Considerations for Financial Reporting 2011

Supervision of Financial Reporting

September 2011

Contents

1 Summary

Since 2010, the Netherlands Authority for the Financial Markets (AFM) publishes the issues that have emerged from the supervision of financial reporting prior to the activity report. The publication of this report has moved forward this year to late September. This is partly at the request of the companies concerned. By doing this the AFM expects that companies will take more account of the improvement points when preparing the financial reporting for 2011. This report contains the main findings and issues resulting from regular reviews the AFM conducts and has conducted. It also takes into account the findings of fellow enforcers in Europe and the developments in financial markets. The AFM feels that the disclosures in the financial statements have improved further and that its notifications are properly implemented.

There is room for improvement in a number of areas. This concerns in particular the following disclosures:

1. The assessment of going concern;
2. The key assumptions and other estimation uncertainties;
3. The most significant "accounting policies";
4. Impairments;
5. Methods and significant assumptions used in determining the fair value of property investments;
6. About financial instruments;
7. About income taxes;
8. About share-based payments to key management and directors; and
9. Segment information.

Besides these disclosures, the cash-flow statement can be improved by disclosing only the actual cash-flow and not including the "non-cash items”. The improvement points will be further explained in Chapter 3.

Chapter 4 reports on the preliminary findings from the thematic reviews and in Chapter 5 a roundtable meeting on the measurement of and transparency about government bonds and other positions with sovereign risks is announced. Almost all the financial institutions assessed seem to have determined the fair value of direct holdings in Greek government bonds on the basis of the market rates as at 30 June 2011 (level 1 valuation). In accordance with the requirements, the cumulative loss recognised in other comprehensive income for Greek government bonds that are impaired (maturing up to and including 2020) is included in the profit and loss account as a loss. Lastly, the revised standards for the year 2011 and the topics of thematic reviews in 2012 are addressed.

Companies that have questions or concerns following this publication should contact the Department of Supervision of Financial Reporting at fin.verslaggeving@afm.nl or on +31 (0)20-7973721.

2 Introduction

The main (preliminary) findings from the regular and thematic reviews by the AFM are published by the AFM some months before the publication of the complete and final activity report. This report is called "Considerations for Financial Reporting 2011.”

Below is a list of times when the AFM publishes information about the supervision of financial reporting:
- End of August: announcement thematic reviews
- End of September: preliminary findings AFM supervision
- End of October: final results of thematic reviews
- Mid-January: activity report.

Companies have indicated that the earlier and separate reporting of the "Considerations for Financial Reporting 2011" is helpful in the preparation of financial statements for the current year. At the request of the companies concerned, from now on the AFM will publish this (annual) report late September. Moreover, this report will also focus on the thematic reviews the AFM will conduct in 2012. These were published on 31 August 2011 on the website of the AFM.

With this earlier publication, the AFM expects that companies will increasingly make use of the suggested improvement points when preparing the financial reporting for 2011. Until 2010, the annual activity report of the AFM had too little impact on the quality of the financial reporting by companies. The AFM has the impression that the separate and earlier reporting of the issues has had a positive influence on the quality of financial reporting in 2010. The relevant issues have led to fewer questions than in previous years. The AFM is pleased with the continuation of this trend.

The findings from the supervision in 2011 are largely based on current (thematic) reviews. It is therefore possible that the final results differ. The preliminary findings relate mainly to the lack of, incomplete or inaccurate disclosures in the consolidated financial statements of the companies under review. This does not mean that financial reports cannot have other errors or inadequacies. The supervision by the AFM is primarily focused on making sure that the reporting requirements are correctly applied across the board so that a true and fair view is provided of the (changes in) financial position, performance, shareholders' equity and cash flows. The AFM is not reperforming the work of the auditor. Estimates and judgments of the management can only be tested marginally. The AFM can question companies only if it has doubts about the correct application of reporting standards based on public information.

Moving forward the publication of the preliminary findings means that the results of the thematic review topics Business Combinations (IFRS 3R), earnings per share (IAS 33) and financial statements of debt issuers will be reported separately at the end of October. Some preliminary findings are already included in this report.

In view of the importance of these issues, the evaluation and transparency of bonds and other positions with sovereign risk will be addressed separately in Chapter 5.

Finally, the annexes focus on (the adjustments of) IFRS standards and interpretations which will be applied for the first time in 2011 and on the topics for the 2012 thematic reviews.

3 Preliminary findings from the regular review (desktop reviews)

This chapter provides an overview of the primary preliminary findings and issues from the regular reviews (desktop reviews), which the AFM has performed and is performing, of the annual financial statements for 2010 and semi-annual financial statements 2011. Most of the reviews of the semi-annual financial statements have yet to be launched, while more than 40% of the more than 70 initiated reviews of the annual financial reporting have not yet been completed. It also takes into account the findings of fellow regulators in Europe and the developments in the financial markets.

Disclosures seem to have improved further and the notifications issued in 2010 have been well observed

Based on the desktop reviews performed to date, mostly follow-up reviews, the AFM has the impression that the disclosures in the financial report have improved further and that announcements made regarding the 2009 financial statements have been well observed in the 2010 financial statements. In some areas there is room for further improvement. Listed below are the main areas where improvements are possible.

What needs attention and what can be improved?

<u>Disclosures</u>
Given the uncertainties in the financial markets it is important that attention is paid to the disclosure on the going concern assumption and the disclosure of the key assumptions and estimation uncertainties. Also the disclosures regarding financial instruments and impairments have not lost relevance. In addition, explanations do not always seem to be entity-specific and there is "boilerplate language": standard texts that contain little specific information.

Disclosure on the assessment of going concern
If there is material uncertainty about the company's ability to continue as a going concern, the going concern assumption can still be applied. This is different if management of the company intends to liquidate the company or end its business, or has no realistic alternative but to do so. If aware of material uncertainties about going concern, management should disclose this in the financial statements. In one of the reviewed financial statements the description of the assumptions why the application of going concern was justified was missing, although there was material uncertainty about the going concern. In another set of financial statements the disclosure of material uncertainties was omitted.

Disclosure of the key assumptions about the future and other estimation uncertainties
The disclosure should include the key assumptions about the future and other major sources of estimation uncertainties. This mainly concerns the uncertainties that have a significant risk of material adjustment to the carrying amounts of the assets and liabilities within the next financial year, where judgment of management is most difficult or most subjective. If the fair value of an asset or liability is based on a recently observed market price, the disclosure of the assumptions and uncertainties can be omitted. The AFM has found that this exemption is sometimes wrongly applied, when the fair value is not based on a recently observed market price.

In this context many companies list the balance sheet line items where the risk of a material adjustment of the fair value is greatest. Some companies state the assumptions and estimated uncertainties for part of the balance sheet line items only.

Disclosure of key accounting policies
IFRS requires the disclosure of the most significant accounting policies. These accounting policies are not always entity-specific. This year the AFM has again seen many financial statements that do not comply with this requirement. One of these financial statements is from a company that has very different activities, each of which are of material importance. The financial statements indicate only that the revenue and expenses are recognised in the year in which the services are rendered. This explanation is not very informative. Furthermore, the nature of the various activities means that the degree of progress differs for each activity.

Disclosures on impairments have been improved in some areas. Further improvement is needed.
Compared to last year it seems that an improvement is visible in the impairment disclosures. However, this is not the case for all financial statements. The disclosures on impairment can be further improved by including the following in the financial statements:

- the assumptions used in determining the recoverable amount. In cases where the assumptions are disclosed they are often not very specific and/or informative;
- the effects of possible variations in key assumptions used in determining the recoverable amount where these impact the outcome. Knowledge of assumptions and the effects of the possible adjustments are relevant to investors in assessing impairments and its impact on the financial position and performance; and
- whether the determined recoverable amount is based on the fair value less cost or on the basis of the value in use.

In 2012 the AFM will include this issue in its thematic reviews (see Chapter 7). The interim financial reports (quarterly and semi-annual reports) show that a substantial number of companies have accounted for impairment in 2011.

Disclosure on the method and significant assumptions used in determining the fair value of investment properties should be improved
The measurement of investment property remains a current topic, partly due to current economic developments. It is important that the methods and significant assumptions applied in determining the fair value of investment properties are disclosed. This mainly

relates to the impact of so-called rent-free periods and vacancy rate, the discount rates and assumed trends in rent. In most cases these disclosures can be improved upon.

As an example the AFM points out that a regulator of the German market (Bafin) ordered a real estate investor to make a public announcement that its disclosure did not comply on this point.[1]

Information on financial instruments can be further improved

Although the disclosures on financial instruments have improved, further improvement is necessary. The relevant accounting standard IFRS 7 is principle-based and requires that a company must provide all disclosures (underlined by AFM) that enable the users of the financial reporting to make an assessment of a) the significance of financial instruments for financial position and performance of the company and b) the nature and extent of risks arising from financial instruments.

The AFM regularly notes that the so-called analyst presentations, which are released together with the publication of the (semi) annual financial reports, in some areas, including the disclosure of financial instruments, such as positions in sovereign debt of GIIPS countries[2], contain more detailed information than the (semi) annual financial reports. Given the broadly formulated requirements in IFRS 7, this additional information needs to be included in the (semi) annual financial reports.

Information about income taxes in the financial statements can be further improved

In some of the financial statements this disclosure can be further improved. This concerns in particular the reference to:

- components of income tax expense, divided into current tax and deferred tax. The latter component must also disclose the type of temporary differences related to the expense or income. Temporary differences are differences between the measurement of balance sheet items in the financial statements and the fiscal balance sheet;
- causes of deviation between the applicable tax rate and the effective tax rate.

In some cases, these disclosures are insufficiently specific and offsetting factors are reported in the line item "other".

Information on share-based payments to key management and directors has to be improved

IFRS requires that the disclosure of the share-based payments to key management should be stated separately. Book 2 of the Dutch Civil Code requires the same when reporting management compensation per director/supervisory board member.
The application of these requirements should be improved because some of the companies either do not or only partially record the share-based compensations. One example of the misapplication of the accounting requirements is to report the fair value of the shares received by the key management and/or directors in the actual year, less the amounts paid

[1] *http://investor.ftd.de/pdffiles/776764_TAG_Immobilien80.pdf*
[2] *Greece, Italy, Ireland, Portugal and Spain*

by the directors and/or key management. This information can be useful in terms of answerability for remuneration. Proper application of the standard and law requires that those reported amounts are equal to the amounts recorded in the profit-loss statement for such benefits. The amount in the profit-loss statement is calculated based on the requirements of IFRS 2.

Segment Information
A task force of the European Securities and Markets Authority (ESMA) is actively engaged in identifying bottlenecks in the application of the requirements on segment reporting (IFRS 8).

The taskforce has consulted with representatives from the Corporate Reporting Users' Forum ("CRUF”), a discussion forum on financial reporting of professional investors and analysts. These representatives indicated that they favour a report based on the principle “through management's eyes”, when fairly and fully applied. However, they indicate that they need more detailed segment information in order to derive good “forecasts”. In this regard, companies are encouraged to report the following information per reported segment; operating profit, operating cash flows, operating assets, working capital, material fixed assets, capital expenditures and loans taken up. Furthermore, many analysts and regulators have the impression that the number of reported segments is too small. In other words, it seems that too many operating segments are combined into one reportable segment.

In this context, ESMA recently pressed[3] the IFRS Interpretations Committee ("IFRIC") to include an additional disclosure requirement in IFRS 8. According to ESMA, companies should explain which operating segments have been combined and what economic indicators have been used in the assessment to determine that the operational segments have the same economic characteristics. This disclosure results in an improvement in the quality of financial reporting and helps users understand how operating segments are combined into reportable segments. Therefore, the AFM calls upon companies to be transparent on this issue, although it is still uncertain whether the International Accounting Standards Board (IASB) and/or IFIRC will take up this issue. The AFM also points out the obligation to explain what factors were used to identify reportable segments and what the key products and services of the reportable segments are. In the desktop reviews that are carried out in 2012, the AFM will pay extra attention to the aggregation of operating segments in reported segments.

<u>"Non-cash items" should not be included in the cash flow statement</u>
In the 2010 financial statements, the AFM has again found examples of "non-cash items" that were wrongly recorded in the cash flow statement. Once it concerned an as yet unpaid portion of the capital stock that had been incorrectly recorded as cash flow from the financing activity with a corresponding adjustment in the operating cash flow. The investor assesses the extent to which the company is able to generate (operational) cash, based on the cash flow statement. The inclusion of "non-cash items" can thus lead to an incorrect estimate of the cash flows by the investor.

[3] *http://www.esma.europa.eu/popup2.php?id=7718*

4 Preliminary findings from the 2011 thematic reviews

In 2011, the AFM conducts three thematic reviews, of which the results will be reported late October. Following are, albeit briefly, the preliminary findings:

<u>Business combinations: IFRS 3R</u>
The thematic review of IFRS 3R shows that in 2010 approximately 18% of the equity issuers acquired one or more businesses that are individually material. Furthermore, almost all companies explain the name of the acquired company, the percentage of control, the acquisition date, purchase price and the fair value of acquired assets and liabilities. Remarkably, almost no recognition of contingent assets and liabilities was identified. For acquisitions resulting in third party interests in the acquired entity, goodwill is recorded according to the partial method.

<u>Earnings per share: IAS 33</u>
The results of the thematic review "Earnings per Share" (EPS) show that the presentation and disclosure in the financial reporting in 2010 is generally sufficient. All companies present basic and diluted earnings per share in the consolidated profit-loss statement. In this basic primary statement, several companies also present additional information ranging from the presentation of the average number of shares to a detailed explanation including the calculation of the EPS, reconciliations, movement schedules of the number of outstanding shares and additional indicators such as dividend per share or earnings per share adjusted for special items. This additional information, which is useful for users of financial statements, must be included in the disclosures. Nearly all companies give a more detailed account of the EPS in the notes to the financial statements. The disclosure on the result (the numerator in the EPS calculation) is generally good. However, the disclosure of the applied weighted average number of shares (the denominator in the EPS calculation) need improvement in some cases. It is not always clear how a company has arrived at the number of shares.

<u>Separate financial statements of debt issuers</u>
The following can be stated about the thematic review "Separate financial statements of debt issuers". It appears that there will be further review actions with respect to the proper application of accounting requirements for twenty percent of the companies reviewed. The topics that will be further investigated vary widely and will be further reported upon in the publication of the thematic review.

5 Measurement and transparency of bonds and other positions in countries with sovereign risk

As a result of the debt crisis, the bonds and other positions in countries with sovereign risk, such as credit default swaps (CDS) and receivables secured by guarantees from the respective governments, are in the spotlight. Currently this mainly involves the GIIPS countries. Within ESMA, the regulators have agreed to take concerted and coordinated action with regards to the financial reporting as much as possible. This cooperation has resulted among other things in the "ESMA Statement on disclosures related to sovereign debt to be included in IFRS Financial Statements" dated 28 July 2011, which has been published on the website of the AFM.[4]

It is important that companies are transparent about the above mentioned positions they report on the date of the balance sheet and that they properly apply the impairment rules. The IASB stressed the importance of this in a letter to ESMA early August.[5] The AFM pays specific attention to these topics in the interim reports reviewed to date. The AFM has the impression that almost all the financial institutions reviewed have determined the fair value of their investment in Greek government bonds on the basis of the market rates as at 30 June 2011 (level 1 valuation). In accordance with the regulations, the cumulative losses recognised in other comprehensive income with regard to Greek government bonds that are impaired (maturity up to and including 2020) are included in the profit and loss account as a loss. It has also become apparent that the rules on classification of these assets under the applicable accounting policy should be improved. It should be clear whether the assets belong to the category "available for sale", "held to maturity" or "loans and receivables".

Regarding the transparency of the positions held, the AFM also points to the section "Information on financial instruments has improved," included in Chapter 3 of this publication.

Within ESMA it is investigated to what extent the financial reporting requirements for the semi-annual financial reports 2011 are correctly and consistently applied with respect to the measurement of Greek government bonds. It is difficult to predict the developments in the European debt crisis and its impact on the financial markets. For that reason the AFM would like to enter into a dialogue with all stakeholders. Therefore, the AFM intends to organize a roundtable on measurement of and transparency about such bonds and other positions with sovereign risk in mid-December, 2011. For this roundtable the preparers and users, DNB, NBA, and auditors will be invited.

ESMA publications on this subject can be followed on the websites of the AFM and ESMA.

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[4] *http://www.afm.nl/nl/professionals/afm-actueel/nieuws/2011/juli/esma-staatsobligaties.aspx*
[5] *[5]http://www.ifrs.org/NR/rdonlyres/949CAE0C-3E3B-4F64-9F1D-53B491458880/0/LettertoESMA4August2011.pdf*

6 Revised standards from the year 2011[6]

The IASB and IFRIC have issued revised standards and interpretations, which, after endorsement by the EU, are applicable starting 2011. Before briefly discussing these, the AFM notes the requirements regarding the IFRS standards which are not yet effective.

<u>Not applied IFRS standards which are not yet effective</u>

IAS 8.30 requires companies to give an estimate of the impact of the future application of IFRS standards published by the IASB that are not yet in effect on the financial statements. Given the radical changes that will take place in IFRS in the upcoming years, the importance of this requirement will increase. Recently, the IASB issued IAS 19 R. This standard is effective for periods beginning 1 January 2013 and the application will often affect the financial statements. The AFM expects that the anticipated effects will be disclosed in the financial statements of 2011. This could include the consequences of abolishing the so-called corridor method, the processing of the actuarial results in "other comprehensive income", the introduction of the approach in which net interest is calculated on the net liability (asset), and the possible change in the classification of the pension regulation.

Below we set out the main characteristics of the most important changes.

<u>IAS 24R</u>

The new, revised standard for disclosure regarding related parties applies to financial years beginning on or after 1 January 2011. On the one hand, the change in the definition of related party leads to an extension. The following relations are considered related parties:

- Associated participations of subsidiaries with a common investor and vice versa;
- Entities in which key management invest and entities that are controlled by the key management;
- Entities with a common shareholder where the shareholder has significant influence over one entity and has control or joint control over another entity, and
- Entities in which an individual investor has control or joint control over the reporting entity and a relative of the individual investor who has control or joint control over another entity.

On the other hand, there is an exemption for the usual disclosures about the transactions and outstanding assets and liabilities, including obligations related to so-called "government-related entities."

<u>Revised IAS 32 financial instruments presentation; classification of rights issues</u>

This revision applies to financial years beginning on or after 1 February 2010 and relates to the changes to the notion of liability so that rights issues can qualify as equity. The condition is that all holders of shares of the same class pro rata to their shareholdings will be given the right to acquire a fixed number of shares at a fixed price.

[6] *The preparers of the financial report respond differently to changing this part of the publication. A number of authors believe this part to be unnecessary, while an equal share finds this part of the publication useful. The AFM has maintained this part for the latter group.*

Revised IFRIC 14 regarding pre payments in case of a minimum funding requirement

This revision of IFRIC 14 is effective for financial years beginning on or after 1 January 2011 and is required to correct an unintended effect, whereby it was not allowed to capitalise an advance which was made under a minimum funding requirement.

IFRIC 19 Conversion of financial liabilities in equity

IFRIC 19 applies to financial years beginning on or after 1 July 2010. The interpretation provides guidance on the process of converting financial commitments into equity instruments. When converting, the financial obligation has to wholly or partially disappear. The fair value of shares issued is the amount the company pays for the repurchase of the debt. Any difference between the purchase price and the carrying amount of the liability should be recognized in the income statement.

Annual improvements

"Annual improvements" have resulted in limited amendments to the IFRS 1 (First time adoption of IFRS), IFRS 3 (Company Combinations), IFRS 7 (Financial instruments; explanations), IAS 1 (Presentation of the financial statements), IAS 27 (Consolidated and separate financial statements) and IFRIC 13 (Customer loyalty programmes).

7 Thematic review topics in 2012

The AFM will perform four thematic reviews in 2012. The reviews relate to:

1. Investments properties;
2. The measurement and transparency of government bonds and other investments with sovereign risk;
3. Depreciation of fixed assets and their explanations; and
4. Explanations of third party interests (non-controlling interests).

On 31 August of this year the AFM issued a press release in which the four thematic reviews for 2012 were announced. For further details please refer to the press release[7].

[7] *http://www.afm.nl/nl/professionals/afm-actueel/nieuws/2011/aug/themaonderzoeken-fv.aspx*