Chapter 1

ESMA issued enforcement priorities for 2021 annual financial reports

This article aims to:

Discuss the key priority areas for the 2021 annual financial reports of listed entities as envisaged by ESMA in its latest annual public statement.

Introduction

On 29 October 2021, the European Securities and Markets Authority (ESMA) has issued its annual public statement. The statement prescribes the common enforcement priorities for the 2021 annual financial reports of listed entities. Following key topics have been considered as the common enforcement priorities for IFRS financial statements and non-financial statements:

Impacts of COVID-19 and related matters (Financial and non-financial impacts)	Climate related matters (Financial and non-financial impacts)
Expected Credit Losses (ECL) disclosures of credit institutions (Financial impacts)	Other considerations related to Alternative Performance Measures (APMs)

ESMA, together with the national enforcers, will pay particular attention to these areas when monitoring and assessing the application of the relevant reporting requirements. In this article, we will discuss each of the key priority areas along with the recommendations provided by ESMA in its statement.

Impacts of COVID-19 and related matters

Financial impacts

ESMA requires entities to carefully assess the longer-term impacts of COVID-19 on their activities, financial performance, financial position and cash flow. ESMA also reiterated the guidance given in its 2020 public statement[1].

In accordance with the guidance, some of the key considerations vis-à-vis long-term impact of COVID-19 includes:

Going concern assumptions

- Entities should provide sufficiently detailed disclosures on the going concern assessment pertaining to a company, when such assessment requires significant judgement. While making such an assessment, entities should consider all available information about the future, which is at least, but not limited to,12 months from the end of the reporting date.
- Entities should disclose material uncertainties related to events or conditions that may cast significant doubt upon their ability to continue as a going concern (such as restricted access to financial resources due to the impacts of COVID-19). These disclosures should also include close call scenarios, where the entities conclude that there are no material uncertainties that would impact the going concern assumption.

1. Enforcement priorities for 2020 annual financial reports issued by ESMA on 28 October 2020.

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- Entities should assess and disclose if material uncertainties exist related to events or conditions that may cast significant doubt upon the issuers' ability to continue as a going concern if relevant beyond the 12-month period after the reporting period.

Significant judgements and estimation uncertainty

- Entities should disclose the assumptions underlying significant judgements and estimates made while applying their accounting policies, and the impact of COVID-19 on such judgements and estimates. For example, assumptions underlying impairment of assets, recoverability of deferred tax assets and valuation, and how the consequences of COVID-19 (such as market price volatility) have impacted these assumptions.
- Entities should also provide information about the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculations.

Presentation of COVID-19 related items

Considering the pervasiveness of the impact of COVID-19 on the financial performance of a company, ESMA cautions entities that a separate presentation of COVID-19 impact may not faithfully represent a company's current and future overall financial performance. Therefore, ESMA encourages entities to provide quantitative and qualitative information and a clear and unbiased picture of the multiple areas affected by COVID-19 either in a single note or in multiple notes, with appropriate cross references.

Impairment of assets

Impact of COVID-19 should be considered while assessing the indicators of impairment. ESMA emphasised that the scale of reasonably possible changes in the key assumptions used in impairment testing may be larger than usual. It also reminds entities that the annual impairment test for a Cash Generating Unit (CGU) to which goodwill has been allocated is performed at the same time every year.

Other considerations

ESMA reminds entities to provide full transparency of any material arrangements that take the form of supply chain financing (e.g., management judgements in accordance with IAS 1, *Presentation of Financial Statements*, of financial position and of cash flow as well as impacts).

ESMA also recommended that entities should provide transparent information regarding their liquidity risk as required by IFRS 7, *Financial Instruments: Disclosures* and that this information is, as for all disclosures, sufficiently entity-specific. Both qualitative and quantitative information is necessary to enable investors to evaluate an entity's exposure to liquidity risk.

Recovery from COVID-19

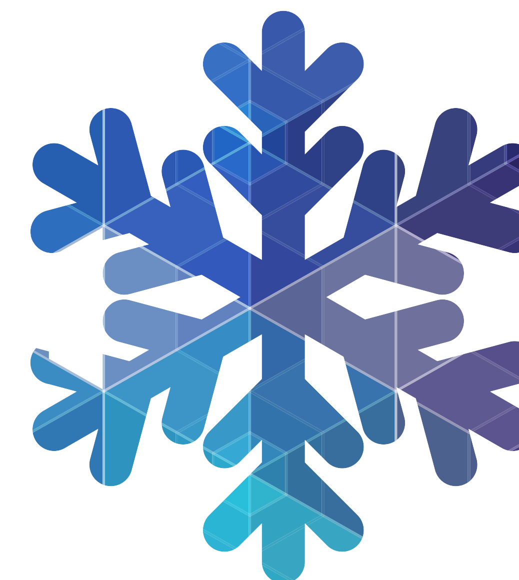
ESMA expects issuers, in particular those operating in sectors that are severely impacted by the longer-term impacts of COVID-19 (e.g., transportation, hospitality, retail), to disclose information on the judgements, estimates and assumptions that were updated as a result of any recent changes in their economic and financial situation together with the basis for those changes, where this is necessary for an understanding of the financial statements. These include, but are not limited to, the main assumptions used (and respective sensitivity analyses) to determine whether an impairment or reversal of impairment of non-financial assets should be recognised or whether the useful life of non-financial assets should be revised.

ESMA also reminded entities to assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. While making such an assessment, issuers should consider, at a minimum, the internal and external indications as specified in paragraph 111 of IAS 36, *Impairment of Assets* and that an impairment loss recognised in prior periods for an asset other than goodwill is reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the period in which the last impairment loss was recognised.

Additionally, there should be utmost transparency on the criteria and assumptions used in the recognition of deferred tax assets arising from the carry forward of unused tax losses and unused tax credits due to COVID-19 (e.g., analysis of the origin of the losses and nature of convincing evidence required in the specific circumstances).

Government support measures

ESMA expects entities to include a description of the nature and extent of any significant public support measure received by category (e.g., loans, tax relief, compensation schemes) in the financial statements. ESMA also expects entities to give information on the main characteristics of the support measures (e.g., expected duration, reimbursement and main conditions) as well as on the effects of their termination. Additionally, ESMA expects entities to make a link with the going concern assumptions or other planned actions, wherever relevant.



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Non-financial impacts

ESMA has recommended entities to provide transparency on how the consequences of the pandemic are affecting their plans to meet any sustainability targets and whether any new or adjusted goals have been determined. Entities are also encouraged to provide disclosures on how they foresee the development of their business in response to the changing conditions arising from the pandemic, in particular, in relation to any expected structural changes to the way they conduct their business (e.g., restructuring of supply chains and distribution channels) and arrange the working conditions for their employees.

It also recommended that issuers provide transparency on any material effects that the pandemic might have had on non-financial Key Performance Indicators (KPIs) as well as on any new non-financial KPIs which may have been developed to reflect any long-term effects of the pandemic.

Climate related matters

Financial impacts

Climate risks and consistency between IFRS financial statements and non-financial information

ESMA observed that investors are increasingly interested in information regarding the impacts that climate-related matters may have on entities as well as information on the entities' impacts on the mitigation of the effects of climate-related matters. Accordingly, ESMA requires entities and auditors to consider climate risks when preparing and auditing IFRS financial statements to the extent that the effects of those risks are material to those financial statements, even if IFRS standards do not explicitly refer to climate-related matters.

Additionally, all entities (irrespective of the extent of impact) should consider the climate-related matters holistically in their communications to the market by ensuring consistency in the information disclosed across the management report, the non-financial statement, the financial statements, and, where applicable, the prospectus. To ease reporting, entities are encouraged to include all information required to be disclosed by the IFRS standards on climate-related matters, including those concerning ECL, in one single note or alternatively to provide a mapping of where different notes address climate-related matters.

ESMA has also encouraged issuers to consider the requirements of the educational material on the effects of climate-related matters on financial statements issued by the International Accounting Standards Board (IASB) in November 2020[2].

Significant judgements and estimation uncertainty

In accordance with the requirements of IAS 1, ESMA urges entities, in particular those belonging to the most affected sectors, to consider disclosure of management judgements related to climate risks (for example those related to any climate scenarios on which assumptions have been made). ESMA also expects issuers to disclose in the financial statements how the forward-looking assumptions, estimates and judgements applied in preparing the financial statements are consistent with the information included in the corresponding management report and non-financial statement.

Entities should also clearly explain why apparently significant climate-related risks have not had a material impact on the financial statements.

ESMA also expects entities to consider climate change when assessing whether the expected useful lives of non-current assets and the estimated residual values in IAS 16, *Property, Plant and Equipment* and IAS 38, *Intangible Assets* should be revised.

2. For a detailed overview of the guidance given in the educational material, please refer KPMG in India's AAU article *'Climate change: Implications on financial reporting'* issued in November 2020 (Issue no. 52/2020).

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Additionally, in accordance with IAS 36, entities should:

a. Assess whether indications exist that non-financial assets are impaired as a result of climate risk

b. Use assumptions reflecting climate risks

c. Adapt the sensitivity analysis disclosed to consider climate risks and commitments in the assumptions used. For instance, external information about significant changes with an adverse effect on the company, such as significant changes in the environment in which a company operates, is an indication that an asset may be impaired as per IAS 36

d. Consider the significant impacts on future expected cash flows for a particular asset or CGU, when making disclosures of assumptions used to determine the recoverable amount of assets or CGUs.

ESMA also requires entities to carefully consider the requirements in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* with regard to contingent liabilities for potential litigation, regulatory requirements to remediate environmental damage, additional levies or penalties related to environmental requirements, contracts that may become onerous, or restructurings to achieve climate-related targets.

ESMA also calls for transparency in the accounting treatment applied regarding carbon and greenhouse gas emission trading schemes. In particular, entities are encouraged to provide information on their accounting policies and information on how these schemes affect their financial performance and financial position.

Materiality

Entities are expected to consider the requirements of IAS 1 and IFRS Practice Statement 2, *Making Materiality Judgements* issued by IASB relating to material financial information while evaluating need to disclose information about climate risks. In accordance with the guidance provided by IAS 1 and practice statement, entities should consider quantitative and qualitative factors as well as the interaction among different factors while assessing whether or not an information is material.

Non-financial impacts

ESMA emphasised the importance of providing transparency on policies pursued in relation to non-financial matters and the related outcomes in the area of climate-related matters. It reminded entities to consider the guidance provided by the European Commission in its Guidelines on reporting climate-related information which, notwithstanding its non-binding nature, is also consistent with the disclosures envisaged by the Task-Force on Climate-Related Financial Disclosures (TCFD)[3].

ESMA emphasised the importance of disclosing which policies, if any, issuers have put in place to address climate change, both in terms of any identified risks and opportunities that climate-related matters may give rise to for the undertakings' activities as well as on the impact (positive or negative) that the undertaking's actions may have on such matters. Disclosure of such policies should include reference to the most significant transitional risks and physical risks that entities have identified with a current or future expected material impact on their business model and activities and disclose how those risks are managed and which climate change mitigation or adaptation actions are put in place to address those risks.

Entities should provide transparency of the process leading to the identification of such risks and on the outcomes of their climate-related policies also by providing specific indicators and explaining how the entity's performance on such indicators is consistent with any pre-defined targets. Entities should also disclose the progress made towards achieving any such targets. An entity's strategy, plans, targets and current performance in relation to climate-related matters should be taken into account both in terms of non-financial disclosures as well as financial information.

ESMA also highlights the importance of ensuring consistency and connectivity between the information provided within the non-financial statements in relation to climate-related matters with the information provided in the financial statements, including the judgements made and estimates which should duly consider any financial implications of climate-related matters.

ECL disclosures of credit institutions

Management over-lays

As per ESMA, when material adjustments (also referred to as 'management over-lays') are used in the measurement of ECL, enhanced transparency should be provided by issuers in order to fulfil the overarching objectives and principles of IFRS 7. ESMA has observed that such adjustments either take the form of ECL model revisions, including updates of the model inputs (in-model adjustments), or are applied outside the primary models (post-model adjustments).

ESMA acknowledged that it may often be difficult to quantify the effect of the in-model adjustments, though following considerations apply in substance to both types of adjustments:

- For each material adjustment, ESMA expects issuers to disclose detailed and specific information on its impact on the ECL estimate, the rationale and the methodology applied. These disclosures should be provided at an appropriate level of granularity, for example by explaining to which specific type of products, exposures, sectors or geographic areas the adjustments

3. Guidelines on reporting climate-related information, European Commission, 17 June 2019.

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relate to, if relevant. In order to increase transparency and meet the requirements of IFRS 7, a corresponding breakdown of the quantitative impact of the adjustments may be appropriate.

The rationale should clearly specify the reasons for the adjustment (e.g., to include the latest macroeconomic outlook, or to address model limitations resulting from insufficient inclusion of certain risks). The description of the methodology should include significant inputs and assumptions.

- ESMA expects entities to provide information on whether the adjustments relate to a specific impairment stage and, if applicable, what impact they have on staging of the underlying instruments.
- Entities should consider how their ECL sensitivity disclosures in the notes to the financial statements can incorporate material management overlays and provide rationale for the chosen method, if relevant.
- Entities should explain any significant changes in methodologies and assumptions from the previous reporting period and the reasons for those changes. This information should enable users to understand the extent of the movements, their nature (i.e., changes in underlining assumptions) and the reasons for the development of adjustments (i.e., incorporation of the post-model adjustments in the core model, if applicable).

Significant changes in credit risk (stage transfers)

- Entities should disclose the basis for the inputs and assumptions and the estimation techniques used to determine whether a significant increase in credit risk (SICR) has occurred for financial instruments since their initial recognition or whether a financial asset is credit impaired.
- Entities should explain the quantitative and qualitative factors applied, including the length of the 'cure' period, and any material differences in the application of the factors across portfolios.
- ESMA has recommended that issuers disclose any quantitative SICR-thresholds applied, such as probability of default (PD) deterioration triggers. If there are significant differences in thresholds depending on portfolio type, additional explanations are required.
- If, during the reporting period, any significant relief measures were provided to borrowers by issuers, ESMA expect entities to explain how these measures have impacted the assessment of SICR.

  If the relief measures do not result in a derecognition of the financial instrument, credit institutions should include a description of how they determined SICR or whether these instruments are impaired in these specific circumstances providing, for example, information on related significant judgements, type of (new) indicators applied and the level of assessment (e.g., counterparty, sector, type of financial instruments, etc.) at an appropriate level of detail.
- Any significant changes in the assessment of SICR or on whether a financial asset is credit-impaired (i.e., changes in the methodology or significant assumptions) during the reporting period should be disclosed and explained.

Forward-looking information

While explaining how forward-looking information has been incorporated into the determination of ECL, ESMA encouraged credit institutions to provide specific disclosures on the main judgements and estimations related to uncertainties that have been taken into account when defining the scenarios and their weight. ESMA emphasised the importance of providing granular disclosures on the sensitivity analysis (e.g., regarding each scenario) and the quantitative impact of this analysis on the ECL and, where appropriate, on staging.

Transparency on changes in loss allowances, credit risk exposures and collateral

ESMA highlighted that the tabular reconciliation of the loss allowance (impairment amount) from the opening balance to the closing balance in accordance with IFRS 7 should be disaggregated by class of financial instrument and it should separately provide information about the changes in loss allowances for off-balance sheet commitments. To provide sufficient transparency, reconciliations should be disclosed

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both at the entity level and for significant portfolios with shared credit risk characteristics.

Additionally, ESMA has encouraged credit institutions to disclose a joint reconciliation of the loss allowance and the gross carrying amount. Quantitative disclosures and the narrative descriptions provided in different parts of the financial statements or of the management report should be clearly linked to each other.

Disclosures on credit enhancements should be sufficiently granular to enable users to understand material concentrations of credit risk. Where appropriate, disaggregation of exposures by loan to value (LTV) ranges can be provided.

Effect of climate-related risk on the ECL measurement

ESMA expects credit institutions to disclose whether material climate-related and environmental risks are taken into account in credit risk management, including information about the related significant judgements and estimation uncertainties. Wherever applicable, credit institutions should provide explanations on how these risks are incorporated in the calculation of ECL, on any credit risk concentrations related to environmental risks and how those risks affect the amounts recognised in the financial statements.

Other considerations related to APMs

ESMA calls for caution when adjusting APMs used and/or when including new APMs solely with the objective of depicting the impacts that COVID-19 may have on their financial performance.

ESMA noted that, at this point, it is more likely that the impacts of COVID-19 rather represent a general development that has been induced by the pandemic than the result of a one-off event. Therefore, as per ESMA, in most cases, these impacts should not necessarily be presented separately in APMs but in the accompanying narrative information.

Further, APMs disclosed should be given meaningful labels reflecting their content and basis of calculation to avoid conveying misleading messages to users. For example, entities or persons responsible for the prospectus should not use the term 'EBITDA' if items other than interest, taxes, depreciation, and amortisation are adjusted from the net result (adjusted EBITDA).

Also, APMs presented should be neutral. In accordance with ESMA presenting biased APMs which are adjusted to exclude only one-off losses (e.g., impairment losses) but include one-off gains of the same nature (e.g., reversal of impairments or grants) may violate the principles set out in articles 4 and 5 of the Transparency Directive relating to fair review of the development and performance of the business and the position of the issuer.

Conclusion

The priority areas highlighted by ESMA, especially COVID-19 and climate related matters requires immediate attention by companies in India as well due to significant disruption on account of climate related matters and COVID-19. There is an increase in demand for disclosures on these areas from all stakeholders, in particular, investors and regulators to enable them to assess the financial and operational performance of the companies.

Needless to mention, assessment of the potential impact areas and effective reporting requires timely deliberation of management with the audit committees and other supervisory bodies of listed entities which is key to ensure the overall internal consistency of the annual financial report and contribute to high-quality annual financial reports. Entities must also consider other international developments in the sustainability area, for instance, formation of a new International Sustainability Standards Board (ISSB) by IFRS foundation to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs.

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