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PUBLIC STATEMENT

European common enforcement priorities for 2015 financial statements

The European Securities and Markets Authority ('ESMA') issues this Public Statement which defines the European common enforcement priorities in order to promote consistent application of the International Financial Reporting Standards ('IFRS') as indicated in the ESMA Guidelines on enforcement of financial information[1].

As in previous years, ESMA, together with European national enforcers (hereafter referred to as "enforcers"), identified financial reporting topics which listed issuers and their auditors should particularly consider when preparing and auditing, respectively, the IFRS financial statements for the year ending 31 December 2015. In addition to these common priorities, enforcers may also choose to set additional enforcement priorities focusing on other relevant topics in their jurisdictions.

ESMA, together with the enforcers, will pay particular attention to these common priorities when monitoring and assessing the application of all relevant IFRS requirements. Enforcers will continue to focus on material issues in the financial statements that are relevant for an individual issuer under examination. On the basis of examinations performed, enforcers will take corrective actions when material misstatements are identified. ESMA will report on findings regarding these priorities in its Report on the 2015 enforcement activities.

The common priorities for the 2015 financial statements encompass the following topics which are detailed in this Statement:

- Impact of the financial markets conditions on the financial statements;
- Statement of cash flows and related disclosures; and
- Fair value measurement and related disclosures.

ESMA and the enforcers selected the 2015 common priorities based on the recurrence of issues in the application of certain IFRS requirements identified when reviewing financial statements and to the economic environment which poses particular challenges to issuers. Furthermore, in addition to the 2015 common priorities, ESMA has included in this statement specific references to the 2014 common priorities and to the new IFRS requirements.

When preparing or auditing annual financial statements, ESMA urges issuers and auditors to consider this statement together with the ESMA statement on improving the quality of disclosures[2]. This statement

[1] Guidelines: Enforcement of financial information, ESMA, 28 October 2014
[2] Statement: Improving the quality of disclosures in the financial statements, ESMA, 27 October 2015

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draws issuers' attention to a number of potential additional descriptions or explanations in the notes to the financial statements. When assessing what information should be disclosed, issuers should consider the materiality and the relevance of the underlined transactions, assets and liabilities to ensure the understandability and readability of the notes.

2015 European common enforcement priorities

Impacts of the financial markets conditions on the financial statements

The financial markets conditions have changed significantly in the past year: some reference interest rates and the market prices of a number of commodities have decreased significantly and continue to be highly volatile while some exchange rates have fluctuated significantly.[3] Furthermore, macroeconomic conditions in some countries have deteriorated in such a way that these countries have enacted measures limiting free movement of capital. When applying the IFRS requirements, issuers should pay particular attention to the above mentioned elements and adapt both the information and the level of detail given on the risks to which they are significantly exposed. In this context, issuers might also consider inserting cross-references to the notes when the information provided is interrelated (e.g. country risk) to promote the understanding of the risks to which they are exposed and the economics of the transactions.

ESMA reminds issuers that paragraphs 122 and 125 of IAS 1 *Presentation of Financial Statements* require issuers to provide information about the judgements and assumptions made by management when applying accounting policies and when measuring assets and liabilities wherever these judgements or assumptions would significantly affect the amounts recognised in the financial statements. Likewise, issuers should also disclose other major sources of estimation uncertainty that have a significant risk of resulting in material adjustments to the carrying amounts of assets and liabilities in the next reporting period.

Interest rate environment

ESMA draws issuers' attention to the current interest rate environment in Europe (highly volatile, low or even negative interest rates for certain benchmarks, i.e. for some government and high-quality corporate bonds, especially for shorter maturities) which is expected to have an impact on the cost of debt and capital and on inputs used in various valuation techniques.

ESMA reminds issuers that the current interest rate environment should be taken into account when adjusting the inputs to their valuation models to determine the measurement of financial and non-financial assets and liabilities. That should be the case when determining the discount rate to be used when assessing the recoverable amount required by paragraph 55 IAS 36 *Impairment of Assets,* the long term provisions as prescribed by paragraph 47 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and in determining the liabilities of defined benefit plans in accordance with paragraph 83 of IAS 19 *Employee Benefits.*

3 Report: Trends, Risks and Vulnerabilities, No. 2, 2015, ESMA, September 2015

Furthermore, paragraph 134[4] of IAS 36 and paragraphs 144-145 of IAS 19 require the disclosure of the discount rate used and a sensitivity analysis for each significant assumption. In addition, the methods and assumptions used in preparing the sensitivity analyses as well as any related changes are also required in paragraph 145 of IAS 19. Consistently with the elements referred to above, ESMA encourages issuers to provide similar disclosures in relation to the discount rate used when determining the present value of long term provisions measured in accordance with IAS 37 (e.g. in the case of dismantling costs).

ESMA urges issuers to use assumptions which are mutually compatible as required by paragraph 75 to 78 of IAS 19 and to ensure their consistency over time. For example, when determining defined benefit liabilities, issuers should ensure that the salary and benefits increases used are consistent with the expected inflation level in a given geographical area.

When applying the above mentioned requirements of IAS 36, IAS 19 and IAS 37, and where issuers decide to change the significant key assumptions used or how these are determined compared with prior periods, the changes shall be disclosed together with the related explanations. When determining what is considered a reasonable change in the assumptions used, issuers should take into account the economic and financial market context (e.g. by adapting the sensitivity analysis to the interest rate's volatility observed in the recent past).

Finally, ESMA highlights the requirements in paragraphs 40 and 41 of IFRS 7 *Financial Instruments: Disclosures* in relation to market risk and expects that entities with financial instruments exposed to interest rate risks provide relevant disclosures regarding the sensitivity analysis.

Exposure to high volatility and low prices for commodities

Some industries are significantly exposed to commodity prices (e.g. oil, gas, iron ore). Therefore, it is expected that the current decrease in the prices of some commodities will impact the valuation of assets, notably if market trends indicate sustained low level of prices for a medium to long term period of time. In this context, ESMA urges issuers to be transparent on these effects in the financial statements (e.g. on the lines and subtotals presented on the face of the statement of comprehensive income) and encourages them to also disclose any changes in their operations resulting from their exposure to commodity risk (e.g. cancellation or postponements of projects).

ESMA expects that, where relevant, the assumptions[5] used by issuers take into account the market conditions and are disclosed to ensure that readers understand the impact that these conditions have on the financial statements. In particular, information on the main assumptions used for the measurement of assets (e.g. for the initial measurement of assets acquired in a business combination, or for accelerated amortisation or impairment of intangible assets, property plant and equipment, inventories, or goodwill) should be provided in the financial statements.

[4] A sensitivity analysis is required for significant goodwill or intangible assets with an indefinite useful life when a reasonably possible change in a key assumption would cause the carrying amount to exceed the recoverable amount (IAS 36.134(f)).

[5] Paragraphs 125 to 129 of IAS 1

When a commodity price is as a key assumption in the valuation of the relevant assets, issuers should consider disclosing the closing price and, where relevant, a sensitivity analysis on the changes to these key assumptions. In addition, if a recovery in the price of a commodity is expected, ESMA encourages issuers to provide information on the time schedule expected for this recovery or an explanation when they expect that the recovery is postponed.

Foreign exchange rate and country risk[6]

Some countries are exposed to significant uncertainties such as financial difficulties, political tensions, pressure on foreign exchange rates or controls of capital (limitations to movements or repatriation of capital). Issuers may be exposed to country risk or foreign exchange rate fluctuations through the location of subsidiaries or cash-generating units, commercial trades or because of developments in the financial markets.

Issuers should take into account the country risk in the measurement of assets and liabilities (e.g. when performing impairment tests, assessing the need for recognising provisions or for providing disclosures about contingent liabilities). In this context, ESMA reminds issuers to use assumptions (e.g. for the projection of future cash flows) aligned with the economic environment where the issuer or its cash-generating unit is operating.

Issuers with significant exposure to a country at risk, in which more than one foreign exchange rate exists, should provide information about the exposure, the foreign exchange rate and an analysis of the main judgements used[7] (e.g. the judgements made and the reasons for selecting one specific foreign exchange rate rather than another[8]), as well as a sensitivity analysis where relevant. In addition, IFRS 7 requires issuers to disclose information about their exposure to credit, market and liquidity risks, including concentrations of risk. ESMA encourages issuers to adapt the level of detail of the information provided based on their level of exposure.

Finally, ESMA reminds issuers that paragraphs 13, 19D and 22 of IFRS 12 require the disclosure of the nature and extent of significant restrictions in relation to consolidated and unconsolidated subsidiaries, joint arrangements and associates and their assets. In addition, paragraph 48 of IAS 7 *Statement of Cash Flows* requires disclosure, together with a commentary by management, of the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

Statement of cash flows and related disclosures

The statement of cash flows is a key element in understanding and analysing an issuer's performance and allows users to assess the ability of an issuer to generate cash and use it or to assess its reliance on new financing. Despite its importance, enforcers have often come across problems in the application of the IFRS requirements in relation to the statement of cash flows. ESMA highlights that as the statement of

[6] Country risk is composed of transfer and convertibility risk (i.e. the risk a government imposes capital or exchange controls that prevent an entity from converting local currency into foreign currency and/or transferring funds to creditors located outside the country) and cases of force majeure (e.g. war, expropriation, revolution, civil disturbance, floods, earthquakes).

[7] Paragraphs 125 to 129 of IAS 1

[8] Paragraph 26 of IAS 21

cash flows is analysed together with the other primary statements, issuers should ensure consistency in the classification of the items in the primary statements and provide cross references to the relevant related notes[9].

Classification of cash flows

Paragraph 6 of IAS 7 defines operating activities as all the principal revenue-producing activities of an issuer and other activities that are not investing or financing activities. Therefore, cash flows arising from activities or transactions not usually entered into in the normal course of business (e.g. unusual cash flows) should be presented as cash flows from operating activities unless they meet the definition of cash flows from financing or investing activities[10]. Furthermore, cash flows arising from obtaining control or from losing control over a subsidiary or a business should be disclosed separately and classified as investing activities (paragraph 39 of IAS 7).

There are cases where the classification of cash flows involves more judgement, such as for cash flows of an operator in a service concession agreement, cash payments for deferred or contingent consideration arising from a business combination, interest and dividends). In those cases, and where the amounts are material, the accounting policies[11] should provide information on the classification of each item together with the reasoning. ESMA also expects that the decisions taken on the classification of cash flows are applied consistently over time.

Where items of the working capital are subject to significant variations from the comparative reporting period, ESMA encourages issuers to present a breakdown of the changes in working capital (trade receivables, inventories, trade payables) and to provide further explanations where deemed appropriate. In addition, ESMA notes that some issuers put in place structuring schemes related to their working capital, for example issuers have been increasingly implementing supplier chain financing (SCF) arrangements (also called *"reverse factoring"*) for their trade payables. The terms of these arrangements vary, but they generally involve a bank processing the issuer's payments for purchases from suppliers.

Considering the potential impact of SCF arrangements on the statement of cash flows and statement of financial position, issuers should analyse the substance of those arrangements. In particular, issuers should assess whether the trade payables should be reclassified as financial liabilities towards banks and whether its cash flows should be presented as operating or as financing cash flows. Issuers should ensure that the related transactions which stem from the SCF arrangements are appropriately accounted for in both the statement of financial position and the statement of cash flows. Issuers are encouraged to disclose the accounting policy applied to the classification, indicate the judgements made by the management, describe the relevant provisions of those arrangements, the quantitative impact on their financial statements and how the arrangements are used to manage their liquidity needs.

9 Paragraph 113 of IAS 1
10 16th Extract from the EECS's Database of Enforcement (Decision EECS/0214-04), ESMA, 18 November 2014
11 As required by paragraph 125 to 129 of IAS 1

Cash and Cash Equivalents

ESMA highlights that all the conditions set out in the definition of cash and cash equivalents in paragraph 6 of IAS 7 shall be assessed carefully for all types of financial instruments including deposits. For example, deposits should not be classified as cash equivalents when the risk of changes in value is significant (e.g. due to penalties or nonadjustable fixed-rate interest determined at inception of the agreement).

Furthermore, ESMA emphasises that in accordance with paragraph 7 of IAS 7, the purpose of holding cash equivalents is to meet short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. ESMA also reminds issuers that they should disclose in their accounting policies what they consider as cash equivalents. For example, ESMA expects those who consider a bank overdraft repayable on demand as referred to in paragraph 8 of IAS 7 to be within the definition of cash equivalents to disclose this fact in the notes.

Non-cash transactions

ESMA reminds issuers that transactions that do not generate cash flows during the period should be excluded from the statement of cash flows (e.g. financial leases) but be subject to separate disclosure as referred to in paragraph 43 of IAS 7. Furthermore, significant cash flows shall be presented separately and should not be reported on a net basis, except when permitted by paragraphs 22 and 24 of IAS 7.

Fair value measurement and related disclosures

ESMA and the enforcers consider that there is still room for improvement in the measurement and disclosures related to the fair value of non-financial assets and liabilities and urges issuers to use the guidance provided in IFRS 13 *Fair Value Measurement*. In particular, ESMA and the enforcers will closely monitor the measurement and the disclosures provided for assets and liabilities recognised at fair value or at fair value less cost to sell as required by IFRS 3 Business Combinations[12], IAS 40 *Investment Property* or IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

ESMA reminds issuers that valuation techniques used to measure fair value shall be compliant with the IFRS requirements, maximise the use of observable inputs and minimise the use of unobservable inputs. In addition, unless specified in the standard and where available, issuers shall use quoted prices in an active market without any adjustment (i.e. a Level 1 input)[13,14].

ESMA expects issuers to provide relevant information to ensure that the objectives of the standard are fulfilled, including when the fair value is determined by third parties. In accordance with paragraph 93 (d) of IFRS 13, issuers should provide a description of the valuation technique, the inputs used (e.g. quantitative information for significant unobservable inputs) to determine the fair value in particular if those measures are within Level 2 and 3 of the fair-value hierarchy and whether there have been any changes in the valuation techniques used together with the reasons for those changes.

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[12] Report: Review on the application of accounting requirements for business combinations in IFRS financial statements, ESMA, 16 June 2014

[13] Report: 16th Extract from the EECS's Database of Enforcement (Decision EECS/0214-02), ESMA, 18 November 2014

[14] Report:17th Extract from the EECS's Database of Enforcement (Decision ref EECS/0115-03), ESMA, 21 July 2015

Furthermore, ESMA reminds issuers that they should assess the extent of the use of unobservable inputs to determine whether the fair value level is Level 1, 2 or Level 3 (e.g. valuation of investment property). Where relevant, issuers should disclose a description of the sensitivity of the fair-value measurement to changes in unobservable inputs in accordance with paragraph 93 (h) and (i) of IFRS 13.

Finally, when the use of the non-financial assets differs from the highest and best use, issuers should disclose this fact together with explanations (e.g. on their assessment of the highest and best use).

Other requirements

European Common Enforcement Priorities issued in previous years

In the 2014 European Common Enforcement Priorities[15], ESMA drew attention to the application of requirements related to the assessment of control and joint control as well as to disclosure of significant judgements and assumptions made when assessing control and joint control and of the nature and risks associated with interests in other entities and the effects of those interests on the financial statements (e.g. non-controlling interests). ESMA highlights that, where material, enforcers might specifically consider the application of the so-called *'consolidation package'*, i.e. IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, and IFRS 12 *Disclosure of Interests in Other Entities* on the financial statements of an issuer.

New IFRS requirements

ESMA draws issuers' attention to the impact that the new standards might have on their financial statements, in particular to the impact of IFRS 9 *Financial instruments* and of IFRS 15 *Revenue from Contracts with Customers* which will be applicable[16] as of 1 January 2018.

As some aspects of the new requirements of these standards might represent a significant change compared with the current standards, the recognition, measurement and presentation of assets, liabilities, income, expenses and cash flows may be affected. For this reason, ESMA encourages issuers to prepare for the implementation of these standards, to ensure that their reporting procedures and systems are adapted and ready when the new requirements become mandatory.

Finally, ESMA reminds issuers that paragraphs 30 and 31 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which are applicable irrespective of whether a standard has already been endorsed[17] in the European Union. They require issuers to provide information to allow users to assess the impact that those new standards will have on the issuer's financial statements in the period of initial application, when those impacts are known or reasonably estimable. Therefore, ESMA encourages issuers to explain in their 2015 financial statements the progress in implementing the new requirements and the main effects expected, such as qualitative information on the accounting policies that will potentially change. Where applicable, issuers should also disclose if they have decided to early apply a standard.

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[15] Statement, European common enforcement priorities for 2014 financial statements, ESMA, 28 October 2014
[16] Subject to endorsement for use in the European Union
[17] Report:17th Extract from the EECS's Database of Enforcement (Decision ref EECS/0213 -12), ESMA, 29 October 2013