Mazars' newsletter on accounting standards

Beyond the GAAP

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Editorial

As we move into the new year, many of us are wondering what will be the outcome of the debate over the correct accounting treatment of puts on non-controlling interests. The IFRS Interpretations Committee itself seems to have doubts as to whether changes in the value of the liability should really be recognised in profit or loss. Once again, it has asked the IASB to reconsider the issue. This seems to be the equivalent of launching a message in a bottle into the waves. Will it find a more welcoming shore than it has done previously? Only time will tell!

In Europe, ESMA has published a study on impairment testing of goodwill in 2011 IFRS financial statements. It makes several recommendations that it would like to see implemented by issuers in the 2012 financial statements (although the timing of the publication makes it short notice for issuers).

Happy reading!

Michel Barbet-Massin Edouard Fossat

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News

Françoise Flores, Mazars Partner, reappointed as EFRAG Chairman

On 14 December 2012, Françoise Flores, a Mazars Partner, was reappointed as EFRAG Chairman (European Financial Reporting Advisory Group) for a second term starting on 1 April 2013.

ASAF: IASB launches call for nominations

On 1 November 2012, the IFRS Foundation published its proposals for the creation of an advisory body called the Accounting Standards Advisory Forum (ASAF).

Two months on, the IASB has now published a report on the comment letters received, together with a call for candidates to become the first 12 members of the ASAF. More details can be found at the following link: http://www.ifrs.org/Alerts/PressRelease/Pages/ASAF-nominations-and-Feedback-Statement.aspx

Rate-regulated activities

The IASB has just launched a call for nominations for membership of a consultative group on the Rate-regulated Activities project, which it has recently reactivated.

The aim of the consultative group will be to analyse accounting issues which are specific to rate-regulated activities. More details can be found at the following link:

http://www.ifrs.org/Alerts/ProjectUpdate/Pages/IASB-invites-nominations-for-membership-of-rate-regulated-activities-consultative-group.aspx

MAZARS

➲ Puts on non-controlling interests: confirmation that changes in the value of the liability shall be recognised in profit or loss

At its January 2013 meeting, the IFRS Interpretations Committee (formerly the IFRIC) examined the comment letters on the draft interpretation which was published at the end of May 2012 (see Beyond the GAAP no. 57).

The Committee clarified that the interpretation would apply retrospectively, and would apply to both put options and forward contracts on shares in a subsidiary, in the parent company's financial statements.

The Committee also confirmed that changes in the value of the liability should be recognised in profit or loss, in accordance with IAS 39 and IFRS 9. The Committee holds that this is a correct interpretation of the existing standards.

Finally, the Committee reiterated its opinion that recognising puts on non-controlling interests as derivatives, and measuring them at fair value, would result in better financial information. In view of this, it requested the IASB to reconsider paragraph 23 of IAS 32.

Many commentators feel that the Committee or the Board should take a more comprehensive approach to the subject of puts on non-controlling interests, considering all derivatives written on an entity's own equity.

Readers will remember that the Committee investigated the possibility of recognising these puts consistently with derivatives under IAS 39, but without success (see Beyond the GAAP nos. 43 and 48).

In light of the serious doubts expressed by the Committee on the quality of financial information that is likely to result from this project, questions are raised as to whether the interpretation will be adopted by the EU.

The Committee's decision to confirm the recognition of changes in value in profit or loss, on the grounds that this is "the correct interpretation of existing standards", is reminiscent of the fate of IFRIC 3 on emission rights.

Readers will remember that this interpretation, originally published in December 2004, was withdrawn by the IASB in June 2005. The Board felt that although the interpretation was the correct interpretation of standards in technical terms, it would nonetheless result in undesirable accounting outcomes.

➲ Levies charged on entities that participate in a specific market – discussions continue

Having examined the comment letters on the draft interpretation published at the end of May 2012 (see Beyond the GAAP no. 57), the Committee made the following tentative decisions at its November 2012 and January 2013 meetings:

- The interpretation should apply both to levies for which the amount and timing are certain, and to levies falling within the scope of IAS 37, but not to liabilities relating to emissions trading schemes.
- The levies in question should be defined as transfers of resources imposed by governments in accordance with laws or regulations, unless the levies fall within the scope of other standards (such as IAS 12) or unless they are fines or penalties imposed for breaches of the law or regulations.
- In the event that the levies are conditional on reaching a certain threshold, the Committee decided that the obligating event is the achievement of this minimum threshold, in line with the principles established in the draft interpretation.
- The final interpretation should address recognition of the liability, but will not cover the issue of when a levy should be recognised as an asset and when it should be accounted for in P&L.

Some members of the Committee also asked the Board to:

- re-examine the principles of IAS 34;
- confirm that an interim period should be treated in the same way as a full financial period ("discrete view") rather than as an integral part of the annual period ("integral view");
- consider whether the illustrative examples in the standard are consistent with the principles for drawing up interim financial statements.

➲ Discount rate for post-employment benefits

In October 2012, the IFRS Interpretations Committee (formerly the IFRIC) received a request for guidance on the method for determining the discount rate for post-employment benefits. The Committee was asked for clarification on the definition of "High Quality Corporate Bonds" – specifically whether this category could be held to include corporate bonds with a rating lower than AA, in the light of the financial crisis and the decrease of the number of corporate bonds rated 'AAA' or 'AA'.

The Committee began looking at this issue in November 2012, noting that:

- the predominant past practice has been to consider corporate bonds to be high quality if they receive one of the two highest ratings given by an internationally recognised rating agency (i.e. AAA or AA);
- IAS 19 does not specify how to determine the market yields on HQCBs, and in particular it does not specify what grade of bonds should be designated as high quality;
- an entity shall apply judgement in determining what the current market yields on HQCB are; and
- an entity's policy for determining the discount rate should be applied consistently over time.

As a result, the Committee said not to expect that an entity's method of determination of the discount rate changes significantly from period to period.

At its January 2013 meeting, the Committee continued its discussions, looking in particular at the principles underlying determination of the discount rate, and especially whether the basket of HQCBs should be determined at the Eurozone level or at country level for liabilities denominated in Euro.

On this point, the Committee:

- felt that the deepness of the HQCB market should be assessed at the Eurozone level; and
- requested its staff to consult with the IASB to confirm that IAS 1 should be amended to clarify that when government bonds are used to establish the discount rate in the absence of HOCBs, those government bonds used must themselves be high quality.

➲ IASB proposes amendments to IAS 36 disclosures on recoverable amount of impaired assets

On 18 January 2013, the IASB published an exposure draft of proposed amendments to IAS 36 – *Impairment of Assets.*

The proposed amendments relate to disclosures on the measurement of the recoverable amount of impaired assets, particularly in situations where this amount is based on fair value less costs of disposal.

It aims to "correct" an unexpected effect of the disclosure requirements in IAS 36 that were introduced by IFRS 13 – *Fair Value Measurement.* These principles effectively require entities to **disclose the recoverable amount of each cash-generating unit for which the carrying amount of goodwill or intangible assets with indefinite useful lives is significant,** when compared to the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives.

The IASB is therefore planning to withdraw these disclosure requirements and to clarify that an entity must **disclose the recoverable amount of any asset or cash-generating unit for which an impairment loss was recognised or reversed over the reporting period.** The requirement will not apply to cash-generating units with intangible assets with indefinite useful lives (including goodwill) if there is no impairment loss.

The comment period is open until 19 March 2013 and the exposure draft can be accessed on the IASB's website via the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/Recoverable-Amount-Disclosures-for-Non-Financial-Assets/ED-January-2013/Pages/Exposure-Draft-and-Comment-letters.aspx

➲ IASB puts Philippe Danjou article online

On 6 February 2013, the IASB published an article by Philippe Danjou, a member of the IASB's Board, on its website. The article is entitled "Une mise au point concernant les International Financial Reporting Standards (normes IFRS)", which translates as "Setting the record straight on IFRS" (the article is only available in French at the time of writing).

IFRS

In his article, Philippe Danjou responds to some of the criticisms frequently levelled against the IFRS framework, particularly in France.

The article can be accessed via the following link: http://www.ifrs.org/Features/Pages/Philippe-Danjou-Feb-13.aspx

European matters

➲ ESMA issues Public Statement on accounting treatment of forbearance practices in IFRS financial statements of financial institutions

On 20 December 2012, the European Securities and Markets Authority (ESMA) published a document entitled "Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions".

The document can be downloaded from ESMA's website via the following link: [http://www.esma.europa.eu/news/ESMA-issues-statement-forbearance-practices?t=326&o=home.](http://www.esma.europa.eu/news/ESMA-issues-statement-forbearance-practices?t=326&o=home)

ESMA observes that there is a lack of consistency in the accounting treatment and disclosures of renegotiation and amendments to loan conditions when the borrower is in financial difficulty (referred to as forbearance practices).

ESMA begins by clarifying the relationship between forbearance practices and impairment of financial assets under IAS 39.

ESMA also points out that European financial institutions should provide higher-quality disclosures on the nature and extent of their forbearance practices, and the impact of these measures on the level of impairment. To facilitate this, ESMA lists the information that it would expect to see in the disclosures of financial institutions which employ forbearance practices.

ESMA encourages financial institutions to include these qualitative and quantitative disclosures in their financial statements for the year ending 31 December 2012, to the maximum extent possible.

Given this short notice and the fact that necessary data may not be available, ESMA expects that in any case these recommendations be implemented and reflected in 2013's annual financial statements.

ESMA calls for improvements in disclosures related to goodwill impairment

On 21 January 2013, ESMA published a report on disclosures related to the impairment of goodwill and other intangible assets in 2011 IFRS financial statements from European issuers.

The findings of this review have led ESMA to make a number of recommendations, in addition to the existing recommendations for 2012 reporting (see BEYOND THE GAAP no 61), which it expects to be taken into consideration by issuers and their auditors, despite the fact that it is rather late in the day for issuers.

ESMA will follow up these questions by collecting data on the disclosures published in IFRS financial statements in 2012.

BEYOND THE GAAP offers a summary of the main findings and recommendations of the review.

➲ Introducing the review

ESMA starts by recalling the general background of crisis against which the 2011 financial statements were published, and the questions that arose regarding the impact of goodwill impairment tests, in respect of:

- the appropriateness of the key assumptions used in goodwill impairment tests (these assumptions can sometimes seem too optimistic when compared with the underlying assumptions included in the market values of listed entities), and
- the adequacy of the disclosures provided in the notes.

The review looked into the accounting practices of a sample of 235 European issuers from 23 countries, representing a total goodwill figure of €800bn (€790bn in 2010).

The review focused on the following four categories:

1. general information on goodwill impairment testing and its accounting impacts;
2. disclosures on the basis on which the recoverable amount has been determined(value in use and fair value less costs to sell) and on entity-specific approaches;
3. analysis of the parameters used in calculating the recoverable amount in accordance with the discounted cash flows method (DCF); and
4. disclosures related to sensitivity analysis.

➲ 1. General information on impairment testing

1.1 Information on impairment losses

What the standard requires

Paragraph 130(a) of IAS 36 requires disclosures of the events and circumstances that led to the recognition or reversal of the impairment loss for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit (CGU).

Findings and recommendations

Findings	Recommendations
The total amount of impairment in 2011 represents approximately 5% of the total amount of goodwill recognised at the end of previous year. Significant goodwill impairments were limited to a handful of issuers (5% of companies account for almost 75% of total goodwill impairment).	**The increase in the equity/market capitalisation ratio between 2010 and 2011, together with relatively low level of impairment losses for both goodwill and other intangible assets (as compared with 2010 balance sheet values), lead ESMA to question whether the level of impairment in 2011 appropriately reflects the effects of the financial and economic crisis.**
One-third of issuers that recognised impairment on goodwill or other intangible assets in 2011 did not comply with the requirements of paragraph 130(a) of IAS 36.	**The disclosures on the events and circumstances which lead to the recognition of an impairment loss could be improved.**

1.2 Composition of CGUs, level of aggregation and goodwill allocation

What the standard requires

Paragraph 80 of IAS 36 provides guidance on the allocation of goodwill to CGU for impairment testing purposes.

Paragraph 130 (d) of IAS 36 requires a description of the CGU for each material impairment loss recognised (or reversed) in the period, disclosure of the amount of the impairment loss by reportable segment and by sector if the entity provides sectorial information under IFRS 8, together with a description of any changes to the aggregation of assets for identification of the CGU.

Findings and recommendations

Findings	Recommendations
86% of the issuers provide information on the aggregation level at which CGUs are being defined. In almost 75% of the sample, a link between the level of CGUs used for impairment testing and the operating segments was apparent.	**ESMA found that most issuers provide appropriate information regarding the allocation of goodwill and the level of aggregation.**
13% of the issuers in the sample indicated that they changed the way the CGUs were defined in 2011. All those issuers provide a qualitative explanation of the change. However, 70% state that the change was due to internal changes without expanding on the reason.	**Descriptions of the reasons for the changes in how assets are aggregated and CGUs are identified compared with the previous period could be improved where material impairment losses are recognised.**

➲ 2. Determination of the recoverable amount

What the standard requires

IAS 36 requires an asset or a CGU to be tested for impairment by comparing its recoverable amount with its carrying amount. Paragraph 134(c) of IAS 36 requires the disclosure of the basis on which the recoverable amount has been determined, i.e. whether it is a fair value less costs to sell or a value in use.

Paragraphs 20 and 25 to 29 of IAS 36 describe how to determine fair value less costs to sell. These paragraphs introduce a fair value hierarchy under which the fair value less costs to sell can be determined by reference to a binding sales agreement, an active market in which the asset is traded, or, when neither is available, the best information available. In practice this last category includes the use of the DCF method. Disclosures of the methodology used are required in application of the paragraph 134 (e) of IAS 36.

Paragraph 30 of IAS 36 sets out the principles to be applied when calculating value in use. The calculation is always a discounted cash flow computation with IAS 36 setting the requirements for estimating future cash flows, dealing with foreign currency cash flows and the discount rate.

According to paragraph 33 of IAS 36, cash flow projections should be based on reasonable and supportable assumptions by the management and greater weight should be given to external evidence. When calculating value in use, cash flow projections should exclude cash inflows (and outflows) from future restructurings or from improving the asset's performance.

Paragraph 134(d) of IAS 36 sets out the disclosures required for value in use calculations.

Findings and recommendations

Findings	Recommendations
92% of the issuers in the sample provide disclosures on the basis on which the recoverable amount has been determined, which comply with the requirements in IAS 36. More than three quarters of the issuers stated that the recoverable amount is determined based on value in use, whereas 6% of the issuers use fair value less cost to sell. Finally, 14% of issuers say that they use both value in use and fair value less costs to sell to determine the recoverable amount, depending on the CGU.	**ESMA reminds issuers who use both value in use and fair value less costs to sell to determine the recoverable amount that they should disclose the method used for each (significant) CGU, as required by IAS 36.**
Half of the issuers that used fair value less cost to sell stated that the fair value less costs to sell reflected market assumptions.	**When estimating fair value less costs to sell using the DCF method, ESMA would expect more weight to be given to external sources of information rather than entity-specific assumptions.**

➲ 3. Analysis of parameters used in DCF calculations

3.1 Discount rate

What the standard requires

In accordance with paragraphs 134 (d)(v) and 134 (e)(v) of IAS 36 entities shall disclose the discount rate applied to the cash flow projections for each CGU with significant goodwill or another significant intangible asset.

Paragraph 55 of IAS 36 states that, for "value in use" calculations, the discount rate must be a pre-tax discount rate that reflects the current market assessments of the time value of money and of the specific risks to the asset for which the future cash flow estimates have not been adjusted. Paragraph A16 of IAS 36 requires issuers to estimate the discount rate, when an asset-specific rate is not directly available from the market. In practice, the weighted average cost of capital (WACC) is commonly used. Paragraph A19 of IAS 36 requires determining the discount rate independently of the capital structure of the issuer.

The cost of equity is often determined by using the capital asset pricing model (CAPM). In this model, assumptions regarding the risk-free rate, the market risk premium and beta must be made. When determining the risk-free rate, attention must be paid to its correlation with the inflation assumptions and the time horizon of expected cash flows.

Findings and recommendations

Findings	Recommendations
Two-thirds of the issuers in the sample gave the discount rate specific for each disclosed CGU, whereas 25% of the sample disclosed an average discount rate for all the CGUs. Only 8% of issuers in the sample did not disclose any information regarding the discount rates used for impairment testing.	**Given the significant impact of the discount rate on determining value in use, ESMA strongly urges issuers to use separate discount rates when the risk profile of the CGUs differs.**
Two-thirds of issuers also presented the discount rate for the comparative period. Based on the information provided, there were no significant changes in disclosed discount rates between 2010 and 2011.	**Given the omission by one-third of the issuers of discount rate information regarding the previous period, ESMA points out the requirement of paragraph 38 of IAS 1 to disclose comparative information for all amounts reported in the current period's financial statements.**

3.2 Growth rate used for extrapolating cash flow projections

What the standard requires

Paragraphs 134 (d)(iv) and 134(e)(iv) of IAS 36 require disclosure of the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent forecasts (terminal growth rate).

These paragraphs also require justification for using a growth rate that exceeds the long-term average growth rate for the products, industrial sectors or countries in which the entity operates.

The requirement is related to the concept that higher than average growth can only be sustained over the short-term, since such conditions will attract new entrants and give rise to competition; the long-term growth rate will thus be the same as the overall economic long-term growth rate.

These paragraphs require entities to provide the growth rate for each cash-generating unit to which goodwill or other significant intangible assets have been allocated.

The terminal value constitutes a very important component of the recoverable amount when a DCF method is used.

Therefore, the assumptions regarding the normalised perpetual cash flows and the estimated terminal growth rate significantly impact this calculation.

Findings and recommendations

Findings	Recommendations
The review suggests that there are no significant differences in the terminal growth rates applied by issuers whose market capitalisation was below the book value of equity and those whose market capitalisation exceeded the book value.	**In some cases, the terminal growth rates applied might appear to be too optimistic, especially compared with the long-term expectations of the investors reflected in the market capitalisation.** **Issuers should carefully consider how the cash flows of the most recent projection period are normalised when used as a reference in determining terminal value.**
83% of issuers have disclosed a terminal growth rate. A majority of issuers disclosed a growth rate specific to each CGU, while a quarter of the issuers presented a range of growth rates. The remaining issuers disclosed an average growth rate for all CGUs. Of the issuers that disclosed a terminal growth rate, around 15% used growth rates greater than 3%.	**In the current economic circumstances, using a long-term growth rate exceeding 3% in mature markets might appear ambitious and may lead to overstating long-term growth. ESMA strongly urges issuers to provide realistic estimates of future growth rates that are consistent with current predictions for economic growth.** **ESMA reminds issuers that, like cash flow projections, the terminal growth rate must be based on reasonable and justifiable assumptions, giving more weight to external sources.**
Information on the terminal growth rate used in the previous period is provided by less than half of issuers.	**ESMA reminds issuers of the requirement in paragraph 38 of IAS 1 to disclose comparative information on the previous period for all amounts reported in the current period financial statements.**

3.3 Period covered by cash flow projections

What the standard requires

Paragraph 134(d)(iii) of IAS 36 requires disclosure of the period over which management has projected cash flows based on financial budgets/forecasts approved by management (the period over which detailed projections have been used before application of the long-term or terminal growth rate).

Where the forecast period is greater than five years, the standard also requires disclosure of an explanation justifying the longer period.

Findings and recommendations

Findings	Recommendations
The review showed a high degree of compliance with this requirement, with 88% of the issuers in the sample providing information about the period covered by detailed cash flow projections.	**None**
Of the issuers who used forecast periods of over five years, 61% (representing 14% of the total sample) disclosed the basis for the chosen period. The remaining 39% did not. Explanations for this varied widely in length and content.	**ESMA reminds issuers that fi they use cash flow projections exceeding five years, the projections reliable and management should be able to demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.**

3.4 Key assumptions

What the standard requires

Paragraphs 134(d) (i) and (ii) of IAS 36 require extensive disclosures concerning key assumptions used in value in use calculations for each cash-generating unit to which significant goodwill or intangible assets are allocated.

IAS 36 paragraph 134(d)(i) requires a description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the CGU's recoverable amount is most sensitive.

Paragraph 134(d)(ii) of IAS 36 requires issuers to provide a description of management's approach in determining the values assigned to each key assumption. This description should state whether these values reflect past experience or, if appropriate, are consistent with external sources of information and, if this is not the case, why they differ from past experience or external sources of information.

Similar disclosures concerning key assumptions used in fair value less costs to sell calculations are required.

In ESMA's view, disclosures on key assumptions are distinct from those on the long-term growth rate and discount rate (which are treated in separate sub-paragraphs 134(d)(iv)-(v) in IAS 36).

ESMA considers that the key assumptions on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts are those which determine the results for the forecast period itself, as exemplified in Illustrative Example 9 of IAS 36 [see Illustrative Examples, paragraphs 80 to 89, in the annexes to IAS 36].

According to ESMA, it appears from this example that the IASB envisaged assumptions at a deeper level than, for example, a simple reference to profit growth. ESMA states that the information disclosed should assist users of financial statements in evaluating the reliability of the impairment tests.

Findings and recommendations

Findings	Recommendations
Approximately 70% of issuers in the sample focus insufficiently on disclosing the key assumptions in detail (in comparison to the level of detail suggested in Illustrative Example 9 in IAS 36, which presents assumptions such as gross margin, market-specific inflation, market share and exchange rate) and in a way useful to users of financial statements. Of these, around 40% provided no disclosures on the key assumptions.	**ESMA's conclusion is that issuers should improve disclosure of the key assumptions as required byIAS 36.** **The nature and number of the assumptions disclosed should be appropriate to the entity' situation.** **Disclosures on the key assumptions are additional to those relating to discount rate and the terminal growth rate.**
ESMA notes that, when detailed disclosures are provided on the key assumptions, the quality of the information varies: - Some referred to indicators which could be seen as the result of more basic assumptions, for example, EBITA and EBITDA, profitability or operating cash flows. - Other assumptions appeared not to apply to the forecast period but rather to other factors in the calculation of value in use, such as the discount rate (risk-free interest rate, premium to reflect inherent risk). - Some issuers gave a long list of factors (sometimes 10 or more), raising the question of whether all these assumptions were actually 'key'.	**ESMA is particularly concerned about the inadequacies in this area, given the role that the disclosure of key assumptions is meant to play in assisting users of financial statements to evaluate the reliability of an issuer's impairment tests.** **Therefore, ESMA strongly urges issuers to disclose all the key assumptions and to detail the management's approach in determining the values attributed to the key assumptions used in impairment testing.**

➲ 4. Disclosures related to sensitivity analysis.

What the standard requires

According to paragraph 134(f) of IAS 36, an entity shall disclose a sensitivity analysis, if a reasonably possible change in a key assumption on which management has based its determination of the CGU recoverable amount would cause the carrying amount of the CGU to exceed its recoverable amount.

This sensitivity analysis includes both the value attributed to the key assumption and the change in value, taking account of all the impacts of this change on the other variables used to measure the recoverable value such that the recoverable value of the CGT is equal to its carrying value. It also includes the amount by which the recoverable value of the CGU exceeds its carrying value (the 'headroom').

> *ESMA states that the objective of the sensitivity analysis is to provide investors with information on what changes in the values of key assumptions would lead to the recoverable amount of the CGU becoming equal to its carrying value; that is, how imminent is an impairment loss.*

The assumptions used in calculating the recoverable value using the DCF method, and which may require a sensitivity analysis, include sales volumes and margins (e.g. gross margin - 'headroom' - or EBIT) for the forecast period, their anticipated growth compared to past performance, their terminal growth rate and the discount rate.

ESMA notes that issuers may also use other variables, including changing market share, the development of new technologies etc.

It states that IAS 36 requirements for disclosures on sensitivity analysis primarily rely on management judgement. If management considers that a reasonably possible change in any key assumption would cause the carrying value of a CGU to exceed its recoverable value, the standard requires a sensitivity analysis; otherwise no information is required.

Findings and recommendations

Findings	Recommendations
A quarter of the issuers disclosed all the variables required for the sensitivity analysis: the amount of 'headroom' between the recoverable value and the carrying value of the CGU, the values of key assumptions and the amount by which these would have to change in order for the headroom to disappear. Of these, only one-third disclosed how much the values of key assumptions would have to change in order for the headroom to disappear. The majority limited the analysis to terminal growth rate and discount rate. Around 40% of issuers provided only one or two of the required disclosures on the sensitivity analysis. Most commonly, their financial statements disclose the values of key assumptions and the amount of headroom without giving any information on the changes in key assumptions that would consume the headroom. Nearly 50% suggested that no reasonably likely change in key assumptions could cause an impairment loss. 10% of issuers merely stated that no reasonably likely change in key assumptions could cause an impairment loss; in other words, they only provided a negative confirmation of the impairment risk. Finally, around 25% of issuers gave no information on the sensitivity of key assumptions, providing neither a negative confirmation of the impairment risk, nor any numerical information on sensitivities.	**ESMA notes that disclosure on the sensitivity of key assumptions is an area where different practices are observed, suggesting an absence of clarity in the standard, particularly regarding the circumstances under which sensitivity analyses are required.** **It also notes that sometimes disclosures are provided in a way that clearly informs investors about the extent to which impairment losses may be imminent; however, in other cases issuers disclose only some of the elements of sensitivity analysis required by IAS 36, or provide information which is difficult to interpret. ESMA stresses that vague and incomprehensible sensitivity analyses are of no use to users of financial statements.** **ESMA notes that sensitivity analyses should not be limited to discount rates and terminal growth rates, but should also be applied to other key assumptions.** **ESMA also strongly urges issuers to make realistic estimates in determining possible changes in key estimates that would cause the carrying amount of the CGU to exceed its recoverable amount.**
Only half of the issuers where the carrying value of equity exceeds market capitalisation presented a sensitivity analysis, and around 40% claimed that no reasonable change in any key assumption was likely to cause an impairment loss.	**In ESMA's view, it is surprising that only 50% of issuers whose equity book value exceeds market capitalisation presented a sensitivity analysis, since the lower market capitalization suggests that the market perceives a potential for impairment. ESMA would therefore expect these issuers to adopt greater transparency and to disclose clearer information on the sensitivity of the impairment calculations to changes in key assumptions.**

➲ What are the key messages?

The **key assumptions** used in DCF calculations:

- **ESMA considers that the disclosures published by issuers in the sample are insufficient in 70% of cases.**
- ESMA notes that **disclosures on key assumptions constitute a requirement under IAS 36, in addition to disclosures on discount rates and the terminal growth rate;**
- ESMA considers that the **key assumptions are those which determine results over the period of the financial forecasts** (*see the AMF recommendations for 2011 and 2012 annual accounts*) and urges issuers to follow the model in Example 9 in IAS 36 (IAS 36.IE 80-89). The number and type of the key indicators should reflect the circumstances of the entity;
- ESMA reminds issuers that assumptions must be **appropriately reflect the economic operating environment**: in particular, it highlights the risk of **overestimating terminal growth rates** when, in the current economic circumstances, a long-term rate exceeding 3% is used in mature markets.

Disclosures of sensitivity analyses of recoverable value:

- **ESMA calls on issuers whose market capitalisation has fallen below the book value of their equity**, and which do not yet provide a sensitivity analysis as required by IAS 36, to **justify their position** and be more transparent about the extent of reasonably possible changes in key assumptions and their impact on the recoverable amount;
- ESMA also asks issuers to be **realistic about the extent of reasonably possible changes in key assumptions;**
- ESMA notes that **sensitivity analyses should study the impact of changes in <u>all the key assumptions</u> on the recoverable amount**, not just the discount rate and the terminal growth rate *(in its 2011 and 2012 recommendations, the AMF went a little further and suggested presenting the impact of on recoverable value of scenarios combining changes in all the ley assumptions).*

ESMA also **reminds issuers of the requirements in the standards** regarding:

- the **level of detail of the information** presented (separate presentation of discount and terminal growth rates for <u>each CGU</u> to which significant goodwill or intangible assets are allocated);
- the **need for comparative information** (issuers must disclose the discount and terminal growth rates applied during the previous period).

Finally, **ESMA stresses the importance of giving greater weight to external information sources when calculating fair value less costs to sell following the DCF method.**

Now that IFRS 13 on Fair Value has come into effect on 1 January 2013, this subject will see further developments in the future.

Frequently asked questions

- Sale and leaseback transactions relating to property with fixtures and fittings: breaking down the transaction into a financing transaction and a sale and leaseback transaction with a new operating lease.
- Valuation of investment property (IAS 40) classified as held for sale (IFRS 5): should transaction costs be taken into account?
- Premises that will be vacant following a planned re-location of head office.
- The accounting treatment of a trade dispute between two entities forming part of the same group.
- The impact of annulation of an employment preservation plan on provision.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB	Committee	EFRAG
13 - 22 February 2013	12 - 13 March 2013	27 February – 1 March 2013
14 - 22 March 2013	14 - 15 May 2013	3 - 5 April 2013
17 - 26 April 2013	16 - 17 July 2013	6 - 8 May 2013

The drafting of the present edition was completed on 15 February 2013

MAZARS