



## **Bank of Italy-Consob-Isvap Document no. 4 of 3 March 2010**

### **Bank of Italy, Consob and Isvap coordination forum on applying IAS/IFRS**

#### **Fiscal years 2009 and 2010 – Disclosure in financial reports <sup>(1)</sup> on asset impairment tests, financial debt contract clauses, debt restructuring and fair value hierarchy**

##### **Introduction**

With Document no. 2 of the Bank of Italy, Consob and Isvap coordination forum on applying international accounting standards (IAS/IFRS), which was issued in February 2009 (“the Document”), the three Authorities drew “the attention of the management and control bodies and managers in charge to the need to ensure disclosure that makes clear the effects of the crisis on the company’s profits and losses, assets and liabilities and financial position, its operating and strategic decisions and any adjustments made to adapt its strategy to the altered environment. Suitable transparency of information can help to reduce uncertainty and its adverse effects.”

The financial reports published during 2009 by listed companies, insurance companies, banks and financial companies reveal that despite some improvements there are still shortcomings in the areas of disclosure most sensitive to the effects of the crisis.

These effects still seem to be significant and widespread. In 2009 there was a large reduction in turnover and a marked deterioration in loan quality. Although there are signs that the economic situation is improving, forecasts are still marked by considerable uncertainty. This could still influence companies’ fundamentals and consequently the main items in the financial statement.

In this context, the quality of public disclosure is of fundamental importance for the users of such information (e.g. analysts, investors, the economic press). Financial reports must provide a clear, complete and timely picture of the risks and uncertainties to which companies are exposed, the capital at their disposal to cope with them, and their ability to generate income.

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<sup>1</sup> In this document “financial reports” means annual and half-yearly financial statements.

As already established in the Document, the three Authorities consider the legislation on financial statements and the provisions of the International Accounting Standards adequate for an effective response to the market's needs for information. It is therefore confirmed that precise and full compliance is essential, especially in the current context.

In particular the attention of all those who participate in preparing financial reports is drawn to the need for the greatest care in evaluating the applicability of the "going concern" assumption and in preparing the related disclosure in the financial statement. For their part, the control bodies must carefully evaluate the correct application of these standards.

Having said this, the current document:

- indicates some areas of disclosure in which companies must ensure a higher degree of transparency (Sections 1-3). Reference is made, in particular, to (i) impairment testing of goodwill, other intangible assets with an indefinite useful life, and equity interests (IAS 36); (ii) impairment testing of equity instruments classified as "available for sale" (IAS 39); and (iii) the classification of financial liabilities in the event of non-compliance with the contractual clauses that triggers the acceleration clause;
- provides some further details on the information to be disclosed about debt restructuring (Section 4);
- discusses the new disclosure obligations concerning the fair value hierarchy (Section 5).

The document does not have an autonomous mandatory content, in that it does not introduce any further obligations; rather it reminds all those involved in preparing financial reports to make a thorough application of the relevant accounting standards, considered in their entirety.

## **1. IAS 36 – Impairment of Assets**

In the current economic environment, asset impairment testing is of great importance.

The Document highlighted the fact that impairment testing was "a fundamental process in the preparation of financial reports, considering, among other factors, the significant incidence of intangible assets, goodwill and equity interests on the balance sheet assets of some companies."

In this regard, the attention of directors and control bodies was drawn to the need to disclose adequate information in financial reports to allow users to obtain "an appropriate grasp of the entire asset valuation process (the basic assumptions, estimation methodology, parameters used, etc.) and assess the results of such valuations, and especially the reasons for the write-downs made."

The three Authorities underline the need to ensure full compliance with the requirements of IAS 36 when preparing financial reports, as regards both (i) the impairment test procedure adopted and (ii) the information disclosed in the notes to the financial statements.

1.1 As regards the procedure and with reference to the calculation of value in use, a study of the 2008 financial statements showed that, at the time of the testing, some companies did not have up-to-date company plans taking due account of the complex changes in market scenarios introduced by the crisis.

In the absence of multiyear forecasts, some companies deemed it possible to determine the value in use of goodwill on the basis of medium-term projections obtained by extrapolating only the data in the 2009 budget, on the basis of normalized growth rates. Other companies decided to estimate the recoverable amount of their assets (the fair value less costs to sell) using stock exchange or transaction multiples.

Only if backed by adequate evidence, can such approaches be considered as conforming to the text of IAS 36.

In general, and above all in the absence of appropriate company plans, the conformity of the impairment test procedure with the provisions of IAS 36 must be the subject of formal and express approval by the board of directors, responsible for preparing a company's financial statements. Approval of the impairment test procedure by the directors must be done separately and before the financial reports are approved.

Another aspect worth emphasizing is the need for directors to give adequate consideration to any external signs of impairment loss, such as those expressed by the financial market, for example if the company's market capitalization is significantly lower than its shareholders' equity shown in the accounts. In this context, the directors must look for the reasons for any differences between the "external" assessments and the results of the impairment procedure. This analysis, required under IAS 36, paragraph 12(d), must be fully documented as part of the procedure.

1.2 Again with reference to disclosure, the Document drew attention to the correct application of the regulations contained in IAS 36.

Examination of the financial reports published in 2009 shows that there is still ample room for improvement. At the very least, effective disclosure of the process of evaluating goodwill must contain the following fundamental elements <sup>(2)</sup>:

- (i) definition of "cash-generating units ("CGUs");
- (ii) allocation of goodwill to individual CGUs (or groups of CGUs);
- (iii) description of the method for estimating the recoverable amount, when this is based on value in use;

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<sup>2</sup> In this regard, it is worth recalling that the provisions of paragraph 134 of IAS 36 introduced the concept of "significant" as regards the information required for each CGU (or group of CGUs). The meaning of "significant" is defined in terms of the ratio of the carrying value of goodwill (and intangible assets having an indefinite useful life) assigned to a specific CGU to the overall value of the goodwill (and intangible assets having an indefinite useful life).

- (iv) description of the method for estimating the recoverable amount, when this is based on fair value;
- (v) description of the analysis of the sensitivity of the result of the impairment test to changes in the key assumptions;
- (vi) remarks on the presence of any external indicators of impairment loss in the absence of write-downs of the assets following the impairment test.

(i) **Definition of CGUs.** Disclosures must describe the operating characteristics of the company as closely as possible. It is therefore not sufficient merely to refer to the definitions provided by IAS 36 <sup>(3)</sup>.

The identification of CGUs must be consistent with the management's strategic vision for the company; the description of the estimation must make it possible to understand the specific sector and the relative importance of the single CGUs <sup>(4)</sup>. If no concrete evidence is given to identify the CGUs, it is not possible to understand the management's vision of its activity.

(ii) **Allocation of goodwill to CGUs.** In accordance with IAS 36, paragraphs 134(a) and 134(b), companies must indicate the book value of the goodwill (and of the intangible assets having an indefinite useful life) attributed to the single CGUs.

(iii) **Value in use.** The notes to the financial statements must contain a description of the method adopted to determine the recoverable amount (value in use and fair value less costs to sell). When the recoverable amount is based on value in use, the attention of the directors is drawn to the requirement to disclose the following information (IAS 36, paragraph 134(d)):

- a description of each key assumption on which the directors have based their cash flow projections for the period covered by the most recent budgets/forecasts;
- a description of the approach taken to determine the values assigned to the key assumptions, indicating whether they reflect past experience, if they are consistent with the external sources of information and, if not, how and why they differ from past experience or from the external sources of information;
- the period considered by the directors, based on forecasting plans or budgets approved by board of directors, to determine detailed cash flows. When estimating financial flows, if a forecasting plan exceeds five years, the directors must explain why a period longer than five years is necessary;

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<sup>3</sup> Paragraph 6 of IAS 36 defines the generating unit of financial flows as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

<sup>4</sup> In some industrial sectors, for example, CGUs refer to large geographical areas or groups of products whereas in others, they can be identified as single establishments. In the retail sector, a description of how CGUs are identified, for example at the level of distribution channels rather than single shops, is useful information in itself.

- the growth rate used to extrapolate cash flow projections beyond the period covered by forecasting plans or budgets, providing, if necessary, the justification for using a growth rate that exceeds the long-term average growth rate for the products, sector, area or market in which the company operates;
- the method used to determine the terminal value, making the key assumptions explicit even when a different approach is used from discounting back the perpetuity;
- the discount rate(s) applied to the projections of financial flows. From an examination of the annual financial flows published in 2009, it emerged that the information disclosed by companies regarding the discount rate was not always adequate. Companies must disclose the rate applied to any CGU which has been allocated a significant part of goodwill (or of the intangible assets with an indefinite useful life). Furthermore, the directors must indicate the determinants of the discount rate, whether it is in line with that used in the previous financial period, and whether it is gross or net of taxes.

(iv) **Fair value less costs to sell.** When the recoverable amount is based on the fair value less costs to sell, the attention of the directors is drawn to the requirement (IAS 36, paragraph 134(e)) to disclose the following information:

- describe the methodology used to estimate the fair value;
- if the fair value is determined on the basis of observable market prices, the sources used must be given;
- otherwise, the directors must provide a description of each key assumption with which the fair value was determined; a description must also be given of the approach followed to determine the values assigned to each key assumption, indicating whether these values reflect past experience, if they are consistent with external sources of information and, if not, how and why they differ from past experience or from external sources of information. For example, if the multiples method is used, it is necessary to describe the method for selecting the sample, the multiples used, how they were estimated, and whether they can be observed on the market. If the comparable transactions method is used, it is necessary to give the number, reporting period, market and size of the transactions selected.

(v) **Sensitivity analysis.** The directors must pay particular attention when conducting this analysis and must disclose all the information required under IAS 36, paragraph 134(f). In particular they must indicate:

- the recoverable amount of the CGU in excess of its book value;
- the value assigned to the key assumptions;
- the change in the value assigned to the key assumptions that, having considered any effects on the other variables used, makes the recoverable amount of the CGU equal to its book value.

This information is all the more important in light of the current volatility in the markets and uncertainty as to future economic prospects.

(vi) **External indicators.** The management's attention is drawn to the need for full and complete disclosure when, even if the external indicators show an impairment loss, the impairment test procedure does not lead to any reduction in the value of the assets being tested. In the event of an appreciation – by the market and stakeholders external to the company – that is different from that indicated by the directors, the latter must disclose adequate information to explain these differences and also concerning the reasonableness, consistency and reliability of the valuations made.

## **2. IAS 39 – Reduction in value of equity instruments classified as “Available for sale”**

In view of the highly uncertain conditions in the financial markets, information on the methods used to value equity instruments classified as “available for sale” (“AFS equity”) is particularly important in order to understand firms' gains and losses, assets and liabilities and financial position when the portfolio of these assets is significant.

In this respect, it should be noted that IAS 39, paragraph 61, states that a “significant or prolonged decline in the fair value” of an investment in an equity instrument below its cost is objective evidence of impairment. In this case IAS 39, paragraph 67, requires that any accumulated capital loss recognised directly in the shareholders' equity must be reclassified to the income statement even if the financial asset has not been derecognized.

The meaning of the expression “significant or prolonged decline in the fair value” has created numerous problems of interpretation, especially with regard to the identification of the quantitative thresholds that substantiate the concepts of “significant” and “prolonged” impairment loss.

In June 2005, the International Financial Reporting Interpretations Committee (IFRIC) had already provided a first indication of the abovementioned concepts, clarifying that “significant” should be evaluated against the original cost at initial recognition while “prolonged” over time should be compared with the period in which fair value was below original cost at initial recognition <sup>(5)</sup>.

In July 2009 the IFRIC returned to this question. In particular, although it did not consider it necessary to issue a specific interpretation, it showed that some accounting policies found in practice were inconsistent with the provisions of IAS 39 <sup>(6)</sup>. The IFRIC clarified that:

- IAS 39 does not require the concurrent presence of both criteria. In other words, it is sufficient that there should be either a significant or a prolonged impairment loss to have to write down the financial asset;

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<sup>5</sup> See the IFRIC Update of June 2005: <http://www.iasb.org/NR/rdonlyres/F9B2124E-5F77-4A32-8F45-9374DB801408/0/jun05.pdf>

<sup>6</sup> See the IFRIC Update of July 2009: <http://www.iasb.org/NR/rdonlyres/2DED3CF2-147A-4830-A9AC-BDE2C0CA48BC/0/IFRIC0907.pdf>

- in the event of objective impairment loss, it must be recognized in the income statement. IAS 39 provides that any significant or prolonged reduction of the fair value of an investment in an equity instrument below its cost is objective evidence of impairment loss;
- the fact that the impairment loss of an AFS equity instrument is in line with a decline in its price in the reference market does not allow the company to conclude that the investment has not been impaired;
- the existence of a “significant or prolonged decline in market prices” cannot be overcome by expectations of a recovery in such values, regardless of when it is expected to occur. The IFRIC concluded that in these cases expectations of a recovery were not relevant to the assessment of “significant or prolonged”.

While recognizing that the determination of what constitutes a significant or prolonged decline in fair value requires the application of judgment, the IFRIC recalled the disclosure obligations under IAS 1 paragraphs 122 and 123 and IFRS 7 paragraph 20.

The need for adequate disclosure in the notes on the accounting policies and methods adopted was also put forward by CESR <sup>(7)</sup> and IOSCO <sup>(8)</sup> in their comments to the IFRIC.

The persistence of some kinds of inadequate accounting behaviour is also confirmed, at the Community level, in CESR’s publication of three decisions made by Community enforcers in the document “6th extract from EECS’s database of enforcement decisions” <sup>(9)</sup>.

Nationally, some company’s financial statements for the year ended 31 December 2008 showed available for sale equity instrument impairment procedures that could pose problems in relation to the IFRIC’s approach (after approval of the financial statements). For example, the practice of combining a time restriction (number of months) with a threshold for depreciation of the equity price, expressed as a percentage of its historic cost <sup>(10)</sup>, does not seem to fully comply with the contents of IAS 39, paragraph 61.

This makes it crucial for preparers of financial statements to take note that – as the IFRIC pointed out in July 2009 – the concepts of “significant” and “prolonged” must be evaluated separately.

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<sup>7</sup> See CESR’s comments regarding IFRIC’s tentative agenda decision on IAS 39 “significant or prolonged”: <http://www.cesr-eu.org/popup2.php?id=5780>

<sup>8</sup> See IOSCO’s comments regarding IAS 39 Financial Instruments: Recognition and Measurement – Meaning of “significant or prolonged” : [http://www.iosco.org/library/comment\\_letters/pdf/IFRIC-9.pdf](http://www.iosco.org/library/comment_letters/pdf/IFRIC-9.pdf)

<sup>9</sup> The three decisions concern accounting policies that, according to the enforcers, do not conform to IAS 39, because a) they mistakenly require that both criteria (“significant” and “prolonged”) be met before proceeding to record this in the income statement; b) in the case of exceeding one of the thresholds for “significant” or “prolonged”, they envisage further tests in order to verify whether there has been any impairment. For further details, see (Ref. CESR/09-720): [http://www.cesr-eu.org/data/document/09\\_720.pdf](http://www.cesr-eu.org/data/document/09_720.pdf)

<sup>10</sup> For example, “a decline of X per cent continuing over Y months”.

As previously mentioned, the directors must use their judgment in making this evaluation. In any case, they must exercise their technical discretion in identifying the quantitative thresholds of “significant” and “prolonged”. Once these standards have been established, the policy of subjecting the value of equity instruments to further and unforeseen checks such as analytical evaluation techniques, cannot be considered to conform to the IAS. In other words, once one of the two thresholds – significant or prolonged – has been exceeded, the loss on AFS equity instruments must be reported in the income statement, independently of any other valuation considerations.

Naturally, in exceptional circumstances, for example, when a sudden and anomalous decline in the price of shares on the closing date does not reflect the normal performance of the equity resulting from the level of prices recorded in the weeks both before and after the closing date and is not supported by any new information or event, the directors could consider that the fall does not represent a decline in the value of the equity and make an exception from the predetermined threshold. Obviously, the reasons for this exception and the impact of the change on the financial statements (in terms of a reduction in the impairment adjustments to AFS equity instruments) should be fully covered in the notes to the financial statements.

Furthermore, in exceptional circumstances, the thresholds adopted may be modified to reflect any significant changes in the external situation. In this case, the directors must give the reasons for such changes and their effects in the notes to the financial statements.

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As regards the information to be disclosed in the notes to the financial statements, the attention of the directors is drawn to the need to disclose the following information:

- a summary of the accounting policies applied (IAS 1 paragraph 117 and IFRS 7 paragraph 21);
- the reasoning, including the underlying assumptions, on which the company has based its own judgment whether a loss has been incurred (IAS 1 paragraphs 122 and 123);
- details of the quantitative criteria used (significant decline in terms of value, the size of the threshold of a prolonged decline) to ensure that no value is ignored (IAS 1 paragraphs 122 and 123);

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Lastly, it should be recalled that the above considerations also apply to holdings in subsidiaries, joint ventures, and related companies, entered in the individual companies’ financial statements (IAS 27 paragraph 38).

### **3. IFRS 7 – Contractual clauses of financial debt**

Companies’ attention is drawn to the need for adequate disclosure of medium- and long-term financial liabilities for which non-compliance with some contractual clauses may have triggered an acceleration clause.



IAS 1, paragraph 74 provides that when a firm breaches a condition of a long-term financing contract on or before the closing date – so that the debt becomes payable on demand – the liability is classified as “current”, even if the lender has agreed, after the closing date and prior to the financial statements’ approval, that repayment will not be demanded as a result of the breach. The liability is to be classified as “current” because, on the closing date, the firm does not have the unconditional right to postpone repayment for at least twelve months from that date.

More generally, IFRS 7, paragraph 31, establishes that the company must disclose information in its financial statements that will enable users to evaluate the nature and extent of the risks arising from financial instruments to which the company is exposed at the closing date.

Furthermore, Consob Communication No. DEM/6064293 of 28 July 2006 requires that a description be given of negative pledges and covenants relating to debt positions outstanding at the closing date and at the reporting date, if they are significant. Information must also be given on the effects of non-compliance with covenants and any other divergences from the values of the parameters considered in the underlying contractual agreements. The “significant” criterion must also be considered in relation to the likelihood of defaults.

In the light of these regulatory indications, the attention of the directors is drawn to the usefulness of analysing the situation of these clauses in advance of the approval date of the financial statements in order to identify any clauses or conditions that may not have been respected.

This would allow them to inform the market adequately in an upcoming financial report about the possible consequences deriving from the failure to comply with one or more such contractual terms or conditions.

In this regard, if there is a significant risk of non-compliance with contractual clauses, the following information could be useful for the market: (i) the threshold value foreseen by the contract (ii); the date of the next measurement of the parameter and the frequency of such measurements; (iii) any negotiations initiated with credit institutions; and (iv) the actions that are going to be undertaken.

This information, which is generally a valuable supplement to the financial statement, is naturally more of a problem for companies in economic difficulties.

For such companies, the disclosure requirement results directly from the general indications given in IAS 1, which calls for additional information to be disclosed when conformity with the specific IAS/IFRS provisions is insufficient to ensure the true and fair representation of a company’s gains and losses, assets and liabilities and financial position.

#### **4. IAS 39 – Debt restructuring**

The renegotiation of financial debt can frequently result in some parts being written off in exchange for equity. These operations are the subject of IFRIC 19 “Extinguishing Financial Liabilities with Equity Instruments”, published on 20 November 2009.

In this regard, in conformity with IAS 8, paragraph 30, preparers of financial statements are invited to include information in the notes to the statements to clarify the impact of adopting IFRIC 19 on renegotiation operations.

Looking at the same operations from the point of view of the creditor, it has been noted that during 2009, some intermediaries started credit restructuring operations involving the partial or total conversion of loans into the equity of the debtor companies. More specifically, different approaches were found to have been taken to the valuation of loans in the period between the date of the restructuring agreement and that of the actual conversion of the credit into the debtor company's equity.

Since valuations made in significantly different ways reduce the comparability of financial statements and create competitive disparities, the attention of intermediaries is called to the need to take account of the conversion agreements entered into with debtor companies when valuing this kind of financing. In such cases, since the credit is basically repaid with equity, it must necessarily be valued considering the value of the stock.

In practice, the fair value of the equity can be estimated in various ways, according to its nature (listed or not) and the availability of market information. In any case, the difference between the book value of the loans and the value thus determined must be recorded in the accounts under value adjustments.

Lastly it is important to note that where the restructuring involves credit positions classified as impaired, their conversion into risk capital does not affect the quality. Therefore, in this kind of situation, if the equity is allocated to the AFS portfolio, its later devaluation should be shown in the accounts until the issuer becomes a performing borrower again.

## **5. IFRS 7 – Information on the fair value hierarchy**

In March 2009, the IASB issued an amendment to IFRS 7 introducing a series of changes in response to the need for greater transparency resulting from the financial crisis and connected with the high level of price uncertainty in the market. These changes included the introduction of a fair value hierarchy. In particular, the amendment defines three levels of fair value (IFRS 7, paragraph 27(a)):

- **Level 1:** if the financial instrument is listed in an active market;
- **Level 2:** if the fair value is measured on the basis of reference parameters observable on the market, other than the quoted prices of the financial instrument;
- **Level 3:** if the fair value is calculated on the basis of valuation techniques whose reference parameters are not observable on the market.

The amendment to IFRS 7 was incorporated into European law in Commission Regulation (EC) No 1165/2009 of 27 November 2009.

Given the continuing uncertainty in the financial markets, it is worth reminding companies of the importance of correctly defining the three levels of fair value and their consequent disclosure. In this regard, it should be noted that the correct identification of the level of fair value to which the valuation of a financial instrument refers, requires companies to give careful consideration to the importance of the inputs used in the valuation. For example, if the fair value is estimated using market data (other than prices observed in an active market) which nevertheless require sizeable adjustments based on data that cannot be observed in the market, this measurement is placed at Level 3. For this reason, it is crucial that the notes to the financial statements provide adequate information on the methods and assumptions used to estimate the fair value and on any changes in the valuation techniques compared with the previous period (see IFRS 7, paragraph 27).

Furthermore, IFRS 7, paragraph 27(b) (introduced with the amendment) requires the following information to be given in the notes to the financial statements for each portfolio of financial instruments valued at fair value:

- any significant transfer between Level 1 and Level 2 and the reasons for the transfer;
- any transfer into or out of Level 3 and the reasons for the transfer;
- for Level 3, a reconciliation from the beginning balances to the ending balances, disclosing separately total gains or losses recognized in profit or loss, or total assets, purchases, sales, issues and settlements made during the reporting period and the transfer into or out of Level 3;
- an analysis of the sensitivity of the fair value of Level 3 financial instruments to variations in the observability of market data, where changes to one or more inputs could determine a significant adjustment to the fair value.

For banks, financial intermediaries and insurance companies, these disclosures must be made in the tabular format dictated, respectively, by the Bank of Italy <sup>(11)</sup> and ISVAP <sup>(12)</sup>.

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More generally, the three Authorities, considering the need to disclose correct information on financial instruments to the market, especially in the current market situation, call for directors to pay the greatest possible attention to the quality of disclosure on financial instruments, in line with the provisions of IFRS 7 <sup>(13)</sup>.

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<sup>11</sup> In particular, Bank of Italy Circular 262/2005 (updated for the first time on 18 November 2009) and the Bank of Italy Order of 14 February 2006 (as amended by the Regulation of 16 December 2009) provided for a new section devoted to the disclosure of fair value in Part A – Accounting Policies” in the Complementary note of the company financial statements and consolidated financial statements.

<sup>12</sup> ISVAP Regulation No. 7 of 13 July 2007 and successive amendments.

<sup>13</sup> See also the CESR Statement “Application of and disclosures related to the reclassification of financial instruments” of 15 July 2009 (Ref. 09-575).

**For the Bank of Italy**

**The Governor**

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