Hot topics for Year-end Closing

This letter brings together the most relevant accounting and regulatory issues affecting the European Financial Services Industry to provide you with insight as you prepare your year-end accounting and regulatory reports. It includes major accounting concerns and recommendations from regulators across Europe.

European Union economic conditions

Whilst the general economy has been recovering slowly over recent months and market conditions have remained benign, the European financial system is still facing a range of inter-related and cross-sectorial risks.

- The **fragile nature of the weak economic recovery within the EU** may currently be masked by **benign market sentiments**.
- The continuous **fall of the oil prices**.
- The **protracted nature of the low-interest-rate** environment and risk of **deflation**.
- Ongoing **asset quality reviews and stress tests** in the banking sector should dispel some concerns over the deterioration of asset quality and improve the reliability of the balance sheets of EU financial institutions.
- Significant **aggregate exposure to political and economic uncertainties in a number of global emerging market economies** such as the US and EU sanctions on Russian economy which will have a direct impact on the European banking sector.
- Business-conduct risks.

The application of new accounting standards (section 2) or existing standards should give due consideration to the conditions described above and the associated uncertainties at the year end.

Financial disclosures

1. ESMA priorities issues for the closing 2014

The European Securities and Markets Authority ('ESMA') issued a Public Statement identifying financial reporting topics which listed companies and their auditors should particularly consider when preparing and auditing, respectively, the IFRS financial statements for the year ending 31 December 2014.

The European Common Enforcement priorities for 2014 financial statements encompass the following topics:

1. Preparation and presentation of consolidated financial statements and related disclosures;
2. Financial reporting by entities which have joint arrangements and related disclosures; and
3. Recognition and measurement of deferred tax assets.

Specific consideration relevant for the banking sector in 2014

In respect of the comprehensive assessment undertaken with the asset quality review, ESMA expects that:

- Any material impacts of or following the Comprehensive Assessment on the IFRS financial statements will be sufficiently explained in line with the relevant IFRS requirements.
- Banks provide sufficient information on any changes in the level of regulatory capital required.
- A reference to the information published in the context of the Comprehensive Assessment could be included in the IFRS Financial Statements.

Also, ESMA reminds financial institutions of the findings of its report on the financial statements of banks in Europe[1] that called for enhance disclosures among others on fair value measurement, liquidity and funding risks and credit risk management (including disclosures on impaired and forborne loans, credit quality and accounting policies on impairment of financial assets).

1 Report: *Comparability of Financial Statements of Financial Institutions*, ESMA, Paris, 17 November 2013 (ESMA/2013/1664)

Disclosures in IFRS Financial Statements

ESMA has previously expressed concerns about the overload of disclosures, which continue to be valid. However, ESMA wishes to underline that the desired outcome is not a mechanical decrease in the number of items disclosed, but rather clear and complete disclosures focused on the relevant facts that are specific to the entity and are necessary to understand its financial performance and position. This should help ensure that the financial statements allow users to understand the consequences of events which influence the economic environment in which the issuer operates.

2. Application of new IFRS accounting standards for 2014

a. IFRS 10, 11, 12

The requirements of IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IFRS 12 Disclosure of Interests in Other Entities, amended IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures (the so-called 'consolidation package') became mandatorily applicable in the EU for financial reporting periods starting on or after 1 January 2014. In applying these new standards ESMA notes the following in the presentation and preparation of consolidated financial statements:

- **Application of the control principle:** All the requirements described in the application guidance should be considered while evaluating the existence of a control.
- **Disclosure of non-controlling interests (NCIs):** Issuers should provide sufficient information and have to mention to which operating segments these significant NCIs have been allocated.
- **Nature of risks associated with an entity's interests in structured entities:** Issuers should note the specific disclosures requirements with respect to the nature of, and change in, the risk associated with their interests in consolidated structured entities (IFRS 12) and unconsolidated structured entities.
- **Classification of joint arrangements:** In 2013 and 2014, the IFRS Interpretations Committee (IFRS IC) considered various issues arising from the implementation of IFRS 11 which should be given due attention.
- **Disclosures related to joint arrangements:** Issuers should provide disclosures about significant judgments and assumptions made in determining the joint arrangement classification notably in circumstances when the arrangement has been structured through a separate vehicle.
- **Significant changes resulting from the first-time adoption of IFRS 10 and IFRS 11:** When an entity change its assessment whether to consolidate an investee on first time adoption of these new standards ESMA expects disclosure of the relevant factors that led the entity to reconsider their relationships with the respective investees, disclose the judgments and assumptions made and describe the impact of the changes in the accounting policy in accordance with IAS 8.
- **Aggregation of disclosures:** IFRS 12 provide guidance on aggregation of disclosures in relation to interests in subsidiaries, joint ventures, joint operations, associates and unconsolidated structured entities.

b. Novation of derivatives

In June 2013, IASB issued *'Novation of Derivatives and Continuation of Hedge Accounting'* (Amendments to IAS 39 *'Financial Instruments: Recognition and Measurement'*). Following the amendments there would be no need to discontinue hedge accounting if a hedging derivative was novated, provided certain criteria are met. The amendment was published to make it easier for financial institutions to continue with hedge accounting when they are required (e.g. under the European Market Infrastructure Regulation) to use a Central Counterparty to clear transactions. The amendments are effective for annual periods beginning on or after 1 January 2014.

c. Offsetting rules of financial assets and financial liabilities

In December 2011, the IASB, jointly with the FASB published amendments to IAS 32 *'Financial Instruments: Presentation'* to clarify certain aspects of the requirement to offset financial assets and financial liabilities.

The amendment focused on four main areas:

- the meaning of 'currently has a legally enforceable right of set-off'
- the application of simultaneous realization and settlement
- the offsetting of collateral amounts
- the unit of account for applying the offsetting requirements.

The amendments to IAS 32 are effective for periods beginning on or after 1 January 2014.

Accounting and Auditing Issues

1. Deferred tax assets (IAS 12)

This topic is at the top of the agenda of the Single Supervisory Mechanism which consider it as a serious concern.

The financial crisis, followed by an extended period of low economic growth, led to a widespread deterioration of issuers' financial performance that might be expected to result in the recognition of tax losses or the existence of deductible temporary differences (e.g. impairments not yet deductible for tax purposes). Particular attention should be paid to the recognition of deferred tax assets coming from the carry forward of unused tax losses, to the assessment whether future taxable profits exist, and to the need for disclosing judgments made when recognizing deferred tax assets.

2. Measuring an entity's own credit risk under IFRS 13

IFRS 13 *Fair Value Measurement* has been required since 2013. However the comprehensive assessment has put a strong emphasis on this topic and resulted in extensive discussions between the ECB and the banks.

IFRS 13 requires that the fair value of financial instruments be based on the transfer notion, not the settlement notion, and therefore, the resulting fair value for financial liabilities may differ from the fair value that used to be applied under IAS 39:

- To comply with IFRS 13, banks will need to take into account both the counterparty risk (credit value adjustment or CVA) and their own credit risk in derivative valuation (debit value adjustment or DVA).
- Institutions should be careful to avoid double counting either their own credit risk or that of a counterparty when a funding value or funding cost adjustment is also applied, as the funding adjustment is likely to also take into account that same credit risk.
- If a DVA was not applied before the application of IFRS 13, the inclusion of a DVA could, in some cases, cause the fair value to move from level 2 to level 3 of the fair value hierarchy if the adjustment is regarded as a significant unobservable input.

3. Results of the Comprehensive Assessment

The results were published on 26 October 2014 and showed that most European banks successfully passed the Asset Quality Review and the Stress Tests.

The AQR impacts are still under review by the banks in order to identify whether findings will impact financial reporting under IFRS and regulatory reporting.

The shortfalls identified in the Asset Quality Review or under the baseline stress test scenario have to be covered by the end of April 2015; those identified under the adverse stress test scenario by the end of July 2015.

Nevertheless, those impacts should be communicated to those charged with governance and discussed with the banks' auditors before the closing. As noted in section 2 above, ESMA has published recommended disclosures on the impacts of the AQR for the financial statements.

4. Contributions to single EU resolution fund

On May 15, 2014, the Bank Recovery & Resolution Directive (BRRD) created a resolution tool which requires funding.

Every Member State will have to set up financing arrangements that will be funded through contributions from banks and investment firms in proportion to their liabilities and risk profile (through a national resolution fund):

- Each national fund will finance the resolution of the entities established in its territory
- Financing arrangements to be financed ex-ante starting 1 January 2015
- Ex-ante contributions to be raised from banks annually in order to reach a target funding level of at least 1% of covered deposits by 31 December 2024
- Possibly, additional contributions can be considered (ex-post)

The calculation of the ex-ante contributions will follow certain guidance:

- Takes into account the size (covered deposits) and risk profile of each bank/investment firm
- Up to 30% of the ex-ante contributions can be in the form of irrevocable payment commitments with collateral accepted to back these irrevocable payment commitments
- Similar scheme for Member states belonging to the European Monetary Union

It should be noted that there will be no impact as of 31 December 2014. However, given the potential materiality in Q1, the banks should consider disclosing the potential future commitments in in the notes to the financial statements.

Other matters for discussion with governance bodies

Major projects to anticipate:

1. Implementation of BCBS 239

On January 9, 2013, the Basel Committee on Banking Supervision published 'BCBS 239': 14 principles designed to strengthen the ability of banks to aggregate risk data and improve reporting practices reporting related to them. Eleven of these principles refer to the systemically important banks in the world (G-SIBS) and three concern the supervisory authorities.

Although the systemic banks (G-SIBS) have until January 2016 to comply, many have not started the implementation of the compliance program.

Those principles of regulations affect systemic banks worldwide but will eventually be extended on a domestic level to D-SIBS (domestic systematically important banks) who will be accountable to national regulators. Once identified, the bank will have only three years to demonstrate compliance. Early implementation of such a program will offer a real competitive advantage.

2. Reform of financial instruments accounting (IFRS 9)

In July 2014, the IASB finalised IFRS 9 *Financial Instruments* which supersedes IAS 39 and it is effective for annual reporting periods beginning on or after 1 January 2018 with early application permitted (subject to endorsement for use in the EU). The standards introduce a new model for classification and measurement of financial assets; changes the presentation for own credit risk for certain financial liabilities; introduces a new single, forward-looking 'expected loss' impairment model and substantially reforms hedge accounting.

- **Classification and Measurement**: IFRS 9 introduces a new approach for the classification of financial assets, which is driven by the cash flow characteristics of the assets and the business model in which an asset is held. The standard also requires that the own-credit element of certain non-derivatives financial liabilities measured at fair value is remeasured to other comprehensive income, not profit or loss.

- **Impairment**: IFRS 9 has a new, expected-loss impairment model that will require more timely recognition of expected credit losses.
- **Hedge accounting**: The new model represents a significant overhaul of hedge accounting that aligns the accounting treatment with risk management activities, enabling entities to better reflect these activities in their financial statements.

3. Macro-hedge accounting

This project considers the accounting for dynamic risk management activities at a portfolio level (i.e. dynamic portfolio hedging). This type of risk management strategy tends to have a time horizon (e.g. five years) over which exposures are hedged. Consequently, as time passes new exposures are continuously added to the hedged portfolio and other exposures are removed from it.

This area of accounting is complex and currently only accommodated to a limited extent in IAS 39 *Financial Instruments: Recognition and Measurement* which includes a macro fair value hedging model for interest rate risk. The IASB's objective is to consider an alternative macro hedging model that will ultimately replace the macro fair value model in IAS 39 and have wider applicability to other risks.

As of today, the IASB has retained the existing macro hedge accounting requirements under previous IFRSs whilst this project is finalized.

4. Prudent valuation

The European Banking Authority (EBA) published its final draft Regulatory Technical Standards (RTS) laying out the requirements related to prudent valuation adjustments of fair valued positions.

The EBA final draft RTS on prudent valuation put forward a methodology to calculate additional valuation adjustments (AVAs) for the purpose of determining the prudent value of fair valued positions.

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