27 June 2025
ESMA32-193237008-9182

Report

30th Extract from the FRWG (EECS)'s Database of Enforcement

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List of abbreviations and acronyms used in this report

APM	Alternative Performance Measure.
BC	Basis for Conclusions.
CGU	Cash Generating Unit.
DTA	Deferred Tax Asset.
EEA	European Economic Area.
ESMA	European Securities and Markets Authority.
FRWG (EECS)	Financial Reporting Working Group (European Enforcers Coordination Sessions).
GLEFI	Guidelines on enforcement of financial information.
IAS	International Accounting Standards.
IASB	International Accounting Standards Board.
IFRS IC	IFRS Interpretations Committee.
IFRS	International Financial Reporting Standards.
(v)PPA	(Virtual) Power Purchase Agreement.
SPV	Special Purpose Investment Vehicle.
Transparency Directive	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004.
ViU	Value in Use.

Executive Summary

According to its Founding Regulation[1], the European Securities and Markets Authority (ESMA) shall act in the field of financial reporting to ensure the effective and consistent application of European legislation. To this effect, ESMA publishes extracts from its database of enforcement decisions on financial statements to enhance supervisory convergence and inform issuers, auditors and users about the correct application of International Financial Reporting Standards (IFRS) and of the ESMA Guidelines on Alternative Performance Measures (APMs)[2].

ESMA ensures consistent application of European legislation in financial reporting through the Financial Reporting Working Group (FRWG (EECS)). The FRWG (EECS) comprises 38 enforcers from the EEA countries, coordinating the supervision of nearly 4,000 issuers admitted to trading on the EEA regulated markets which prepare IFRS financial statements. The FRWG (EECS) constitutes the largest regional network of enforcers of financial information.

FRWG (EECS) members discuss and share experiences on IFRS and APMs application before and after enforcement[3] decisions are taken concerning relevant enforcement cases and provide technical advice in ESMA Statements and Opinions. They apply their judgement, knowledge, and experience to individual cases, considering national laws in addition to the accounting requirements effective at the time the decisions are taken. As IFRS are principles-based, there may be no single way of addressing situations or transactions which may seem similar but in substance are different. Therefore, financial market participants should carefully consider the specific facts and circumstances when reading the cases included in this extract.

Decisions by European enforcers do not provide general IFRS interpretations; this is the role of the IFRS Interpretations Committee. The publication of enforcement decisions aims to assist market participants to identify (non) compliant accounting treatments, promote consistent application of IFRS and of ESMA Guidelines on APMs[4] in the EEA and prevent the misapplication of European legislation.

According to ESMA Guidelines on enforcement of financial information (GLEFI)[5], decisions are published[6] if they:

- Address complex accounting issues or divergent IFRS application,
- Relate to widespread issues among issuers or specific business types,
- Address issues with inconsistent enforcer experiences,
- Are based on provisions not covered by accounting standards.

The criteria highlighted above applies *mutatis mutandis* to decisions related to the APM Guidelines.

The decisions included in this report were taken by national enforcers in the period from **December 2023 to February 2025**. ESMA will continue to publish further extracts from the database on a regular basis.
Published decisions are based on **IFRS requirements effective at the time the decision is taken which may be superseded** by later developments.

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[1] EUR-Lex - 02010R1095-20200101 - EN - EUR-Lex
[2] ESMA/2015/1415en ESMA Guidelines on Alternative Performance Measures, 5 October 2015.
[3] Enforcement refers to examining the compliance of financial information with the relevant reporting frameworks and taking appropriate measures where infringements are discovered during the enforcement process.
[4] APMs are disclosed outside financial statements but within regulated documents like management reports and prospectuses.
[5] ESMA32-50-218 ESMA Guidelines on enforcement of financial information, 4 February 2020.
[6] Guideline 17 of the Guidelines on enforcement of financial information (GLEFI).

I. Decision ref EECS/0126-01 – Impairment test of goodwill

Financial year end
31 December 2021

Category of issue
Impairment test, goodwill, forecast period

Relevant standards/requirements
IAS 36 *Impairment of Assets*

Description of the issuer's accounting treatment

The issuer develops and sells IT hardware components. The issuer's intangible assets consist of technology patents and customer relationships, capitalised development costs and goodwill. The most substantial part of issuer's goodwill stems from an acquisition in 2017.

The projected future cash inflows used in measuring value in use (ViU) are revenues resulting from future sales of new technology products. When performing the impairment test for goodwill, the issuer applied, starting from 2018, cash flow forecasts covering nine subsequent years. The cash flow forecasts prepared by the issuer (in 2018 and subsequent years) projected the cash flows from sales and operating profits mainly at the end of the respective forecast period. Each year, the issuer shifted forward by one year the forecasted sales and operating cash flows.

In 2020, goodwill was partially impaired, due in part to effects related to the COVID-19 pandemic. In 2021, no impairment was recognised by the issuer based on the impairment test performed using the nine-year forecast period starting in 2022. After the year of examination, an additional impairment of goodwill and other intangible assets was recognised at the end of 2022. According to the issuer's interim financial report for the fourth quarter of 2022, the impairment was related to i) an increase in the discount rate and ii) to the expectation that cash flows would shift forward, both due to macroeconomic factors.

According to the issuer, the acquired business focused on the development of solutions in the automotive industry and was largely in the development phase. The forecasted cash flows from sales and operating profit were mainly expected after seven to nine years. The issuer provided the following arguments to support the longer forecast period:

a. The cash flows depend on demand from the automotive industry, which has a long development cycle and requires extensive quality testing.

b. The expected cash flows are affected by changes in legislation. From 2026, systems that use the issuer's products will become mandatory in the EU.

c. Experience has shown that it takes time to develop technologies and patents before they start generating revenue.

d. One example of the issuer's past experience is a hardware component for mobile phones that was developed between 2004 and 2010 and started generating revenue in 2015. This product is still contributing to the issuer's revenue.

The enforcement decision

The enforcer concluded that the issuer's management had not been able to make reliable cash flow forecasts for a projection period as long as nine years. As a consequence, the issuer corrected the cash flow forecast, reducing the projection period to five years, which resulted in an impairment of goodwill.

Rationale for the enforcement decision

The enforcer noted that, according to paragraph 33(b) of IAS 36, projections based on budgets and forecasts shall cover a maximum period of five years unless a longer period can be justified. Moreover, paragraph 35 of IAS 36 stipulates that '*detailed, explicit, and reliable financial budgets and forecasts of future cashflows for periods longer than five years are generally not available. (..) Management may use cashflow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experiences, to forecast cashflows over that longer period*.'

Because the forecast period of nine years (initially applied by the issuer in 2018) was applied again in 2021 and the initially expected cash flows were continuously shifted forward in time, the enforcer concluded that the cash flows initially projected by the issuer's management have not materialised. This view was also supported by the fact that an adjustment of the forecasted cash flows resulted in a material impairment in 2020. Therefore, the enforcer concluded that the issuer was not able to demonstrate its ability to forecast cashflows over a period as long as nine years, based on past experiences.

II. Decision ref EECS/0126-02 – Cash flows projections and useful life of assets

Financial year end
31 December 2022

Category of issue
Useful life, cash flow projections, impairment, cash-generating units

Relevant standards/requirements
IAS 36 *Impairment of Assets*, IAS 16 *Property, Plant and Equipment*

Description of the issuer's accounting treatment

The issuer operates in the production of electrical energy from renewable sources, in particular from wind and solar energy sources. In its 2022 annual consolidated financial statements, the issuer stated that wind plants are systematically depreciated over their useful life of 25 years and the concession is amortised over 29 years.

In 2022, the issuer performed an impairment test on its tangible and intangible assets allocated to each wind farm, which represents a separate cash-generating unit (CGU), and calculated the recoverable amount based on the ViU. No impairment was identified.

When determining the ViU of the wind farms, the issuer used cash flow projections over 49 years and explained that the total projection period was longer than both the useful life of the plant used to determine depreciation in accordance with IAS 16 (25 years) and the amortisation period of the project concession (29 years). The rationale given was that continuous technological evolution, ongoing maintenance of the plant and the implementation of refitting measures (extension of the service life) should lead to an extension of the useful life of wind farms. The issuer expected that the concessions would be renewed.

In this respect, the issuer considered the operating cash flows (which consider the investment levels appropriate to maintaining the operational efficiency of the plants and are based on the term of the concessions required) of 29 years after the start of production (explicit period). A terminal value was estimated as the net present value of the operative cash flows generated by the wind power plant during the additional 20 years period after the end of the concession.

The enforcement decision

The enforcer did not agree with the cash flow projection period of 49 years used by the issuer and concluded that the cash flows projections used by the issuer to calculate the ViU cannot be longer than the useful life of the concession (29 years), which is an asset essential to the ongoing operation of the issuer's CGUs.

Rationale for the enforcement decision

The enforcer noted that, according to paragraph 33 of IAS 36, an entity shall base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence. Moreover, paragraph 49 of IAS 36 requires that, when a CGU consists of assets with different estimated useful lives - all of which are essential to the ongoing operation of the CGU, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the CGU when estimating the future cash flows associated with the CGU.

The enforcer considered that, based on paragraphs 33 and 49 of IAS 36, the cashflow projections can usually not cover a period longer than the longest useful life of an asset essential to the ongoing operation of the CGU. Additionally, the enforcer observed that:

a. Currently, the issuer had no evidence about the extension of the useful life of the plant and/or of the concession for a total period of 49 years.

b. While the issuer expected that the concession rights, which are essential to the ongoing operation of the wind farms, would be renewed based on past experience, the issuer did not provide any further evidence to demonstrate that this would happen.

Therefore, the enforcer considered that the cash flows projections used to calculate the ViU of the wind farms could not be longer than the useful life of the concession that represents an asset essential to the ongoing operation.

III. Decision ref EECS/0126-03 – Recognition of deferred tax assets on tax losses

Financial year end 31 December 2022
Category of issue Deferred tax assets, tax losses, going concern
Relevant standards/requirements IAS 12 *Income Taxes*

Description of the issuer's accounting treatment

The issuer is a global biotech company specialising in the development and manufacture of biosimilar medicines. It has one product (B1), which is already commercialised in certain countries and has several other programs for products in various stages of development.

The issuer has incurred tax losses since its creation in 2013 and has negative equity. In its 2022 annual consolidated financial statements, the issuer stated that there is a material uncertainty regarding its ability to obtain funding, which may cast significant doubt upon its ability to continue as a going concern. Since 2020, the issuer has fully recognised the deferred tax assets (DTA) arising from tax losses, based on a 10-year budget for the period 2020 to 2030 approved by the board of directors in January 2021 (2020 10Y Plan). At the end of 2022, the net DTA amounted to 25% of the total assets.

Around 90% of the total revenue planned for 2023-2030 was product revenue resulting from sales of biosimilar products to commercial partners, half of which was allocated to product B1. The issuer expected that the main part of the profits generated by B1 would be made in the US, where prices and margins are significantly higher than in Europe. The product revenue projections over 2023-2030 have not been updated since the 2020 10Y Plan. For the DTA year-end 2022 recognition assessment, the issuer excluded all product revenue planned with products other than B1.

In 2021, B1 received regulatory approval and was commercialised in Europe and several other countries. The product was not approved for commercialisation in the US as per the date of publication of the 2022 annual consolidated financial statements. However, the issuer argued that, according to an independent study published in February 2021, the success rate for the approval of products that were in the same phase of the approval process as B1 was around 90%.

The issuer explained the use of a 10-year budget period (actually an 8-year period for the assessment at the end of 2022) using the typical life cycle for the development of a biosimilar product, with development costs being incurred in the early stages. This was also evidenced by the fact that the issuer began commercialising B1, which was created in 2013, in April 2022.

The enforcement decision

The enforcer disagreed with the recognition of the DTA arising from tax losses by the issuer. Notably, the issuer did not provide convincing evidence that sufficient taxable profit would be available in the future against which the unused tax losses could be utilised.

Rationale for the enforcement decision

According to paragraph 35 of IAS 12, when an entity has a history of recent losses, the entity recognises a DTA arising from unused tax losses only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. As the issuer's taxable temporary differences were immaterial, to recognise DTA there should have been other convincing evidence that sufficient taxable profit would be available.

The enforcer noted that three of the four criteria in paragraph 36 of IAS 12 (a, c and d) to be applied in assessing the probability that taxable profit will be available were not met. To assess whether it would have been probable that the issuer would have taxable profits before the unused tax losses or unused tax credits expire (criterion b), the enforcer considered the available evidence, negative and positive, and in particular took into account the following[7]:

[7] See paragraph 9 of ESMA Public Statement: Considerations on recognition of deferred tax assets arising from the carry-forward of unused tax losses, 15 July 2019.

a. Generally, the longer the estimates/forecasts extend into the future, the less reliable they are; therefore, their weight should be assessed accordingly.

b. The existence of unused tax losses is strong evidence that future taxable profits may not be available.

c. Forecasts/planning should be reasonable, realistic and achievable in all cases.

d. When issuers have a history of recent losses and do not have sufficient taxable temporary differences, forecast/planning should provide convincing (other) evidence in order to recognise DTAs.

In this regard, the enforcer noted that the issuer used a period of eight years for its estimates, whereas the common market practice is to take future taxable profits over the next two to five years, as longer-term estimates are usually not considered sufficiently reliable.

Moreover, with respect to the issuer's assumption that the underlying assumptions for the 10-year plan prepared in 2020 were still valid for the 2022 DTA assessment, the enforcer noted that an annual budget update was particularly important given the rapidly changing competitive environment for biosimilars and the fact that the issuer was at an early stage of the business.

Regarding the positive evidence supporting the assessment that it is probable that sufficient future taxable profits will be available[8], the enforcer noted that such evidence appears to be limited to the new business opportunities related to the products of the issuer that are in different stages of development.

On the other hand, there are several indications that sufficient future taxable profits might not be available (negative evidence):

a. The issuer had a recent history of operating losses for tax purposes, whereas it is common practice in the pharmaceutical industry to recognise DTAs only when an activity becomes profitable.

b. The issuer was at an early stage of business requiring additional significant financing to develop their business model and a high level of risk of failure (akin to start-up business).

c. There was a history of significant variances of actual outcomes against the historical business plans.

d. A material uncertainty on the issuer's going concern was raised by management and the auditor in the 2022 annual consolidated financial statements.

e. The issuer had a history of unused tax losses and in accordance with the applicable tax legislation, tax losses can be utilised only within a period of ten years.

f. The losses related to the core activity of the issuer and thus could reoccur in the future.

The enforcer therefore determined that there was more negative evidence than positive evidence regarding the potential availability of sufficient taxable profit. Moreover, the timing and likelihood of future taxable profits were highly uncertain. Consequently, the enforcer concluded that the issuer did not provide convincing evidence that sufficient taxable profits would be available against which the unused tax losses could be utilised and, therefore, that the issuer should not have recognised DTAs arising from tax losses in its 2022 annual consolidated financial statements.

[8] See paragraphs 14 and 15 of the above mentioned ESMA Public Statement for examples of negative and positive evidence.

IV. Decision ref EECS/0126-04 – Disclosure of parent company

Financial year end
31 December 2023

Category of issue
Related party disclosures

Relevant standards/requirements
IAS 24 *Related Party Disclosures;* IAS 1 *Presentation of Financial Statements*

Description of the issuer's accounting treatment

The issuer is an industrial company, with a fragmented capital shareholder structure: Entity B and Entity C control around 35% and 25%, respectively, of the issuer's share capital. Entity B and Entity C signed a shareholders' agreement according to which Entity B was acknowledged as the issuer's ultimate controlling parent. In light of the existing shareholding agreement, the issuer disclosed in its 2022 annual financial statements, in accordance with paragraph 138 (d) of IAS 1 and paragraph 13 of IAS 24, that Entity B was its ultimate parent.

In June 2023, there were changes to the issuer's corporate governance structure (notably, changes in the composition of the Board of Directors of the issuer) and restrictions in Entity B's ability to control the issuer. In its 2023 annual financial statements, the issuer, based on the information received from Entity B, disclosed: (i) that Entity B continued to be its ultimate parent, (ii) the basis for this disclosure (i.e. the information received by Entity B) and (iii) that the issuer's own assessment as to whether Entity B was its ultimate parent or not was ongoing (i.e. was not yet finalised).

Finally, the issuer noted that the transactions occurring between the issuer and Entity B were not material from a quantitative perspective.

The enforcement decision

The enforcer challenged the disclosure provided by the issuer in its financial statements concerning its ultimate parent. The enforcer considered that paragraphs 138 of IAS 1 and 13 of IAS 24 require the issuer to assess who its ultimate parent is and to disclose the name of the ultimate parent based on this assessment. While the issuer should have considered the information received from Entity B, it should not have solely relied on the accuracy of the analysis carried out by its shareholder, the result of which was communicated to the issuer. The issuer should have conducted its own assessment on whether it has a parent entity and, if so, which entity was the parent entity.

Rationale for the enforcement decision

The enforcer noted that, in accordance with paragraph 1 of IAS 24, *'the objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties'*. Paragraph 13 of IAS 24 states that *'relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been transactions between them. An entity shall disclose the name of its parent and, if different, the ultimate controlling party (…)'*.

Furthermore, paragraph 14 of IAS 24 states that it is appropriate to disclose the related party relationship when control exists, irrespective of whether there have been transactions between the related parties, to *'enable users of financial statements to form a view about the effects of related party relationships on an entity'*. In particular, paragraph 7 of IAS 24 notes that *'the profit or loss and financial position of an entity may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the entity with other parties.'*

Finally, the enforcer noted that regarding the term 'control' paragraph 9 of the IAS 24 refers to IFRS 10. Given the complexity of the analysis of de facto control and the significant judgement required to identify the controlling party of the issuer, the enforcer was of the view that the issuer should have, in accordance with paragraph 31 of IAS 1, provided disclosure about any uncertainties related to the assessment of control. This disclosure should enable users to understand the impacts of related party relationships on the issuer. Therefore, the enforcer required the issuer to make its own assessment of control pursuant to IFRS 10 and to include in the notes: (i) the name of the parent entity as identified by the issuer (if any), even if there were no material transactions with the parent, (ii) information about any significant judgements applied in the analysis, and (iii) the information required by paragraph 18 of IAS 24. As a result, the issuer included material information in the financial statements.

V. Decision ref EECS/0126-05 – Assessment as to whether a transaction qualifies as a business combination

Financial year end
31 December 2022

Category of issue
Business combination, Definition of a business

Relevant standards/requirements
IFRS 3 *Business Combinations*

Description of the issuer's accounting treatment

The issuer is a real estate investment firm that primarily operates logistics properties in several European countries. In 2022 it acquired another listed real estate investment firm ('the Acquiree'). The issuer considered that the acquiree was a special purpose investment vehicle (SPV) that owned several real estate properties whereby all relevant processes of the SPV, including day-to-day management, were outsourced. Because the issuer considered that the assets acquired did not constitute a business, it accounted for the acquisition as an asset acquisition, as required by paragraph 3 of IFRS 3.

According to paragraph B7 of IFRS 3, a business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. To be considered a business, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output (paragraph B8 of IFRS 3).

While the issuer identified inputs and outputs resulting from the activities carried out by the Acquiree, it was of the opinion that no substantive processes were acquired. The issuer identified four processes that required further analysis as to whether they were substantive or not: (i) strategic management, (ii) accounting, (iii) property management and (iv) lease management.

Applying the guidance in paragraph B12C of IFRS 3 the issuer concluded that:

a. None of the acquired processes were critical to the ability to continue producing outputs, as producing outputs and generating revenues was possible for a longer period of time without the need for external processes or intervention.

b. No organised workforce in the Acquiree was acquired, since the management board, that was responsible for all strategic and operational decision making and therefore critical to the management of the entity as a business, left per the terms of the transaction.

c. Although some of the processes (property management and lease management) could be considered as 'significantly contributing to the ability to continue producing outputs', these processes were outsourced, not unique nor scarce and could be readily replaced without significant cost (three months' notice and no termination cost), effort or delay.

When considering the guidance in paragraph B12D of IFRS 3, the issuer concluded that the duration and renewal terms of the outsourcing contracts supported the assessment that these contracts did not give access to an organised workforce. This was supported by the fact that the outsourced services were terminated and replaced by the issuer's internal processes without difficulties one year after the acquisition date.

In addition, the issuer noted that the acquisition of the Acquiree was similar to the acquisition of a single property SPV, which is also typically accounted for as an acquisition of an asset.

The enforcement decision

The enforcer concurred with the issuer's view that there are inputs and outputs in place. However, the enforcer disagreed with the issuer's view that no substantive processes were acquired. Therefore, the enforcer concluded that all three elements of a business in paragraph B7 of IFRS 3 were met and the issuer should have accounted for the acquisition of the investment firm as a business combination.

Rationale for the enforcement decision

The enforcer agreed with the four processes identified by the issuer. In the enforcer's view, three processes (strategic management, property management and lease management) contributed significantly to the ability to deliver outputs. Given that the strategic management left the Acquiree in accordance with the terms of the acquisition only two of those processes (property management and lease management) were in place at the time of the acquisition.

The enforcer noted that, when assessing whether significant processes were acquired, the issuer should have considered the conditions that existed in the Acquiree at the time of acquisition (and not subsequently). For this purpose, the intentions of management regarding the continuation or discontinuation of such processes and businesses after the acquisition took place were not relevant. In this respect, both the enforcer and the issuer agreed that the property management and lease management processes were in place and operational at the time of acquisition.

When assessing whether the acquired processes are substantive both conditions in paragraph B12C of IFRS 3 should be considered. The enforcer agreed with the issuer that condition (b) was not met as the acquired processes were not unique nor scarce. However, when assessing whether condition (a) (the process is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce) was met, the enforcer considered the guidance in paragraph B12D of IFRS 3.

With regards to letter (a) of paragraph B12D, the enforcer concluded that the acquired outsourcing contracts gave the issuer access to an organised workforce that performed a substantive process that the issuer controlled. The enforcer reached this conclusion because none of the parties involved in the outsourcing contracts could unilaterally cease operations at the time of acquisition and/or denounce the contracts without incurring significant costs. Under the terms of the outsourcing contracts, the contracts could only be terminated approximately two years after the acquisition date, unless the issuer paid an early termination fee. Consequently, the enforcer concluded that the issuer controlled the organised workforce through these contracts.

With regards to letter (b) of paragraph B12D, difficulties in replacing an acquired workforce may indicate that the acquired organised workforce performs a process that is critical to the ability to create outputs. However, the enforcer noted that the absence of such difficulties does not necessarily imply that the processes are not critical to the ability to create outputs.

With regards to letter (c) of paragraph B12D, based on the assessment of the terms of the outsourcing contracts, the enforcer concluded that the outsourced processes were not ancillary or minor. Specifically, the enforcer noted that, in addition to the day-to-day management of the portfolio (rent collection, annual rent increase, small maintenance, etc.), the outsourcing contracts also covered the acquisition of new tenants, short and mid-term maintenance and refurbishment planning as well as strategic advice. In particular, the outsourcing partners gave strategic advice about the composition of the portfolio. In fact, all important business processes were performed by the outsourcing partner; the board of the Acquiree (which stepped down at the acquisition date) had the final say only regarding major strategic choices.

Based on the above considerations, the enforcer concluded that the two processes acquired were substantive as they were critical to produce outputs. Furthermore, the inputs acquired included organised workforce with the necessary skills, knowledge and experience to perform those processes.

Finally, the enforcer disagreed with the analogy the issuer drew with the acquisition of a single property SPV. In the case of a single property SPV, that SPV is part of a larger portfolio which remains with the seller, and thus the processes also remain with the seller. The issuer, on the contrary, acquired the whole Acquiree, including both the property portfolio and its financing.

VI. Decision ref EECS/0126-06 – Power-purchase agreements and categorisation of fair value inputs

Financial year end
31 December 2022

Category of issue
Fair value disclosures, input parameters, Level 3

Relevant standards/requirements
IFRS 13 *Fair Value Measurement*

Description of the issuer's accounting treatment

The issuer operates renewable energy plants (wind and photovoltaic) and generates revenue from the sale of the electricity produced. To minimise the risk resulting from the volatility of the market prices the issuer has entered into power purchase agreements ("PPAs") with industrial customers, which provide for a fixed price for the majority of the electricity produced.

The issuer enters into PPAs in which the electricity produced is physically delivered to the consumer, as well as into PPAs without physical delivery ('virtual PPAs' or 'vPPAs'). Under vPPAs, the issuer pays the positive difference to the customer if the spot price is higher than the contractual vPPA price. Otherwise, the customer pays the difference to the issuer.

The issuer treated the vPPAs as derivative financial instruments within the scope of IFRS 9 due to the contractually agreed and obligatory net settlement. The fair value of these derivative financial instruments was determined using a discounted cash flow method. For this purpose, the forward curve available on the valuation date was applied, together with other input parameters. The forward curve, which was used to model future electricity prices, was made up of three sections:

a. Liquid period (years 1 to 3): Use of (unadjusted) exchange-listed prices from recognised electricity exchanges.

b. Medium period (years 4 to 8): Mix of the mathematical extrapolation of the exchange-listed prices and the price models from the reports of three market price providers recognised within the industry, which integrate various macro and microeconomic factors into the pricing (e.g., electricity demand, commodity prices or the progress in the expansion of renewable energies). The issuer adjusted the price curve from the reports to take inflation into account.

c. Fully illiquid period (from year 9): The prices from the reports of the above-mentioned three market price providers are used without further adjustment. These are extrapolated if necessary. Moreover, an inflation factor is added to this part of the forward curve.

According to the issuer, all material inputs used to measure fair values of the vPPAs, including the forward curves described above, are observable (either directly or indirectly). In the issuer's view, the studies of market price providers used to build the forward curve in the medium period and the fully illiquid period were generally accessible, used by other industry participants and can, therefore, be considered Level 2 inputs. The same applied to the combination of the prices from the reports with (where necessary, extrapolated) quoted prices.

Therefore, in providing the fair value disclosures required by IFRS 13, the issuer categorised fair value measurements of the vPPAs within Level 2.

The enforcement decision

The enforcer disagreed with the issuer's categorisation of fair value measurements of the vPPAs. The enforcer concluded that the valuation of the vPPAs incorporated unobservable input parameters. Therefore, the fair value measurements of the vPPAs should have been categorised as Level 3 instruments within the fair value hierarchy considering that these unobservable input parameters were material with respect to the resulting fair value. Accordingly, the issuer should have provided the related disclosures required by IFRS 13, to the extent material.

Rationale for the enforcement decision

The enforcer noted that, according to paragraph 82 of IFRS 13, if the asset or liability has a specified (contractual) term, an input parameter must be observable for substantially the full term to be classified as a Level 2 input. However, with regards to forward prices used by the issuer, prices on energy exchanges are only available for the first three years and are therefore observable only for a small fraction of the total term of the long-term vPPAs.

In the enforcer's view, extrapolation of publicly quoted prices leads to a classification as Level 3 of the fair value hierarchy, unless the impact of the extrapolation is immaterial.

Furthermore, the enforcer disagreed with the issuer's argument that the forward prices based on studies by market price providers can be considered observable input[9] parameters according to IFRS 13 simply because these studies are widely used and generally available.

The enforcer noted that classification as a Level 3 instrument would have required numerous additional disclosures in the notes, including quantitative information about the significant unobservable input parameters and a sensitivity analysis (i.e. paragraphs 91 b), 93 d), e), f), g) and h) of IFRS 13).

[9] Appendix A of IFRS13.

VII. Decision ref EECS/0126-07 – Principal vs. agent

Financial year end
31 December 2022

Category of issue
Principal vs. agent; recognition of revenue

Relevant standards/requirements
IFRS 15 *Revenue from Contracts with Customers*

Description of the issuer's accounting treatment

The issuer purchases goods for customers (end users). The customers order the goods through the issuer, and the issuer then orders the goods from the suppliers in its own name. The suppliers then deliver the goods directly to the customers. The customers can also order the goods directly from the supplier in the issuer's name benefiting from the issuer's purchasing conditions.

The issuer considered itself a principal and presented the revenues and related expenses on a gross basis. The gross profit on the revenue stemmed from the fee charged to the customers representing less than 1% of the suppliers' invoice amounts, depending on the volumes purchased. According to the contract between the issuer and the customers, this fee compensated the issuer for its service of selecting the supplier and negotiating discounts and rebates that the issuer passed on to the customer.

The issuer took advantage of any early payment discounts available and volume discounts that it had previously negotiated with the suppliers based on the total purchases from all of its customers, sharing a portion of the volume discounts with the customers. The purchased products acted as security for the related payable to the issuer (reservation of title). The suppliers agreed to transfer to the issuer the right to the delivered goods as security for the ultimate payment, once the suppliers received its payment from the issuer.

In the issuer's view, it acted as principal as it controlled the goods before they were transferred to customers pursuant to paragraph B37 of IFRS 15. According to the issuer:

a. Controlling the order process is evidence that the issuer had control of the transaction (paragraph B37(a)). The issuer stated that it was responsible for the delivery to the end user and bore credit risk in conjunction with the outstanding receivable.

b. The issuer bore inventory risk (paragraph B37(b)), since end users would reduce the payments for any incorrect deliveries. Being able to use the delivered goods as security for its outstanding receivable also supported the issuer's view that the issuer was the principal.

c. The issuer was able to set the prices of the goods to the customers (paragraph B37(c)). However, due to the high price transparency in the market, the products allowed for only a narrow price variance between the suppliers' and the end users' price.

The enforcement decision

The enforcer did not agree with the issuer's conclusion that the issuer acts as a principal with respect to goods delivered to its customers. The enforcer concluded that the issuer does not obtain the control of the goods and, as an agent, it should recognise, as revenue, the sales net of the related material expenses.

Rationale for the enforcement decision

Paragraph 33 of IFRS 15 clarifies that control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

The enforcer noted that the issuer did not have control of the inventory prior to the order from the customer. Before the order and delivery of the goods to the end user, the issuer had no rights to the inventory and could neither direct the use of, obtain substantially all of the remaining benefits from the goods, nor prevent other entities from doing so. The issuer only obtained the right to use the goods as security for the end user's outstanding payment, after the end user received the goods and the transaction was complete.

The right to use the delivered goods as security for the payment to the issuer had no impact on whether the issuer was principal or agent (paragraph B35 of IFRS 15). The issuer's reservation of title for the outstanding payment, for example, did not prevent the end user from reselling the goods to another third party.

As additional support in determining which party is the principal and which is the agent, IFRS 15 provides certain indicators:

a. Paragraph B37 (a) refers to the primary responsibility for the acceptability of the specified good. The supplier decides which goods to use to meet the end user's specifications and delivers the order directly to the end user. While the issuer argued that its payments from the end users could have been reduced if deliveries were incomplete, it was the supplier who was responsible for the quality of the products and who would need to reimburse the issuer or rectify any problems.

b. Paragraph B37 (b), refers to inventory risk. Inventory risk is the risk normally taken by an entity that acquires inventory in the hope of reselling it at a profit. The enforcer noted that the issuer did not have inventory risk prior to the transaction as it only arranged the purchase and did not take title of the goods at any point in the order-to-delivery process (e.g., the issuer did not have sales, damage or obsolete inventory risk).

c. Paragraph B37 (c) refers to pricing discretion. The issuer stated that it had full discretion over the prices it charged to the end users. However, based on the contract with the end user, the issuer added only a minimal fee (less than 1%) directly to the supplier's invoice. Therefore, the issuer could not freely determine the price of the goods, provide significant discounts or increase the prices of products to increase its own commercial margins.

The fact that the end user could have reduced the outstanding claim when the deliveries were incomplete does not mean that the issuer was responsible for the quality of the items and potential returns of the goods, especially since the supplier was contractually obliged in such situations to reimburse the issuer.

Finally, the issuer's argument that it bore credit risk was also not convincing. The IFRS 15 Basis of Conclusions (paragraph BC385J(d)) clarifies that the IASB removed the exposure to credit risk as an indicator in IFRS 15 since it was not considered to be a helpful indicator.

VIII. Decision ref EECS/0126-08 - Control considering Substantive Rights

Financial year end
31 December 2022

Category of issue
Business combinations, call and put options, acquisition of subsidiaries

Relevant standards/requirements
IFRS 3 *Business Combinations*, IFRS 10 *Consolidated Financial Statements*

Description of the issuer's accounting treatment

In November 2022, the issuer, a retail company, acquired the remaining 56% interest in a previously held (equity-method) investment ('investee') and performed a purchase price allocation, applying the step acquisition guidance in IFRS 3 paragraph 41 et seq. The issuer had already acquired 44% of the investee in June 2021. Since that date, only the two founders of the investee and the issuer held interests in the investee. The issuer was the only customer and a main creditor of the investee.

The 2021 agreement included both a put and call option to the founders and the issuer, respectively. With the founders' put and the issuer's call options, the founders had the right to sell their shares to the issuer in certain situations and the issuer had the right to buy the founder's shares at any time. However, the put and call terms did not exactly mirror each other, as follows:

a. Founders' put option: Subject to the founders' continued employment at the investee for at least two years (or no 'Bad Leaver'[10] event for three years), the founders had the right to sell their shares to the issuer at €X per share. The €X per share multiplied by the number of founders' shares would be paid using shares of the issuer, converted at a predetermined price. If a 'Bad Leaver' event was to occur within three years and the founders had previously exercised their put option, they would have to refund all but €2 of the put option price per share.

b. Issuer's call option: The issuer had the right to buy the founders' shares at any time within three years. The call option price was also €X per share (unless a leaver or bad leaver event occurred within two or three years, respectively, or within 15 days after the 3-year period. In those events, the call option price would reduce to €2 per share). Upon exercising the call option at €X per share, the issuer would pay for the founders' shares using its own shares at a predetermined price. If the call options were exercised at €2 per share, the purchase would be paid in cash.

The enforcement decision[11]

The enforcer disagreed with the accounting treatment followed by the issuer. The enforcer considered that the issuer had control over the investee since 2021, when it acquired 44% of the investee's shares and signed the agreement comprising the put and call options for the remaining shares. Therefore, the business combination presented in the 2022 financial statements should have been accounted for in 2021, while the transaction in 2022 should have been accounted for as a transaction between controlling and non-controlling interests.

Rationale for the enforcement decision

The enforcer concluded that, since 2021, the issuer had the power over the investee since it had existing rights that gave it the ability to direct the relevant activities of the investee in accordance with paragraph 10 of IFRS 10. In assessing whether it had power over an investee, the issuer should have considered only substantive rights relating to the investee. According to paragraph B22 of IFRS 10, a right is substantive if the holder has the practical ability to exercise that right.

After the initial investment in 2021, the issuer held 44% of the associate as well as call options for the remaining interest (56%) from the founders. According to paragraphs B23 and B24 of IFRS 10, the call options should have been considered substantive rights because:

[10] E.g., Fraud
[11] As the focus here is on the substantive rights of the issuer, the effect of different prices of the put and call options for the remaining shares on the accounting are not discussed further in this extract.

a. They could be exercised at any time within the subsequent three years for either €X or €2 per share, depending on the timing of the exercise.

b. No barriers (economic, legal or otherwise) existed that would prevent the issuer from exercising the call options. No party could have prevented the issuer from controlling the investee.

c. While the exercise price of the call option of €X per share exceeded the amount that the issuer had paid per share for the initial 44% interest in the investee by approximately 9%, the enforcer considered that a 9% premium for the controlling interest in the investee did not necessarily imply that the call options were out-of-the-money. In the issuer's jurisdiction, average control premiums approximate 20%.

When determining whether a potential voting right is substantive, the IASB indicates in paragraph BC124 of IFRS 10 that the comparison should not be based strictly on the exercise price or a conversion rate. Although the exercise or conversion price is one factor to consider, the determination of a substantive right requires a holistic approach. When taking a holistic approach, other factors may solidify the argument that the call options are substantive, such as the purpose and the design of the call instrument.

With regards to the purpose and design in the case at hand, it is important to highlight that the issuer was the only customer of the investee and the investee's operations and products were important to the issuer's activities.

Additionally, the reduction of the call price to €2 per share after three years or if the founders' employment was terminated within two years indicated that, from the start, there was high likelihood that the issuer planned to acquire the remaining shares in the investee. In this respect, the issuer indicated in its annual 2022 financial report that the acquisition of the 56% share in the investee had been completed a year earlier than originally expected. This supports the conclusion that in 2021 the issuer already expected to acquire 100% of the investee.

Therefore, based on the above, the enforcer concluded that the call options in combination with the 44% ownership interest provided the issuer with the ability to direct the relevant activities of the investee since 2021 (paragraph B50 of IFRS 10). The issuer should have consolidated the investee since that date.