ESMA PUBLIC STATEMENT: EUROPEAN COMMON ENFORCEMENT PRIORITIES FOR 2016 FINANCIAL STATEMENTS

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2017/01

Summary

The European Securities and Markets Authority (ESMA) has issued a Public Statement identifying enforcement priorities for listed companies' 2016 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:

- Presentation of financial performance;
- Financial instruments: distinction between equity instruments and financial liabilities; and
- Disclosure of the impact IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* will have when they become effective.

The Statement also highlights the need for transparency in disclosing the potential impact of the United Kingdom's referendum in June 2016 and the decision to leave the European Union ("Brexit") on issuers' financial statements.

This IFRB summarises the main points in the Public Statement. The full statement can be accessed from the following link:

https://www.esma.europa.eu/press-news/esma-news/esma-sets-enforcement-priorities-listed-companies%E2%80%99-2016-financial-statements

STATUS
Final

EFFECTIVE DATE
Immediate

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

Presentation of Financial Performance

ESMA notes that presentation of financial statements, in particular the presentation of financial performance, is an area where many enforcement actions have been taken against issuers in the past. In its 2015 report on enforcement and regulatory activities, 21% of actions taken by enforcers related to the presentation of financial statements. As well as issuing guidance in July 2016 on the presentation of Alternative Performance Measures, the International Accounting Standards Board (IASB) has underlined that one of its priorities is to increase the communication effectiveness of financial statements, which includes performance. Consequently, the decision has been taken by ESMA and enforcers to focus on how financial performance is being presented in financial statements.

ESMA's Public Statement specifically addresses the following matters, emphasising certain financial reporting requirements in relation to each of them:

Presentation of information not specifically required by IFRS within the financial statements

- All information included in financial statements must comply with the overall principles in IAS 1 *Presentation of Financial Statements.*
- Additional performance measures should be calculated from IFRS-based measurements and be presented in an unbiased manner.
- Income statement expenses should be classified based on their nature or function, whichever is the most relevant, with additional disclosures being made in the notes to the financial statements when an issuer chooses a presentation by function.

Line items, heading and subtotals

- An amendment to IAS 1 (effective for periods beginning on or after 1 January 2016) enhanced the requirement for additional line items, headings and subtotals to be presented when relevant to an understanding of the entity's financial performance and position. When doing so, and additional subtotals are disclosed, these should only be comprised of line items measured in accordance with IFRSs. They should also be presented and labelled in a clear and understandable way, be presented consistently from one period to the next, and should not be displayed with more prominence than mandatory subtotals and totals required by IFRS.
- Although IFRS does not include a definition of 'operating profit' ESMA (like the IASB) is of the view that it is misleading if items of an operating nature such as the impact of business combinations, depreciation of assets or inventory write downs are excluded from to operating profit. This is true even if it may in the past have been industry practice.
- Items must not be presented as 'extraordinary' and labels used to describe line items should be meaningful. Therefore, items that affected past periods and / or are expected to affect future periods should not be labelled as 'non-recurring'.
- Suitable cross references should be used to link significant line items presented in the primary financial statements to the notes, with an appropriate level of detail on material items. ESMA also highlights that material information should not be obscured by immaterial information or by aggregating items that have a different nature or function.

Segment information

- ESMA's Public Statement includes a reminder that segment information should be disclosed 'through the eyes of management'.
- Although not required by IFRS 8 *Segment Information*, ESMA expects the elements presented in segment information to be consistent (both in terms of segments identified and measures disclosed) with those included in press releases, management reports and analysts' presentations.
- Where applicable, entity-wide disclosures are also required by IFRS 8. Disclosures are also required of judgements made when aggregating operating segments into reportable segments, with reconciliations being provided to amounts disclosed in the primary financial statements.

Movements in OCI

- Gains and losses recognised in Other Comprehensive Income (OCI) should be grouped into those movements that are not, and those movements that may be, reclassified to profit or loss in future periods.
- For each item of OCI, the impact on each component of equity should either be presented in the statement of changes in equity or disclosed in the notes to the financial statements.
- IAS 12 *Income Taxes* clarifies that where the income tax rate is impacted by the amount of profit or retained earnings paid out as dividends, the tax consequences are linked to past transactions rather than the distribution to owners and therefore should be recognised in profit or loss for the period. At the IASB's June 2016 meeting, following discussions at the IFRS Interpretations Committee, it tentatively decided to amend IAS 12 to clarify that this presentation requirement applies to all payments on financial instruments classified as equity, not only dividends to shareholders. ESMA therefore encourages entities materially affected by this issue to separately disclose the amount of income tax related to any such equity instruments already recognised in their financial statements.

Earnings per share

- Basic and diluted EPS should be presented with equal prominence on the face of the income statement.
- Details of the calculation including the numerator, weighted average number of shares and potentially dilutive instruments (e.g. options and convertible bonds) should be clearly presented in the notes.
- Information should also be disclosed on instruments that could potentially dilute basic EPS in future, but are antidilutive in the period presented and therefore excluded from the denominator used in the current period diluted EPS calculation.
- If issuers choose to voluntarily present other measures of EPS using an earnings figure other than that required by IAS 33 *Earnings per share,* such ratios should not be presented on the face of the statement of comprehensive income, but rather in the notes with reconciliations to the earnings figure used in the EPS calculations required by IAS 33.

Guidelines on Alternative Performance Measures (APMs)

Where an entity chooses to present APMs, ESMA reminds issuers that they should make every effort to comply with the principles included in their Guidelines issued in October 2015. The guidelines can be accessed from ESMAs web site here.

Financial Instruments: Distinction between Equity Instruments and Financial Liabilities

As with reporting financial performance, ESMA and enforcers have identified several cases over the years where the distinction between equity and liability requires significant judgement and / or where IFRSs do not provide clear guidance. This therefore continues to be a focus of enforcers, with the Public Statement drawing attention to the following:

- The general principle for distinguishing liabilities from equity issued by an entity is whether it has an unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation.
- Contingent settlement provisions give rise to a liability unless one of the conditions in paragraph 25 of IAS 32 *Financial Instruments: Presentation* is met.
- Economic compulsion (i.e. when an entity has an economic motivation but not a contractual obligation) to make cash payments on an instrument is insufficient by itself to result in liability classification. ESMA recommends, however, that issuers disclose information about equity instruments with features compelling the issuer to settle through payments of cash or other financial assets (such as instruments which contain a dividend blocker clause).
- Complexities arise when settling obligations in own equity because the instrument may still need to be classified as a liability if there is potential for variability in the number of own shares to be issued. Further, in such situations the instrument may be classified as a derivative liability and accounted for at fair value through profit or loss.
- Clear disclosure in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* should be made of any judgements applied in determining the classification of an instrument as either equity or liability. ESMA also calls for the main characteristics of the instrument (e.g. par value, interest and step-up clauses, coupon payment terms , triggering events for payments, key contract dates, conversion or call and put features) to be disclosed.
- Where an entity has issued an instrument that contains both a liability and an equity component, and the instrument has multiple embedded derivatives whose values are interdependent (such as callable convertible debt), paragraph 17 of IFRS 7 *Financial Instruments: Disclosures* requires disclosure of those features.
- ESMA encourages preparers to present additional line items in the statement of comprehensive income and statement of financial position if the amounts are material, as well as a disaggregation of cash flows between holders of debt and equity instruments.

Impact of IFRS 9, IFRS 15 and IFRS 16

EMSA 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 IFRS will have on financial statements in the period of initial application. This is of particular relevance to IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*, which become effective in future (periods beginning on or after 1 January 2018 in the cases of IFRS 9 and IFRS 15, and periods beginning on or after 1 January 2019 in the case of IFRS 16).

ESMA highlights that any of these standards could have a significant impact on any entity and therefore encourages issuers to work as soon as possible on implementing them to ensure they are ready when they become mandatorily applicable and to be able to comply with the disclosure requirement in paragraph 30 of IAS 8 in accounting periods leading up their effective date

ESMA has published separate Public Statements in relation to both IFRS 15 and IFRS 9 dealing with the implementation of these standards, which set out ESMA's expectations of progressively more entity-specific qualitative and quantitative information being disclosed in their 2016 annual and 2017 interim financial statements. It is expected that for most issuers, quantitative information (or the magnitude of changes) will be known or be reasonably estimable when their 2017 interim financial statements are being prepared. IFRB 2016/15 summarises the Public Statement made in relation to IFRS 9.

ESMA reminds issuers of the importance of compliance with the requirements of IAS 17 *Leases* (prior to adopting IFRS 16) and in particular the need to disclose minimum lease payments, a general description of leasing arrangements, and the amount of lease payments recognised as an expense. The relevance of these disclosures increases as they might enable users to estimate the potential impact of IFRS 16.

Brexit

ESMA expect companies to be affected (directly or indirectly) to:

- provide disclosure on the exposure to risks (financial, operational and/or strategic), their expected impacts and the uncertainties that might affect issuers' activities, as well as plans on how those risks will be mitigated;
- pay attention to disclosures related to liquidity risk or debt repayments due to breaches of covenants and hence consider any impact on the sensitivity disclosures required by IFRS 7;
- consider the impact on the assumptions used in valuations made in accordance with IFRS 13 *Fair Value Measurement* and associated disclosure;
- assess the assumptions used in impairment testing models; and
- take into account any volatility in foreign currency rates when translating the results of foreign operations, noting that the use of an average rate for the whole period is not appropriate if exchange rates fluctuate significantly.

The Regulator in the UK, the Financial Reporting Council, has issued a press release which further details the potential impact on interim and annual financial statements (with many of the impacts being applicable to companies located in any jurisdiction). The press release can be accessed by clicking here.

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