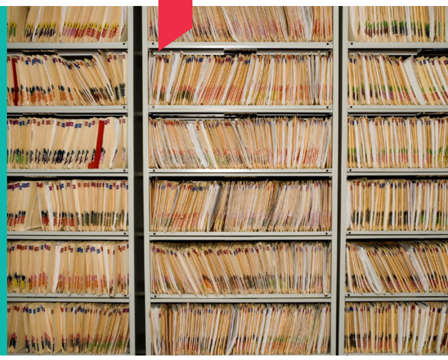
EUROPEAN COMMON ENFORCEMENT PRIORITIES FOR 2013 FINANCIAL STATEMENTS
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/22



Executive summary

The headlines

ESMA, together with European national enforcers, has published common enforcement priorities for IFRS financial statements for the year ending 31 December 2013. These are:

1. Impairment of non-financial assets
2. Measurement and disclosure of post-employment benefit obligations
3. Fair value measurement and disclosure
4. Disclosures relating to significant accounting policies, judgements and estimates
5. Measurement of financial instruments and disclosure of related risks, particularly relevant for financial institutions.

What this means

National enforcers carry out reviews of published IFRS financial statements. If these do not appear to comply with IFRS in one or more respects, these enforcers will typically write to the companies concerned and ask for an explanation of the issues that have been identified. If an enforcer is not satisfied with the explanations provided, the company may need to restate its financial statements; one or more of the directors can be subject to public criticism, as can the auditor.

The enforcement priorities listed above are areas where it should be expected that national enforcers will place particular emphasis during their reviews. However, national enforcers may also focus on additional issues that are relevant to their own jurisdictions.

A number of the enforcement priorities are linked to issues that have been raised with the IFRS Interpretations Committee.

What you should do

Companies and their auditors need to identify whether the enforcement priorities are relevant to their circumstances. Where relevant topics are identified, particular care is needed to ensure that the underlying accounting approach is appropriate, and that the amounts and associated disclosures in the financial statements are clear.

Consideration should also be given to any additional topics that are relevant to specific jurisdictions. These may have been highlighted separately by national enforcers in their own published enforcement priorities.

STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Additional guidance for the application of IFRSs.

Background

The European Securities and Markets Authority (ESMA) have, as a source of information to assist in the appropriate application of International Financial Reporting Standards (IFRSs), developed a confidential database of enforcement decisions taken by EU National Enforcers participating in European Enforcers Co-ordination Sessions (EECS). EU National Enforcers monitor and review financial statements and consider whether they comply with IFRSs and other applicable reporting requirements, including applicable national law. The EECS is a forum in which all EU National Enforcers of financial information meet to exchange views and discuss experience of enforcement.

No decisions are taken at the EECS, and decisions taken by EU National Enforcers are neither approved nor rejected. Relevant factors for each enforcement decision may include consideration of national law, the requirements of which may go beyond the requirements of accounting standards and interpretations. In consequence, when considering the cases that are publicly reported, careful consideration should be given to their individual circumstances.

ESMA regularly publishes extracts from its database relating to its previous financial statement reviews, with the intention of informing market participants about which accounting treatments EU National Enforcers (the Enforcers), may consider as complying with IFRSs and thus contribute to a consistent application of IFRSs in the European Union. The published decisions generally include a description of the accounting treatment or presentation at issue, the decision taken by the Enforcer and a summary of the Enforcer's underlying rationale.

Previous extracts published by ESMA are summarised in the following BDO IFR Bulletins: 2007/06, 2008/07, 2008/17, 2009/04, 2010/05, 2010/06, 2010/07, 2012/01, 2012/02, 2012/03, 2012/04, 2012/14, 2013/11, and 2013/21.

While ESMA is a European regulator, listed companies in other jurisdictions that apply IFRS (and their auditors) should be aware of, and take into account, the enforcement priorities raised in the statement, as they relate to financial reporting issues that are not isolated to the European financial reporting environment. It is also relevant that enforcers worldwide are increasingly sharing information that they collect in the process of their activities.

Set out below is a summary of ESMA's European common enforcement priorities for 2013 financial statements.

Summary of ESMA's enforcement priorities for 2013 financial statements

1. Impairment of non-financial assets

General observations

ESMA notes the period of slow economic growth in Europe that followed in the wake of the financial crisis may mean that assets held by entities (especially those in industries subject to cyclical or structural downturns) may no longer be able to generate the cash flows that were expected upon acquiring the asset.

In January 2013 ESMA released a report in relation to its specific review of impairment of goodwill and other intangible assets noting a number of areas of concern from its 2011 financial statement reviews that it would be targeting in future reviews (please refer to BDO's IFR Bulletin 2013/7 for a summary of this report).

Specific arrears of focus

ESMA has highlighted the following areas relating to impairment of non-financial assets.

Specific area	Considerations
Cash-flow projections	(i) Must be based on reasonable and supportable assumptions. (ii) Reasonable and supportable assumptions must represent management's best estimate of the range of future economic conditions. (iii) Management must examine the differences between previous forecasts and actual results in determining whether managements assumptions and estimates are in fact reasonable and supportable. (iv) Greater emphasis must be given to external sources of evidence (rather than internal).
Key assumptions (Value in use)	(i) Must be disclosed on a disaggregated level (i.e. by CGU or group of CGUs). (ii) All key assumptions must be disclosed (not just the long-term growth rate and the discount rate). (iii) Must explain the approach in determining the values of each key assumption, including: – Whether it is consistent with external sources of evidence, if not, how and why not – Whether it differs from past experience and, if so, how and why.
Sensitivity analysis	(i) Must be disclosed on a disaggregated level (i.e. by CGU or group of CGUs) for each key assumption. (ii) A generic statement '*that no reasonable possible change in a key assumption would result in an impairment loss*' is likely to be inadequate in providing useful information to users of the financial statements when the difference between carrying amount and recoverable amount is small.

2. *Measurement and disclosure of post-employment benefit obligations*

General observations

ESMA notes that there has been considerable discussion in the accounting community about the discount rate to be used in determining the present value of post-employment benefit obligations, given that IAS 19 *Employee Benefits* requires the discount rate to be based on:

- The market yields of high quality corporate bonds (HQCB) (where a deep market of HQCB exists)
- The market yields on government bonds (where no deep market of HQCB exists).

The financial crisis in the corporate bond market has led to questions about whether, in some jurisdictions:

- A deep market still exists for HQCB, and
- Whether corporate bonds that previously had been HQCB are still of a high quality.

The IFRS Interpretations Committee (IFRS IC) and International Accounting Standards Board (IASB) has considered these issues during 2012 and 2013. In 2012 ESMA advised issuers not to change their approach in determining discount rates until the IFRS IC had clarified these issues.

In addition to issues around discount rates, ESMA has also noted:

- Weaknesses in post-employment benefit disclosures from previous financial statement reviews
- The impact of the introduction of the revised IAS 19 (effective for periods beginning on or after 1 January 2013).

Specific arrears of focus

Based on its own observations and comments made by the IFRS IC and IASB, ESMA has highlighted the following areas relating to measurement and disclosure of post-employment benefit obligations:

Specific area	Considerations
Discount rates based on HQCB	Provided that the HQCB market remains deep, there should be no change in the approach followed in determining the discount rate.
Type of bond to be used when there is no deep market for HQCB	The government bond to be used when there is no deep market for HQCB should be at the *currency level* (e.g. Eurozone) and not the *country level* (e.g. an individual Eurozone EU member state).
Disclosures	Entities must ensure they disclose: – Significant actuarial assumptions – Sensitivity analysis for significant actuarial assumptions – Significant judgements made by management (i.e. in determining the discount rate) – Disaggregation of information (including plan assets) where the risks of the entity's different post-employment benefit plans vary.
Third statement of financial position	Where the initial application of IAS 19 revised is material to the entity, a third statement of financial position must be presented in accordance with IAS 1 *Presentation of Financial Statements*.

3. Fair value measurement and disclosure

General observations

ESMA notes that IFRS 13 *Fair Value Measurement* becomes effective for periods beginning on or after 1 January 2013. IFRS 13 does not introduce any new requirements for when fair value measurement is to be used, but replaces and adds to fair value measurement requirements of IFRSs, and:

– Defines fair value
– Clarifies and refines the principles for determining fair value
– Establishes a fair value measurement framework.

IFRS 13 applies not only to financial instruments, but also to other assets, liabilities and equity instruments that have a requirement for fair value recognition, measurement, or disclosure under other IFRSs (e.g. investment property under IAS 40 *Investment Property*).

Disclosure requirements of IFRS 13 are based on:

– The level of the fair value measurement (Levels 1-3, based on how observable the lowest rank input in the fair value measurement is)
– Whether the fair value measurement is recurring or non-recurring.

ESMA also notes that the IASB is currently discussing an apparent inconsistency within IFRS 13 relating to the unit of account, which is that IFRS 13 requires:

– In some cases an adjustment to observable market inputs (i.e. control premium or discounts for the fair value of shares)
– Fair value measurement being precluded from including a premium or discount that is inconsistent with the unit of account (i.e. the price x quantity calculation for the fair value of quoted shares).

Specific arrears of focus

ESMA has specifically highlighted the following areas relating to fair value measurement and disclosure.

Specific area	Considerations
Non-performance risk (NPR)	(i) NPR includes, but is not limited to, the entity's own credit risk. (ii) NPR must be incorporated into the fair value of financial liabilities, including derivatives. (iii) Counter-party credit risk (CCR) needs to be incorporated and properly accounted for in determining the fair value of all financial instruments. (iv) Fair value valuation techniques must: – Maximise the use of relevant observable inputs – Be based from the perspective of market participants – Have their methodologies adequately and transparently disclosed. (v) The effects of significant counter-party risk on the following must be disclosed, including: – Fair value of assets – NPR on the fair value measurement of liabilities.
Unit of account	Entities must ensure that they clearly disclose their analysis regarding the unit of account when determining fair value measurements. This is considered to be particularly important in the context of the inconsistency in IFRS 13 noted above.
Disclosures (Level 3 unobservable inputs)	Disclosures for level 3 fair value measurements must be complete and clear, including: – If changes to level 3 input might result in a significantly different fair value measurement, disclosure of a narrative sensitivity analysis.

4. Disclosures relating to significant accounting policies, judgements and estimates

General observations

ESMA notes that both the IASB and other stakeholders believe that there is a need to improve the quality of financial statement disclosures, including a move away from generic 'boiler plate' disclosures to more entity specific disclosures.

Common criticisms include:

- Disclosure of immaterial and/or irrelevant items
- Excessive disclosure of immaterial and/or irrelevant items.

ESMA also notes that there are a number of new IFRSs that will become effective in Europe for periods beginning on or after 1 January 2014 that may have a material impact on many entities, including:

- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*.

(Note: Issuers in Europe apply EU-endorsed IFRSs. IFRS 10 and IFRS 11 were endorsed by the EU with an effective date one year later than IFRS 10 and IFRS 11 as issued by the IASB, which were effective for periods beginning on or after 1 January 2013).

Specific arrears of focus indicated by EMSA

ESMA has specifically highlighted the following areas relating to disclosures of significant accounting policies, judgements and estimates.

Specific area	Considerations
Summary of significant accounting policies	(i) Only material and relevant accounting policies should be disclosed. (ii) Presentation should be in order of materiality (i.e. the most material accounting policies to the entity should be disclosed first). (iii) Disclosure of when the application of an accounting policy is optional.
Judgments made by management	Disclose only those management judgements that have the most significant effect on amounts recognised in the financial statements.
Estimation uncertainties	Disclose only significant estimation uncertainties that could result in a future material adjustment.
Going concern assumption	Disclose uncertainties related to events and conditions that may jeopardise an entity's ability to continue as a going concern.
Sensitivity of carrying amounts	Disclose a sensitivity analysis of carrying amounts to the methods, assumptions and estimates in determining their calculation.
IFRSs issued but not yet effective	Where the future initial application of a new/amended/revised IFRS is likely to be material, an entity must disclose: – The name of the new standard – The effect.

5. Measurement of financial instruments and disclosure of related risks

General observations

ESMA notes that the comparability of financial reporting of financial institutions in particular has come under scrutiny in the wake of the financial crisis and continuing market turbulence in the financial sector.

ESMA also notes that IFRS 7 *Financial Instruments: Disclosures* sets broad disclosure objectives that require entities to present quantitative and qualitative disclosures to enable users of financial statements to understand the significance of financial instruments on the financial position and performance of the entity.

Specific arrears of focus indicated

ESMA has highlighted the following areas relating to the measurement of financial instruments and disclosure of related risks:

Specific area	Considerations
General disclosures	Entities with material exposures to financial instruments should ensure that they disclose quantitative and qualitative disclosures relating to: – The nature and extent of risks arising from financial instruments – Concentration of exposure to relevant risks – Elements related to the valuation of financial instruments: – Also, the valuation should reflect economic reality.

Impairment of financial assets, forbearance practices and credit risk	(i) Entities must ensure all available information at the reporting date is considered in determining whether there is evidence of impairment.
	(ii) In relation to forbearance practices, entities are reminded that:
	  – Impairment is based on expected cash flows (rather than new contractual cash flows)
	  – Disclosure of quantitative information is required to assess the impact of impairment on financial position and performance.
	(iii) Entities must ensure all available information at reporting date is considered in determining whether there is evidence of impairment.
	(iv) Clear and transparent disclosure of credit quality for financial assets within the categories defined by IFRS 7:
	  – Neither past due nor impaired
	  – Past due but not impaired
	  – Individually determined to be impaired.
	(v) Entities must ensure there is unambiguous disclosure of the accounting policy regarding the collective impairment assessment for financial assets that are themselves not deemed to be individually impaired.

Liquidity risk	(i) Entities must ensure that the granularity of liquidity risk disclosures corresponds to their risk profile. (ii) The maturity analysis of contractual cash flows of financial liabilities must be disaggregated into an appropriate number of entity specific time bands. (iii) A maturity analysis must be provided for financial assets held for managing liquidity risk. (iv) Consideration should be given to the disclosure of quantitative and qualitative elements related to availability and/or restrictions on assets that could be used for supporting liquidity needs. (v) Entities must ensure that the different disclosures relating to liquidity risk and funding are sufficiently clear and explicit.

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