European Securities and Markets Authority

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PUBLIC STATEMENT

European common enforcement priorities for 2014 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 the previous years, ESMA, together with European national enforcers, identified 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. In addition to these common priorities, national enforcers might also set additional enforcement priorities focusing on other relevant topics.

ESMA, together with the European national enforcers, will pay particular attention to these common enforcement priorities as well as priorities identified in previous years, when monitoring and assessing the application of all relevant IFRS requirements. National 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, national enforcers will take corrective actions whenever material misstatements are identified. ESMA will report on findings regarding these priorities in its Report on the 2015 enforcement activities.

The European common enforcement priorities for 2014 financial statements encompass the following topics as detailed on pages 3-7:

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

ESMA and European national enforcers decided to select these topics as they either introduce significant changes to the accounting practices following implementation of new standards or the current economic environment poses particular challenges to issuers in the application of certain IFRS requirements.

In light of their continuing relevance, ESMA and European national enforcers will continue to assess relevant issues described in European common enforcement priorities published in previous years. These

[1] Guidelines: Enforcement of financial information, ESMA, 28 October 2014. These guidelines will enter into force by 29 December 2014.

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include requirements related to the impairment of financial and non-financial assets, fair value measurement and disclosures on risks arising from financial instruments. In particular, ESMA reminds issuers of the specific requirements related to using cash-flow projections and the disclosure of key assumptions when performing impairment tests of non-financial assets as highlighted in the 2013 Public Statement.[2] ESMA also highlighted related valuation risk in its recent *Report on Trends, Risks and Vulnerabilities*.[3]

Furthermore, ESMA believes that the following topics, even though not explicit enforcement priorities, should be considered in preparation of 2014 financial statements, where relevant:

Specific consideration relevant for the banking sector in 2014

ESMA believes that, in the light of the specific circumstances related to the changes in regulation and supervision of the European Banking sector, and in particular the European Central Bank's Comprehensive Assessment of the European banking sector that includes the Asset Quality Review, additional consideration should be paid to the financial reporting of European banks.

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.[4] These might include, for example, a change in an accounting estimate, a correction of an error or changes in the way risks arising from financial instruments are assessed, monitored and managed. ESMA also expects that banks provide sufficient information on any changes in the level of regulatory capital required. In addition, a reference to the information published in the context of the Comprehensive Assessment could be included in the IFRS financial statements.

ESMA reminds financial institutions of the findings of its report on the financial statements of banks in Europe[5] that called upon enhancing 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). ESMA expects banks to continue their efforts to improve these disclosures when preparing 2014 IFRS financial statements.

Furthermore, as more complex financial instruments are expected to be issued in order to increase the level of regulatory capital (e.g. in the form of contingent convertible instruments), ESMA expects issuers to describe the judgements made when classifying these instruments as equity or as financial liability, including an explanation on the related classification of the interest or dividend payments.

Disclosures in IFRS Financial Statements

ESMA has previously expressed concerns about the overload of disclosures, whether because disclosures are boilerplate rather than entity-specific, or are unnecessary because they refer to transactions that are not relevant for the issuer, or relate to immaterial items. These concerns continue to be valid. Howev-

[2] Statement: European common enforcement priorities for 2013 financial statements, ESMA, 11 November 2013
[3] Report: Trends, Risks and Vulnerabilities, No. 2 2014, ESMA, 3 September 2014
[4] However, disclosure in the IFRS financial statements would not replace the requirements for ad-hoc disclosure of price sensitive information in accordance with the Market Abuse Directive
[5] Report: *Comparability of Financial Statements of Financial Institutions*, ESMA, Paris, 17 November 2013 (ESMA/2013/1664)

er, 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.

ESMA continues to emphasise the need to improve the quality of disclosures in the financial statements, particularly, in view of the significant new disclosures required in recently applied standards (e.g. the '*consolidation package*') and in the context of the IASB *Disclosure Initiative*, the overall aims of which ESMA supports. In order to improve the quality of disclosures, ESMA encourages issuers to focus accounting information on factors that are specific and relevant to understanding the issuer's financial position, its financial performance and its cash flows as well as the risks it incurs. For instance, when the safety margin in a goodwill impairment test is low, issuers should provide more detailed assumptions (together with explanations as to how these assumptions were made, linking them to external evidence and past experience) and disclose analyses related to the sensitivity of the results of the test.

Entities should avoid, on the one hand, overloading financial statements with excessive detail that may not assist users of financial statements and, on the other hand, obscuring information as a result of too much aggregation. 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.

2014 European common enforcement priorities

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. IFRS 10 identifies 'control' as the single basis for consolidation for all types of entities, IFRS 11 changes the requirements for financial reporting for entities which are parties to a joint arrangement, whereas, IFRS 12 expands the disclosure requirements for consolidated entities, unconsolidated structured entities, joint ventures and associates.

Presentation and preparation of consolidated financial statements (IFRS 10, IFRS 12)

Application of the control principle

Principles on which the assessment of control is based are set out in paragraphs 7-18 of IFRS 10, and are accompanied by detailed application guidance comprising numerous indicators and examples describing factors that may or may not grant control to the investor. Accordingly, ESMA believes that it would not be appropriate to conclude that 'control' does or does not exist based on a single requirement from the standard, or on a similarity to an example, without considering the other points of analysis described in the application guidance. These might be particularly important in relation to the consolidation of investment funds or securitisation structures. ESMA noted that paragraph 7(a) of IFRS 12 requires disclosure of significant judgements and assumptions made when assessing control over another entity, and expects issuers to carefully explain the judgements made in case of complex situations.

Disclosure of non-controlling interests (NCIs)

Paragraph 10 of IFRS 12 requires disclosures about interests in subsidiaries to enable users of the consolidated financial statements to understand the interests that NCIs have in the group's activities and cash flows. ESMA expects issuers to provide sufficient information and encourages them to mention to which operating segments these significant NCIs have been allocated.

ESMA highlights the importance of materiality assessment when identifying subsidiaries that have NCIs that are material to the issuer when providing information required by paragraphs 12 and B10 of IFRS 12. The September IFRS IC tentative agenda decision clarified that the issuer should apply its judgement in determining whether it presents this information about the sub-group of the subsidiary together with its investees or about the subsidiary/individual subsidiaries within that sub-group.[6] The disclosure includes profit or loss allocated to and dividends paid to NCIs of a subsidiary during the period and summarised financial information about these subsidiaries before intercompany eliminations.[7] In order to achieve the disclosure objectives set out in paragraph 10(a)(ii) of IFRS 12, ESMA expects issuers to carefully assess which financial information about those subsidiaries should be disclosed in their financial statements. When a group presents a significant amount of NCIs but none of the NCIs is individually significant, ESMA encourages issuers to disclose and explain this fact.

In addition, ESMA reminds issuers to carefully assess and disclose the nature and extent of any significant contractual or statutory restrictions (such as 'protective rights') on its ability to access or use assets and settle liabilities, in particular related to transfers of cash and dividends or other capital distributions (e.g. in case of capital and/or foreign exchange controls or other regulatory limitations) as required by paragraph 13 of IFRS 12. In this respect, ESMA also reminds issuers that 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.

Nature of risks associated with an entity's interests in structured entities

ESMA draws issuers' attention to specific disclosure requirements with respect to the nature of, and changes in, the risks associated with their interests in consolidated structured entities (paragraph 10(b)(ii) of IFRS 12) and unconsolidated structured entities (paragraph 24(b) of IFRS 12). When these risks can have a material impact on entity's financial statements, issuers should consider the information, level of disaggregation and entity-specific factors that are relevant for users and should therefore be disclosed.

[6] IFRIC Update, September 2014, IFRS IC Foundation

[7] The IFRS IC tentatively concluded in September 2014 that when the information required is provided about the subgroup of the subsidiary together with its investees, the transactions within the sub-group would be eliminated.

Financial reporting by parties to a joint arrangement (IFRS 11, IFRS 12)

Classification of joint arrangements

Paragraphs 14-19 of IFRS 11 provide criteria on the classification of joint arrangements as either joint operations or joint ventures on the basis of the rights and obligations of the parties to the arrangement including consideration of the structure and the legal form of the arrangement, the terms and conditions of the contractual arrangement and where relevant 'other facts and circumstances'. This differs from the previous assessment based on the legal structure of the joint arrangement. In order to classify a joint arrangement as a joint operation, the parties have to have, in substance, both direct rights to the assets and direct obligations for the liabilities relating to the joint arrangement.

In 2013 and 2014, the IFRS Interpretations Committee[8] (IFRS IC) considered various issues arising from the implementation of IFRS 11, especially in relation to the classification of joint arrangements and the role of 'other facts and circumstances' as part of this assessment. As this topic remains on the active agenda of the IFRS IC, ESMA urges issuers to consider the conclusions of these discussions when preparing their 2014 financial statements.

ESMA reminds issuers that the assessment of 'other facts and circumstances' should focus on whether those create enforceable rights to the assets and obligations for the liabilities. Accordingly, the design and the purpose of the entity, its business model or past experience are not considered when analysing 'other facts and circumstances' unless they create enforceable rights and obligations.

Two joint arrangements with similar features can be classified differently depending on whether the joint arrangement is structured through a separate vehicle. This is because in order for the joint arrangement to be classified as a joint operation the legal form of the vehicle must be overcome by other contractual arrangements or specific 'other facts and circumstances'.

Disclosures related to joint arrangements

ESMA expects issuers to provide disclosures required by paragraph 7 of IFRS 12 about significant judgements and assumptions made in determining the joint arrangement classification notably in circumstances when the arrangement has been structured through a separate vehicle.

ESMA notes that paragraph 20 of IFRS 12 requires issuers to disclose information that will enable users of its financial statements to evaluate the nature, extent and financial effects of its interests in joint arrangements. This should include the nature and effects of the issuer's contractual relationships with the other investors in joint arrangements, summarised financial information and other specific information for each material joint venture. To assess whether a joint venture is material, issuers should consider quantitative but also qualitative information.

ESMA believes that issuers should thoroughly consider which disclosures and which figures of the financial statements of joint venture, in addition to those specifically required by paragraphs B12-B13 of IFRS

[8] IFRIC Update November 2013, January, March, May, July 2014, IFRS Foundation

12,[9] will enable them to fulfil these objectives. For example, as stated in paragraph BC 48 of IFRS 12, users of financial statements have pointed out that a good understanding of the net debt position of the joint venture and of its financial performance (e.g. by specific disclosure of net interest expense, depreciation and amortisation) would be particularly useful. Furthermore, ESMA encourages issuers to mention their allocation to the operating segments.

Significant changes resulting from the first-time adoption of IFRS 10 and IFRS 11

The first-time adoption of IFRS 10 and IFRS 11 might lead to changes in the scope of consolidation or accounting for joint arrangements. ESMA expects that entities that change the assessment whether to consolidate an investee clearly detail the relevant factors that led them to reconsider their relationships with the respective investees, disclose the judgements and assumptions made and describe the impact of the changes in the accounting policy in accordance with paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.[10] The impact of the change of accounting policy should also be provided for entities that had previously used proportionate consolidation to account for interests in jointly controlled entities and which now classify them as joint ventures accounted for using the equity method.

This might be the case, for example, when the first application of IFRS 10 leads to a change in the assessment whether control is achieved by an investor holding less than a majority of voting rights in an investee[11] or when assessing potential voting rights. In these cases, ESMA expects issuers to explain which investee-specific factors had a decisive impact on the analysis. Furthermore, as IFRS 10 introduces an exception to the consolidation requirement for investment entities, ESMA expects issuers to be specific in their disclosure required by paragraphs 9A-9B of IFRS 12 about the judgements and assumptions made to qualify for that exception and other elements as required by paragraphs 19A-19G of IFRS 12.

Aggregation of disclosures

Paragraphs B2-B6 of IFRS 12 provide guidance on aggregation of disclosures in relation to interests in subsidiaries, joint ventures, joint operations, associates and unconsolidated structured entities. ESMA underlines the need to consider the individual circumstances of issuers when aggregating or disaggregating disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

Recognition and measurement of deferred tax assets (IAS 12)

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). ESMA believes that particular attention should be paid to the recognition of deferred tax assets coming

[9] Paragraph B13 of IFRS 12 includes disclosure requirements for material joint ventures in addition to those required for either associates or joint ventures in paragraph B12 of IFRS 12.
[10] Paragraphs C2A of IFRS 10 and C1B of IFRS 11 restrict the requirement to present the quantitative information required by paragraph 28(f) of IAS 8 to the immediately preceding period
[11] As concept of de facto control was only implicit in IAS 27 *Consolidated and Separate Financial Statements*

from the carry forward of unused tax losses, to the assessment whether future taxable profits exist, and to the need for disclosing judgements made when recognising deferred tax assets.

If the deductible temporary differences, carry-forward of unused tax losses or tax credits exceed the amount of suitable existing taxable temporary differences, paragraphs 29 and 34 of IAS 12 limit the recognition of a deferred tax asset to the extent it is probable that taxable profits will be available against which the deductible temporary difference can be utilised. Specifically, paragraph 35 of IAS 12 explicitly states that the existence of unused tax losses is strong evidence that future taxable profit might not be available. Therefore, a history of recent losses makes the recognition of deferred tax assets conditional upon the existence of convincing other evidence. Consequently, ESMA expects issuers to consider carefully the criteria in paragraph 36 of IAS 12 when assessing the probability that taxable profit will be available against which the unused tax losses can be utilised and to review the carrying amount of the resulting deferred tax asset at the end of each reporting period in accordance with paragraph 56 of IAS 12.

When the utilisation of the deferred tax asset is dependent on such taxable profits or when the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates, paragraph 82 of IAS 12 requires the disclosure of the amount of a deferred tax asset and the nature of the evidence supporting its recognition.

ESMA expects issuers to disclose specific significant assumptions made in their business plans, as losses can be carried forward over very long periods and the business plans that support the existence of future taxable profits are based on assumptions that are often highly judgmental. When material, issuers should consider disaggregating disclosures based on the characteristics of the tax losses, e.g. considering different time limits during which tax losses must be utilised. ESMA believes that it is particularly relevant to disclose the period used for the assessment of the recovery of a deferred tax asset, the judgments made when determining it and the amount of tax losses carried forward for which deferred tax assets were recognised compared to the total tax losses carried forward that are available for each material tax group or entity.

Uncertain tax positions

Finally, ESMA notes that the IFRS IC[12] recently discussed the question of recognition and measurement of income taxes in relation to uncertain tax positions. In particular, it referred to the principle in paragraph 46 of IAS 12 and is planning to discuss further the issue of recognition and measurement. In light of these discussions ESMA expects issuers to disclose their accounting policy related to material uncertain tax positions in accordance with paragraphs 117 and 122 of IAS 1 *Presentation of Financial Statements*.

[12] IFRIC Update January, May, July and September 2014, IFRS Foundation