Summary

The European Securities and Markets Authority (ESMA) has issued a Public Statement identifying enforcement priorities for listed companies' 2017 financial statements. The Statement is directed at listed companies and their auditors and sets out the areas ESMA and national enforcers will focus on in particular when they examine listed companies' financial statements in order to promote consistent application of International Financial Reporting Standards (IFRSs) across the European Union (EU).

The Statement identifies the following common priorities, detailing the financial reporting matters that companies should pay attention to:

- disclosure of the impact IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers will have, both of which become effective for periods beginning on or after 1 January 2018, and IFRS 16 Leases, particularly if adopted early (IFRS 16 is effective for periods beginning on or after 1 January 2019 with early application permitted);
- specific issues relating to IFRS 3 Business Combinations; and
- specific issues relating to IAS 7 Statement of Cash Flows. In particular it refers to paragraph 44A, which requires entities to disclose information that enables users to evaluate changes in liabilities arising from financing activities, and is applicable for the first time for periods beginning on or after 1 January 2017.

The Statement also:

- reminds issuers that December 2017 year-ends mark the first time that the requirements of the amended Accounting Directive (as transposed into the national law) to disclose non-financial and diversity information apply;
- notes that the Accounting and Transparency Directives require that the management report includes a fair review of the development and performance of the business and the position of the issuer, together with a description of the principal risks and uncertainties that it faces;
- urges issuers to meet the principles in the Guidelines on Alternative Performance Measures (APMs) when including APMs in annual financial reports; and
- suggests entities should disclose the associated risks and expected impacts of Brexit on their business strategy and activities either in the IFRS financial statements or in the management report.

Impact of IFRS 9, IFRS 15 and IFRS 16

Following on from public statements issued in 2016, ESMA again draws attention to the requirement in paragraph 30 of IAS 8 to disclose known or reasonably estimable information relevant to assessing the possible impact that application of an issued IFRS will have on financial statements in the period of initial application, even though it may not be effective until a future accounting period. This is of particular relevance to IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers both of which become effective for periods beginning on or after 1 January 2018. It is also relevant to IFRS 16 Leases, which becomes effective for periods beginning on or after 1 January 2019, particularly if an entity uses the option to adopt it early, and IFRS 17 Insurance Contracts, which becomes effective for periods beginning on or after 1 January 2021.

In 2017 ESMA undertook a fact-finding exercise on the 2016 annual financial statements and 2017 interim financial statements to assess the information issuers provided to users concerning the implementation of IFRS 9 and IFRS 15. Although ESMA identified a number of informative qualitative disclosures on the implementation of the new standards, it also notes practice has varied concerning the specificity of the information provided. Notably ESMA states that it had expected a higher level of disclosure of the quantitative impact of the new standards than was provided. A summary of the results of this fact-finding exercise are available from the ESMA web site here.

ESMA now expects that entity-specific quantitative and qualitative disclosures about the application of the new standards will be provided in 2017 financial statements. As the 2017 annual financial statements will be published after the requirements in IFRS 9 and IFRS 15 (and IFRS 16, if early adopted) will have become effective, ESMA expects that issuers will have substantially completed their implementation analyses. Therefore, it expects that the impacts of the initial application of the new standards will be known or reasonably estimable at the time of the preparation of the 2017 accounts and should therefore be disclosed. In ESMA’s view, such disclosure should include sufficiently disaggregated information on both:

- accounting policy choices expected to be applied, including those relating to the transition approach and the use of practical expedients; and
- the amount and nature of the expected impacts compared to previously recognised amounts. When explaining the impacts, issuers that expect to be significantly impacted by the new standards are encouraged to provide financial communication enabling analysts and other users to update their models.

ESMA also highlights that paragraph 31 of IAS 8 states that issuers should consider disclosing the nature of the impending changes in accounting policy. When providing this disclosure, ESMA recommends that issuers focus on disclosing a concise entity-specific description of the changes introduced by the new standards and, where specific choices are permitted by the standards, what choices the entity has made so as to enable users to assess the impacts. In doing so, ESMA states that issuers should not merely repeat the requirements of the standards and should avoid the risk of overloading financial statements with boilerplate disclosures that do not fulfil the objective.

In an appendix to the public statement, ESMA sets out detailed recommendations on the disclosure of the impact of the new standards. This summarises some of the areas in which IFRS 9, IFRS 15 and IFRS 16 could impact issuers, and in the case of IFRS 9 distinguishes between the impacts on financial institutions, insurance companies, and other corporates.

Business Combinations

Referring to its 2014 report on the application of IFRS 3 Business Combinations, much of which remains relevant in light of recent enforcement activity, ESMA:

- urges issuers to ensure consistency between the assumptions used to measure intangible assets at fair value for the purpose of a purchase price allocation (PPA) in a business combination and the assumptions applied for any impairment testing as well as for determining useful lives used for the amortisation;
- reminds issuers of the importance of performing the analysis of the intangible assets in accordance with the separability criterion as set out in paragraph B33 of IFRS 3 and to disclose, where relevant, the significant judgements underlying the conclusion whether separation of intangible assets was deemed necessary;
- draws attention to the requirements in IFRS 3 on the adjustments to fair value during the measurement period, noting that when the initial accounting for a business combination is incomplete at the end of the reporting period in which the business combination occurs issuers are required to disclose that fact and provide the provisional amounts of assets, liabilities, non-controlling interests or items of the consideration paid. Additionally, ESMA notes that issuers should disclose the reasons why the business combination accounting is incomplete and the nature and amount of any measurement period adjustments recognised during the reporting period;
- highlights that the existence of bargain purchases and the emergence of a related gain is not expected to arise frequently, with paragraph 36 of IFRS 3 providing guidance on the steps that need to be performed before a gain from a bargain purchase can be recognised. When a gain is recognised, ESMA expects issuers to provide the disclosures required by paragraph B64(n) of IFRS 3, including information on the rationale for the transaction resulting in a gain. In providing this
disclosure, ESMA encourages issuers to indicate how the assets and liabilities were re-assessed, including information, if applicable, of the fact that the gain arises from the application of exemptions in IFRS 3 for measuring particular items (e.g. restructuring provisions);
• draws issuers’ attention to the analysis needed to identify whether part of consideration received in a business combination qualifies as contingent consideration or is required to be accounted for as remuneration for post-combination services. Particularly, ESMA points out that paragraph B54 of IFRS 3 states that this depends on the nature of the arrangement. If it is not clear, paragraph B55 provides guidance to conclude whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions;
• acknowledges IFRS 3 does not address the accounting in cases where regulatory requirements oblige the issuer to offer to purchase the ownership interests of non-controlling interests (usually referred to as MTO). Similarly, IFRS 3 does not apply to business combinations under common control. Therefore, ESMA expects that, until the treatment of such transactions is addressed by the IASB, issuers should apply consistently the accounting policy selected in accordance with paragraphs 10-12 of IAS 8 and disclose it in accordance with paragraphs 117 and 121-122 of IAS 1; and
• notes that the disclosure requirements in IFRS 13 Fair Value Measurement about non-recurring fair value measurements address only measurements subsequent to initial recognition and therefore do not apply to assets and liabilities recognised at fair value in a business combination. However, ESMA reminds issuers that the information on the assumptions and measurement techniques used in the valuation of material assets, liabilities and non-controlling interests acquired in a business combination is relevant for investors. In this respect, ESMA notes that mere reference to the reliance on external valuations does not provide sufficient transparency on the methodologies and inputs used.

Statement of Cash Flows

Regarding IAS 7 Statement of Cash Flows, ESMA:
• reminds issuers that paragraph 44A of IAS 7, applicable for the reporting periods starting on or after 1 January 2017, requires disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including changes arising from both cash flows and non-cash changes. Although there are various ways to provide the required information, issuers are encouraged to use the tabular format of reconciliation as shown in the Illustrative Example E to IAS 7;
• highlights the need to provide an entity-specific accounting policy on which issuers’ instruments or facilities meet the definition of cash and cash equivalents in accordance with paragraph 6 of IAS 7. In particular, where relevant, ESMA expects disclosure of whether, and to what extent, overdraft bank facilities (notably those repayable on demand) and balances resulting from cash pool facilities are considered as cash and cash equivalents; and
• advises that the disclosure of cash and cash equivalents balances not available for use by the group required by paragraph 48 of IAS 7 is also required by paragraphs 13 and 22 of IFRS 12 Disclosure of Interests in Other Entities, which refers to the disclosure of significant restrictions (e.g. statutory, contractual and regulatory) on the ability of an entity to access the assets of the group, including cash. Such disclosure might be particularly relevant if material cash balances are held in a jurisdiction whose currency is subject to limited exchangeability or capital controls. However, ESMA emphasises that these are not the only circumstances in which cash is not available for use by the group.

Other

ESMA:
• reminds issuers that the 2017 year end will be the first time that the requirements of the amended Accounting Directive (as transposed into the national law) to disclose non-financial and diversity information will be applied and that it will coordinate the enforcement activities related to both non-financial and corporate governance information. Although different disclosure frameworks can be used to meet these requirements which are applicable to certain large groups and undertakings, ESMA states that it believes issuers should meet these requirements in a way that provides the most useful information to users and that the Guidelines of the European Commission describing a methodology for reporting non-financial information could be helpful for the issuers in this respect;
• notes that the Accounting and Transparency Directives require that the management report includes a fair review of the development and performance of the business and the position of the issuer, together with a description of the principal risks and uncertainties that it faces. Such reviews should provide a balanced and comprehensive analysis of the development and performance of the issuer’s business, consistent with its size and complexity. In providing the analysis, the management report must, where appropriate, include references to, and additional explanations of, amounts reported in the annual financial statements. When fulfilling these requirements, ESMA reminds issuers of the importance of providing entity-specific disclosure;
• urges issuers to meet the principles in the Guidelines on Alternative Performance Measures (APMs) when
including APMs in the annual financial reports, considering whether their use in the annual financial report contribute to a fair review of the development and performance of the business.

- Suggests that issuers potentially affected by the United Kingdom’s decision to leave the European Union (EU) should assess and disclose the associated risks and expected impacts on their business strategy and activities as appropriate in the IFRS financial statements or in the management report. The recognition and measurement of deferred taxes in accordance with IAS 12 *Income Taxes* is cited as one area where issuers may need to disclose major sources of risks and uncertainties whose resolution will depend on the outcome of Brexit negotiations.
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