ESMA PUBLIC STATEMENT: EUROPEAN COMMON ENFORCEMENT PRIORITIES FOR 2018 FINANCIAL STATEMENTS

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2018/09

Summary

The European Securities and Markets Authority (ESMA) has issued a Public Statement identifying enforcement priorities for listed companies' 2018 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:

- application of IFRS 15 *Revenue from Contracts with Customers*, including disclosures surrounding the transition and significant judgments made in areas such as identifying performance obligations, determining the transaction price and the timing of revenue recognition;
- application of IFRS 9 *Financial Instruments* for both corporate and credit institutions (e.g. banks and lenders), including disclosures surrounding the transition and significant judgments made in areas such as the definition of default, identifying a significant increase in credit risk, the incorporation of forward-looking information and the reconciliation of expected credit losses from period to period; and
- disclosure of the implementation and expected impact IFRS 16 will have, which becomes effective for periods beginning on or after 1 January 2019.

The Statement also:

- reminds issuers of the requirements in Article 19a of the Accounting Directive concerning transparency surrounding environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters;
- urges issuers to meet the principles in the Guidelines on Alternative Performance Measures (APMs) when including APMs in annual financial reports, and provides additional guidance on the effects that may be felt by IFRS 9, 15 and 16 on APMs;
- 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, with special consideration given the timing of Brexit negotiations that may be ongoing close to year-end, or subsequent to 31 December 2018.

This bulletin summarises the main points in the Public Statement. The full statement can be accessed [here](#).

STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Information on regulators' expectations and forthcoming areas of focus in financial statements.

Application of IFRS 15

Given the importance of revenue in financial reporting, ESMA urges issuers to focus on entity-specific disclosures surrounding the effects of the transition to IFRS 15 and how it is applied to the various revenue streams. These disclosures are important regardless of the actual transitional impact recorded upon adoption of IFRS 15.

ESMA highlighted that disclosures about the transitional impact are crucial, with explanation of each effect having a material impact (e.g. the identification of new performance obligations, a change in timing of revenue recognition, etc.). When the modified retrospective method is utilised, line-by-line disclosure of the effects of IFRS 15 must be provided, as comparative figures are not restated.

ESMA highlighted several specific areas within IFRS 15 for issuers to focus on:

- identification of performance obligations, especially in situations where there is significant judgment applied (e.g. telecommunications and media industries as examples);
- Determining the satisfaction of performance obligations, with focus on determining and disclosing when control of goods and services is transferred, and which criteria in paragraph 35 of IFRS 15 are satisfied to conclude over time revenue recognition is appropriate. ESMA also highlights that issuers should review the March 2018 IFRIC agenda decisions, which highlights the application of paragraph 35 to specific fact patterns (see BDO's IFRB on IFRIC's March 2018 agenda decisions here).
- principal versus agent assessments, including disclosure of the judgments made in determining whether an entity is a principal or an agent, linking back to the guidance on control in IFRS 15;
- allocation of the transaction price to multiple performance obligations;
- presentation of contract assets and liabilities;
- disaggregation of revenue in such a manner that depicts how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors; and
- disclosure objectives and significant judgments, including interpretation of the primary objective of the disclosure requirements in paragraph 110 of IFRS 15.

Application of IFRS 9 – Corporate Entities

ESMA highlights that aside from the detailed measurement guidance within IFRS 9, significant new disclosure requirements become effective via IFRS 7 *Financial Instruments: Disclosures.* These disclosure requirements relate both to the transition to IFRS 9 as well as revised ongoing disclosure requirements.

Concerning the transition to IFRS 9, ESMA highlights IFRS 7's disclosure requirements concerning:

- reclassification of financial assets and financial liabilities upon the initial application of IFRS 9; and
- a reconciliation of the closing impairment allowance under IAS 39 *Financial Instruments: Recognition and Measurement* to the opening impairment allowances under IFRS 9, disaggregated by measurement category.

Depending on the circumstances, entities may need to further disaggregate such reconciliations (e.g. by major portfolios) together with narrative explanation of the main drivers of the impact, including the impact on performance.

ESMA emphasises that while IFRS 9 will have a more significant impact on credit institutions, the standard has wide-reaching impact to all issuers. ESMA expects issuers to provide relevant, material and entity-specific disclosures, taking into account the importance of financial instruments in their business operations. Entities with significant trade receivables, lease receivables and contract assets are reminded that these balances are subject to the new expected credit loss requirements in IFRS 9. Despite the simplifications available for certain types of balances for corporate entities, the effect is still expected to be significant.

ESMA also highlights that issuers should review the March 2018 IFRIC agenda decision concerning the presentation of interest revenue calculated using the effective interest method for financial assets subsequently measured at amortised cost or fair value through other comprehensive income (see BDO's IFRB on IFRIC's March 2018 agenda decisions here).

Finally, ESMA also reminds issuers of the new disclosures in IFRS 7 relating to the application of hedge accounting, even to those entities who choose not to apply the hedge accounting requirements of IFRS 9 and continue to apply IAS 39's guidance instead.

Application of IFRS 9 – Credit Institutions

Given the impact of IFRS 9 on credit institutions, ESMA highlights several aspects of the new requirements, including:

- the disclosure of entity specific assumptions, methods and inputs, with focus on the requirements of paragraphs 35D, 35F and 35G of IFRS 7. These disclosures should be sufficiently disaggregated in line with internal credit risk management policies (e.g. based on different types of products or geographical markets). Disclosure should also be made of the issuer's definition of default (paragraph 35F(b) of IFRS 7), including the reasons for selecting this definition and the extent to which the definition aligns to the definition for regulatory purposes;

- the need to disclose the issuer's approach to setting the criteria for identifying a significant increase in credit risk (SICR). This disclosure should detail both the quantitative and qualitative information considered in identifying a SICR, including the extent to which the 30-day past due backstop is utilised and how remedies of a SICR are identified (e.g. probation or cure periods);
- disclosure requirements concerning the reconciliation of expected credit loss balances from period to period, including explanation of how the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance;
- the measurement of expected credit losses on credit-impaired financial assets. IFRS 9's expected credit loss model is expected to have a significant impact on performing loans, however, ESMA reiterates its concern from its 2017 enforcement priorities that issuers must consider the impact of the expected credit loss methodology on non-performing loans (NPLs) as well;
- consideration of sale of loan scenarios in expected credit loss calculations, if selling the loan is one of the recovery methods that the entity reasonably expects to pursue in a default scenario; and
- the application of the solely payments of principal and interest (SPPI) test on an instrument-by-instrument basis. Relevant factors to consider may require judgment, including the effect of non-recourse features that must be evaluated on a "look-through" basis.

Application of IFRS 9 – Insurance Entities

ESMA notes that IFRS 4 *Insurance Contracts* was amended to allow a reporting entity whose activities are predominantly connected with insurance to continue applying IAS 39 rather than IFRS 9 until 1 January 1 2021, concurrent with the effective date of IFRS 17, *Insurance Contracts.* Issuers must provide relevant and entity-specific disclosures concerning how they satisfied the criteria in IFRS 4 in order to apply the deferral.

ESMA also highlighted the Commission Regulation that allows the use of the temporary exemption option for consolidated financial statements of banking-led financial conglomerates with regards to legal entities in the insurance sector, subject to certain conditions. Issuers utilising this option are expected to disclose its use and how the criteria are satisfied. ESMA also highlighted the importance of disclosing the amount of financial assets for which the temporary exemption from the application of IFRS 9 is applied as well as the extent of significant restrictions on the use of the group's assets subject to the transfer ban. Enforcers will closely scrutinise the compliance of issuers who choose to use the temporary exemption.

Disclosure Related to the Expected Impact of IFRS 16

IFRS 16 *Leases* supersedes IAS 17 *Leases* and several related interpretations and is effective for periods beginning on or after 1 January 2019.

ESMA highlights the disclosure requirements in IAS 8, paragraph 30 concerning the disclosure of known or reasonably known estimates of the effects of upcoming standards. Given that 2018 annual financial statements will be published in 2019 when IFRS 16 is effective, ESMA expects that issuers will have substantially completed their implementation activities, and therefore will have sufficient information to meet the disclosure requirement in IAS 8, paragraph 30.

Disclosure of the impending changes may include information surrounding the choices the issuer has made (e.g. transition method and practical expedients to be utilised), as well as significant judgments, such as the determination of the lease term, discount rate and how right-of-use assets will be measured on transition to IFRS 16.

ESMA notes that for issuers planning to utilise the modified retrospective approach and therefore not restate comparative figures, issuers will be required to explain the difference between their previously disclosed minimum lease commitment disclosure and the lease liabilities recognised on transition to IFRS 16. Issuers should pay particular attention to their minimum lease disclosure in their 2018 annual financial statements.

Finally, ESMA expects users will make a link between minimum lease payments for operating leases disclosed in the 2018 accounts in relation to the disclosure of the expected impact of IFRS 16, hence, issuers are encouraged to explain these differences.

Other

ESMA:

- reminds issuers of the requirements in Article 19a of the Accounting Directive concerning transparency surrounding environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. ESMA particularly highlights the requirements to disclose a description of the policy addressing environmental matters, which ESMA considers should include climate change related matters. These disclosures would include actual and potential impacts related to environmental factors, such as risks arising from technological obsolescence or from the potentially abrupt need to shift from a carbon-intensive to a low-carbon technological landscape;
- considers that it is important that issuers disclose the reasons why certain key performance indicators (KPIs) were deemed relevant to explain the impact of an issuer's actions to pursue the policies related to the non-financial matters disclosed. ESMA highlights the importance of disclosing the methodology adopted and

the perimeter of activity being covered by the non-financial reporting;

- 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. Issuers are also reminded to consider whether APMs may require modification or entirely new APMs should be used due to the effects of IFRS 9, 15 and 16;
- 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. Given the fluid nature of Brexit negotiations, ESMA notes that exit scenarios might become clearer by the date the 2018 annual financial reports are authorised for issue and thus issuers should provide sufficient transparency on its impact on their exposures and activities as well as risks and source of estimation uncertainty.

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