CHAPTER 2

ESMA enforcement decisions: Guidance on IFRS application issues

This article aims to:

Summarise the key guidance provided by ESMA on application issues under IFRS through its enforcement decisions.

Introduction

The European Securities and Markets Authority (ESMA) organises the European Enforcers Coordination Sessions (EECS), a forum of 38 European enforcers from all European Economic Area (EEA) countries which is responsible for supervision of International Financial Reporting Standards (IFRS). Through EECS, European enforcers discuss and share their experience on the application and enforcement of IFRS. Additionally, EECS produces technical advice on ESMA statements and opinions on accounting matters and reviews accounting practices applied by European issuers to enable ESMA to monitor market developments and practices.

Recently, ESMA has issued an extract[1] from EECS's database of enforcement decisions on financial statements covering decisions taken by national enforcers in the period from November 2019 to July 2020. The decisions aim to provide issuers and users of financial statements with relevant information on the appropriate and consistent application of IFRS[2] in the EEA. It also intends to inform market participants about which accounting treatments European enforcers may consider as complying with IFRS i.e. whether the treatments considered are within the accepted range of those permitted by IFRS.

We aim to summarise key guidance provided by the enforcers in each of the specific scenarios under IFRS.

Financial Instruments

Measurement of Expected Credit Losses (ECL)

The enforcer considered a situation wherein an issuer expects to fully recover its trade receivables within six months' delay from the reporting date. Accordingly, the issuer did not recognise an ECL charge in its financial statements. However, the amount of trade receivable and interest for late payment were past due for between eight and 18 months.

Guidance: In accordance with IFRS 9, *Financial Instruments*, an entity should measure ECLs of a financial instrument in a way that reflects reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. Further, an entity should adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historic data is based.

Basis above, in the given case, it was concluded that the issuer did not comply with the recognition and measurement requirements of IFRS 9 which states that an entity should consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low. Accordingly, an issuer would need to provide a probability-weighted calculation of the trade receivables' ECL as at the reporting date that reflects a range of possible outcomes as required by IFRS 9.

Measurement of purchased credit impaired assets

As per IFRS 9, interest revenue for purchased or originated credit-impaired financials assets (POCI assets) should be calculated using the effective interest method, with the credit-adjusted effective interest rate applied to the amortised cost of the financial asset from initial recognition. The ECLs for these assets should be discounted using the credit-adjusted effective interest rate determined at initial recognition.

Accordingly, an issuer should use credit-adjusted effective interest rate determined at initial recognition to calculate the amortised cost of the purchased credit-impaired assets.

1. 25th Extract from the EECS's Database of Enforcement, ESMA, 15 July 2021.
2. The decisions published are based on the IFRS requirements valid at the time of the IFRS financial statements and may be superseded by subsequent developments in IFRS.

Leases

Identification of a lease

Under IFRS 16, *Leases* to determine whether a contract conveys the right to control the use of an identified asset, a company needs to assess whether the customer has the rights to:

a. Obtain substantially all the economic benefits from the use of an identified asset

b. Direct the use of the identified asset throughout the period of use.

Further, an asset can be either explicitly specified in the contract or implicitly specified at the time it is made available for use by the lessee. IFRS 16 also allows a portion of an asset's capacity to be an identified asset if it is physically distinct.

In a given situation, an issuer with projects on development, construction, and operation of wind farms leases plots of land where the wind farms are located. The lease contracts in most of the cases allow the owners of the land to use the parts of the land not constructed by the issuer for other activities to the extent that such use does not interfere with the operations of the lessee. However, the issuer considered that the existence of clauses that allow the landowner to use parts of the land to carry out other activities significantly limited its ability (i) to obtain the economic benefits related to the land and (ii) to control the asset. Accordingly, the issuer concluded that the contracts did not contain a lease and thus, did not comply with the requirements set out in IFRS 16,

Guidance: In the given case, it was concluded that there is an identified portion of an asset, which is physically distinct, consisting of the part of the land occupied exclusively by the wind turbine (including the air space occupied by the blades). Further, the issuer (lessee) has the right to:

a. Obtain substantially all the economic benefits from the use of the portion of the land as the land on which the wind turbine is located is exclusively used with the objective of generating wind energy.

b. Direct the use of the asset as the issuer takes all the important decisions related to the use of the asset during the contract period such as determining the exact location of the windmills and the day-to-day operation of the windmills. Also, the issuer has unlimited access to the leased land in order to repair, ensure maintenance or carry out any other activities that the issuer considers necessary to uphold or to increase the efficiency of the equipment. The landowner does not have the right to object or to change the issuer's operating instructions.

Accordingly, basis above it was concluded that the issuer in the given case is required to apply IFRS 16 to the said transactions.

Depreciation of leased assets and dismantling costs

In a given situation, an issuer entered into a lease agreement to rent land. As per the terms of the agreement, the issuer is obliged to remove the Property, Plant and Equipment (PPE) (e.g., telecommunications equipment) that is being installed on the leased space at the end of the lease.

The issuer capitalised the costs for Asset Removal Obligations (ARO) within the Right-of-Use (RoU) assets and did not capitalise the costs with the item of PPE that is to be dismantled. Further, the issuer used the useful life of the telecommunications licenses as the depreciation period for ARO and not the estimated terms of the leased lands or the useful life of the telecommunications equipment as it is unable to foresee the dates when each individual telecommunications site would have to be dismantled.

Guidance: As per IFRS 16, the costs of the RoU asset shall comprise an estimate of costs to be incurred by the lessee in dismantling and removing the asset and restoring the underlying asset to the condition required by the terms and conditions of the lease. Accordingly, in the given case, capitalisation of the costs of removing the telecommunications equipment and restoring the leased land as part of the RoU assets is in accordance with IFRS 16.

However, the issuer is required to consider the lease term of its RoU assets for the depreciation of the asset representing the costs of ARO instead of useful life of the telecommunications licenses. The reasons are as follows:

a. The dismantling obligation is foreseen by the terms and conditions of the lease agreement

b. The costs for ARO are incurred in relation to the leased land and not in relation to other specific telecommunication equipment, i.e. the issuer could replace the telecommunications equipment without the obligation to dismantle being triggered

c. The issuer is obliged to restore the land to its original condition when the lease is over and

d. The depreciation period of the costs for ARO should be aligned with the lease term of the land which is the underlying asset and would also coincide with the reasonably certain period of the lease.

Presentation and disclosures

Expenses related to COVID-19

In a given case, an issuer presented some costs and expenses related to COVID-19 such as, exceptional bonuses of employees, logistic costs including sanitising and protective measures for employees, as non-recurring items. As per the issuer, these costs result from events or transactions that do not relate to the issuer's ordinary activities in view of their nature, frequency or materiality.

Guidance: As per IAS 1, *Presentation of financial statements*, a fair presentation requires an entity to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information. Therefore, the issuer's presentation of COVID-19-related items did not comply with the presentation requirements of IAS 1 for the following reasons:

a. COVID-19 impacted more than one line item of the statement of profit and loss and thus, it was not appropriate to isolate some of the costs and expenses in a single line and exclude them from the recurring operating income when other effects, which were positive, were presented in aggregate.

b. The explanation provided by the issuer to classify some costs and expenses as linked to COVID-19 was not convincing. For instance, certain employee bonuses were classified by the issuer as COVID-19 related. However, these costs were also linked to an increase of the activity and efficiency of the issuer.

c. It was not certain whether the effects of the COVID-19 would be limited to one period and not affect the performance of the issuer in future reporting periods.

Current/non-current liabilities in the balance sheet

In a given situation, an issuer issued debt fully subscribed by a company B, for an amount representing around 30 per cent of the total liabilities of the issuer with repayment due in October 2020. The issuer signed another contract with company B with similar maturity, to develop activities in the area of biotechnology. The issuer considered the two contracts linked as the loan was used to finance the activities and operations foreseen in the second contract.

At the end of 2019, the issuer requested the extension of the term of both contracts (the loan and the development contract) by one year. Company B signed a letter notifying the issuer that the extension of the debt maturity to October 2021 was upon a condition that the issuer formally demonstrated its ability to reimburse the loan at the new maturity date. As at 31 December 2019, company B had not formally validated that the condition set in the letter was met.

Additionally, in December 2019 the issuer signed a preliminary financing term agreement with another company C for an amount that would be sufficient to finance its current operations for two years and the reimbursement of the debt with company B by October 2021.

As company B had representatives on the issuer's board of directors, it was informed of the financial situation, the liquidity, the financial projections of the issuer and the new financing term signed with company C.

The issuer classified the financial liability as a non-current liability as of 31 December 2019.

Guidance: As per IAS 1, if an entity has the right, at the end of the reporting period, to roll over an obligation for at least 12 months after the reporting period under an existing loan facility, it classifies the obligation as non-current even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (e.g., there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

Basis above, it was concluded that in the given case as of 31 December 2019, the issuer did not have an unconditional right to defer the repayment of the liability for at least 12 months after the reporting date. Further, there was no legal and formal amendment of the debt agreement, or a formal and legally binding acknowledgement of company B that the conditions for extension of the debt maturity were met. The issuer had not signed a definitive, formal and irrevocable contract with company C but a preliminary financing term agreement. Additionally, company B did not formally confirm that the conditions set out in its letter were met as of 31 December 2019. The participation of company B in the issuer's board meetings and its knowledge of the issuer's financial situation did not demonstrate that the liability was no longer due to be settled within 12 months after the end of the reporting period. Moreover, refinancing was not at the discretion of the issuer as a third party investor was involved. Accordingly, the financial liability should be reclassified as current in the financial statements as of 31 December 2019.

Changes in liabilities arising from financial activities

Paragraph 44A of IAS 7, *Statement of Cash Flows*, requires an entity to provide 'disclosures that enable investors to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes'.

Further, paragraph 44D of IAS 7 states that 'one way to fulfil the disclosure requirement in paragraph 44A is by providing a reconciliation between the opening and closing balances in the

statement of financial position for liabilities arising from financing activities, including the changes identified in paragraph 44B (e.g. changes in fair values, effect of changes in foreign exchange rates, etc.).

In a given case, an issuer presented a reconciliation of a net financial debt in the notes to the financial statements which included – opening financial debt, total net cash flows movements of the period stemming from operating, investing and financing operations, other non-cash movements in net financial debt and closing net financial debt.

Narrative and quantitative information regarding the nature and amount of the main cash flows arising from financing activities was also disclosed in the notes to the financial statements. For example, dividends paid to the issuer's shareholders, acquisitions and disposals of treasury financial assets, cash payments on acquisitions of non-controlling interests and capital increase, and the nature and amount of the main movements on borrowings and financial debt.

Guidance: It has been concluded that the said disclosures made by the issuer did not fully enable users of financial statements to evaluate changes in liabilities arising from financing activities in accordance with paragraph 44A of IAS 7. The changes in liabilities arising from financing activities should have been disclosed separately and with sufficient details. Further, while disclosing the reconciliation, an entity should ensure that the reconciliation enables investors to link items included in the reconciliation to other items/ amounts included in the financial statements[3]. Also, the issuer should add a narrative or tabular disclosure detailing the non-cash changes in liabilities arising from financing activities separately from non-cash changes in other assets and liabilities from operating and investing activity.

Forward-looking information and risk factors

In a given situation, the issuer (a bank), in its consolidated financial statements, offsets negative interest paid on financial assets against 'interest income' and positive interest income received from financial liabilities against 'interest expense'. The offset amounts were neither presented separately in the income statement nor disclosed in the notes. Further, the issuer discloses limited information on:

a. The use of forward-looking information when determining ECLs

b. Its write-off policy, including information on the expectation of recovery and on financial assets that were written off

c. How it determines whether the financial asset is credit impaired and

d. Its definition of default. The issuer referred to the definition of default in EU regulation no. 575/2013, whereas, according to its definition of credit-impaired financial assets, stage 3 facilities are facilities where the financial asset is non-performing or otherwise credit-impaired.

Guidance

- **Effects of negative interest rates:** IAS 1 generally does not permit offsetting income and expenses. IFRS Interpretations Committee (IFRIC) in its agenda decision issued in January 2015 concluded that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue, because it reflects a gross outflow, instead of a gross inflow, of economic benefits. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue, but in an appropriate expense classification. Accordingly, issuer in the given case would need to change the presentation of the effects of negative interest rates in the income statement and to provide further information regarding the amounts of interest expense on financial assets and interest income from financial liabilities in order to comply with the requirements of IAS 1.
- **Disclosure on the use of forward-looking information:** Disclosures on the use of forward-looking information when determining ECLs need to be more specific. Disclosures on how the issuer considered macroeconomic variables such as expected GDP growth, number of bankruptcies, unemployment and inflation deemed relevant to enable users to understand the issuer's assessment of ECLs. To enable users to assess the recoverability of claims, the issuer should also provide a company-specific description of its write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity in accordance with IFRS 7, *Financial Instruments: Disclosures.*
- **Disclosure on credit impairment:** Disclosures should also cover inputs to the assessment of impairment, the underlying assumptions as well as the estimation techniques used and should demonstrate how the issuer determined that financial assets are credit impaired.
- **Definition of default:** The definition deemed too generic. The definition should allow users to understand the effects of credit risk on the amount, timing and uncertainty of future cash flows as required by IFRS 7. In particular, an issuer should disclose how it applies the different default definitions in relation to the various types of financial instruments and the reasons for selecting those definitions.

3. An entity applies judgement in determining the extent to which it disaggregates and explains the changes in liabilities arising from financing activities included in the reconciliation to meet the objective in paragraph 44A of IAS 7 as per IFRS interpretations committee.

Effects of changes in the credit risk related to financial liabilities designated as at FVTPL

While designating financial liabilities as at Fair Value Through Profit or Loss (FVTPL), paragraph 10A of IFRS 7 requires an issuer to disclose the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability. Additionally, an issuer is required to disclose a detailed description of the methods used to comply with the requirements in paragraph 10A in accordance with paragraph 11 of IFRS 7.

Therefore, in a given situation, disclosure of the impact of changes in the credit risk of liabilities designated as at FVTPL and of the methods applied is material information. Disclosure of this information is necessary to assess whether and how changes in the credit risk of the liabilities affect the financial statements.