

PUBLIC STATEMENT

European common enforcement priorities for 2016 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 International Financial Reporting Standards (IFRS Standards) as indicated in the ESMA Guidelines on enforcement of financial information.¹

As in the previous years, ESMA, together with European national enforcers (hereafter referred to as “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 2016. In addition to these common priorities, enforcers might also set additional enforcement priorities focusing on other relevant topics.

ESMA, together with 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 whenever material misstatements are identified. ESMA will report on findings regarding these priorities in its Report on the 2016 enforcement activities.

The common priorities for the 2016 financial statements encompass the following topics as detailed in this statement:

- Presentation of financial performance;
- Financial instruments: distinction between equity instruments and financial liabilities; and
- Disclosures of the impact of the new standards on IFRS financial statements.

ESMA and enforcers selected these topics based on the recurrence of problems identified when examining financial statements and on the expected significant changes that the new requirements will introduce to current accounting practices. In the light of their continuing relevance, ESMA and enforcers will continue to assess relevant issues described in European common enforcement priorities published in previous years. These include, for instance, the requirements related to the impact of the financial markets conditions on the financial statements of issuers.²

Apart from the 2016 European common priorities, ESMA encourages issuers potentially affected by the result of the United Kingdom’s referendum to leave the European Union (EU) to assess and disclose the associated risks and expected impacts that the referendum result may have on their business activities.

¹ Guidelines: ESMA Guidelines on enforcement of financial information, ESMA, 28 October 2014

² Statement: European common enforcement priorities for 2015 financial statements, ESMA, 27 October 2015

ESMA expects information about the impact will become more reasonable estimable as the date of the Brexit approaches.

This statement draws issuers' attention to a number of potential additional descriptions or explanations in the notes to the financial statements. Issuers should consider the materiality and the relevance of the information before making additional disclosures.

2016 European common enforcement priorities

Presentation of financial performance

In the past, ESMA has drawn issuers' attention to the need to provide good quality disclosures³ in particular those that relate to financial performance, for instance, by providing relevant entity specific disclosures on the different revenues streams. Where necessary, enforcers have taken enforcement actions against issuers when the presentation of the financial statements reviewed did not follow the principles included in IFRS Standards.⁴ In July 2016, ESMA Guidelines on Alternative Performance Measures (ESMA Guidelines on APMs) became effective.⁵ Also this year, the International Accounting Standards Board (IASB) underlined that one of its priorities for the following years is to increase the communication effectiveness of financial statements (which includes performance).⁶ Therefore, in 2017, ESMA and enforcers will focus their examinations on how financial performance is being presented in financial statements.

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

While IFRS Standards allow the inclusion of additional information in the financial statements not specifically required by IFRS Standards, ESMA reminds issuers that all information included therein has to comply with the overall principles defined in IAS 1 *Presentation of Financial Statements*. Consequently, ESMA urges issuers to ensure that additional information included in the financial statements is compliant with IFRS Standards. For instance, when including in the financial statements measures of performance not defined in IFRS Standards, issuers should ensure that those measures are calculated and presented in an unbiased fashion (e.g. issuers should not eliminate, remove or omit only negative aspects or items of their performance).

ESMA also reminds issuers that in accordance with paragraph 99 of IAS 1, an entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant. If an issuer chooses a presentation by function, additional information on the nature of the expenses shall also be disclosed in the notes (paragraph 104 of IAS 1).

³ Statement: Improving the quality of disclosures in the financial statements, ESMA, 27 October 2015.

⁴ Report: Enforcement and Regulatory Activities of Accounting Enforcers in 2015, 21% of the actions taken by enforcers related to the presentation of financial statements, ESMA, 29 March 2016

⁵ Guidelines: ESMA Guidelines on alternative performance measures, ESMA, 5 October 2015

⁶ Speech: Better communication, the IASB, 30 June 2016

Line Items, Headings and Subtotals

The amendments to IAS 1 on the information presented in the statement of financial position and/or in the statement(s) of profit or loss and other comprehensive income became effective for annual periods beginning on or after 1 January 2016. ESMA reminds issuers that in accordance with paragraphs 55 and 85 of IAS 1, issuers shall present additional line items, headings and subtotals in the statement of financial position and in the statement(s) of profit or loss and other comprehensive income when these line items, headings or subtotals are relevant to an understanding of the entity's financial position or the entity's financial performance.

While doing so, issuers should, in accordance with paragraphs 55A and 85A of IAS 1, ensure that any subtotals (i) are comprised of line items made up of amounts recognised and measured in accordance with IFRS Standards, (ii) are presented and labelled in a clear and understandable way, (iii) are consistently presented from period to period and (iv) are not displayed with more prominence than subtotals and totals required by IFRS Standards.

Some issuers include measures such as 'operating profit' in the statement of profit or loss or other comprehensive income. While there is no definition of the term "operating profit" in IFRS Standards, ESMA highlights the principles included in paragraph 85A and in paragraph 17 of IAS 1 regarding the relevance and fair presentation of the information disclosed. Therefore, measures such as operating profit, should be clear, understandable and reflect their content, as further explained in paragraph BC 56 of IAS 1. Like the IASB, ESMA is of the view that it is misleading if items of an operating nature (e.g. business combination impacts, depreciation of assets or inventory write-downs) are excluded from the results of operating activities even if that has been industry practice. Where significant judgement is required in the presentation of material items (e.g. service costs and net interest on the net defined benefit liability/asset, impairment of equity-accounted investments), issuers are encouraged to disclose these judgements.

Issuers shall not present any items of income or expense as extraordinary items (paragraph 87 of IAS 1) and labels used should be meaningful. For example, items that affected past periods and/or are expected to affect future periods can rarely be labelled or presented as non-recurring items such as most of the restructurings costs or impairment losses.⁷

Finally, in order to improve the readability of financial statements, cross-reference of significant elements of the primary financial statements to the notes should be provided, as well as details on material line items (e.g. other operating expenses) as required respectively by paragraphs 113 and 97 of IAS 1. ESMA also highlights that according to paragraph 30A of IAS 1, issuers shall not reduce the understandability of financial statements by obscuring material with immaterial information or by aggregating material items that have a different nature or function.

Segment information

ESMA reminds issuers that IFRS 8 *Operating Segments* requires companies to disclose segment information “through the eyes of the management”. Although not required by IFRS Standards, ESMA expects that the elements presented in the segment information in the financial statements and those included in the press releases, management reports or analysts’ presentations are consistent in terms of segments presented and measures disclosed.

Where applicable, entity-wide disclosures should be provided in accordance with paragraphs 32 to 34 of IFRS 8. ESMA reminds issuers that disclosure of the judgements made by management in applying the aggregation criteria for operating segments is required by paragraph 22(aa) of IFRS 8 and segment information should be reconciled as required by paragraphs 21(c) and 28 of IFRS 8.

Movements in Other Comprehensive Income (OCI)

ESMA reminds issuers that some items in OCI will be reclassified to profit or loss whereas others will not. For example, (a) foreign currency translation adjustments will be reclassified to profit or loss on disposal of a foreign operation (paragraph 48 of IAS 21) whereas (b) remeasurements of defined benefit liability (asset) will not be reclassified. (paragraph 122 of IAS 19 *Employee Benefits*). On disposal/ loss of control of a subsidiary, the items to be reclassified to profit or loss shall be included in the gain or loss calculation, whereas the items that will not be reclassified (i.e. the remeasurement of defined benefit plans) will remain in equity, either in the accumulated OCI or in another equity line item.

ESMA highlights that paragraphs 106A of IAS 1 require issuers to present, either in the statement of changes in equity or in the notes, for each component of equity an analysis of the OCI by item. In addition, when the accumulated OCI is material for a specific item, issuers are encouraged to provide more detailed information.

Finally, ESMA draws issuers’ attention to the discussions held in the International Financial Reporting Standards Interpretation Committee (IFRS IC) on the application of paragraphs 52A, 52B, 58 and 61A of IAS 12 *Income Taxes* on the presentation of income tax relating to tax payments on financial instruments classified as equity (i.e. whether these tax effects should be presented directly in equity or in profit or loss). At its June 2016 meeting, the IASB tentatively decided to propose amendments to IAS 12 to clarify that the presentation requirements in paragraph 52B of IAS 12 apply to all payments on financial instruments classified as equity that are distributions of profits as part of the next Annual Improvements Cycle.⁸ ESMA encourages issuers potentially materially affected by this issue to disclose separately the amount of the income tax related to these financial instruments already recognised in their financial statements.

⁸ IASB Update, Annual Improvements—IAS 12 Income Taxes—Presentation of income tax consequences arising from dividends, IASB, June 2016

Earnings per share (EPS)

ESMA draws issuers' attention to the calculation of EPS, a performance measure defined in IAS 33 *Earnings per share* and used to compare performance between different entities in the same reporting period and between different reporting periods for the same entity. Basic and diluted EPS shall be presented with equal prominence on the face of the statement of comprehensive income (paragraph 66 of IAS 33). Details of the EPS calculation, including the numerator, the weighted average number of ordinary shares and potentially dilutive instruments (such as stock-options, convertible bonds), should be presented clearly in the notes (paragraph 70 of IAS 33) together with reconciliations, where applicable. If issuers disclose earnings per share using a reported component of the statement of comprehensive income other than as required by IAS 33, such ratios should not be presented on the face of the statement of other comprehensive income, but rather in the notes together with the reconciliations required by paragraph 73 of IAS 33.

ESMA reminds issuers that paragraph 70(c) of IAS 33 requires information on instruments that are antidilutive in the period presented, but could potentially dilute basic EPS in the future (e.g. a standalone out-of-the money equity option).

ESMA Guidelines on APMs

The ESMA Guidelines on APMs set out principles regarding the presentation of performance measures not defined or specified in the applicable financial reporting framework, such as the labelling, calculation, presentation and comparability. While the ESMA Guidelines on APMs are not applicable to financial statements, their aim is to ensure the usefulness and transparency of APMs included in prospectuses, management reports and market disclosures. The application of the guidelines to measures disclosed outside financial statements ensures that the presentation of those measures is consistent with the information included in the financial statements.

ESMA reminds issuers that they should make every effort to comply with the principles included therein. The implementation of the guidelines is an opportunity for issuers to reassess whether all APMs used are useful and relevant. Enforcers will monitor the compliance of issuers with these guidelines.

Financial instruments: distinction between equity instruments and financial liabilities

Over the years, ESMA and enforcers have identified several cases where the distinction between equity and liability require significant judgement and/or when IFRS Standards do not provide clear guidance. ESMA has brought some of those issues to the attention of the IFRS IC. In some cases, enforcers have taken actions for instance, when they have found errors in the classification of equity instruments or financial liabilities or when more information about the legal nature, the specific features and/or the contractual clauses related to these instruments was relevant.

ESMA reminds issuers that the general principle for distinguishing liabilities from equity issued by an entity is whether the entity has an unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation. If the issuer does not have such an unconditional right to avoid payment, the contract qualifies as either partly or wholly liability. In this context, ESMA recalls that contingent settlement provisions give rise to a liability unless one of the conditions mentioned in paragraph 25 of IAS 32 is fulfilled

and the need for a thorough analysis of the features of the underlying contracts when classifying financial instruments in accordance with paragraphs 15 and 16 of IAS 32 *Financial Instruments: Presentation*.

In addition, ESMA highlights that economic compulsion, which takes place when an entity has an economic motivation, but not a contractual obligation, to make a specific payment decision (e.g. interests, dividends or nominal repayment of principal), does not itself create a financial liability. In this context, ESMA recommends that issuers disclose information about financial instruments accounted for as equity that contain features that give economic compulsion to make payments (e.g. dividend blockers).

Likewise, issuers should be aware of certain complexities that arise when settling obligations with their own equity instruments. Depending on whether the fixed-for-fixed criterion in paragraph 22 of IAS 32 is met, the contract may qualify as equity, a financial asset or financial liability. The IFRS IC noted in the final agenda decision in January 2010⁹ that diversity in practice may exist in certain cases involving the application of the fixed-for-fixed criterion.

In addition, where particular debt/equity issues have been rejected by the IFRS IC due to lack of guidance and/or clarity in the standard, issuers should ensure that the accounting policy applied when assessing whether an instrument qualifies as debt or equity is selected and used consistently for similar transactions (paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). Disclosure of the accounting policy and the judgements made by management is required according to paragraph 117 (b) and 122 of IAS 1 respectively. In this context, ESMA calls for transparency in the disclosure of the main characteristics of these instruments (e.g. par value, interest and step-up clauses, coupon payment terms, triggering events for any payments, key contract dates, conversion or call and put options).

ESMA highlights that paragraph 17 of IFRS 7 requires disclosure of embedded derivatives in the notes to the financial statements where an entity has issued a financial instrument that contains both a liability and an equity component, and the instrument has multiple embedded derivatives whose values are interdependent (e.g. an issued convertible debt).

Where relevant, issuers are encouraged to present additional line items in the statement of financial position or in the statement of other comprehensive income if the amounts related to the financial instrument are material. In addition, a presentation disaggregating all related flows in the statement of cash flows and stating in the notes to the financial statements the distribution to holders of instruments classified as equity (in addition to dividends on ordinary shares) allows readers to identify these items easily.

Disclosures of the impact of the new standards on IFRS financial statements (IFRS 9 Financial Instruments, IFRS 15 Revenue from Contracts with Customers and IFRS 16 Leases)¹⁰

ESMA draws issuers' attention to the impact that the new standards issued by the IASB, but not yet mandatorily applicable, will have on their financial statements, notably to the impact of IFRS 9, of IFRS 15 and

⁹ IFRS IC Update, IAS 32 Financial Instruments: Presentation - Application of the 'fixed for fixed' condition, IASB, January 2010

¹⁰ Subject to endorsement for use in the European Union

of IFRS 16. The first two standards are applicable as of 1 January 2018 while IFRS 16 is applicable as of 1 January 2019.

ESMA highlights that some aspects of the new standards represent a significant change compared to the current standards and thus the recognition, measurement and presentation of assets, liabilities, income, expenses and cash flows may be affected. For this reason, ESMA encourages issuers to work as soon as possible on the implementation of these standards and ensure that they are ready when the new requirements become mandatorily applicable and they provide relevant disclosures on the expected impacts in accordance with paragraph 30 of IAS 8 as soon as they are known or reasonably estimable.

ESMA has published a separate statement on the implementation of IFRS 15¹¹ and will publish a statement on the implementation of IFRS 9. ESMA urges issuers to take those statements into account when preparing their 2016 annual and 2017 interim financial statements. Among others, these statements underline that issuers should provide progressively more entity-specific qualitative and quantitative information about the application of the new standards and that ESMA expects that, for most issuers, the impacts (or the magnitude of its impacts) of the initial application of IFRS 15 and/or IFRS 9 will be known or reasonably estimable at the time of the preparation of their 2017 interim financial statements.

Finally, ESMA reminds issuers of the importance of providing high quality disclosures in relation to (i) the future minimum lease payments under non-cancellable operating leases by periods, (ii) the general description of leasing arrangements and (iii) the lease payments recognised as an expense in the period as required by paragraph 35 of IAS 17 *Leases*. The relevance of these disclosures increased as they might enable users to estimate the potential magnitude of the impacts of IFRS 16 in financial statements.

Other considerations: Impact of the result of the United Kingdom referendum on issuers' financial statements

In the light of the result of the United Kingdom referendum to leave the EU and the consequential uncertainties, ESMA and enforcers urge issuers that expect to be affected (either directly or indirectly) by the Brexit to provide disclosures on (i) the exposure to risks (e.g. financial, operational and/or strategic risks), their expected impacts and the uncertainties that might affect issuers' activities and (ii) how management manages and plans to mitigate those risks. In this respect, where applicable, issuers should provide high quality narrative information that supplements financial statements and/or include this information in the management report in view of the future outlook of their businesses.

Particular attention should be given to disclosures related to liquidity risks or debt repayments due to breaches of covenants. For this reason, ESMA recommends issuers to consider the need to provide the disclosures related to sensitivity analysis (e.g. impairment of assets, financial risks) as well as the disclosures required by IFRS 7 *Financial Instruments: Disclosures* and paragraph 125 of IAS 1.

ESMA draws issuers' attention to the disclosures required by IFRS Standards in relation to measurement of assets and liabilities (e.g. assets measured at fair value under IFRS 13 *Fair Value Measurement* or fair value of plan assets and defined benefit obligations under IAS 19 *Employee Benefits*). In the light of the

¹¹ Statement: Issues for consideration in implementing IFRS 15 Revenue from Contracts with Customers, ESMA, 20 July 2016

potential reduction of estimated cash-flows, changes in the supply chain costs or the volatility of the financial markets and/or exchange currency rates, ESMA reminds issuers to the potential need to (re)assess the assumptions used in the valuation of assets and liabilities and, where applicable, to recognise impairment losses. For example, issuers should assess if relevant triggers for the recognition of impairment losses in financial assets related to the significant or prolonged criteria in IAS 39 *Financial Instruments: Recognition and Measurement* are met and/or if the recoverable amounts determined in accordance with IAS 36 *Impairment of Assets* decrease significantly. In this respect, ESMA underlines that the significant or prolonged criteria should be determined in the functional currency of the issuer.

Finally, ESMA also reminds issuers that the use of an average rate for the translation of foreign currency rates as allowed by paragraph 22 of IAS 21 *The effects of changes in Foreign Exchange Rates* is not appropriate if the exchange rate fluctuates significantly.