Chapter 3

ESMA issues its enforcement priorities for 2020

This article aims to:

Highlight the financial and non-financial reporting areas that ESMA, together with national enforcers will be focusing on when reviewing the listed companies' 2020 annual reports.

Background

In order to promote the consistent application of IFRS standards and EU-specific reporting requirements, the European Securities and Markets Authority (ESMA) issues an annual public statement, to highlight the areas that it would be focussing on when reviewing listed companies' annual reports.

On 28 October 2020, ESMA issued its enforcement priorities for 2020 annual financial reports. Given the severe impact of the coronavirus pandemic (COVID-19), ESMA's key priority is transparent and timely disclosure of information on the effects of the pandemic on a company's financial performance, position and cash flows. ESMA has also focused on reporting of certain non-financial information disclosures. The areas of focus as mentioned in the report are given in figure 1 below

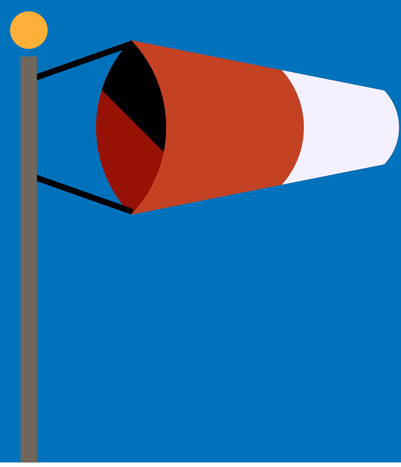
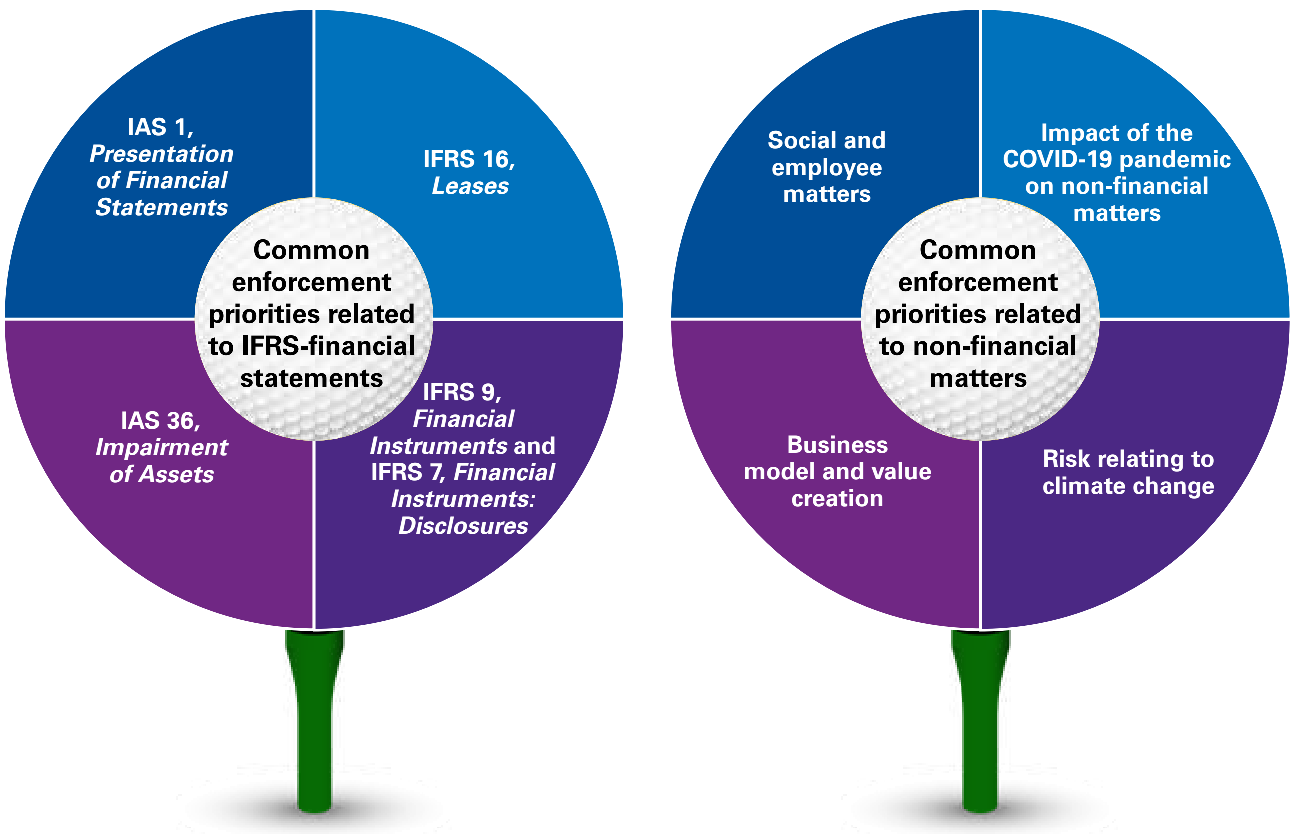


Figure 1: Areas of focus highlighted by ESMA in its Public Statement



Source: KPMG in India's analysis 2020 read with ESMA Public Statement dated 28 October 2020

ESMA has also emphasised the importance of applying its guidelines on Alternative Performance Measures (APM) while reporting on COVID-19.

Areas relating to financial reporting: Presentation of COVID-19 impact

As mentioned above, ESMA emphasised on the importance of transparency of information to further investor's confidence. It requires companies to focus on disclosures pertaining to significant assumptions and judgements made by management, in an environment of uncertainty. The focus areas highlighted by ESMA are:

IAS 1, *Presentation of Financial Statements*

- ***Going concern assumptions***

  Companies should provide sufficiently detailed[1] disclosures on the going concern assessment pertaining to a company, when such assessment requires significant judgement. While making such assessment, companies 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.

  Companies 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 companies conclude that there are no material uncertainties that would impact the going concern assumption.

  ESMA further expects the assumptions used in the going concern assessment to be consistent with those used in other areas of the company's financial statements – e.g. IFRS 7, *Financial Instruments: Disclosures* (on information about exposures to liquidity and other financial risks).

- ***Significant judgements and estimation uncertainty***

  Companies 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. Given the current market conditions, ESMA strongly recommends that entities should 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 companies that a separate presentation of COVID-19 impact may not faithfully represent an company's current and future overall financial performance. ESMA thus encourages companies 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.

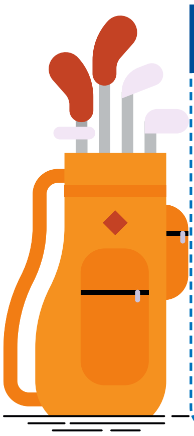
IAS 36, *Impairment of assets*

As per IAS 36, (non-financial) assets should be measured at their carrying amount or their recoverable amount, whichever is lower. For this purpose, companies should assess each year, whether there is any indication of impairment at the end of the reporting period. In this regard, ESMA reiterated[2] that the impact of COVID-19 should be considered while assessing the indicators of impairment.

Additionally, ESMA reminded companies that an impairment test performed for the last interim reporting period does not replace the requirement to perform another when there is an indication of impairment. It emphasises that the scale of reasonably possible changes in the key assumptions used in impairment testing may be larger than usual. It also reminds companies 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.

1. Level of detail would depend upon the situation of each company
2. ESMA had in its previous Public Statement relating to half-yearly financial reports asked companies to consider the effects of COVID-19 in assessing any indications of impairment for non-financial assets.

Considering the increased level of uncertainty, ESMA has issued certain considerations that companies may factor while reporting in their annual financial statements:



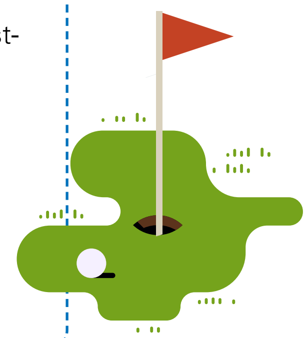
Measurement of recoverable amount of assets

Companies should:

- Model multiple possible future scenarios when estimating the future cash flows of a CGU. Alternatively, further adjustments may be made to the discount rate to reflect additional uncertainty (provided that cash flows have not already been adjusted for the same risk)
- Update assumptions used in previous interim periods to reflect the latest available information and evidence
- Emphasise on external evidence when determining cash flow projections
- Exclude expected cash flows from future uncommitted restructurings or asset enhancements in calculating value-in-use.

Disclosures pertaining to…

- How uncertainty has been factored into impairment testing
- Key assumptions and estimates underlying the impairment assessment, and how these have changed (if at all), compared to the last annual and interim reporting, for example:
  - If and when a return to pre-crisis cash flow levels is realistic, and
  - The time horizon considered in post-COVID-19 scenarios
- Sensitivity of recoverable amounts of CGU to significant changes in key operational and financial assumptions affected by COVID-19.



IFRS 9, *Financial Instruments and IFRS 7, Financial Instruments: Disclosures*

IFRS 9 for credit institutions

ESMA expects companies to reflect the significant uncertainty affecting the economic environment in the measurement of Expected Credit Losses (ECL) in an unbiased way. It reminds companies to use all reasonable and supportable information, including economic forecasts, that is available without undue cost and effort.

Risks arising from financial instruments

IFRS 7 requires adequate disclosure of risks arising from financial instruments. Given that COVID-19 may have given rise to new significant financial risks (for example, debt renegotiations that did not exist before, or were not as significant) these disclosures (in particular with regard to liquidity risks and sensitivities to market risks) are essential. ESMA further emphasised that all disclosures under IFRS 7 should be based on information used for internal reporting.

ESMA reminded companies that quantitative disclosures regarding financial risks should be accompanied by qualitative disclosures, as this would give an overall picture of the risks arising from financial instruments. It further highlighted some important disclosures required regarding:

- **Liquidity risks:** Disclosures pertaining to liquidity risks should:
  - Provide sufficiently detailed maturity analysis of the financial liabilities as well as, where relevant, of the financial assets used to manage liquidity risk
  - Disclose arrangements that take the form of supply chain financing or, more specifically, reverse factoring transactions
- **Other financial risk considerations:** Other disclosures should include:
  - How financial risks arise and how they are managed
  - The specific objectives, policies and processes put in place to address those risks
  - Financial risk concentrations, including how they are measured
  - Details of forbearance or payment moratoria from lenders.

- **Disclosures for credit institutions: Credit institutions should disclose the following:**
  - Approach adopted to measure ECL, along with any changes in approach (if any) from previous reporting periods
  - Information and assumptions underlying the measurement of ECL e.g. changes in macro-economic scenarios considered as compared to previous reporting period, rationale and methodology underlying post-model adjustments, their impact on ECL estimate and specific risks that they capture
  - Nature of changes in loss allowance e.g. due to sale or write-off of financial instruments, or any modifications
  - Granular information on credit risk exposures, their quality and their concentration, giving explanation for those linked to COVID-19
  - Support measures granted to debtors and their effects e.g. impact on the assessment of significant increase in credit risk and the extent to which these measures have mitigated credit risk
  - Sensitivity analysis of ECL calculations and staging.

IFRS 16, *Leases*

ESMA emphasises on specific disclosures required to be given by lessors and lessees as below:

- ***Disclosures required by lessors***
  - Nature of rent concession granted
  - Accounting policy adopted for rent concessions
  - Risks posed by current market conditions on assets subject to operating lease, and
  - Requirements of other standards for assets subject to operating lease.
- ***Disclosures required by lessees***
  - How companies have applied the practical expedient that provides relief to lessees when accounting for COVID-19 related rent concessions:
    - Concessions to which the practical expedient has been applied
    - Nature of the leases and/or concessions to which it has been applied, if it has not been applied to all eligible concessions
  - Depreciation and expenses e.g. variable lease payments recognised in income statement
  - Future cash flows not reflected in measurement of lease liabilities
  - Additional information on impact of COVID-19.

Non-financial matters

Considering the pervasive impact that COVID-19 has had on non-financial matters of entities, ESMA has encouraged companies in disclosing the consequences of the pandemic and mitigating actions taken in response. Disclosures on non-financial matters should be balanced, fact-based and provide evidence of concrete behaviours and actions to enable users of non-financial statements to assess how companies have addressed or plan to address relevant topics. ESMA encourages companies to disclose on the following matters in their reports disclosing non-financial matters:

- ***Social and employee matters***

  Companies should provide disclosures relating to social and employee matters and how their policies address issues highlighted by these matters. Some issues that have attracted attention from users of corporate disclosures include:
  - Inclusion and diversity, to ensure equality and to fight against racism
  - Health and safety of employees, including extensive use of remote working arrangements and strategies to bring employees back to workplace.
- ***Business model and value creation***

  There is a need to provide disclosures on the impact of the pandemic on the business model and value creation over the short, medium and long-term and on the policies put in place to address the non-financial matters. This can, for example, be contingency plans and employment measures as a consequence of the decreasing demand for products or services. While providing such disclosures, it may be particularly important to ensure a link between the company's non-financial and financial disclosure. This can be done, for example, by highlighting how the financial performance and position of the company have been impacted for the reporting year and how this can be put into the context of the ability of the company to continue creating value over time.

- ***Risk relating to climate change***

  ESMA encourages companies to explain risks associated with climate change and the related mitigating actions put in place in the context of their business models, environmental policy and any objective and targets that they are pursuing in this area. Disclosures should also be made with regard to opportunities that may arise in connection with climate change. The explanations should serve to contextualise disclosures on the degree to which pre-set targets can be achieved and to explain any uncertainty surrounding them.

Alternative performance measures

ESMA reminds companies of the requirements in its guidelines on APMs, which are aimed at promoting the usefulness and transparency of these measures. ESMA also highlights its guidance released in April 2020 to help companies apply these guidelines in the current environment.

Our comments

Although the topics included in the statement are those deemed by ESMA to be most relevant at a European level, they are of equal relevance to companies in India. Accordingly, companies should aim to provide adequate disclosures in their interim and year-end financial statements on current and potential impacts of COVID-19 on results of operations, liquidity and capital resources. The assessment should be based on both qualitative and quantitative factors affecting business activities, financial situation and economic performance of the company.

Discussion with the board of directors and the audit committee on potential impacts of COVID-19 and risk assessment would help in the preparation of the financial statements. In this regard, companies should refer to the advisory issued by the Securities and Exchange Board of India (SEBI)[3] and technical materials issued by the Institute of Chartered Accountants of India (ICAI)[4].

3. On 20 May 2020, SEBI issued an advisory and encouraged listed companies to evaluate the impact of COVID-19 on their business, performance and financial results, both quantitatively and qualitatively, to the extent possible and disseminate the same.
4. In March 2020, ICAI released an accounting and auditing advisory-' Impact of Coronavirus on Financial Reporting and the Auditors Consideration'. In May 2020, it issued Frequently Asked Questions (FAQs) on the impact of COVID-19 on Indian Accounting Standard (Ind AS).