European Securities and Markets Authority

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PUBLIC STATEMENT

European common enforcement priorities for 2013 financial statements

According to European Regulation no 1095/2010 establishing the European Securities and Markets Authority (ESMA), ESMA shall act in the field of financial reporting, to ensure the effective and consistent application of European Securities and Markets legislation.

As in 2012, ESMA publishes this Public Statement which defines the European common enforcement priorities for 2013 financial statements in order to promote consistent application of the European securities and markets legislation. ESMA would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided for in the International Financial Reporting Standards (IFRS) for the proper functioning of financial markets.

ESMA acknowledges that it is the role of the International Accounting Standards Board's (IASB) and the IFRS Interpretations Committee's (IFRS IC) to develop accounting standards and to provide authoritative guidance on how IFRS should be applied. ESMA, together with European national enforcers, identified common financial reporting topics which they believe listed companies and their auditors should particularly consider when preparing and auditing, respectively, the IFRS financial statements for the year ending 31 December 2013.

As further detailed in this Statement, the European common enforcement priorities for 2013 financial statements refer to specific aspects of the IFRS application in relation to:

- Impairment of non-financial assets,
- Measurement and disclosure of post-employment benefit obligations,
- Fair value measurement and disclosure,
- Disclosures related to significant accounting policies, judgements and estimates, and
- Measurement of financial instruments and disclosure of related risks, particularly relevant for financial institutions.

Depending on their specific situation and/or the type of activities in which they are engaged, issuers may find that not all the topics covered in this Public Statement will be relevant to their reporting.

It should be noted that the topics mentioned in this statement are those deemed to be the most relevant at the European level as of the date of this Statement. In addition, national enforcers might also focus on other locally relevant topics as part of their review.

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ESMA, together with the European national enforcers, will monitor and assess the application of IFRS requirements relating to the items mentioned in this Statement. These European common enforcement priorities will be incorporated into the reviews performed by national enforcers who will take corrective actions whenever material misstatements are identified in accordance with their enforcement procedures. In addition, ESMA will report on findings regard the European common enforcement priorities in its Report on 2014 enforcement activities.

European common enforcement priorities

Impairment of non-financial assets

The financial crisis followed by the extended period of slow economic growth in Europe imply that assets held by companies may continue to generate lower cash flows than expected when they were acquired. This might be especially relevant in some industries subject to cyclical or structural downturn.

In 2012, the ESMA Public Statement on European common enforcement priorities included aspects dealing with valuation of goodwill and intangible assets with indefinite life and related disclosures.

As part of this year's enforcement activities, European enforcers, coordinated by ESMA, collected data on the quality of disclosures provided for a sample of issuers with significant amounts of non-financial assets. Taking into account the preliminary results of this analysis and in light of the current economic situation, ESMA has included the topic of impairment of non-financial assets in the European common enforcement priorities for 2013 financial statements, with a view to focus on some specific areas:

<u>Cash-flow projections</u>

ESMA reminds issuers that in measuring value in use, cash flows projections should be based on reasonable and supportable assumptions that represent management's best estimate of the range of future economic conditions. As pointed out in paragraph 33(a) of IAS 36, greater weight should be given to external evidence when management determines its best estimate of cash flow projections. Paragraph 34 of IAS 36 states that management should assess the reasonableness of the assumptions on which cash flow projections are based by examining the causes of differences between past cash flows projections and actual cash flows and ensure consistency of the current cash flow projections with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

<u>Key assumptions</u>

Experience shows that many issuers provide a description of the key assumptions used to determine the value in use as required by paragraph 134(d)(i) of IAS 36. For value in use, paragraph 134(d)(ii) of IAS 36 requires management to explain its approach in determining the values assigned to each key assumption by allowing users to understand whether these values are consistent with external sources of information, or how and why they differ from past experience or external sources of information. We observed that often these disclosures are uninformative for users because they are not specific to the cash generating unit (CGU) or group of CGUs but only provided at an aggregate level. ESMA is of the view that it is particularly important for users of the financial statements to be provided with an appropriate level of disaggregated entity-specific disclosures and prompts issuers to consider whether they can improve the quality of their disclosure in this area. ESMA also notes that such assumptions should extend beyond the long-term growth rates and discount rates applied.

Sensitivity analysis

Taking into account the preliminary results of the reviews of 2012 financial statements, ESMA is of the view that, where goodwill or other intangible assets with indefinite useful life are material to an entity, issuers could improve the disclosures related to the sensitivity analysis. Paragraph 134(f) of IAS 36 calls for disclosures aimed at helping users in assessing the safety margin and evaluating how sensitive the assessment is to a change in one or several of the key assumptions used when determining the recoverable amount. From the analysis performed, European enforcers observed that in instances when the safety margin was not large, some issuers did not comply with these requirements and thus did not allow users to form a judgement about the sensitivity implied by changes in each key assumption. In these circumstances, ESMA is of the view that solely the assertion that "no reasonable possible change in a key assumption would result in an impairment loss" might not be sufficient for users in assessing sensitivity.

More generally, ESMA reminds issuers that disaggregated disclosures by significant CGU or group of CGUs should be provided in the financial statements in relation to the long-term growth rate, the discount rate and the key operational assumptions applied (e.g. revenue growth).

Measurement of post-employment benefits obligations

The determination of the discount rate used for measuring post-employment benefit obligations has been an important issue raised by market participants and has been discussed by the accounting community during 2013. Paragraph 83 of IAS 19 – *Employee benefits* requires the rate used to discount post-employment benefit obligations to be determined by reference to market yields at the end of the reporting period based on high quality corporate bonds (HQCB). In countries where there is no deep market in HQCB, the standard requires that market yields on government bonds are used. Due to the economic circumstances which resulted in a significant decrease in the number of HQCB, ESMA addressed this topic in its 2012 European common enforcement priorities and asked issuers not to change their approach in determining discount rates in order to give time to the IFRS IC to provide further clarification on this subject.

During its July 2013 meeting, the IFRS IC noted that the term 'high quality' reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds. The IFRS IC also indicated that an entity's policy for determining the discount rate should be applied consistently over time and that a reduction in the number of HQCB should not result in a change to this policy, provided that the relevant market in HQCB is still deep.

Based on the above, ESMA expects entities to maintain their approach to determining the discount rates for their post-employment benefit obligations in their 31 December 2013 IFRS financial statements, provided that the relevant HQCB market remains deep.

The IFRS IC also discussed which type of bond should be used as a reference to assess the discount rate when no deep market exists for HQCB in a country that belongs to a zone where several countries share the same currency (e.g. the Eurozone). Based on the recommendation of the IFRS IC and consistently with the analysis included in the June 2005 IFRIC Update, the IASB has tentatively decided to amend IAS 19 in order to clarify that the depth of the bond market should be assessed at the currency level and not at the country level. ESMA expects issuers to use an approach consistent with this clarification.

ESMA reminds issuers of the importance of disclosing the significant actuarial assumptions used to determine the present value of the defined benefit obligation and related sensitivity analysis as required by paragraphs 144-145 of IAS 19. As the discount rate is usually considered a significant actuarial assumption, ESMA expects issuers to disclose any significant judgements that management has made in its determination in accordance with paragraph 122 of IAS 1 – *Presentation of Financial Statements*. In addition, issuers should provide disaggregation information on plans and fair value of the plan assets when the level of risk of those plans is deemed to be different as required by paragraphs 138 and 142 of IAS 19.

When the application of IAS 19 revised has a material effect on the financial statements of an issuer at the beginning of the preceding period, ESMA expects that the issuer will include an additional statement of financial position in its financial statements as required by paragraph 10(f) of IAS 1.

Fair value measurement and disclosure

Issuers should assess the impact of any changes to their fair value measurement practice based on the requirements of IFRS 13 – *Fair Value Measurement,* defining fair value, clarifying and refining the principles for its determination as well as setting out its measurement framework. Appendix B of IFRS 13 provides detailed explanations and indicators that should be taken into account when assessing whether a market is active and the consequences for classification of fair value measurement within the fair value hierarchy.

IFRS 13 applies not only to financial instruments, but also to other assets, liabilities and equity instruments the recognition and measurement principles of which are included in standards other than IAS 39 *Financial Instruments: Recognition and Measurement*.

ESMA draws issuers' attention to the following specific elements related to fair value measurement:

Non-performance risk

The fair value of a liability should reflect the effect of non-performance risk which includes, but is not limited to, an entity's own credit risk as required by paragraph 42 of IFRS 13. ESMA notes that this clarification is especially relevant to entities that entered into derivatives transactions. When measuring the fair value of a liability related to a derivative financial instrument, issuers have to incorporate changes in non-performance risk in value of the derivative (Debit Value Adjustment – DVA) in order to take into account their own-credit risk.

ESMA emphasises the need for proper recognition of counterparty credit risk (Credit Valuation Adjustment - CVA) when determining the fair value of financial instruments and providing relevant disclosure as appropriate. When using a valuation technique, ESMA notes that paragraph 67 of IFRS 13 require all valuation techniques to maximise the use of relevant observable inputs and paragraph B13 of IFRS 13 identifies elements such technique captures from a perspective of market participants.

ESMA expects issuers to provide an appropriate level of transparency on the methodologies used, and when the amounts are significant, on the effects of counterparty credit risk on measurement of the fair value of assets and the non-performance risk on the measurement of the fair value of liabilities.

Unit of account

Paragraph 69 of IFRS 13 requires inputs to the valuation technique to be consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or the liability. The standard recognises that, in some cases, an adjustment (premium or discount) will be made to inputs observables in the market (e.g. a control premium when measuring the fair value of a controlling interest). However, the same paragraph states that a fair value measurement shall not incorporate a premium or discount that is inconsistent with the unit of account relevant for that item. As the IASB is currently discussing this matter, ESMA expects issuers to disclose clearly their analysis regarding the unit of account, until the standard is clarified.

Disclosures

IFRS 13 sets out the disclosures objectives related to fair value measurement which should enable readers to understand the valuation techniques and inputs used to measure fair value as well as the effect of the fair value measurement on profit or loss or other comprehensive income for the period when the measurement is based on significant unobservable inputs (level 3). ESMA emphasises the need to provide relevant disclosures to meet these objectives, including when an assessment is based on external valuations.

Paragraphs 93(b) and 97 of IFRS 13 require issuers to provide the level of the fair value hierarchy within which the fair value measurements are categorised for each class of assets and liabilities measured at fair value or for which the fair value is disclosed. The more unobservable data are included in the measurement of fair value, the more important it is for users that the related uncertainties are clearly identified. ESMA underlines the importance of complete and clear disclosures about assets and liabilities for which fair value is classified within level 3, including a narrative description of the sensitivity to changes in unobservable inputs if a change in those inputs might result in a significantly different fair value measurement.

Disclosures related to significant accounting policies, judgements and estimates

There is general agreement about the need for improving the quality of disclosures in the financial statements, as evidenced by the debates and publications at IASB level and in the stakeholders' community. Many market participants have expressed concerns about disclosures that are boilerplate rather than entity specific, redundant because they refer to transactions that are not relevant for the entity concerned, or relate to immaterial items. In addition, certain market participants, notably some users, argue for better, clearer and complete disclosures rather than decreasing their volume.

Issuers need to bear in mind that an enforcer may not be able to conclude solely on the basis of the published financial statements whether an omitted disclosure is likely to be material. A query from an enforcer is an invitation for an issuer to explain its judgments in omitting the disclosure concerned and not always an indication that it should be included in the financial statements.

ESMA expects issuers to focus on the quality and completeness of disclosures that are relevant to an entity's financial statements. High quality disclosures require entity-specific information instead of boilerplate language (e.g. standardized language such as extensive quotation from the standard that does not reflect the specific circumstances of the entity or are not applicable to it).

ESMA draws issuer's attention to the following IFRS disclosure requirements where, based on ESMA experience, quality could be improved:

- Paragraph 117 of IAS 1 requires disclosure of a summary of significant accounting policies. ESMA notes that significant accounting policies could be included in the financial statements in the most appropriate order for the issuer, starting with those policies considered most material and relevant as well as highlighting any options chosen in their application, when allowed.
- ESMA expects issuers to disclose the judgments made by management that have the most significant effect on the amounts recognised in the financial statements as required by paragraph 122 of IAS 1.
- Paragraph 125 of IAS 1 requires disclosure of sources of estimation uncertainties that have a significant risk of resulting in material adjustments in the next financial period. ESMA reminds issuers that these should be reviewed regularly to ensure that they are relevant for each set of financial statements.
- ESMA reminds issuers of the requirements of the paragraph 25 of IAS 1 related to disclosure of uncertainties related to events and conditions that might cast doubt upon the entity's ability to continue as a going concern.
- In line with the examples provided in paragraph 129 of IAS 1, ESMA expects issuers to provide the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including reasons for that sensitivity.
- ESMA emphasises that disclosure of new standards issued but not yet effective as required by paragraph 30 of IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors* is rele-

vant when the new standard might have a material impact on the financial statements (as might be the case in 2013 for many issuers in relation to IFRS 10 – *Consolidated Financial Statements* and/or IFRS 11 – *Joint Arrangements)* or if that impact is not known (as required by paragraph 31 of IAS 8).

Topics related to financial instruments

As a result of the financial crisis and continuing market turbulence, transparency and comparability of financial reporting of financial institutions have come to the forefront of interest of market participants. ESMA has included these two items in its working priorities and has undertaken a review of accounting practices related to financial instruments in the IFRS Financial Statements of financial institutions in Europe, whose conclusions will be published in a separate report in late autumn 2013.

ESMA believes that the following aspects are particularly relevant to financial statements for the year ending 31 December 2013:

General disclosures

Requirements in IFRS 7 – *Financial Instruments: Disclosures* underline the need for transparency in financial statements by setting broad disclosure objectives. Where an issuer has material exposure to financial instruments, ESMA expects financial statements to follow the requirements in paragraph 31 of IFRS 7 and include relevant quantitative and qualitative disclosures enabling users to evaluate the nature and extent of risks arising from these financial instruments, elements related to the valuation of such financial instruments, as well as an analysis of concentration of exposure to relevant risks.

ESMA expects that valuation of financial instruments accurately reflects the economic reality, including any adverse effects on cash flows from financial instruments while taking into account all relevant IFRS requirements.

Impairment of financial assets, forbearance practices and credit risk

Paragraph 58 of IAS 39 – *Financial instruments: Recognition and Measurement* requires that at the end of each reporting period issuers assess whether there is any objective evidence that a financial asset is impaired. ESMA points out that issuers should take into account all information available at the reporting date in order to determine whether there is evidence of impairment and whether some events may have an adverse effect on cash flows from financial assets and disclose judgments related to recognition of impairment.

The experience during the financial crisis showed diverging accounting treatments in relation to forbearance practices. Consequently, European authorities have worked together to contribute to aligning consistency in treatment and disclosure of forbearance practices. In December 2012 ESMA issued the Public

Statement on Forbearance Practices[1], pointing out to the IFRS requirements related to recognition of impairment losses on forborne loans and for enhanced disclosures in this area. In 2013, European Banking Authority (EBA) has consulted on a common definition of forbearance and non-performing loans in Europe. The proposed EBA definition is consistent with the description in ESMA Public Statement.

Although ESMA acknowledges improvement in the level of disclosure of forbearance, there is still room for improvement. In particular, ESMA expects issuers to provide quantitative information on the effects of forbearance enabling investors to assess the level of impairment of financial assets to which forbearance measures have been extended and their impact on the financial position and performance. When determining the level of provisions for forborne assets, ESMA emphasises that paragraph 63 of IAS 39 requires issuers to base impairment calculations on the estimated future cash flows and not on the new contractual cash flows of the forborne loans.

The disclosure requirements in IFRS 7 distinguish between credit quality of financial assets that are neither past due nor impaired (paragraph 36(c) of IFRS 7), past due but not impaired (paragraph 37(a) of IFRS 7) and those individually determined to be impaired (paragraph 37(b) of IFRS 7). Clear and transparent disclosures for each of these categories are necessary to comply with the standard. ESMA also expects issuers to provide an unambiguous description of the accounting policy applied to collective assessment for financial assets that have been assessed individually for impairment but for which no objective evidence of impairment has been identified through individual assessment. These disclosures are necessary to enable investors to assess the effects of credit risk on the entity's financial position and its performance.

Liquidity risk

In light of the current economic situation, investors look closely at the management of liquidity risk and sustainability of sources of funding of financial institutions. ESMA expects issuers to provide liquidity risk disclosures with a granularity that corresponds to their risk profile in order to enable users to get a comprehensive picture of liquidity risk and funding needs of the entity and their evolution over time as required by paragraph 39 of IFRS 7. In particular, issuers should disclose an appropriate number of time bands in the maturity analysis as suggested by paragraph B11 of IFRS 7 and include maturity analysis of financial assets held for managing liquidity risk as required by paragraph B11E of IFRS 7.

Information could include quantitative and qualitative elements related to availability and/or restrictions on assets that could be used for supporting liquidity needs. This is reflected by the recommendation of the European Systemic Risk Board (ESRB) and continuing work of EBA and ESMA in the asset encumbrance area.

ESMA encourages issuers to make sufficiently clear and explicit the relationship between different disclosures related to liquidity risk and funding.

[1] Public Statement: Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions, European Securities and Markets Authority, 20 December 2012, http://www.esma.europa.eu/system/files/2012-853.pdf