ESMA's 20th EXTRACT FROM THE EECS's DATABASE OF ENFORCEMENT

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2017/02

STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Additional guidance for the application of IFRSs.

Background

The European Securities and Markets Authority (ESMA) has, as a source of information to assist in the appropriate application of International Financial Reporting Standards (IFRSs), developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). This forum involves 38 European enforcers from the 28 member states and the two countries in the European Economic Area (EEA) who have responsibilities in the area of supervision and enforcement of financial information. The EECS is a forum in which European enforcers of financial information meet to exchange views and discuss practical experiences of enforcement of IFRS financial information provided by companies which have, or are in the process of having, securities admitted to trading on a regulated market in Europe.

European national enforcers apply their judgement, knowledge and experience to the particular circumstances of the cases that they consider. Relevant factors for each enforcement decision may include consideration of national law, the requirements of which may go beyond the requirements of accounting standards and interpretations. In consequence, when considering the cases that are publicly reported, careful consideration should be given to their individual circumstances. Situations which seem similar may in substance be different, and consistent application of IFRS means consistent with the principles and treatments permitted by IFRS.

ESMA regularly publishes extracts from its database, with the intention of informing market participants about which accounting treatments EU National Enforcers (the Enforcers), may consider as complying with IFRSs and thus contribute to a consistent application of IFRSs in the European Union. The published decisions generally include a description of the accounting treatment or presentation at issue, the decision taken by the Enforcer and a summary of the Enforcer's underlying rationale. However, decisions taken by enforcers do not constitute generally applicable interpretations of IFRS; this remains the role of the IFRS Interpretations Committee.

On 5 January 2017, ESMA published its 20th extract from the database. The full report can be found on the ESMA website at the following address:

https://www.esma.europa.eu/press-news/esma-news/esma-publishes-extract-enforcement-decisions-financial-statements-0

Set out below is a summary of the conclusions reached, which are in the same order as they have been presented in the report.

The previous extracts published by ESMA are summarised in IFRBs 2007/06, 2008/07, 2008/17, 2009/04, 2010/05, 2010/06, 2010/07, 2012/01, 2012/02, 2012/03, 2012/04, 2012/14, 2013/11, 2013/21, 2014/04, 2014/25, 2015/11 and 2016/08.

Transactions and related IFRSs covered by the extracts

1. Qualitative disclosures of the risks arising from financial instruments (IFRS 7 *Financial Instruments: Disclosures*)
2. Disclosure of significant judgements and assumptions in determining the existence of significant influence (IFRS 12 *Disclosure of Interests in Other Entities*)
3. Disclosures relating to determination of value in use (IAS 36 *Impairment of Assets*)
4. Recognition of losses on loans upon conversion to shares (IAS 39 *Financial Instruments Recognition and Measurement*)
5. Presentation of equal and opposite gains and losses in the statement of profit or loss and other comprehensive income for the period (IAS 1 *Presentation of Financial Statements*)
6. Reclassification of capitalised milestone payments by a pharmaceutical company to the statement of profit or loss (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and *IAS 38 Intangible Assets*)
7. Legal requirements that prevent a shareholder from exercising its rights (IFRS 10 *Consolidated Financial Statements*)
8. Determining whether an entity is an investment entity (IFRS 10 *Consolidated Financial Statements*)
9. Depreciation of vessels in the oil and gas industry (IAS 16 *Property Plant and Equipment*)
10. Application of value in use methodology in impairment testing (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, and IAS 36 *Impairment of Assets*)
11. Recognition of onerous contract provisions (IAS 36 *Impairment of Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)
12. Identification of cash generating units (IAS 36 *Impairment of Assets*)
13. Purchase of a car fleet with an agreed buy-back agreement (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, IAS 17 *Leases*, IAS 32 *Financial Instruments: Presentation*, and IFRIC 4 *Determining whether an Arrangement Contains a Lease*)
14. Recognition of deferred tax assets for unused tax losses (IAS 12 *Income Taxes*)

Summary of extracts

1. Qualitative disclosures of the risks arising from financial instruments (IFRS 7 Financial Instruments: Disclosures)

The issuer had purchased a portfolio of loans at a significant discount to their nominal value as they were all past due and in default.

The issuer disclosed that its objective in purchasing the loans was to generate future returns by obtaining the collateral property assets on which the loans were secured through a combination of:

- Subsuming the properties into the issuer's development property portfolio
- Disposing of the properties over time for amounts greater than the amount paid to buy the portfolio of loans; and
- Earning rental income from the underlying property asset portfolio

Although the loan portfolio was categorised as loans and receivables and measured at amortised cost using the effective interest rate method, the issuer did not provide the qualitative or sensitivity disclosures required by IFRS 7 *Financial Instruments: Disclosures* relating to the property market risk inherent in the loan portfolio.

According to paragraph 33 of IFRS 7, entities should make qualitative disclosures for each type of risk arising from financial instruments. . In this specific case the future cash flows of the distressed loan portfolio were based on the value of the underlying property collateral and, therefore, the market risk of property has a significant impact on the portfolio's value. Further, paragraph 40 of IFRS 7 requires an entity to disclose a sensitivity analysis for each type of market risk to which the entity is exposed.

The enforcer's decision

As the loan portfolio amounted to 67% of the issuer's total assets, the enforcer considered the disclosures regarding market risk of property to be important information for users of the financial statements and so should have been disclosed.

2. Disclosure of significant judgements and assumptions in determining the existence of significant influence (IFRS 12 Disclosure of Interests in Other Entities)

The issuer held more than 20% of the voting rights in an investee, but did not have any representation on its management or supervisory boards. There was a separate controlling shareholder with 60% of the voting rights and resolutions at the general meeting, including the election and removal of shareholders' representatives on the supervisory board and the distribution of profits, were adopted by a simple majority

Based on this fact pattern the issuer concluded that it did not exercise significant influence over the investee. However, it did not disclose the significant judgements and assumptions on which this conclusion was reached.

The enforcer's decision

Although the enforcer did not disagree with the conclusion that the issuer did not exercise significant influence, it was of the view that the issuer should have disclosed the considerations that led to this conclusion as required by paragraph 9(d) of IFRS 12 *Disclosure of Interests in Other Entities*.

3. *Disclosures relating to determination of value in use (IAS 36 Impairment of Assets)*

The issuer, a credit institution, had recognised goodwill on the acquisition of another credit institution made a number of years earlier. The goodwill had not since been impaired and, therefore, the following information relating to the goodwill was disclosed:

- the carrying amount of goodwill allocated to each cash generating unit;
- the discount rate applied to the cash flow projections and its composition;
- the growth rate in the forecast period and beyond;
- that budgets, business plans and expected changes regarding solvency needs were taken into account when estimating the cash flows; and
- a sensitivity analysis demonstrating the amount by which the growth rate and discount rate would need to change in order for the unit's recoverable amount to be equal to its carrying amount.

The enforcer's decision

The enforcer concluded that:

- Details should also have been provided on the expected loan impairment ratio. As this has a high impact on the CGU's recoverable amount, this ratio should have been identified as a key assumption resulting in both the ratio and associated sensitivity being disclosed in accordance with paragraphs 134(d)(i) and 134(f) respectively of IAS 36 *Impairment of Assets*.
- As required by paragraph 134(d)(ii) of IAS 36, the financial statements should have included a description on how management determined values assigned to each key assumption used in the impairment model, such as whether they reflected past experience or were consistent with external sources of information.

4. *Recognition of losses on loans upon conversion to shares (IAS 39 Financial Instruments Recognition and Measurement)*

The issuer, a savings bank, had a long term relationship with another entity (operating as a fish farm), both as a lender and an equity investor. The issuer participated in several attempts to refinance the fish farm, which resulted in a loan receivable (classified as loans and receivables measured at amortised cost) being exchanged for an equity interest (classified as an available for sale (AFS) asset).

However, the conversion rate applied on exchanging the issuer's loans for shares was two to five times higher than the subscription price offered to other shareholders, with the fish farm also making unsuccessful attempts at attracting new investors by offering shares at a lower price than was used in the conversion of the issuer's loan receivable. This indicated that the fair value of the shares received on conversion of the issuer's loan receivable was considerably lower than the loan receivable's book value, which in turn would suggest that it was impaired.

However, rather than recognising an impairment on the loan receivable, the issuer accounted for the exchange of its loan receivable for equity by reducing the carrying amount of the loans, with an offsetting increase in the carrying amount of its AFS investment. The AFS investment was then subsequently impaired, with the loss presented in the statement of profit or loss as 'net change in value of financial instruments'

The enforcer's decision

The enforcer disagreed with the presentation. As the debt for equity swap resulted in derecognition of the issuer's loan receivable from the fish farm, the difference between the carrying amount of the loans derecognised and the fair value of the shares received should have been presented as a separate loss on the loans as required by paragraph 26 of IAS 39 *Financial Instruments: Recognition and Measurement* instead of being combined with the movement in the fair value of the AFS investment.

5. *Presentation of equal and opposite gains and losses in the statement of profit or loss and other comprehensive income for the period (IAS 1 Presentation of Financial Statements)*

The issuer did not present fair value gains and losses on financial instruments in the statement of profit or loss and other comprehensive income nor did it disclose in the gains and losses in the notes to the financial statements. This was on the basis that that the issuer believed it had no exposure to market risk as the net outcome of the investment strategy was such that any gains on financial assets and financial liabilities exactly offset each other giving a net nil result for the year.

The enforcer's decision

The enforcer did not accept the issuer's presentation. In the enforcer's view an analysis of gross gains and losses is important information for users, noting that paragraph 85 of IAS 1 *Presentation of Financial Statements* requires additional line items to be presented when such presentation is relevant to an understanding of the entity's financial performance. In addition, the requirements for offsetting income and expense set out in paragraphs 32 to 35 of IAS 1 were not met.

6. *Reclassification of capitalised milestone payments by a pharmaceutical company to the statement of profit or loss (IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and IAS 38 Intangible Assets)*

The issuer, a pharmaceutical company, acquires stakes in development projects when final approval of safety and efficacy is given (i.e. the last phase before a new drug is approved by the competent authorities for use by the general public). When acquiring a stake, the issuer makes an upfront payment and agrees to make a series of payments which are dependent on achieving determined milestones in the process, both before and after the product is given final approval by the relevant authorities.

The issuer historically capitalised the payments on the basis that separate intangible assets were being acquired However, in light of a new strategic plan and other internal considerations the issuer concluded that all capitalised milestone payments in the past prior to a drug project receiving market registration approval should be expensed as research and development costs. The issuer further concluded that this represented a change in accounting estimate and therefore had to be recognised prospectively by writing off through the profit and loss account the previously capitalised milestone payments.

The enforcer's decision

The enforcer disagreed with the issuer's accounting treatment. In the enforcer's view the criteria in paragraphs 21 to 24 of IAS 38 *Intangible Assets* were met. Consequently, the intangible asset should only have been derecognised on its disposal or if it was impaired, neither of which applied.

Further, the enforcer noted that reclassifying intangible assets to research and development costs does not constitute a change in accounting estimate. Had the issuer inappropriately recognised an intangible asset then the effects of correcting such an error would have needed to have been applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

7. *Legal requirements that prevent a shareholder from exercising its rights (IFRS 10 Consolidated Financial Statements)*

The issuer, a savings bank, held a 48.3% equity interest in another entity (Company B) whose activities comprised of investing in regional businesses for capital appreciation. The other 3 largest shareholders of Company B held 13.3%, 8.6% and 3.7% (the latter being the savings bank foundation which owned 35% in the issuer). The remaining 26.1% of Company B was owned by 102 shareholders, 60 of whom owned less than 0.1%. The historic attendance at shareholder meetings had been in the range of 72% to 81%, with decisions taken typically not being disputed and there being no indication of a fight for power or shareholder activism.

The issuer concluded that it held significant influence over the entity but did not control it

The enforcer's decision

The enforcer agreed with the issuer's accounting treatment. Although normally an investor with a 48.3% holding in these circumstances would conclude it has control over its investee, other facts and circumstances meant the issuer's conclusion was appropriate. Specifically:

- decisions over whether Company B should buy or sell investments could only be taken by Company B's management and board of directors and did not require consent at general meetings;
- the board comprised 5 directors and an alternate which was always in attendance, with the issuer's only appointee to the board being that alternate director.
- the issuer was unable to use its dominant voting interest to call a general meeting and replace board members with its own appointees because legal limitations in the issuer's jurisdiction barred the issuer from taking a majority position on the board; and
- none of the key management of Company B was a current or previous employee of the issuer

8. *Determining whether an entity is an investment entity (IFRS 10 Consolidated Financial Statements)*

The issuer, and hence the facts, are the same as discussed in situation 7 above. The issuer concluded that Company B was an investment entity on the basis that board members were provided with a semi-annual estimate of the overall fair value of its investment portfolio. Consequently, in accounting for its investment in Company B using the equity method, in the income statement the issuer included its share of the changes in the fair value of Company B's subsidiaries.

The enforcer's decision

The enforcer disagreed with the accounting treatment.

To be an investment entity paragraph 27(c) of IFRS 10 *Consolidated Financial Statements* requires an entity (Company B in this case) to measure and evaluate the performance of substantially all its investments on a fair value basis. According to Paragraph B85K of IFRS 10 this is demonstrated if the entity provides investors with fair value information. In this case, however, Company B only provided the semi-annual report to the issuer's board of directors, not to those investors without representation on the issuer's board.

Consequently, the enforcer was of the view that entity B did not meet the definition of an investment entity. Therefore, the issuer should have included its share of Company B's results determined on the basis of Company B not being an investment entity, i.e. not accounting for its subsidiaries at fair value through profit or loss.

9. *Depreciation of vessels in the oil and gas industry (IAS 16 Property Plant and Equipment)*

The issuer specialises in the building, operating and leasing of vessels to the oil and gas industry. As there had been a general reduction in the duration of lease contracts entered into, it meant there was scope for vessels to be further deployed at the end of each lease contract. The issuer therefore concluded that it would be appropriate to change the depreciation policy of the vessels in certain specified circumstances from 15 years on a straight-line basis, to one based on usage, which (if certain internally defined conditions were met) resulted in no depreciation being charged on a vessel when it was laid up and being prepared for subsequent redeployment under a new contract.

The enforcer's decision

The enforcer disagreed with the change to a usage based method of depreciation. In the enforcer's opinion there needs to be a strong correlation between the degree of use of the asset and the amount of consumption of future economic benefits from the asset in order to demonstrate that this method of depreciation best reflects the pattern of consumption of an asset's service potential. For vessels that are laid-up until a new lease contract can be concluded, the total service capacity would be unknown and would likely fluctuate over the asset's life. Therefore the issuer could not estimate the future pattern of consumption of the benefits embodied in the asset.

Moreover, for a usage method of depreciation to best reflect the consumption of future economic benefits, the enforcer considered that an asset should not be exposed to a material risk of obsolescence or wear during period of inactivity, and noted that the assets in question would be subject to such risks.

10. *The Application of value in use methodology in impairment testing (IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, and IAS 36 Impairment of Assets)*

The issuer, operating in the extractive industry, assessed the value in use of each cash generating unit (CGU) using a two-stage process before concluding whether there was an impairment.

Firstly, it estimated value in use by making an estimate of possible variations in the amount and timing of future cash flows together with other assumptions relating to the specific asset being tested (the "point estimate"), as required by paragraph 30(b) of IAS 36 *Impairment of Assets*. Due to the significant uncertainty in valuing assets in the extractive industry it then applied an uplift to that value in use of between 15-30% on the basis that when the probability distribution of a value in use estimate is not known, all value in use estimates within such a 15-30% interval around the initial point estimate will be equally probable. Under the issuer's accounting policy, only if the carrying value was higher than the uplifted value in use figure would an impairment be recognised, in which case the CGU would be written down to the original point estimate.

The enforcer's decision

The enforcer disagreed with the accounting policy as the use of such an interval introduces the concept of a threshold that is not in accordance with IAS 36.

Paragraph A3(c) of IAS 36 requires preparers to reflect uncertainties through the discount rate or by reflecting a range of outcomes when estimating future cash flows. As these uncertainties are already taken into account in calculating the point estimate (by making use where necessary of weighted averages of all possible outcomes for inputs as appropriate), the best estimate of value in use required to be calculated by paragraphs 32 and A3(c) of IAs 36 is a single number. It cannot be expressed as an interval or range.

The enforcer also noted that

- the economic uncertainties in the extractive industry are not dissimilar to those found in other industries; and
- the financial statements of the issuer did not contain adequate disclosure of the accounting policy regarding the use of intervals in determining the recoverable amount of CGUs (although as explained above such a policy was considered inappropriate).

11. *Recognition of onerous contract provisions (IAS 36 Impairment of Assets and IAS 37 Provisions, Contingent Liabilities and Contingent Assets)*

The issuer, operating in the extractive industry had a number of years previously acquired three contracts (one sales contract and two take-or-pay supply contracts). These three contracts, along with a number of pre-existing trading contracts for piped gas, were included in a single cash generating unit (CGU). Some years later, when fundamental changes in gas markets suggested a lower expected usage of the take or pay contracts, the issuer recognised an impairment loss on the carrying amount of the CGU and an onerous provision for the take or pay contracts.

In the subsequent accounting period, the issuer further revised downwards its expected usage of the take-or-pay contracts to virtually nil. However, further changes in prices meant the expected cash inflows on sales contracts more than compensated for the previously recognised impairment loss and the total expected loss on the take-or-pay contracts. Therefore the previously recognised impairment loss on CGU assets and onerous provision on the take-or-pay contracts were reversed in full.

The issuer had concluded that, for the purpose of determining the CGU's recoverable amount, it was appropriate to continue to treat the expected cash outflows on the take-or-pay contracts as being part of the CGU. It concluded that in order to redefine the CGU to exclude the take or pay contracts (which would have resulted in a need to continue to recognise a separate onerous provision on those contracts) it would have been necessary for management to either have made a decision not to use the terminal capacity. In the issuer's opinion this would have necessitated either permanent and/or irreversible non-usage or, alternatively, that expectations of no utilisation had to be sustained and evidenced over an extended period of time.

The enforcer's decision

The enforcer disagreed with issuer's accounting treatment not to redefine the composition of the CGU, and was of the view that the cash out flows on the take-or-pay contracts should not have been included in the CGUs cash flows. Specifically, the enforcer was of the view that the issuer's stated threshold for changing the composition of the CGU was too high.

Paragraph 72 of IAS 36 *Impairment of Assets* requires CGUs to be defined consistently from period to period unless a change is justified. Although the enforcer agreed that subsequent changes to economic assumptions that do not modify the expected utilisation of a component of a CGU significantly would typically not justify a change in the composition of the CGU, in this case the expected usage of capacity under the take-or-pay contracts was reduced to virtually nil. Only if there is an expectation of actual usage can it be concluded that the cash flows are not largely independent of one another.

12. *Identification of cash generating units (IAS 36 Impairment of Assets)*

The issuer, operating in the extractive industry, identified a shale play in the United States as a single cash generating unit (CGU) for the purposes of conducting impairment tests notwithstanding that its maturation and development could lead to more CGUs in the future. (A shale play is an area consisting of single or multiple reservoirs related to the same geological feature.)

The issuer considered that each individual well within the shale play did not generate cash flows independently from each other because the output flowed through a common processing system. In addition, the pipeline system was such that the products could be moved around easily, with no allocation of the production from specific areas to specific markets. The process of interconnection was therefore continuous and across the entire share play.

Based on paragraph 69 of IAS 36 *Impairment of Assets* the issuer argued that from an operational standpoint the shale play was viewed and managed as a single business unit, and decisions to divest non-core areas were a result of economic evaluations of the entire play

The enforcer's decision

The enforcer disagreed with the issuer's accounting treatment, and considered that more than one CGU should have been identified in the play area.

The enforcer noted that in estimating the resources in the shale play, the US Energy Information Agency identified eight individually assessed plays (labelled 'distinct plays') in order to capture differences in geologic and reservoir conditions and projected performance. Unlike conventional reservoirs, the different parts of the reservoir rock in a shale play do not communicate with each other, as the resources are trapped in the source rock itself. Even over short distances there will be little or no interdependencies for the productivity between individual wells drilled into the same impervious rock.

To ascertain the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash flows from other groups of assets, paragraph 68 of IAS 36 requires a bottom-up analysis to be performed, starting from an individual well. The existence of infrastructure assets shared by more than one well may be relevant in order to determine whether each well has independent cash flows or not. For conventional fields, the existence of infrastructure assets shared by more than one well will often cause groups of wells to form a single CGU. Although shared infrastructure may be present in shale plays such that more than one well within the play area might comprise a single CGU, this does not necessarily result in all of the wells in the play area comprising a single CGU.

The enforcer believed that for unconventional onshore assets a cluster of wells together with a local gathering system (small pipelines bringing gas to a mainline pipe) and any local processing facilities, usually may serve as a starting point for further analysis. Within such local systems, if the gathering pipeline, the gas processing plant or the compressor connecting the gathering pipelines to the mainline breaks down, all the wells linked to the gathering system will effectively be shut in. If this was the case, the cash inflows from the wells in such a local system would then not be independent of each other. However, in the specific case, the enforcer found that there were no flows between different parts of the shale play and that they were therefore independent from each other.

In supporting the argument that the share play comprised more than one CGU, the enforcer noted that:

- within the shale play, several trading hubs with willing buyers and sellers for both the natural gas and most fractions of the wet gas produced existed, some also with forward markets; and
- the issuer monitored, made strategies, operated, allocated resources and made decisions on acquisitions, continuation or disposals at a more granular level than the shale play as a whole.

13. *Purchase of a car fleet with an agreed buy-back agreement (IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, IAS 17 Leases, IAS 32 Financial Instruments: Presentation, and IFRIC 4 Determining whether an Arrangement Contains a Lease)*

The issuer, which operated in the car rental industry, entered into an agreement with a car manufacturer whereby:

- it bought a fleet of cars from the manufacturer
- it had a put option to sell the cars back to the manufacturer within 12 months
- the manufacturer was contractually required to repurchase the fleet at the end of the agreement if the issuer had not exercised its put option
- the price to be paid by the manufacturer, whether the issuer exercised its put or not, was fixed and would only be adjusted in certain situations, such as if the cars were damaged or the cars had been driven in excess of a specified number of kilometres.

The issuer concluded that no existing IFRSs applied to the accounting for buy-back agreements and therefore developed its own policy in accordance with paragraph 10 of IAS 8. The policy developed resulted in:

- a receivable being recognised to reflect the repurchase price
- a separate asset labelled as 'deferred depreciation expense on vehicles', being the difference between the consideration paid to the manufacturer and the receivable
- amortisation of the separate asset over the length of the agreement on a straight-line basis
- derecognition of the receivable when the repurchase price was received; and
- an impairment loss on the receivable if any of the specified situations for adjustment to the repurchase price arose (e.g. if the car was damaged or stolen).

The enforcer's decision

The enforcer disagreed with the issuer's conclusion that no existing standard applied to the transaction, but agreed that the policy devised was consistent with IFRS.

The agreement met the two conditions in IFRIC 4 *Determining whether an Arrangement Contains a Lease*, namely:

- its fulfilment is dependent on the use of a specified asset; and
- it conveys a right to use the asset

Consequently the agreement should have been classified as a lease in accordance with IAS 17 *Leases*. Based on the terms of the contract this would have resulted in the agreement being classified as an operating lease as none of the examples or indicators in paragraphs 10 and 11 respectively of IAS 17 giving rise to a finance lease applied.

The difference between the consideration paid to the manufacturer and the repurchase price therefore represented an operating lease expense to be recognised over the term of the contract. As the car manufacturer was obliged to repurchase the vehicles in all circumstances, the issuer's right to receive the purchase price met the definition of a financial asset in paragraph 11 of IAS 32 *Financial Assets: Presentation*, and therefore appropriately resulted in the recognition of a receivable for the amount to be received.

14. *Recognition of deferred tax assets for unused tax losses (IAS 12 Income Taxes)*

The issuer, a construction company, had recognised deferred tax assets related to the unused tax losses of its two Russian subsidiaries. However, it did not disclose in its financial statements the nature of the evidence supporting their recognition.

The enforcer's decision

The enforcer disagreed with the issuer's accounting treatment as it could not provide convincing evidence that sufficient taxable profit would be available against which the unused tax losses could be utilised by the entity. Therefore no deferred tax asset for the unused tax losses should have been recognised.

According to paragraph 34 of IAS 12 *Income taxes*, a deferred tax asset should only be recognised to the extent it is probable that future taxable profits will be available against which unused tax losses can be utilised. According to paragraph 35 of IAS 12 the existence of unused losses is a strong evidence that future taxable profit may not be available. Further, paragraph 82 of IAS 12 requires an entity to disclose the nature of the evidence supporting recognition of a deferred tax asset if recovery is dependent on generating future taxable profit and the entity has suffered a loss in the current or preceding period.

The enforcer ascertained that one of the major factors of the losses in both subsidiaries was Russia's economic crisis (including the decline of the Russian Rouble exchange rate). The enforcer was not provided with any convincing evidence that this situation would reverse in the foreseeable future.

Furthermore:

- for one of the Russian subsidiaries no projection of the future taxable income was available, meaning that there was no evidence to support recognition of a deferred tax asset; and
- for the other subsidiary, relief for the losses was dependent on the development of a commercial centre. However, based on the challenging economic environment and the fact that construction had been postponed (and might eventually abandoned entirely), the enforcer was of the view that the planned development did not constitute convincing evidence that justified recognition of a deferred tax asset.

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