Considerations for Financial Reporting 2012

Supervision of Financial Reporting

September 2012

Contents

Disclaimer

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The Netherlands Authority for the Financial Markets

The AFM promotes fair and transparent financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

1 Summary

We hereby present the ‘Considerations for Financial Reporting’ for the current financial year. The considerations published are partly based on the provisional findings of the thematic and other reviews conducted by the Netherlands Authority for the Financial Markets (AFM).
The most important consideration identified by the AFM is that the application of the concept of ‘materiality in the financial statements’ needs to be improved. It appears that reporting companies are too selective in the provision of transparency. The AFM has seen too many financial statements in which significant disclosures in the financial statements are missing or are not up to standard in certain respects. As a result of these shortcomings, investors[1] are not adequately informed, and there is a risk that they will take investment decisions without proper foundation.
The AFM takes the view that the manner in which relevant information on the company is communicated requires continuing attention. In future, this can curb unnecessary growth in the size and complexity of financial reporting.
It is notable that the AFM regularly sees that material disclosures are lacking in the financial statements, but are, however, included in presentations to analysts. These presentations are usually held to coincide with the publication of the annual financial reporting. Inclusion of an item in the analyst presentation suggests to the AFM that the information is material, and that, if required by IFRS, it must be included in the financial statements.

Disclosures

The AFM calls on companies to devote special attention to the following disclosure requirements in the preparation of their financial reporting:

1. The statement of significant uncertainty regarding the going concern of the business, if this is the case;
2. The disclosures relating to financial instruments, in particular regarding (i) the risk to the company’s liquidity, including the case of almost reaching the limits set by its financiers, (ii) the collateral provided for loans taken out and (iii) the manner in which financial institutions account for forbearance transactions (transactions in which banks ease their lending conditions);
3. The estimates used to determine the recoverable amount, as well as the sensitivity to the results of these estimates. This last point should be included if a reasonably possible change to one of the key assumptions would entail an impairment of goodwill;
4. The methods and key assumptions underlying the determination of the fair value of investment property, financial instruments and other assets, to the extent that no quoted prices in an active market are available (the so-called ‘level 1 measurement’);
5. The disclosures that enable users of the financial statements to gain a proper and full understanding of arrangements relating to share-based payments, the consequences

[1] The term ‘investors’ is defined by the AFM to mean the primary users of the financial reporting as described in the conceptual framework of the IASB; existing and potential investors, financiers and other creditors.

thereof for the financial position and the manner in which the fair values of goods, services and/or payments made are determined;

6. The treatment of share-based payments in option schemes in the overview of remuneration for each director;
7. The disclosures of the effects on the financial statements of reporting standards or amendments to existing standards that have been published but that are not yet effective.

Other items of attention

The AFM is calling for attention to other parts of the financial reporting in addition to the disclosures. This concerns the following items.

As a result of the financial crisis and the poor state of the economy, many companies will need to carry out an impairment test and thereby establish that the carrying amounts of the assets can still be expected to be realistic. If unfortunately this is not the case, a loss will have to be recognised.

The cash flow statement, which has to provide investors with a true and fair view of the incoming and outgoing cash flows, needs to be improved in several respects. Examples of shortcomings in the cash flow statement are: (i) movements between operating cash flows and other cash flows, (ii) the presentation of items that are not cash flows as cash flows, such as the conversion of loans into share capital, and (iii) the absence of presentation, or at any rate clear presentation, of interest and tax on profits actually paid. These shortcomings have led the AFM to decide to conduct a thematic review of the cash flow statement in 2013[2].

Finally, the AFM is of the opinion that the paragraph on risk in the annual report should present a better account of the potential effects of the principal risks that are recognised or that should be recognised. Investors are not being better informed if they are provided with a 'brainstorm overview' of all possible risks, without any information as regards relevance or potential effects.

Background

The above-mentioned points of improvement are taken from the provisional findings from the supervision of financial reporting for 2011 and the findings of foreign supervisors that were shared at the European Enforcers Coordination Sessions (EECS). The provisional outcome of the discussions within the European Securities and Markets Authority (ESMA) regarding the shared priorities for the supervision of financial reporting for 2012 in Europe has also been taken into account.

The 'Considerations for Financial Reporting 2012' are already being published now so that companies and auditors can incorporate these points of improvement in their annual financial reporting for 2012 and the audits thereof.

As in previous years, the notifications given in the previous year have, in general, been followed to an acceptable degree. The provisional findings from the thematic review 'Valuation and Disclosure of Investment Property' show that there has been an improvement in the disclosure, by a number of companies, of the methods and key assumptions used to determine the fair value of investment property. In the case of other companies, further improvement is still necessary.

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[2] *http://www.afm.nl/nl/professionals/afm-actueel/nieuws/2012/sep/toetsing-jaarverslagen.aspx*

Many companies that failed to provide transparency in their 2011 annual financial reporting regarding the effects of the introduction of the new reporting standards for pensions that will take effect on 1 January 2013, did provide such transparency, to a significant degree, in their semi-annual financial reporting in 2012. From the point of view of transparency, this is a very welcome development.

2 Introduction

Since 2010, the AFM has been publishing its ‘Considerations for Financial Reporting’ for the current financial year at the end of September. The considerations published are based on the provisional findings of the thematic and other reviews conducted by the AFM. The possibility that the definitive findings will differ cannot be ruled out. The AFM started 53 reviews in 2012, and around 40% of these still have to be completed.

Discussions have recently commenced within ESMA regarding the shared priorities for the supervision of financial reporting for 2012 in Europe. These discussions are expected to lead to definitive decisions in the fourth quarter. The ‘Considerations for Financial Reporting 2012’ takes into account the provisional outcome of these discussions. The findings shared by foreign supervisors in the EECS have also been taken into account.

The ‘Considerations for Financial Reporting 2012’ are being published now so that companies and auditors can incorporate these points of improvement in their annual financial reporting for 2012 and the audits thereof. The AFM’s intention is to contribute to realising the objective of its supervision: to increase the quality of the financial reporting. Other AFM publications that may be useful in the preparation and auditing of financial reporting in 2012 are:

- Considerations for Semi-annual Financial Reporting 2012[3];
- Report of the thematic review ‘Measurement and transparency of bonds and other positions in countries with sovereign risk[4];
- Announcement of the topics of thematic reviews in 2013[5];
- Final results of thematic reviews in 2012, published at end October 2012.

[3] *http://www.afm.nl/~/media/files/fin-verslag/considerations-semi-annual-fv-2012.ashx*

[4] *http://www.afm.nl/~/media/files/rapport/2012/thematic-review-measurement-transparancy-bonds.ashx*

[5] *http://www.afm.nl/professionals/afm-actueel/nieuws/2012/sep/toetsing-jaarverslagen.aspx*

3 Considerations for financial reporting 2012

This section gives an overview of the considerations for financial reporting 2012. The points of improvement cited by the AFM in this publication mainly concern disclosures. This does not mean that there is no need for improvement with regard to measurement and the determination of the result. It should be remembered that the supervision of the AFM is primarily focused on establishing whether or not the reporting requirements have been correctly applied. The establishment of whether or not the financial reporting presents a true and fair view of the size and composition of the results, equity and cash flows is primarily the responsibility of the auditor. The AFM does not duplicate the work of the auditor. Estimates and assessments made by a company's management are only marginally tested by the AFM. The AFM can only raise questions in the event that it has doubts, on the basis of publicly available information, as to whether the reporting requirements have been correctly applied.

3.1. Effects of the debt crisis and the economic situation

As a result of the current economic circumstances, the AFM expects there to be many companies at which indications have arisen that entail an obligation to conduct an impairment test. One possible indication would be the fact that a company's market capitalisation is lower than the carrying amount of its equity. Another example of such an indication would be a lower expectation regarding the future cash flows from an asset or group of assets.

In an impairment test, the company checks to establish whether the recoverable amount of the asset is still greater than its carrying amount. If this is not the case, the company has to recognise an impairment loss in the amount of the difference between the carrying amount of the asset and its recoverable amount. The estimated recoverable amount is usually based on assumptions, such as the possible economic conditions that will exist during the asset's remaining economic life. IAS 36 states that the company must make reasonable assumptions that give the best possible estimate of the circumstances that will occur during the remaining economic life of the asset concerned. These assumptions must be disclosed.

In the course of its thematic review 'Impairment of Assets', the AFM noted that many companies whose market capitalisation was lower than the carrying amount of their equity did not recognise an impairment loss. The market appears to have priced in future losses.

Impairment losses may also have to be recognised for trade receivables, loans and investments. With regard to these assets, as well, the company must make a best possible estimate of the projected future cash flows, and adequate disclosure is required.

3.2. Disclosures

3.2.1. General

There is an extensive international debate ongoing regarding the size and complexity of the disclosures in the financial statements. Many take the view that the list of disclosure requirements has become excessive, so that financial statements have become too lengthy and too complicated. Companies report that meeting the disclosure requirements costs them much time, money and energy. In the Annual Report 2011 of the IFRS Foundation[6] the Chairman states that the increase in size and complexity of financial reporting is not solely due to the reporting standards. This is also partly due to the increased complexity of our society, of businesses and their business models. On the other hand, the International Accounting Standards Board (IASB) states that in cooperation with investors, preparers and supervisors, it wishes to look for ways in which the rules can be simplified. The AFM acknowledges these perceptions, and will where possible strive to make its own contribution.

Furthermore, the AFM has observed that the financial reporting falling under its supervision is not as extensive as that produced in some of our neighbouring countries. The average size of the financial reporting filed with the AFM for the 2011 financial year with consolidated financial statements is 140 pages. Only around 10% of the financial reporting filed amounts to more than 200 pages, and most of these reports originate from the larger financial institutions. Today, it is simply a fact that reporting by financial institutions is quite complex. In the opinion of the AFM, the absence or partial absence of material disclosures is a far greater issue in the Netherlands.

3.2.2. Materiality in the financial statements

The AFM wishes to provide more clarity regarding the application of the concept of 'materiality in the financial statements'. Materiality is the criterion whereby it is established whether information has to be included in the financial statements, and thus also whether a particular provision of IFRS has to be complied with. If information is not either quantitatively or qualitatively material, it does not have to be included.

On January 30, 2012 the AFM organised a round table meeting[7] on the application of the term 'materiality in the financial statements'. At the meeting it emerged that all the attendees were in favour of good financial reporting, but there were various interpretations regarding the practical application of the concept of 'materiality in the financial statements'. The attendees asked the AFM to give a clearer indication of its reasons for considering a particular shortcoming as material in its normal supervision. What criteria are used? In other words, why does the AFM take the view that a shortcoming in the financial statements could influence an investor's decision?

On 26 June 2012, during the National Reporting Day, a presentation[8] was given, on behalf of the AFM, which contained a list of over 20 shortcomings in financial statements that had led to a

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[6] ***Error! Reference source not found.***

[7] *http://www.afm.nl/nl/professionals/afm-actueel/nieuws/2012/jan/jaarrekening.aspx*

[8] *www.afm.nl/materieel-belang*

notification, in some cases accompanied by a recommendation. An explanation was given in each case as to why, in the opinion of the AFM, the shortcoming was material. This autumn the AFM has planned a meeting on this subject with representatives of the audit firms and the Netherlands Institute of Chartered Accountants (NBA).

Before deciding to omit information or not to rectify an omission discovered at a late stage, companies are urged to consider thoroughly whether this constitutes a deviation from IFRS that should be considered as material in either quantitative or qualitative terms. The examples published on the AFM's website may be useful in this regard.

3.2.3. Communication and strict compliance

The AFM cannot escape the impression that when drafting their disclosures, companies are to a large extent letting themselves be guided by the texts of the IFRS standards and the check lists of disclosure requirements. This impression stems from the use of non-specific 'boilerplate' language and in some cases the illogical sequence in which the disclosures are presented, in combination with limited clarity. In order to avoid an unnecessary increase in the size and complexity of the financial statements, the AFM calls on companies to devote more attention to the manner in which the relevant information concerning the company is communicated in their financial reporting. The disclosures are, after all, intended to give the user of the financial statements a true and fair view of the financial consequences of transactions, other events and circumstances, in combination with the balance sheet, the income statement and the cash flow statement.

3.2.4. Serious doubts regarding the company's ability to continue as a going concern must be reported

In principle, a company prepares its financial statements on the assumption that its activities will continue for at least 12 months after the end of the financial year. If the management of the company intends to liquidate the company or discontinue its activities, or there is no realistic alternative whereby the activities can be continued, the going concern principle can no longer be applied.

In the current economic conditions, it is certainly very possible that the management is aware of material uncertainties regarding the ability to continue as a going concern. This is the case for instance in a situation where (additional) funding is required and it is not yet certain that the company can raise it. A lack of profitability and/or sustainability of a company's business model may also be a reason for material uncertainty regarding the company's ability to continue as a going concern.

If the company's management is aware of material uncertainties regarding the ability to continue as a going concern, it may in principle apply the going-concern principle when preparing its financial statements. IAS 1 paragraph 25 states, however, that these material uncertainties must be disclosed in the financial statements. In such cases the auditor should include, in his audit opinion, a mandatory explanatory paragraph referring to this disclosure.

The intention of the disclosure of material uncertainties is to explicitly inform the user of the financial statements that the company's ability to continue as a going concern cannot be assumed. Although this is not specifically prescribed by IFRS, the AFM would assume that disclosure of material uncertainties should be the first subject included under the description of the accounting policies applied. The purpose of the disclosure justifies such prominent presentation. The description of the uncertainties should also feature in the risk paragraph in the annual report.

In one of the financial statements reviewed, the disclosure on funding risks states that the company is in negotiation with financiers regarding the refinancing of a significant proportion of the loans taken out. The loans in question were immediately callable at the end of 2011, but the financier was prepared to continue the funding until a few months after the balance sheet date. The company then states that it expects to have sufficient liquidity, operating cash flow and funding available to be able to continue its activities for at least 12 months. A statement that the company's ability to continue as a going concern is uncertain in the event that no new loans could be obtained was lacking. The auditor does, however, mention the serious uncertainties regarding continuity in the explanatory paragraph, and refers to the section on funding risks in the financial statements.

3.2.5. The disclosures on financial instruments need further improvement

<u>Liquidity risk of the company</u>

The AFM has on several occasions referred to the importance of correct compliance with the reporting requirements in relation to the maturity analysis of the financial liabilities (IFRS 7.39). Despite these reminders, however, there are still financial statements being made in which this analysis is missing or inadequate. The most common mistake concerns the discounting of the payment obligations. The overview only takes repayments into account, and not interest payments. In times of economic difficulty, a proper understanding of a company's liquidity is extremely relevant for investors. The AFM urges companies that have not included an adequate liquidity overview in their 2011 financial statements to ensure that they do so in their 2012 financial statements.

The AFM is under the impression that companies are very reluctant to provide information regarding the fact that they are close to the limits agreed with their financiers, known as financial covenants. The usual argument is that this information is highly sensitive and that IFRS 7 only prescribes disclosure in the event that the agreements with the bank have been breached.

While this is understandable, the AFM's view is that it is definitely not advisable to refrain from informing investors of a danger that the agreements with the bank will be breached. In the period preceding a breach of the agreements with the bank, uncertainty and doubts among investors will increase. Moreover, the AFM has doubts as to whether a company can reasonably take the position, on the basis of IFRS, that this information does not have to be disclosed. One of the guiding principles of IFRS 7 (paragraph 31) is that a company must publish information that enables users to form an impression of the nature and scope of the risks incurred by the company with reference to its financial instruments. The risk of a possible breach of the financial covenants is, in the opinion of the AFM, one of the risks referred to in IFRS 7.31.

Collateral provided for loans taken out

The trend in these difficult economic times is that companies have to provide more collateral for the loans they take out. The result of the provision of collateral is that there are less assets for which recourse is available to other creditors in the unfortunate event of a bankruptcy. For this reason, and in accordance with IFRS 7.14, it is important that the financial statements provide clear information to investors as to which assets have been pledged as collateral and to what degree this is the case.

Transparency regarding forbearance needs to be increased

As a result of the financial crisis, banks may be forced to forgo some of their rights and thereby allow the debtor to survive. This is known as forbearance. The potential benefit for the bank is that it will be able to collect a larger part of its claim than if it were to hold the debtor to the agreements and thereby probably ensure that the latter would go bankrupt. A group has recently been set up within ESMA to identify the reporting issues with regard to forbearance. During a discussion at the EECS, it emerged that in cases of forbearance there was no consistency regarding the recognition of losses on loans and the disclosure thereof. ESMA will publish the results of its review before the end of this year. Financial institutions will be urged to follow the recommendations of this publication and provide transparency regarding the manner in which they report forbearance transactions in the financial statements.

3.2.6. Estimates used in the determination of the recoverable amount need to be improved

When carrying out an impairment test, the company estimates the recoverable amount of the asset or (group of) cash-generating unit or units. The recoverable amount is the highest value of the fair value less costs to sell and the indirect proceeds, also known as the value in use. The estimated recoverable amount is usually based on subjective assumptions, such as the possible economic conditions that will exist during the asset's remaining economic life. The company is considered to have made the best possible estimation of these projections that can reasonably be expected.

It is often the case that an asset does not generate cash flows independently. In these cases, IAS 36 requires that the recoverable amount is determined for the smallest possible combination of assets that do generate independent cash flows. This is known as a cash-generating unit. Goodwill usually relates to several cash-generating units and has to be allocated to these cash-generating units. The AFM wishes to refer in this respect to the provision that the group of cash-generating units to which goodwill is allocated must (i) represent the lowest level within the company at which the goodwill is monitored for internal management purposes; and (ii) not be larger than an operating segment as defined in IFRS 8.5 before aggregation. The AFM in particular urges attention to this latter limitation.

IAS 36 requires that for the most important cash-generating units (or groups of units) to which goodwill and other intangible assets that are not systematically amortised are allocated, specific information used in the determination of the recoverable amount must be disclosed. Among other things, this concerns a description of the key assumptions used to determine the recoverable amount. It must also be stated how the company has determined the values assigned to its key assumptions and the extent to which these are consistent with external information sources or past experience. In the event that a reasonably possible change in the assumptions would lead to a decline in the recoverable amount such that this would become less than the carrying amount, the company must include a sensitivity analysis in its financial statements.

As the report of the thematic review of impairments will also state, the description of the key assumptions and the sensitivity analysis is missing or incomplete with some regularity. The assumptions used for all groups of cash-generating units are moreover incorrectly presented in aggregate form. This often results in very wide bandwidths for the assumptions used. Such wide bandwidths are of little or no use to investors. Investors say that awareness of the values assigned to the key assumptions and sensitivity analyses (if relevant) are useful to them in their assessment of the estimates made by the company's management. One of the disclosures that needs to be improved concerns the discount rate used in the determination of the recoverable amount. The establishment of the discount rate must take sufficient account of the time value of money and the specific risks associated with the asset or group of assets.

Investors are sometimes surprised by impairments to non-current assets such as goodwill. This seems to be the case mainly when an impairment is recognised within a few months after publication of the financial statements, while the published financial statements do not contain a sensitivity analysis. This gives the impression that the recoverable amount is significantly higher than the carrying amount of the asset.

Strictly speaking, the obligation to include the key assumptions and a sensitivity analysis if necessary applies only if the cash-generating unit or group of units includes goodwill or other assets with an indefinite useful life. In other cases IAS 36 encourages the company also to include these disclosures if the cash-generating unit or group of units includes only other types of asset. From the point of view of the information requirement of users, the AFM supports this encouragement in IFRS.

This encouragement moreover becomes less voluntary in nature if, as a result of uncertainties in the estimates, there is a significant risk that the carrying amounts of assets will have to be materially adjusted in the following year. The nature and the carrying amount of the assets must be stated, as this information is relevant to an understanding of the financial information.

3.2.7. Methods and key assumptions used to determine the fair value of investment property have improved

Last autumn, the AFM reported that the methods and key assumptions used to determine the fair value of investment property were not, or not adequately, being disclosed. This finding was one of the reasons for the AFM to carry out a thematic review of the valuation and disclosure of investment property in 2012. Based on initial impressions from the thematic review, the AFM can state that the disclosures in the financial statements have improved, although further improvement is still desirable or necessary in some cases.

The disclosure of methods and assumptions used is not only relevant for investment property, it is also important for all assets and liabilities, including financial instruments, that are not measured on the basis of quoted prices in an active market (known as level 1 measurement).

3.2.8. Disclosures for share-based payments need to be improved

Although they are less popular than they were a few years ago, the AFM notes that, in many financial statements, share-based payments are still being granted. IFRS 2 states certain principles for disclosure in this respect, which require the company to provide disclosures that will enable the user to form a proper understanding of (i) the nature and size of the scheme(s) in operation on the balance sheet date, (ii) the method whereby the fair value of the goods, services or granted shares is determined and (iii) the effects of the share-based payments on the income statement and the financial position.

The AFM has, on several occasions, expressed doubts regarding the correct application of these reporting requirements, and has in some cases issued notifications about these doubts. Section 2:383c of the Dutch Civil Code [*Burgerlijke Wetboek*, or BW] requires that listed companies report both the total remuneration and the components of the remuneration of each director. One of the components that must be reported separately concerns the allocated bonus. The statement of this component is either missing or incomplete in a number of financial statements. This is probably a result of the text in the Explanatory Memorandum to Section 2:383c BW from the parliamentary session year 2000-2001, which states that option schemes do not fall under the requirements of Section 2:383c BW, but are subject to the provisions of Section 2:383d BW.

The AFM drew attention to this issue in its 2011 Activity Report[9]. In our opinion, it can no longer be reasonably argued that option schemes do not have to be reported under the remuneration component of bonuses. Unlike the situation at the time when the parliamentary bill was being debated, the costs of option schemes now have to be recognised in the income statement as a result of changes to the reporting requirements. From the current Claw Back bill (session year 2009-2010, 35 512), the AFM infers that the legislator also takes the view that option schemes should be classed under the remuneration component of bonuses.

The AFM strongly urges the small minority that does not consider option schemes to be part of granted bonuses in the disclosure of individual directors' pay to come into line with the majority by reporting option schemes under this item with effect from the 2012 financial year.

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[9] *http://www.afm.nl/~/media/Files/fin-verslag/2011/activity-report-2011.ashx*

The remuneration component from option schemes should be the same as the amounts recognised in the income statement. The AFM has noted that other amounts are reported in certain cases. In other financial statements, it has doubts as to whether the correct amounts have been recognised.

3.3. Disclosures made at analyst presentations but not in the financial statements

Many companies hold a presentation for analysts to coincide with the publication of their financial statements. The AFM has noted that disclosures are made during these presentations that are not included in the financial statements. To the extent that these are disclosures that do not have to be included in the financial statements, we have no objection. However, this is not the case if the disclosures concerned are material and must be included in the financial statements. The fact that these disclosures are mentioned at analyst presentations gives the AFM reason to suspect that they are material. The AFM urges companies to take a critical view in this respect, and in any case to include the material disclosures required by IFRS in their financial statements. The AFM raises this issue in other publications, including its report of the thematic review ‘Measurement and transparency of bonds and other positions in countries with sovereign risk’.

3.4. Cash flow statement needs improvement in certain respects

Once again, the AFM wishes to draw attention to the correct presentation of cash flows in the cash flow statement. In its supervision of the financial reporting for 2011, the AFM also noted that cash flows are not correctly presented in all cases. Examples of inadequacies in the cash flow statement are: (i) movements between operating cash flows and other cash flows, usually resulting in an overstatement of the operating cash flow, (ii) the presentation of items that are not cash flows as cash flows, such as the conversion of loans into share capital, and (iii) the absence of presentation, or at any rate clear presentation, of payments of interest and tax on profits. These inadequacies have led the AFM to decide to conduct a thematic review of the cash flow statement in 2013.

A study by the IFRS Interpretations Committee (IFRS IC) found that there are two approaches used in the classification of cash flows as operating, investment or financial cash flows. In the first approach, classification is made on the basis of the nature of the activity to which the cash flow relates. In the second approach, classification is made on the basis of the underlying balance sheet item(s) to which the cash flow relates. Under the second approach, it may be necessary to split cash flows into two or three components. According to the IFRS IC, the first approach is the one that must be used. The IFRS IC has requested the IASB to clarify this point in IAS 7.

As a result of the discussion of a number of cases, the IFRS IC considers that the description of operating, investment and financial cash flows in IAS 7 can be improved. Work is currently in progress on this. The AFM notes that incorrect classification of a cash flow due to not classifying the cash flow on the basis of the nature of the activity occurs in only one single case. The AFM can envisage that in the preparation of their financial statements, companies are in principle guided by the interpretation of the IFRS IC that cash flows should be classified on the basis of the activity to which they relate. If a company takes the view that the description of the various cash flows in IAS 7 allows for a choice to be made, and it decides to apply the second approach, the AFM would expect the company to disclose its reasons for the classification it chooses to apply.

3.5. Deconsolidation of subsidiaries must be applied at the right time

Subsidiaries must be deconsolidated at the time that the parent company loses control of the subsidiary concerned. This principle of IAS 27 is becoming more important, because divestment of subsidiaries by companies is a regular occurrence in today's economic situation. The balance sheet often shortens and solvency improves as a result of the deconsolidation. On the other hand, the scale of the operations is reduced, in particular revenue. The AFM considers it important that companies apply deconsolidation at the right time, that is, not too early and not too late. In one of the financial statements currently being reviewed by the AFM, the date of the deconsolidation is reported as several months prior to the date on which the company issued a press release in this regard. This is most probably premature.

3.6. Risk paragraph in the annual report is usually a list of potential risks

The risk paragraph is a component of the annual report. Its purpose is to provide the user with an understanding of the principal risks that a company faces, in particular with (but not restricted to) reference to financial instruments. Under Section 2:391 BW, the company must give a description of its objectives and policy with regard to risk management. Attention must also be devoted to the price, liquidity, cash flow and credit risks the company has incurred.
The AFM and investors have noted that the risk paragraph provided by many companies has become a sort of legal document, and usually amounts to a list of all sorts of events that potentially could occur. For investors, it would be more interesting to know what effect a particular event would have on items such as earnings, cash flows or revenue. Both the AFM and investors would like to see companies provide more information regarding the likelihood that an event could occur, and its effect. In the AFM's view, it is the duty of management to consider these two components (highest likelihood, greatest effect) and to present the five highest risks on the basis of this consideration.

3.7. Disclosure of effects of standards (or amendments to standards) published but not yet effective

3.7.1. General

IAS 8.30 requires that companies state the effects of standards or amendments to standards published by the IASB that are not yet effective. In Europe, this provision raises two questions. Firstly, companies are not sure whether this disclosure should be quantitative or qualitative. The AFM has discussed this question with its European colleagues at the EECS. In the event that a change to a standard affects the size and/or composition of the financial position or the financial performance, an investor cannot make a reliable estimation of the effects of the change if the description is purely qualitative. According to the European supervisors, the reasonably reliable estimates that are usually available within the company should be included in the disclosure. We are pleased to note that many companies include quantitative details of the consequences of new standards in their disclosures.

A second question considered by the European supervisors is whether under EU-IFRS the disclosure required by IAS 8.30 should be included before the standard in question has been ratified or endorsed by the European Commission. Some of the companies take the view that this is not required under IAS 8.30.

The AFM and its European colleagues, however, take the view that this interpretation of IAS 8.30 is too narrow. Their interpretation is broader, and their conclusion is that the fact that a standard issued by the IASB that has not (yet) been ratified does not justify leaving the user unaware of the consequences for the financial statements of the standard that has not yet taken effect. One of the purposes of the introduction of IFRS is to increase international comparability. It is difficult to justify a view that European companies should systematically delay the provision of transparency regarding the effects of new and/or revised standards. Furthermore, in practice, ratification of standards by the European Commission is more or less automatic, apart from exceptions such as IFRS 9.

3.7.2. Better presentation of the effects of IAS 19R in the semi-annual financial reporting

In its publication 'Considerations for Semi-annual Financial Reporting 2012'[10], the AFM notes that, in their financial reporting for 2011, companies did not present well the consequences of the changes to the accounting regulations for pensions on their equity and result. These regulations (IAS 19R) take effect on 1 January 2013. In the above-mentioned publication, the AFM does urge companies to be transparent regarding these effects in their semi-annual financial reporting for 2012. The fact that companies have to a large extent favourably responded to this request is a positive development for investors.

3.7.3. Standards published but not yet effective

In the light of the above interpretation of IAS 8.30, the AFM expects companies to inform users so that they can form an opinion regarding standards that will not yet be effective at year-end 2012 with respect to the potential effect on the financial statements in which they will be applied for the first time. The following standards published by the IASB will not yet be effective at year-end 2012:

- IAS 19R Employee benefits, including pensions
- IFRS 9 Financial instruments
- IFRS 10 Consolidated financial statements
- IFRS 11 Joint arrangements
- IFRS 12 Disclosure of interests in other companies
- IFRS 13 Fair value measurement

[10] *http://www.afm.nl/~/media/files/fin-verslag/considerations-semi-annual-fv-2012.ashx*

With the exception of IFRS 9, both the European Financial Reporting Advisory Group (EFRAG) and the Accounting Regulatory Committee (ARC) have issued positive recommendations regarding the ratification of these standards. The European Commission is expected to ratify the standards in the fourth quarter of 2012.

4 Revised standards to be applied after the 2011 financial year [11]

Only a few changes were introduced in IFRS for financial years commencing on or after 1 January 2012, the most important of which concerned IFRS 7. The purpose of this amendment was to enable users to gain a better understanding of (i) the connection between financial instruments that have been transferred but are not yet derecognised in the balance sheet and the associated liabilities, and (ii) the nature of the risks associated with the continuing involvement in financial instruments that have not been derecognised.

In a number of countries, the amount of the tax rate that is applicable with regard to the realisation of an increase in value of investment property, and property, plant and equipment that are measured at fair value depends on the way in which the increase in value is realised: by use or by sale of the asset. This dependency increases the subjectivity of the measurement of the deferred tax liability that has to be recognised at the time of the increase in value. IAS 12 now includes the rebuttable presumption that the carrying amount of investment property and land will be realised through sale.

[11] The preparers of the financial reporting had varying reactions to this section of the publication. Some considered this section to be excessive, while an equal proportion considered it to be useful. The AFM has retained this section for the latter group.

5 Thematic reviews in 2013

The AFM issued a press release on 13 September announcing the four thematic reviews it will conduct in 2013. The reviews concern:

1. The reporting of credit risks from investments and receivables;

2. The cash flow statement;

3. Provisions; and

4. Integrated reporting.

For further information, please refer to the press release.

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