European Securities and Markets Authority

Date: 12 November 2012
ESMA/2012/725

PUBLIC STATEMENT

European common enforcement priorities for 2012 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.

ESMA publishes this Public Statement which defines the common enforcement priorities for the 2012 financial statements in order to promote consistent application of the European securities and markets legislation, and more specifically that of International Financial Reporting Standards ("IFRS"). 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 IFRS in order to ensure the proper functioning of financial markets.

ESMA acknowledges that it is the role of the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRS IC) to provide authoritative guidance on how IFRS should be applied.

ESMA together with European national competent authorities identified common financial reporting topics which they believe are particularly significant for European listed companies considering the economic and market situation. Companies and their auditors should therefore take into due consideration this Public Statement when preparing and auditing the IFRS financial statements for the year ending 31 December 2012.

As further detailed in this Statement, the common financial reporting topics refer to the specific aspects of the IFRS application in relation to:

- Financial assets,
- Impairment of non-financial assets,
- Defined benefit obligations, and
- Provisions that fall within the scope of IAS 37.

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 elements related to financial assets are mainly, but not exclusively, relevant for financial institutions.

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ESMA together with the national competent authorities will monitor the application of IFRS requirements relating to the items mentioned above and will assess how ESMA's expectations included in this Statement are fulfilled. These common enforcement priorities will be incorporated into the reviews performed by national competent authorities which will take corrective actions whenever material misstatements will be identified in accordance with their usual procedures. In addition, ESMA will collect data on how European listed entities have applied IFRS requirements in relation to these topics and will report the results of this survey to the market.

It should be noted that the above mentioned topics are those deemed to be the most relevant at European level as of the date of this Public Statement. National competent authorities may find it appropriate to publish statements in their respective jurisdictions alerting listed companies on additional matters related to the application of IFRS, and therefore the enforcement process will not be limited to the matters specifically mentioned in this Statement.

Common enforcement priorities

I. Financial Instruments

Financial Instruments subject to risk

Further to the financial crisis, transparency on information related to financial instruments provided to the market has become a top priority for investors, issuers and regulators. Providing disaggregated and expanded disclosures about material exposures to all financial instruments that become subject to risk (not limited to sovereign debt exposures) and explaining the nature and extent of that risk are essential elements for the protection of investors and the well-functioning of markets.

IFRS 7 – *Financial Instruments: Disclosures* paragraph 1 requires entities to provide disclosures that enable users to evaluate (i) the significance of financial instruments for the entity's financial position and performance and (ii) the nature and risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period and how the entity manages those risks. Paragraph 6 requires that an entity should provide disclosures by class of financial instruments that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments.

Where an issuer identifies material exposure to financial instruments subject to risk, ESMA would expect financial statements to follow the requirements in IFRS 7 paragraph 31 and include relevant quantitative and qualitative disclosures reflecting the nature of the risk exposure, elements related to the valuation of such financial instruments as well as an analysis of concentration of exposure to relevant risks.

In this context, IFRS 7 paragraph 34 requires quantitative disclosures related to each type of risk arising from financial instruments. Specifically, IFRS 7 paragraph 34(c) and B8 require disclosure of concentrations of risk, including a description of the shared characteristics that identify each

concentration and the amount of the risk exposure associated with all financial instruments sharing that characteristic.

Sovereign debt

As a result of the sovereign debt crisis, the investors' focus has been on how this crisis impacted the financial performance and financial position of listed financial institutions with exposure to sovereign debt.

In 2011, ESMA issued two statements (ESMA/2012/226 and ESMA/2012/397) with the aim of encouraging issuers to provide an enhanced level of transparency in relation to material sovereign exposures in their IFRS financial statements. In July 2012, ESMA published a review of the accounting treatment of Greek sovereign debt in the 2011 annual financial statements of a sample of European financial institutions (ESMA/2012/482).

In addition to the elements included in those statements and based on the outcome of the review performed in 2012, ESMA encourages issuers to further enhance transparency on the following topics:

- quality of the country-by-country disclosures, more specifically with respect to the granularity of information provided on significant sovereign debt exposures including, but not limited to, quantitative disclosures on gross and net exposures;

- non-sovereign exposures by type of exposures (corporates, banks, municipalities, etc.), including qualitative and quantitative information on credit risk; and

- impact of credit derivatives (e.g. credit default swaps) used in managing the material exposures to financial instruments, more specifically with respect to disaggregation of information (e.g. distinguishing between additional exposures resulting from the sale of derivative instruments and the estimated level of protection resulting from the purchase of credit derivatives).

Impairment of financial assets

IAS 39 – *Financial instruments: Recognition and Measurement* paragraph 58 requires that issuers assess whether there is any objective evidence that a financial asset is impaired. The guidance requires identification of a loss event and that the impact on the future estimated cash flows of the financial asset can be reliably measured.

Given the current economic environment, two issues of particular focus have been identified:

- application of the 'significant or prolonged' criteria for assessment of impairment for the equity instruments (IAS 39 paragraph 61), and

- accounting of loans modified for economic or legal reasons relating to the borrower's financial difficulty (IAS 39 paragraph 59(c)).

Application of the "significant or prolonged" criteria

IAS 39 paragraph 58 requires assessing, at the end of each reporting period, as to whether there is objective evidence that a financial asset is impaired. An impairment loss is recognised if and only if such evidence exists. IAS 39 paragraph 59 provides guidance as to when objective evidence of impairment is deemed to exist: as a result of an event that occurred after the initial recognition of the asset ('loss event'), and when that loss event has an impact on the estimated cash flows of the financial asset(s) that can be reliably estimated.

For an investment in an equity instrument, IAS 39 paragraph 61 indicates that a significant or prolonged decline in the fair value of the investment below its cost is also objective evidence of impairment. Consequently, a significant or prolonged decline in fair value immediately triggers the recognition of an impairment loss for equity instruments held in the available-for-sale portfolio. However, IAS 39 does not provide further guidance on the determination of what constitutes a 'significant or prolonged' decline in fair value.

European enforcers observed divergent practices in the application of the 'significant or prolonged' criteria with varying degrees of transparency in the disclosures of judgements used for the determination of what constitutes a 'significant or prolonged' decline in fair value.

ESMA believes that a higher level of transparency in the disclosures related to the assessment of the triggering event for impairment and to changes in such assessment, as well as the impact of such changes, is necessary to achieve comparability of IFRS financial statements among issuers. Given the high volatility in market prices observed in recent periods, such transparency should be based on the provisions in IAS 1 – *Presentation of Financial Statements* paragraph 122 which requires management to disclose the judgements made in applying the entity's accounting policies that have the most significant effects on the financial statements.

Modified loans

In the current economic environment, it was observed that financial institutions had various approaches in relation to customers who experienced a period of financial stress. Information gathered by European national competent authorities showed diverging practices in the assessment of so-called forbearance practices and significant differences in judgements made on the level of provisioning and disclosures for re-negotiated loans.

IAS 39 paragraph 40 states that an exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. From a financial asset de-recognition perspective, IAS 39 paragraph 17 refers to the expiry of contractual rights to the cash flows from the asset.

ESMA would expect that, when relevant, issuers provide transparent qualitative and quantitative disclosures with regard to the effects of so-called forbearance practices in their financial statements. Such

disclosures should also help readers understand the consequences of these practices in terms of provisioning.

Because transfers of financial instruments are often complex transactions, ESMA emphasises the need for improved transparency in the information provided in accordance with IFRS 7 paragraphs 42A to 42H which will be applicable for the first time in 2012.

II. Impairment of non-financial assets

The current economic situation in certain industries and countries also increases the likelihood that the carrying amounts of assets might be higher than their recoverable amounts. The market value of a significant number of quoted companies has fallen below their book value. According to IAS 36 – *Impairment of Assets* paragraph 12(d), such a situation may represent an indication of impairment and therefore requires performance of an impairment test. Where the recoverable value is lower than the carrying amount an entity should recognise an impairment loss as required by IAS 36 paragraph 59.

Due to the widespread economic slowdown observed in recent months, assessing future cash flows requires considerable judgement to be exercised by management and is subject to higher levels of uncertainty. In this context, ESMA considers that particular attention should be paid to the valuation of goodwill and intangible assets with indefinite life whenever significant amounts are recognised in the financial statements. ESMA emphasises the need to use assumptions that represent realistic future expectations.

IAS 36 paragraph 134 requires detailed disclosures on estimates used to measure the recoverable amount of cash-generating units (CGU) to which significant goodwill or intangible assets with indefinite lives is allocated. When a CGU's recoverable amount is based on its value in use, considerable judgement has to be exercised by management. In the past, European national competent authorities noted a lack of sufficiently CGU-specific qualitative and quantitative disclosures.

The aim of the requirements in IAS 36 paragraph 134(d) is to help users understand the approach followed by the management. Therefore ESMA emphasises that more granular disclosures instead of aggregated quantitative disclosures should be provided in the financial statements with a particular focus on the key assumptions used, the periods over which cash flows are forecast, the growth rates and discount rates applied, as well as on the consistency of those assumptions with past experience (useful guidance is provided in Illustrative Example 9 from IAS 36).

IAS 36 paragraph 134(f) requires additional disclosures on the sensitivity of the recoverable amounts to reasonable possible changes in key assumptions where those changes would cause an impairment to be recognised. ESMA believes that, in the current economic environment, these disclosures are even more relevant and would expect disclosures to include sensitivity analyses related to assumptions used such as, the growth rates, the discount rate, and the operating margin and their impact on revenues or volume of sales. ESMA notes that IAS 1 paragraph 125 requires similar disclosures on the assumptions made about

the future, and other major sources of estimation uncertainty, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets within the next financial year.

III. Measurement of post-employment benefits obligations

IAS 19 – *Employee benefits* paragraph 79 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. In countries where there is no deep market in such bonds, the market yields on government bonds should be used.

In Europe, the sovereign debt crisis and economic downturn resulted in significant swings in market yields for sovereign and corporate debts. Further, economic uncertainties resulted in the downgrading of a number of corporate entities. As a consequence, a question arose as to whether entities should change their approach to determining discount rates for their post-employment benefit obligations.

ESMA is aware that the IFRS IC has planned to discuss the notion of high quality corporate bond during its November 2012 meeting. Based on this information, ESMA believes that entities should wait for a clarification to come from the IFRS IC and should not change their approach to determining discount rates. In the meantime, ESMA emphasises that there is a particular need for transparency in this area. Therefore entities are expected to disclose: if they used yields coming from high-quality corporate bonds or other means, a description of how they determined yields from high-quality corporate bonds (including any significant judgement used, or any reference to a regional market to which the issuer has access).

Regarding IAS 19 Revised which will be effective as of 1 January 2013, ESMA expects that quantitative information on the effects of its adoption which is required by IAS 8.30 will be provided in the 2012 IFRS financial statements. The main changes introduced by IAS 19(2011) relate to the elimination of the corridor, changes in the assessment of interest revenues from plan assets and how service cost is accounted for.

IV. Provisions that fall within the scope of IAS 37

The measurement of provisions involves significant management judgement and is subject to higher levels of uncertainty. Furthermore, there is a strong link between provisions and the risks an entity is subject to, hence the quality of disclosures on provisions is a key aspect for the transparency of the financial statements. However, notes on provisions often provide only aggregated qualitative and quantitative information.

IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* paragraphs 84 and 85 provide clear indications that the objective of disclosures on provisions is to inform users about changes in amounts of provisions. For instance IAS 37 paragraph 85 requires entities to disclose, for each class of provision,

descriptions of the nature of the obligations concerned, the expected timing of outflows of economic benefits, uncertainties related to the amount and timing of those outflows as well as, if relevant, major assumptions made concerning future events. The wording used is a strong indication that these disclosures should be adapted to reflect the risks attached to the issuer's activities. Therefore boilerplate wording should be avoided, and the granularity of disclosures should be such that the financial consequences of risks that are dissimilar in nature should be presented in separate classes of provision.

Lastly, ESMA would expect issuers to provide an appropriate level of transparency on the uncertainties attached to the judgements involved in these assessments.