the same group were considered equally sensitive to changes in the same economic conditions.

For example, the bank placed loans to a fisherman and a farmer in the same group solely because they both had a specific rating grade and despite the fact that they might be subject to different primary economic conditions. For example, for the fisherman, this might be the price developments in the price of fishing quotas whereas the farmer's loan would be most sensitive to developments in milk quotas.

The enforcement decision

The bank's method for grouping loans for impairment review was not challenged by the enforcer.

Rationale for the enforcement decision

According to IAS 39, paragraph 59, a group of loans is impaired if, and only if, there is objective evidence of impairment as a result of one or more events that occur after the initial recognition and the loss event has an impact on the estimated future cash flows from the group that can be reliably estimated.

Objective evidence, in terms of groups of assets includes observable data indicating that there is a measurable decrease in the estimated future cash flows from the group since the initial recognition, including:

- Adverse changes in the payment status of borrowers in the group.
- National or local economic conditions that correlate with defaults on the loans in the group (for example, an increase in the unemployment rate, a decrease in property prices, a decrease in oil prices etc)

Paragraph AG87 states that, for the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). It is further stated that the characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtor's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Paragraph AG89 states that estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude).

Paragraph BC122 states that assets may be grouped on the basis of one or more of the following characteristics:

- Estimated default probabilities or credit risk grades
- Type (for example, mortgage loans or credit card loans,
- Geographical location
- Collateral type
- Counterparty type

- Past-due status
- Maturity

More sophisticated credit risk models or methodologies for estimating expected future cash flows may combine several factors, for example, a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status, and other relevant characteristics of the assets being evaluated and associated loss data.

Finally, paragraph BC123 states that the IASB decided that for the purpose of assessing impairment on a portfolio basis, the method employed for grouping assets should, as a minimum, ensure that individual assets are allocated to groups of assets with similar credit risk characteristics.

On the basis of these provisions, the enforcer found that the bank's method for grouping loans – according to which loans in the same groups are equally sensitive but not necessarily sensitive to changes in the same economic conditions – cannot be challenged, as the minimum requirements of paragraphs AG87 and BC122 are met.

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Decision ref.EECS/0407-10: Individual assessment of impairment of loans
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Financial year end: 31 December 2005 / Annual Financial Statement

Category of issue: Impairment, loans

Standard involved: IAS 39

Date of the decision: 14 December 2005

Description of the issuer's accounting treatment

When calculating impairment losses on individual loans an issuer (a bank) generally took no account of cash flows from probable liquidation dividends. The bank argued that cash flows from liquidation dividends could not be assessed with the necessary degree of reliability as the dividend amount and the exact settlement date were normally not known.

The enforcement decision

The accounting treatment was considered not to be in accordance with IAS 39.

Rationale for the enforcement decision

According to IAS 39, paragraph 59, a loan is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that loss event has an impact on the estimated future cash flows that can be reliably estimated.

According to IAS 39, paragraph 63, the amount of an impairment loss on a loan is measured as the difference between the loan's carrying amount and the present value of the estimated future cash flows of the loan discounted at the loan's original (before impairment) effective interest rate.

IAS 39, paragraph AG86, states that the process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. Further it is stated that in the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date.

On the basis of these provisions it was the enforcer's opinion that cash flows from dividends should be taken into consideration when they are probable and can be reliably measured. Further it was the enforcer's view that a best estimate of the future cash flows from dividends in general satisfies the reliability criterion and that only in exceptional circumstances would probable cash flows from dividends not be taken into consideration because of unreliability of measurement.

Decision ref.EECS/0407-11: Accounting for biological assets
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Financial year end: 31 December 2005 / Interim Financial Statements

Category of issue: Biological assets, fair value

Standard involved: IAS 41

Date of the decision: 14 February 2006

Description of the issuer's accounting treatment

The issuer measured live farmed salmon with a weight exceeding 4 kg (3,3 kg slaughtered head-on-gutted) at their fair value, while more immature salmon was measured at cost. The fair value of mature salmon exceeding 4 kg was determined by using the observed prices in an active market of slaughtered salmon, classified as a similar asset according to IAS 41 Paragraph 18 b. Based on an overall assessment, the issuer considered alternative estimates (incl. present value of future net cash-flows) of the fair value of live immature farmed salmon (< 4 kg) to be clearly unreliable, and hence accounted for these biological assets at cost according to IAS 41 paragraph 30.

The enforcement decision

The enforcer found that there existed observable market prices for similar assets (IAS 41 paragraph 18 b), also for salmon weighing less than 4kg. Hence, such biological assets should be accounted for at fair value and not cost.

Rationale for the enforcement decision

Farming salmon from egg to mature fish takes on average approximately 3 years. There are two main stages of growth; from egg to smolt (approx. 100 grams) and from smolt to mature fish, each stage taking approximately 15-18 months. In some markets there may be some turnover of live smolt, but as a rule farmed salmon is slaughtered before it is sold. The national production and sale in 2004 was approx 540,000 tonnes of farmed salmon. Industry organizations publish weekly price reports, summarizing trades of slaughtered and gutted superior quality salmon specified by weight classes (1-2 kg, 2-3 kg, 3-4 kg, 4-5 kg, 5-6 kg, 7 +, head-on-gutted slaughter weight). Approximately 20-30% of all salmon sold weigh less than 4 kg. These markets for salmon weighing less than 4 kg are not scrap markets, but markets where superior quality salmon is sold for human consumption.

The enforcer was of the view that slaughtered salmon which is sold whole and gutted is, in an accounting sense, to be considered as a similar asset to live salmon, according to IAS 41, paragraph 18 b. This also applies to so-called immature farmed salmon. In the absence of observable prices in an active market for live farmed salmon, fair value of live farmed salmon should be determined based on observable prices in an active market for the same category of slaughtered salmon (IAS 41 paragraph 15 and IAS 41 paragraph 18 b). The alternative method of estimating fair value as the present value of future net cash flows, cf. IAS 41 paragraph 20, should not be used when market determined prices or values as mentioned in IAS 41 paragraph 17 and 18 are available.

Active markets satisfying the criteria in IAS 41 paragraph 8 exist for the trading of such slaughtered salmon. The sizes of slaughtered salmon for which willing buyers and sellers normally can be found at any time, can vary from market to market. According to IAS 41 paragraph 9, the fair value of biological assets should be based on its present location and condition, including its weight and quality at the balance sheet date. Hence live salmon should be valued based on observable prices in an active market of slaughtered salmon in the weight class (taking into account adjustments for conversion from live weight to slaughter weight) in which the salmon would be sold if it were slaughtered at the balance sheet date.

Follow up

The decision was appealed to the Ministry of Finance. The Ministry of Finance upheld the decision of the enforcer, with some adjustments and additions. Most significantly, the final ruling upholds the enforcer's decision that slaughtered salmon which is sold whole and gutted is in an accounting sense to be considered as a similar asset of live salmon, according to IAS 41 paragraph 18 b and that this also applies to so-called

immature farmed salmon. Hence, the observable prices of slaughtered salmon shall be used as a basis for determining the fair value of live immature salmon. The key amendment to the decision made by the Ministry of Finance is that it added certain comments relating to how the term "adjustments to reflect differences" in IAS 41 paragraph 18 b was to be applied. The adjustments should reflect the differences between the price of slaughtered immature salmon and the hypothetical market price in an active market for live immature salmon. These adjustments should be consistent with the assessments that would be expected to be made by market participants to set the price of live salmon in an arms length transaction, given its present location and condition.

The Ministry of Finance ruling was made with effect from the 4th quarter 2006 financial reporting and forward. Comparative financial information relating to prior accounting periods was to be revised accordingly.

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Decision ref.EECS/0407-12: Business combination
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Period end: 30 June 2005 /Interim Financial Statements

Category of issue: Business combination

Standard involved: IFRS 3

Date of the decision: 5 September 2005

Description of the issuer's accounting treatment

An issuer presented its interim report for the period to 30 June 2005 in accordance with the recognition and measurement principles of IFRS.

During the period, the issuer had acquired a much larger non listed company, Company B. The acquisition was accounted for as follows:

1. Prior to the business acquisition, the principal shareholder in Company B (Company C) had only a minority interest in the issuer.
2. Company C contributed its shares in Company B as a non-cash contribution in the issuer. The transaction represented an exchange of equity interests as, in effect, the shareholder exchanged his shares in one company for shares in another company.
3. By virtue of this transaction Company C became the parent company of the issuer which in turn became the parent of Company B. The business combination was recognised in the interim financial statements as the issuer having acquired Company B. The assets and liabilities of Company B were re-valued at fair value in accordance with the principles of acquisition accounting. Comparative figures were taken from the issuer's historical annual report.

The enforcement decision

The enforcer found that the business combination was a reverse acquisition.

Rationale for the enforcement decision

Under IFRS 3 the acquirer is the combining entity that obtains control of the other entity in a business combination (paragraph 17). When the combination is effected through an exchange of equity transactions, the acquirer is normally the entity that issues the equity interests. However, all 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(s). In reverse acquisitions, where a private company is acquired by a smaller public company to obtain a stock exchange listing, the acquirer may be the entity whose equity interests have been acquired.

The regulator found that Company B was the acquirer and the issuer the acquiree in this case as B had the power to govern the financial and operating policies of the legal parent, so as to obtain benefits from its activities. The business combination was a reverse acquisition under IFRS 3, being an exchange of equity instruments under which Company B achieved a Stock Exchange listing through the significantly smaller

listed issuer. The exchange of instruments also had the effect that the principal shareholder in Company B (Company C) became the principal shareholder in the listed issuer.

As the combination was a reverse acquisition, the assets and liabilities in the issuer were to be revalued at fair value whilst the assets and liabilities in Company B should be measured at their previous value. The comparative figures in the interim financial statements for the issuer were to be the amounts for the corresponding period in the previous accounting year of the legal subsidiary, Company B (IFRS 3 paragraph B7).

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Decision ref.EECS/0407-13: Recognition of costs related to an acquisition and an issue of equity instruments

Financial year end: 30 June 2005 / Interim Financial Statements

Category of issue: Acquisition accounting, equity instruments, business segments, fees

Standards involved: IFRS 3, IAS 32

Date of the decision: 5 September 2005

Description of the issuer's accounting treatment

During the first half of 2005, the issuer entered into a business combination funded by cash and non-cash consideration, including refinanced and converted debt. The interim financial statements as of 30 June 2005 show that the group's result for the period was significantly affected by costs incurred in connection with the business combination and increases in capital.

In its interim financial statements, the issuer recognised the costs for the consultancy fee in its profit and loss account together with other costs for the capital increases relating to the issue of equity instruments. The costs in question include lawyers' and accountants' fees, consultants' fees, bank commission, commission to the Securities Centre and a prospectus fee payable to the stock exchange.

The enforcement decision

The interim report was considered not to have complied with the recognition principles of IFRS, specifically, those of IFRS 3 paragraph 29 in respect of the accounting treatment of costs related to an acquisition and IAS 32 paragraph 37 in respect of costs related to the issuance of equity instruments.

Rationale for the enforcement decision

In accordance with IFRS 3, paragraph 29, all costs, such as consultancy fees, that can be attributed directly to the business combination are to be regarded as part of the overall costs of the business combination. These costs should therefore be capitalised as part of the cost of the business combination.

Under IFRS 3, paragraph 31, the costs for a business combination that relate to the issue of equity instruments are, however, not to be recognised as part of the business combination, but are to be treated in accordance with IAS 32. Under IAS 32, paragraph 37, such costs are to be set against the proceeds of the issue of the equity instruments and should consequently be recognised and accounted for as a deduction from equity.

The enforcer was of the opinion that costs directly attributable to a business combination, such as consultancy fees, should be treated in accordance with IFRS 3, paragraph 29, and be recognised as part of the cost of the business combination. That part of the costs relating to the issue of equity instruments should be treated in accordance with IAS 32, paragraph 37, and should be recognised and booked directly against equity.

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Decision ref. EECS/0407-14: Forward purchases and sales of non-financial assets to be settled through physical delivery.

Financial year end: 31 December 2005 / Annual Financial Statements/ Pre-clearance

Category of issue: Forward contract, inventories

Standards involved: IAS 2, IAS 39

Date of the decision: 31 January 2005

Description of the issuer's accounting treatment

The issuer operates in the electricity business, both in the industrial and commercial sectors.

In the year to 31 December 2005 the issuer entered into several forward contracts to buy gas for consumption in its electricity production process. These contracts guarantee a part of the issuer's future production process and ensure that, once acquired, the gas is not resold in the market. The contracts were to be settled through the physical delivery of gas; cash settlement was not anticipated. Included in the contract terms was a penalty (take or pay) clause should the issuer not want the gas at the end of the contract. In recent similar contracts, the issuer had taken the gas – and it intends to do so in respect of the current contracts. The issuer had introduced appropriate internal controls to ensure that the contracts are executed in accordance with its expected usage requirements which are determined at the commencement of each contract.

The issuer believed that contracts to be settled through physical receipt of non-financial items (gas) where they are planned to be used or consumed in the production process should be accounted for as forward purchases in accordance with IAS 2, rather than IAS 39. Accordingly, payments of brokers' commissions, guarantee margins and other items typical of futures markets were treated as advance payments and included in the cost of acquisition of the gas.

The enforcement decision

The issuer's accounting treatment adopted in respect of these contracts was not challenged by the enforcer.

Rationale for the enforcement decision

Paragraph 5 of IAS 39 confirms that the standard applies to the purchase or sale of non-financial items that can be settled net in cash or through a financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments. Paragraph 6 of IAS 39 sets out a number of ways in which such a contract may be settled. The exception is for contracts that are entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the issuer's expected purchase, sale or usage requirements.

The enforcer agreed that IAS 39 paragraphs 5 and 6 do not apply to these contracts as the underlying non-financial items will be physically received and used in the company's production process.

The enforcer also agreed that as IAS 2 is applicable, broker's commissions, guarantees and other payments typical of forward purchase contracts should be treated as prepayments and be included in the cost of the gas.

These type of contracts do not have to be registered and valued as inventories at the date of the contract, nor is it necessary to book the result or price difference between the date of contract and the date of maturity/execution (when the inventories are physically delivered). These contracts are booked as inventories on the date of receipt of the non financial underlying asset, taking as basic valuation reference the price agreed in the contract plus any disbursement, payment, or deposit made (from the date of the contract until the date of receipt) not discharged or applied in the final settlement of the contract.

* * *

Decision ref.EECS/0407-15: Redenomination of a foreign currency loan

Financial year end: 31 December 2005 / Annual Financial Statements/ Pre-clearance

Category of issue: Foreign exchange rates, Net investment in a foreign operation

Standards involved: IAS 21

Date of the decision: 31 October 2005

Description of the issuer's accounting treatment

A parent issuer recognises certain foreign exchange loans granted to its subsidiaries as part of its investment in them, in accordance with IAS 21 paragraph 15. Following changes in tax regulations and exchange rate performance, management converted these loans from US dollars into euros.

The change in denomination had no impact on the functional currency of the subsidiaries. The loans will be converted using a dollar-euro spot exchange rate at the date of redenomination. The issuer took the view that exchange differences prior to the loan redenomination should remain in equity, as there had been no disposal of the net investment in the foreign operation (IAS 21 paragraph 32).

The enforcement decision

The enforcer did not challenge the issuer's accounting treatment.

Rationale for the enforcement decision

Exchange differences arising on a foreign currency loan that forms part of a net investment in a foreign operation are recognised in equity until disposal of the investment when they are recognised in profit or loss (IAS 21 paragraph 32). A conversion or redenomination of such a foreign currency loan affects the form but not the substance of the investment as it does not involve a disposal. Therefore, exchange differences prior to the redenomination of the loan remain in equity.

* * *

Decision ref.EECS/0407-16: Accounting treatment of a written puttable instrument on a minority interest
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Financial year end: 31 December 2005 / Annual Financial Statements / Prospectus

Category of issue: Revenues, sales of goods, services provider

Standards involved: IAS 32

Date of the decision: 18 April 2006

Description of the issuer's accounting treatment

Accounting policy up to 2005

The issuer acquired 75% of the shares of company C in January 2001. Company B owns the remaining 25%. As part of the company C business combination in 2001, the issuer and company B entered into a put agreement. Company B is entitled to put its 25% stake in company C to the issuer for an amount equal to the fair value of the shares at the time the option will be exercised. The issuer has the choice either to settle in cash or an equivalent amount of its shares. The option can be exercised without cause.

Up to and including the financial year 2004, the issuer recognised company B's 25% share in company C in the consolidated balance sheet as minority interest within equity (IAS 1 paragraph 68 (o) and IAS 27 paragraph 33). In the consolidated profit and loss account, the interest of company B in the profit of company C was recognised as minority interest (IAS 1 paragraph 82 (a) and IAS 27 paragraph 33). The written put option was not recognised.

Change in accounting policy 2005

As of 1 January 2005, the issuer applies revised IAS 32 (2003) retrospectively (IAS 32 paragraph 97). This revised standard provides modified guidance on whether a minority interest in an entity shall be classified as equity or as a financial liability. IAS 32 paragraph 23 states that a contract that contains an obligation for an

entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability. As a consequence the minority interest of company B is derecognised.

Due to the retrospective application of revised IAS 32, the issuer reported the following in the financial statements 2005:

At January 2001, the moment the business combination was formed:

- Recognition of the liability for puttable instruments (hereafter: “the liability”) (IAS 32 paragraph 23).
- Derecognition of the minority interest of company B in company C (IAS 32 paragraph 23).
- Decrease of equity as a reversal of the historically recognised dilution gain.
- The liability was valued at fair value instead of the present value of the redemption amount because it was considered as a current liability. Company B can exercise the option at any moment and it is not clear to the issuer at which moment this will be done.

During the period 2001 through 2005:

- Dividend payments made to company B have been treated as partial repayments of the liability; consequently reducing the liability, i.e. the fair value of the 25% stake of company B in company C.
- Up to December 2003 the liability has only been affected by the respective dividends paid to the issuer.

After 2003, the fair value of the 25% stake of company B in company C increased due to higher sales volumes and sales amounts of company C resulting in higher profits. Based on IFRS 3 paragraphs 32 and 33 the increase of the value of the liability has been treated as an adjustment of the contingent purchase consideration. Consequently, in 2004 and 2005 goodwill increased even further.

Development of the minority interest has been reclassified from minority interest to the issuer shareholders' equity (IAS 32 paragraph 23)

No interest expenses have been recognised due to the fact that the issuer considered “the liability” as a current liability.

The enforcement decision

The enforcer decided that the accounting treatment in the 2005 financial statements did not constitute an infringement.

Rationale for the enforcement decision

Presentation of minority interest in consolidated financial statements

IAS 32 paragraph AG29 states that an entity shall present minority interests in accordance with IAS 1 and IAS 27. However when classifying a financial instrument in the consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and holders of the financial instruments in determining whether the group as a whole has an obligation to deliver cash or another financial instrument in respect to the instrument or to settle it in a manner that results in liability classification. Consequently IAS 32 paragraph 23 is applicable to the minority interest of company B in company C.

Initial recognition and measurement of the liability and derecognition of the minority interest

IAS 32 paragraph 23 does not state clearly whether the contra to the liability requires that the minority interest be derecognised or whether the general reduction in equity is sufficient. It seems logical to derecognise the minority interest and this approach is not forbidden by IAS 32 paragraph 23.

According to IAS 32 paragraph 23 the liability shall be measured at the present value of the redemption amount of the liability. Due to the fact the put option is generally exercisable at any time the issuer considered the liability as a current liability. Consequently the present value of the redemption amount is equal to the fair value of the 25% stake of company B in company C.

Under the prospectus directive the EU National Enforcer is not entitled to analyse whether considering this financial liability as current is correct, nor to evaluate the fair value of the financial liability. These are estimates of the board of the issuer and its auditors. Based on the judgment of the board of the issuer the enforcer agrees that the fair value of the 25% stake and the present value of the redemption amount are equal.

Accrual of the interest

IAS 39 paragraph 47 states that an entity shall measure all financial liabilities at amortised cost using the effective interest method after initial recognition. Because the financial liability is deemed to be current instead of non-current, an imputed interest calculation is negligible and interest costs have not been recognised.

Goodwill recognised

The liability could represent the (contingent) purchase consideration of the future acquisition of the 25% stake of company B in company C. The contingent purchase consideration is excluded from the scope of IAS 32 (IAS 32 paragraph 4 (c)) and IAS 39 (IAS 39 paragraph 2 (f)) and measured in accordance with IFRS 3, except for the cumulative amortisation using the effective interest method, as stated under “Accrual of the interest”, which amounts to nil and the repayments (dividends).

IFRS 3 paragraph 32 states that when a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the amount of that adjustment in the costs of the combination at the acquisition date, if the adjustment in the costs of the combination at the acquisition is probable and can be measured reliably. In addition, IFRS 3 paragraph 33 states that the costs of the business combination shall be adjusted accordingly, if the future events do not occur or the estimate needs to be revised.

IFRS 3 paragraph 36 states that the acquirer shall allocate the cost of a business combination by recognising the acquiree’s identifiable assets and (contingent) liabilities etc. at their fair values at the acquisition date. At that date (January 1, 2001) all identifiable assets and liabilities are measured at their fair values and recognised in the consolidated balance sheet. Consequently the adjustments of the liability shall be recognised as goodwill (IFRS 3 paragraph 51 (a)).

In case the aforementioned adjustments would have taken place before 2004, IAS 22 would have been applicable to these adjustments of the fair value of “the liability”. As a consequence the recognised goodwill would have been depreciated until IFRS 3 is applicable.

Payment of dividend

Due to derecognition of the minority interest the dividend payments made to company B shall be regarded as a repayment of the liability for puttable instruments.

Retrospective application

According to IAS 32 paragraph 97, this standard shall be applied retrospectively.
