ESMA enforcement priorities for 2020 financial statements

This note includes a summary of the common enforcement priorities related to 2020 IFRS financial statements. For more details, including a link to the full ESMA statement, please refer to IASPlus: ESMA announces enforcement priorities for 2020 financial statements.

The application of IAS 1 Presentation of Financial Statements

Focus will be on going concern, disclosure of significant judgements, estimation uncertainty, and information about the sensitivity and the presentation of COVID-related items in the financial statements.

Companies should take into account items relating to the business model, financial position, performance and cash flows, which have raised particular concerns or discussions in the management, administrative or supervisory bodies, including the audit committee and with the external auditors.

ESMA highlights importance of explaining how COVID-19 affected significant judgements and the degree of uncertainty in estimations, for example market price volatility due to COVID-19 or uncertainties regarding the future development of the business in the medium and long term requiring particular caution in assessing the assumptions underlying the impairment of assets and the recoverability of deferred tax assets.

When it comes to presentation of COVID-related items in the financial statements, ESMA calls for caution regarding any separate presentation of the impacts of the COVID-19 pandemic in the profit or loss statement. ESMA encourage companies to disclose qualitative and quantitative information on the significant impacts of COVID-19 and the methodology applied for their determination, in a way that provides a clear and unbiased picture of the multiple areas affected by COVID-19.

The application of IAS 36 Impairment of Assets

It continues to be ESMA’s view that the adverse impact of COVID-19 provides a strong indication that one or more of the impairment indicators in IAS 36 have been triggered for many companies. Therefore, it require consideration of the recoverable amount of items such as goodwill, intangible assets and tangible assets that may be impacted by the deterioration of the economic outlook of various sectors.

To reflect the increased level of uncertainty, companies should consider modelling multiple possible future scenarios when estimating the future cash flows of a cash-generating unit, if it provides more relevant information to depict the possible future economic developments, using updated assumptions used in previous interim periods to reflect the latest available information and evidence.

ESMA recommends companies disclose how the assumptions and measurements have changed, if at all, compared to the last annual and interim reporting. Alternatively, when calculating the recoverable amount based on value in use, the additional uncertainty may be taken into account by further adjusting the discount rate, if the cash flows have not been already adjusted for the same risk.

ESMA reminds companies to provide adequate transparency of the estimates and key assumptions (and changes therein during the year) underlying the impairment assessment and highlights that detailed disclosure of the sensitivity of the recoverable amounts of cash-generating units (CGU) to significant changes in key operational and financial assumption(s) affected by COVID-19 may be required. For instance, the change of the time horizon considered for the expected timing to return to pre-crisis levels of economic activity may be required. ESMA reminds companies of the disclosure requirements in relation to the impairment test that are applicable in accordance with IAS 36:135 and IAS 1:129 (assumptions and sensitivities in relation to the impairment test).

The application of IFRS 9 Financial Instruments and IFRS 7 Financial Instruments: Disclosures

ESMA reminds companies of disclosures in relation to risks arising from financial instruments and, in particular, those relating to liquidity risk and the sensitivities to market risks. ESMA emphasises that the pandemic may have given rise to new significant financial risks that did not exist before or which were not as significant. Events and transactions that might reveal liquidity risk include, for example, new significant amounts of debt, debt renegotiations, new financial arrangements or the breach of debt covenants.

ESMA reminds companies to disclose how financial risks arise and how they are managed, taking into account the specific objectives, policies and processes put in place to address those risks. Companies shall also disclose the financial risk concentrations including quantitative information required by IFRS 7:34(c) and IFRS 7:B8 and information on how such concentrations are measured. It is also important to disclose a sufficiently detailed maturity analysis of the financial liabilities as well as, where relevant, of the financial assets used to manage liquidity risk.

ESMA reminds that, in the context of liquidity risk disclosures, companies should provide transparency of any arrangements that take the form of supply chain financing or, more specifically, reverse factoring transactions, which may give rise to liquidity risks. In addition, companies, which have benefitted from forbearance or payment moratoria measures, should clearly disclose this fact, along with the features of any such measures to enable users to understand any risks that may stem from their discontinuation.

The statement from ESMA includes a separate section about specific considerations related to application of IFRS 9 for credit institutions. ESMA reminds institutions that when measuring expected credit losses (ECL) in accordance with IFRS 9, they shall reflect in an unbiased way the significant uncertainty that characterises the current economic environment by taking into account all reasonable and supportable information about past events, current conditions and forecasts of future economic conditions that is available without undue cost and effort. Please refer to IASPlus: ESMA announces enforcement priorities for 2020 financial statements and the statement from ESMA for more details.

Specific issues related to the application of IFRS 16 Leases

ESMA notes that IFRS 16:60A requires specific disclosures by lessees, which have applied the IASB's amendment providing relief to lessees when accounting for rent concessions. ESMA emphasises that lessors which have granted rent concessions, particularly in sectors for which the impact of the COVID-19 pandemic has been most severe, should provide adequate disclosures reflecting the risks that the current market conditions may result in significant changes in the assets subject to operating lease agreements.

More in general, ESMA reminds lessees to disclose the information required in relation to expenses and depreciation charges, which impact the statement of profit or loss for the reporting period. This include separately disclosing those relating to variable lease payments not included in the measurement of lease liabilities and those stemming from exemptions in IFRS 16 (e.g. short-term or low-value asset leases). Important is also disclosure of a maturity analysis of lease liabilities and in relation to future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities, including exposures arising from variable lease payments, extension and termination options, residual value guarantees and leases not yet commenced to which the lessee is committed.

Priorities related to non-financial statements

Impact of the COVID-19 pandemic on non-financial matters

ESMA notes that the COVID-19 pandemic has had a pervasive impact on companies' activities in relation to the non-financial matters (i.e. environmental, social and employee matters, respect for human rights, anticorruption and bribery matters). When companies prepare their non-financial statements, ESMA therefore calls on them to pay particular attention to providing transparency on the consequences of, and the mitigating actions taken in relation to, the pandemic. ESMA also encourages that companies carefully assess how the different non-financial matters have been impacted.

Social and employee matters

ESMA notes that health crises such as the COVID-19 pandemic further increase the relevance of providing transparency on employee-related matters, especially regarding health and safety.

In the context of COVID-19, relevant topics include the extensive use of remote working arrangements as well as strategies to bring employees back to the workplace while ensuring compliance with health and safety rules and management of employees, whether direct or in the supply and contract chains, who had to continue working in close physical contact during the pandemic. ESMA recommends that companies provide disclosures of the policies they have put in place towards their employees, including whether these policies are permanent (for example, a new right for employees to work remotely a certain proportion of the time) and how those policies are put into action.

ESMA notes that the increased use of home-working arrangements has triggered considerations regarding the resilience of IT infrastructures and the ability to prevent and manage cyberattacks. In this respect, ESMA encourages companies to provide disclosure on how these matters have been addressed, the preventive policies that have been put in place and the outcomes of these actions.

Business model and value creation

ESMA emphasises that in order to enable users of non-financial statements to get an understanding of the business model and its relationship with and implications for the non-financial matters, companies are expected to provide information about their strategy together with its implementation. Companies are also expected to explain how the business model impacts - and is being impacted by - the non-financial matters, taking into account their short-, medium- and long-term goals/objectives.

ESMA considers that it would be helpful if companies were to disclose their definition of value creation and explicitly mention, if relevant, the disclosure framework, which provided this definition. ESMA notes that the European Commission’s non-binding Guidelines on non-financial reporting indicate that a company's business model describes how an entity generates and preserves value through its products or services and provides an overview of how companies operates and the rationale of its structure by describing how it transforms inputs into outputs through its business activities.

When describing the business model, ESMA encourages companies to include appropriate disclosures relating to their business environment and the main trends and factors that may affect their future development. ESMA also encourages issuers to explain how their process of value creation is linked to objectives relating to the non-financial matters

Companies are expected to highlight and explain when material changes to their business model and their value creation ability have taken place in the reporting year, for example as a consequence of actions taken by the issuer to manage physical and/or transition risks related to climate change.

It is important for users of non-financial statements to understand the degree of resilience of the company’s business model to the consequences of exceptional events such as the COVID-19 pandemic. For example, the use of government support, the increase or decrease in the demand for certain products or services, the disruption of value chains and, more generally, substantial changes in the value of assets and the emergence of impairments may have a significant impact on business models.

ESMA believes that the presentation of the business model may be facilitated by means of schematic illustrations, which may then serve as a map to guide users through the disclosures relating to the different aspects of the business model.

Risk relating to climate change

ESMA continues to emphasise the relevance of environmental matters and in particular the measures adopted by issuers to prevent and mitigate the negative consequences associated with climate change and with the risk of an increase in world average temperatures above 1.5 degrees

ESMA therefore reminds companies of the need to disclose, where material, both physical and transition risks related to climate change as well as any measures put in place to prevent such risks from materialising and to mitigate their effects. Companies may for example choose to prepare disclosures in this area based on the European Commission's guidelines on reporting climate-related information.

Other

ESMA reminds companies of the guidance it has provided on applying its Guidelines on APMs in the context of the COVID-19 pandemic. This guidance provides indications to issuers on how they should present the impact of the pandemic on their operations for complying with the Guidelines on APMs.

Given the complexities of the current environment, ESMA underlines the responsibility of management and supervisory bodies of companies as well as the importance of the oversight role of audit committees, which is key to ensure the overall internal consistency of the annual financial report and contribute to high-quality annual financial reports.

ESMA reminds that, starting from the financial year 2020, annual financial reports of companies whose securities are admitted to trading on a regulated market shall be prepared in compliance with the European Single Electronic Format ("ESEF").

Finally, ESMA highlights that following the United Kingdom's departure from the European Union on 31 January 2020 ('Brexit'), the EU and the UK have entered a transition period that is currently planned to last until 31 December 2020. It remains important to monitor closely Brexit negotiations and to provide disclosures on what impact Brexit will have on activities and financial and non-financial information.

For more details, please click through on or more of the links below

- IASPlus: ESMA announces enforcement priorities for 2020 financial statements
- ESMA press release: European accounting enforcers to enhance transparency on COVID-19 impact.
- ESMA public statement: European common enforcement priorities for 2020 annual financial reports.