Beyond the GAAP

Mazars' newsletter on accounting standards

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Editorial

At the end of October, the European Securities and Markets Authority (ESMA) published its common priorities at European level for the 2021 reporting period.

Unsurprisingly, the Authority is drawing entities' attention to the importance of monitoring the impact of the health crisis, which varies according to activity and geography. Equally unsurprisingly, given their high profile at all levels, the link between climate-related topics and financial statements is the latest addition to the year-end recommendations. The climate challenges facing companies, which are leading many to make firm commitments for the future, must therefore be understood in a consistent manner in all an entity's reports and no longer solely in its non-financial reporting.

IFRS highlights

IFRS IC agenda decision on non-refundable VAT on lease payments

The IFRS Interpretations Committee (IFRS IC) had been asked whether or not non-refundable VAT on lease payments, either because of the nature of the leased property or because of the situation of the lessee, forms part of these lease payments.

At its September meeting, the IFRS IC discussed this issue again, particularly in light of the comment letters received following the publication of a tentative agenda decision, and decided not to include this topic in its work plan because there was insufficient evidence that the matter has widespread and significant effect.

The IFRS IC agenda decision, which in consequence contains no analysis, was endorsed by the International Accounting Standards Board (IASB) at its October 2021 meeting, and published as an addendum to September's IFRIC Update (accessible here).

IFRS IC rules on the subsequent accounting treatment of warrants initially classified as financial liabilities

Following approval by the IASB in October, the IFRS IC published its final decision (available here) on the accounting treatment of warrants classified as financial liabilities on initial recognition. The request asked whether the issuer could subsequently reclassify the warrant as an equity instrument.

The warrants in question provided the holder with the right to buy a fixed number of the issuer's equity instruments for a variable exercise price that will be fixed at a future date and remain so for the residual term of the contract. At initial recognition, the issuer classified these instruments as financial liabilities because the variability in the exercise price did not meet the 'fixed-for-fixed condition' (i.e. exchanging a fixed amount of cash for a fixed number of its own equity instruments) for classification in equity under IAS 32.16.

The request asked if it was possible to reclassify the warrant as an equity instrument following the fixing of its exercise price, given that the fixed-for-fixed condition would at that stage be met.

In its decision, the IFRS IC observed that IAS 32 does not address the question of reclassifying financial liabilities as equity instruments after initial recognition when the instrument's contractual terms are unchanged, and that similar questions arise in other circumstances.

Nonetheless, the reclassification of instruments by the issuer has been identified as one of the practical issues the Board will consider addressing in its Financial Instruments with Characteristics of Equity (FICE) project. The Committee therefore proposed it should be considered as part of the FICE project. An exposure draft will be published at a date not yet announced in the IASB's work plan.

Fifth compilation of IFRS IC agenda decisions

On 28 October, the IFRS Foundation published the fifth compilation of IFRS Interpretations Committee (IFRS IC) agenda decisions, taken between April and October 2021. The compilation is available here.

The decisions summarised in this document concern the following standards:

- IFRS 9 – Financial instruments
- IFRS 16 – Leases
- IAS 2 – Inventories
- IAS 10 – Events after the reporting period
- IAS 19 – Employee benefits
- IAS 32 – Financial instruments: presentation

Ongoing IASB deliberations on the presentation of financial statements

During its October meeting, the IASB continued to redeliberate the proposals in the December 2019 exposure draft primarily focusing on the replacement of IAS 1 on the presentation of the financial statements.

The subjects discussed were:

- the classification and presentation of income and expenses from associates and joint ventures in the statement of profit or loss;
- the presentation of operating expenses in the statement of profit or loss and disclosures in the notes;
- the operating profit or loss before depreciation and amortisation as a specified subtotal in the statement of profit or loss.

Classification and presentation of income and expenses from associates and joint ventures in the statement of profit or loss

Readers will remember that the December 2019 exposure draft proposed that the share of profit or loss of integral associates and joint ventures would be presented below operating profit as defined by the IASB in the draft text, in connection with the new "operating" category in the income statement. The share of profit of non-integral associates and joint ventures would be presented in profit before financing and tax, in the "investing" category. IFRS 12 would need to be amended to provide guidance for distinguishing between 'integral' and 'non-integral' entities.

This distinction, along with the classification in the statement of profit or loss of income and expenses of entities accounted for under the equity method, was by no means unanimously supported, as an analysis of the comment letters received by the IASB showed (see Beyond the GAAP no 150 of December 2020).

October's redeliberations arrived at the following tentative decisions (taken unanimously):

- confirmation of the proposal to require an entity to classify income and expenses from equity-accounted associates and joint ventures outside the operating category;
- withdrawal of the proposal to require an entity to present the subtotal 'operating profit or loss and income and expenses from integral associates and joint ventures'.
- withdrawal of the proposal to require an entity to identify and present income and expenses from integral associates and joint ventures separately from income and expenses from non-integral associates and joint ventures.

By a very narrow majority (the President having used his additional casting vote) the IASB also tentatively decided that income and expenses from equity-accounted associates and joint ventures would be presented after the new mandatory subtotal for operating profit and before the new mandatory subtotal for profit before financing and income tax. However, the IASB deferred a decision on whether to include such income and expenses in the investing category until such time as it has considered the definition of the investing category. While profit before financing and income tax should include both the operating and investing categories of the income statement and the single line of income and expenses from equity-accounted entities, there is therefore still uncertainty as to the level of the income statement at which this line will be presented.

Presentation of operating expenses in the statement of profit or loss and disclosure in the notes

In terms of the aggregation and disaggregation of information, the December 2019 exposure draft proposed:

- to prohibit a "mixed" presentation of operating expenses in the statement of profit or loss (i.e. broken down by both nature and function). The presentation either by nature or by function would not be a free choice for issuers but should be made in the light of a set of factors to be proposed by the IASB;
- an entity opting for a presentation by function would also be required to disclose a disaggregation of its operating expenses by nature in the notes. The level of detail of this information would no longer be left to the entity's discretion, as currently authorised by IAS 1, since the exposure draft calls for a complete analysis by nature of all operational expenses (but without requiring a "matrix" approach to operating expenses).

Here again, the IASB's proposals were far from unanimously welcomed, with a fairly marked contrast between users of financial statements, who were generally in favour of the proposals, and preparers, who were generally opposed.

On these sensitive issues, the IASB has essentially set the stage for future decisions by deciding to explore:

- retaining the proposal to require an entity to analyse and present operating expenses in the statement of profit or loss based on their nature or function;

- withdrawing the proposed prohibition on a mixed presentation, instead providing application guidance in order to improve comparability and help achieving faithful representation; and
- retaining the proposal to provide application guidance which entities could use to determine which presentation method would provide the most useful information (but modifying that guidance as a consequence of withdrawing the proposal to prohibit a mixed presentation).

The IASB also tentatively decided, where an entity presents operating expenses by function:

- to explore the possibility of supplementing the exposure draft by providing specific application guidance on how to combine and allocate operating expense in the income statement by the 'function of expense' method in order to allocate these expenses to the different functions identified;
- not to develop a definition of the item 'cost of sales' (though this is a separate line to be presented in the income statement, if this method of presenting operating expense is adopted);
- to explore providing application guidance to explain that, as a minimum, cost of sales would include inventory expense (if applicable), calculated in accordance with IAS 2.

While the IASB tentatively decided not to explore providing partial cost relief for the disclosure of information about operating expenses by nature when an entity presents an analysis by function in the statement of profit or loss, the Board deferred a decision on the exact extent of information to be provided under these circumstances, pending detailed analysis of feedback.

Operating profit or loss before depreciation and amortisation

As a reminder, in the December 2019 Exposure Draft the IASB had identified specific non-mandatory income statement subtotals that are not management performance measures (MPMs) (see the discussions of this subject reported in Beyond the GAAP no. 153, 156 and 158, of March, June and September 2021 respectively). The operating profit or loss before depreciation and amortisation was hence identified as a 'specified subtotal'. In addition, the IASB had indicated in its call for comments that it was not proposing a definition of EBITDA ("earnings before interest, tax, depreciation and amortisation"), which is nevertheless frequently used in entities' financial reporting. In practice, in some situations, and depending on an entity's definition of EBITDA, the 'operating profit before depreciation and amortisation' subtotal could be equal to EBITDA, in which case EBITDA would not be a MPM. In other cases, these two subtotals in the statement of profit or loss could be different.

At the October meeting, the IASB tentatively decided to change the wording and therefore the interpretation of the specified subtotal presented above and initially proposed in the exposure draft, by excluding from this subtotal impairments of assets within the scope of IAS 36. This specified subtotal would therefore be known as 'operating profit or loss before depreciation, amortisation, and specified impairments'.

The IASB also tentatively decided not explicitly to prohibit the use of 'EBITDA' as a label for this subtotal as now defined, but to explain in the Basis for Conclusions that such a label would rarely be a faithful representation of the subtotal. Finally, the IASB would include no further specific requirements in relation to this subtotal.

The Board will continue to redeliberate the project proposals in the coming months.

European highlights

EFRAG questionnaire for preparers to get feedback on a new approach to developing disclosure requirements

On 7 October, the European Financial Reporting Advisory Group (EFRAG) posted a questionnaire on its website inviting preparers to provide feedback on the IASB's proposed new approach to developing disclosure requirements as set out in the exposure draft published last March and entitled "*Disclosure Requirements in IFRS Standards - A Pilot Approach (Proposed amendments to IFRS 13 and IAS 19)*" (see Beyond the GAAP no 153 March 2021).

EFRAG is targeting small and medium entities, but also welcomes replies from large entities.

The first part of the questionnaire deals with the general approach that the IASB would expect to use when drafting IFRS standards, while the second part deals with proposed amendments to IFRS 13 - Fair Value Measurement and IAS 19 - Employee Benefits, resulting from the practical application of the IASB's proposed new disclosure standardisation approach to these two standards.

This questionnaire, accessible here, is available for completion until 20 November 2021.

ESMA: appointment of Verena Ross as Chair

On 15 October, the Council of the European Union confirmed the appointment of Mrs Verena Ross as Chair of the EU's securities markets regulator ESMA (press release available here).

Appointed for a five-year term, renewable once, Mrs Ross officially took over from Steven Maijoor on 1 November, following Mrs Anneli Tuominen who acted as Interim Chair for a period of seven months. A German national, Mrs Ross was Executive Director at ESMA from 2011 to 2021.

The appointment comes a few days after ESMA announced its 2022 work programme, setting out its priorities for the next 12 months (available here). The coming year will see ESMA undertake an ambitious programme of work to meet the challenges facing the European Union, its capital markets and its citizens. In particular, ESMA will work to promote sustainable finance and long-term markets.

COVID-19: June 2021 update to the study presenting credit loss impacts on European banks

Follow our study of 31 December last (see Beyond the GAAP no. 155 of May 2021), you can consult an update as of 30 June 2021 here.

This is based on the half-yearly reports published by the same sample of 26 European banks.

As before, the main aim of this update is to identify the general trends within the sample, broken down my geographical area where relevant.

The main findings to highlight for the first half of 2021 are as follows:

- An average decrease in the cost of risk (i.e. the impact of expected credit losses on P&L observed by banks) by 86%. UK and Irish banks have actually recorded an ECL profit.
- Most of the banks that experienced the highest increase in ECL charges last year are now among those with a net ECL profit in the first half of 2021;
- The average amortised cost loan coverage ratio has fallen slightly, mainly due to a lower coverage ratio for stage 3 instruments;
- 18 banks have published their post-model adjustments at both 30 June 2021 and 31 December 2020, where a post-model adjustment (or management overlay) is defined as an incremental adjustment of the ECL derived from IFRS 9 models. On this basis, the study highlights the increasing weight of post-model adjustments at 30 June 2021 compared with 31 December 2020: the cumulative adjustments at 30 June 2021 represented 18% of the ECL stock on the balance sheet at that date, while the cumulative adjustments at 31 December 2020 represented 15% of the ECL stock on the balance sheet at 31 December 2020.

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IASB Request for Information for the post-implementation review of IFRS 9 – classification and measurement

Background

IFRS 9 on financial instruments came into force in 2018, after a development process in three successive phases, the first being classification and measurement and the second and third addressing the provisioning of assets and hedge accounting respectively.

In September 2021, in accordance with its governance process that requires it to conduct a Post-Implementation Review (PIR) after a standard has been implemented for at least two years, the IASB issued a Request For Information (RFI, available here).

This relates to the first phase of the IFRS 9 PIR, which focuses on the classification and measurement section of the standard. The PIR phases relating to impairment and hedge accounting requirements will be carried out at a later date.

This process allows the IASB to assess the impact of the implementation of a recently issued standard on the various stakeholders (preparers, users, auditors, regulators) and to determine whether:

- the objectives of the standard-setting project have been met;
- information provided by the standard is useful to users of financial statements;
- the costs associated with applying the standard are as expected by the various stakeholders;
- the standard can be applied consistently by entities.

This process is also an opportunity to draw lessons that could result in future amendments to IFRS 9.

The IFRS 9 RFI represents a first step. Subsequent steps will consist of:

- an analysis of the feedback (leading to the publication of a summary of findings in a “report and feedback statement”);
- proposals, where applicable, for amendments to the standard, or for educational materials to make it easier to apply.

Abbreviations used

In this study, we use the following abbreviations:

- SPPI: Solely Payments of Principal and Interest. This is the criterion that characterises a basic lending instrument whose contractual flows correspond solely to payments of principal and interest;
- HTC: Held to Collect and HTCS: Held to Collect and Sell, representing the two main business models described by the standard for debt assets, corresponding respectively to a strategy of holding the assets on over the life of the instrument for the purpose of collecting contractual flows, and a combined strategy of holding and selling these assets;
- CLI: Contractually Linked Instruments. This is a category of financial assets defined by the standard (IFRS 9.B4.1.20). These are instruments usually issued by a special purpose vehicle and backed by financial assets held by the

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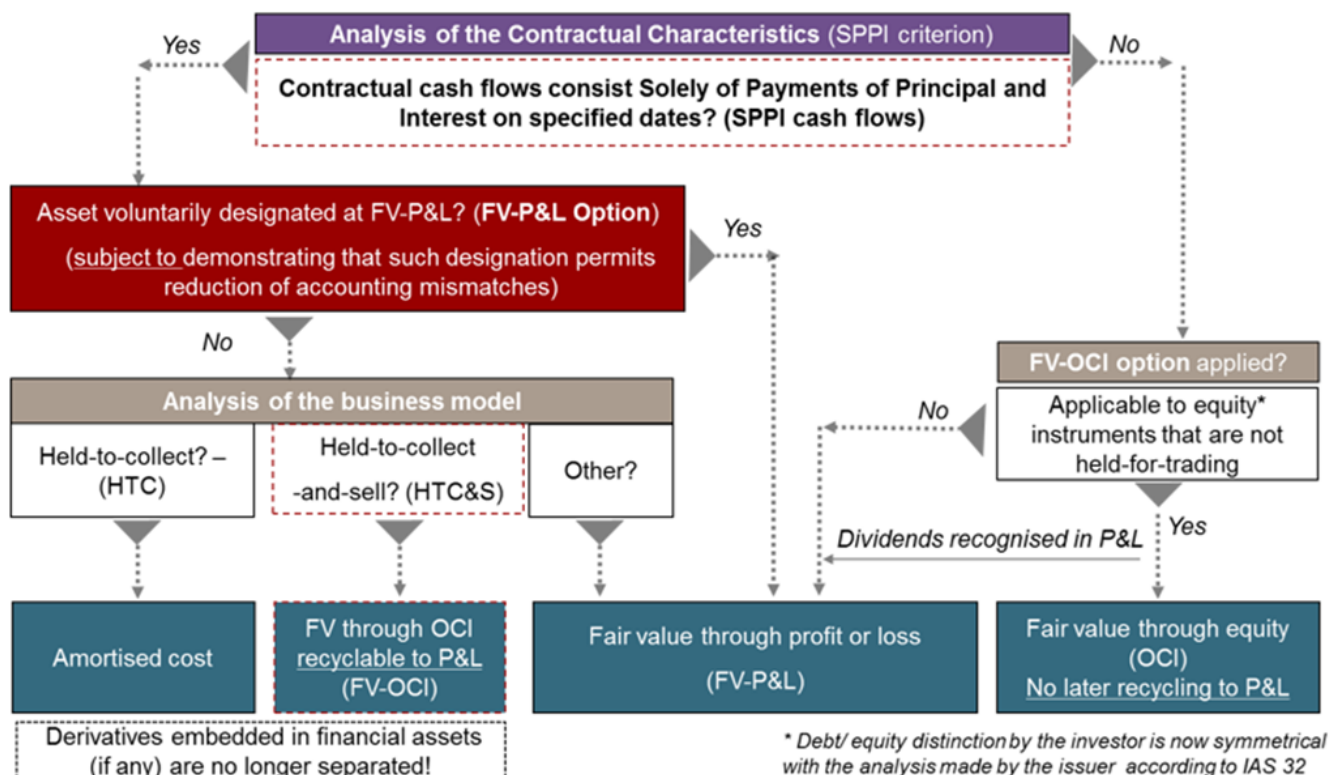
vehicle. The operation of the vehicle is based on the principle of allocating payments to the various liability tranches in an order of priority according to their respective subordination rankings.

IFRS 9 approach to the measurement of financial assets

As a reminder IFRS 9 articulates its measurement model for financial assets on two building blocks:

- the contractual cash flows of the financial instrument, leading to its classification as an equity instrument, SPPI debt instrument or non-SPPI debt instrument;
- the business model: HTC, HTCS, or "other".

This results in four categories: amortised cost, fair value through equity with recycling to P&L (FV-OCI), fair value through profit or loss (FV-PL) and fair value through equity without recycling to P&L (FV-OCI/NR), as summarised in the following decision tree:



After consultation with the stakeholders, the RFI identifies seven topics for analysis by respondents (questions 2-8):

i) the business model for managing financial assets;

(ii) the contractual cash flow characteristics of debt instruments (SPPI test);

iii) the accounting treatment of equity instruments;

iv) accounting for own credit risk on financial liabilities designated at fair value by option;

v) accounting for modifications to contractual cash flows of debt instruments;

vi) practical implementation of the effective interest method;

vii) transitional reliefs available when first applying the standard.

Other questions relate to the relevance of the overall approach to the classification of financial assets (question 1) and whether there are other matters of interest deserving comment that have not been identified by the RFI (question 9).

Without attempting to be exhaustive, we will consider each of these seven topics in more detail, together with the main issues raised by the Board.

i) The business model for managing financial assets

Background: the standard identifies three potential business models for management of cash flows: HTC, HTCS and "other", which is the default category covering trading activities. The identification of each of these models is based on an objective assessment of the activity, carried out at a sufficiently high level of aggregation and not dependent on any management intention.

The objective criteria for determining the business model include how the entity's risks and performance are evaluated and reported to management (e.g. on a fair value basis), and how managers of the business are compensated. Consequently, changes in the business model are rare, and can only be justified by the occurrence of a significant event, such as the sale or acquisition of a business.

Issue raised: the Board would like to understand in which situations and how frequently the business model has changed, and more generally if the requirements for changing a business model have been correctly calibrated in terms of how they affect the relevance of financial reporting and its comparability over time.

(ii) The contractual cash flow characteristics of debt instruments

Background: If a debt instrument has SPPI cash flows, how it is classified between the different accounting categories will depend on the business model under which it is held. The debt instruments eligible as SPPI under the standard are "basic" instruments, i.e. those whose cash flows essentially remunerate the issuer's credit risk and the time value of money, to which may be added liquidity risk, compensation for administrative management costs, or a pure margin component.

Issue raised: the Board highlights two areas:

- **green finance instruments**, or economically responsible finance (in conjunction with environmental, social and governance targets (ESG)). The Board distinguishes three categories of green finance:
    - loans or bonds which finance ESG projects, but which do not

  - give rise to variability in the contractual cash flows which may be linked to these factors;
  - structured instruments whose performance is linked to an ESG index that is not specific to a party to the contract;
  - financial instruments whose contractual cash flows may vary reflecting performance criteria linked to ESG targets specific to the borrower. For this category, the Board hopes to obtain more information on the various types of clauses encountered and on the SPPI analysis conducted by stakeholders, particularly in terms of their correlation with credit risk, profit margin or the remuneration of another risk specific to the borrower.
- **CLI:** the standard allows a contractually linked instrument with a basic cash flow profile to qualify as SPPI if the underlying assets are themselves SPPI or similar and the credit risk associated with the instrument is equivalent to or better than the average credit risk of the underlying portfolio. The Board would like to understand the fact patterns encountered and the analysis applied to them, as well as any complexities in terms of practical application, in order to determine whether it is necessary to supplement or amend the standard.

iii) The accounting treatment of equity instruments

Background: The standard requires equity instruments to be measured at fair value and, by default, remeasured through profit or loss (JV-PL), but entities may make an irrevocable election, on an individual basis and at initial recognition, to present in OCI changes in the value of an equity instrument not held for trading (JV-OCI/NR).

Issue raised: the Board would like to identify the type of instruments that entities have presented in JV-OCI/NR, and to better understand how the requirements for this new accounting category, including the absence of recycling in P&L of accumulated performance in OCI, have been taken into account by entities when deciding whether to use this category, or may even have influenced investment decisions.

iv) Accounting for own credit risk on financial liabilities designated at fair value by option

Background: the standard requires these financial liabilities to be remeasured:

- in profit or loss for all components except the own credit risk component;
- in other comprehensive income/OCI without recycling for the own credit risk component, in order to limit the counterintuitive effects of remeasuring changes in the entity's own credit risk through profit or loss. However, this measurement method does not apply to financial liabilities that are remeasured through profit or loss due to a held-for-trading business model.

Issue raised: the Board would like to determine whether this mechanism captures the appropriate population of financial liabilities and if the disclosures on this subject are appropriate.

v) Accounting for modifications to contractual cash flows of debt instruments

Background: the standard requires that when there is a modification in the contractual cash flows of a debt instrument held or issued that does not lead to derecognition, its value is adjusted in profit or loss by discounting the new post-modification cash flows at the instrument's original effective interest rate. In the specific case of financial liabilities, the standard includes additional qualitative and quantitative criteria to determine whether the modification in contractual cash flows is sufficiently substantial to result in derecognition of the instrument. When considering the effects of interest rate benchmark reform, the Board also had to examine the notion of modification in a situation where, without any modification of the contractual terms of the instrument, the bases for calculating an index used to determine the contractual flows had changed.

Issue raised: the Board would like to understand how the provisions on the modification of financial assets (absent from the pre-existing standard IAS 39) and those on the modification of financial liabilities have been applied. The IASB also hopes to determine whether these provisions can be applied consistently and result in useful information for users of financial statements.

vi) Practical implementation of effective interest method (EIR)

Background: this method is used to calculate the amortised cost of a debt instrument issued or held, and in the allocation of the interest income or interest expense in profit or loss over time, based on the estimated cash flows of the instrument over its expected life. If the estimated cash flows are revised, the standard requires either:

- a 'catch-up adjustment' to the balance sheet value through profit or loss; or
- a prospective adjustment of the EIR, without immediate impact in profit or loss.

Issue raised: the Board would like to better understand how the scope of each of these two accounting treatments for revised estimates is determined in practice, particularly when those revisions are related to changes in the likelihood of meeting the conditions of the original estimates. This question arose recently concerning:

- compliance with the conditions under which banks grant loans as required by the European Central Bank (ECB) through the TLTRO III refinancing program;
- the fulfilment of ESG criteria included when determining the level of the amounts due on certain banking arrangements.

vii) Transitional reliefs available when the standard

Background: IFRS 9 allowed entities to use some reliefs transitional to address difficulties in retrospective application of the standard, including:

- waiving the requirement to present restated comparative information on initial application;
- allowing entities to use the effective date of the standard, rather than the initial recognition date of the instruments, for the application of some of the new provisions introduced by the standard, such as the determination of business

model, or assessing whether an instrument met the criteria for designation under the fair value through profit or loss option.

At the same time, the standard required entities to disclose sufficient information in the notes to the financial statements to estimate the impact of the transition from the pre-existing IAS 39 to the new standard.

Issue raised: in order to draw lessons for the development of future standards, the Board would like to ensure that the transitional arrangements have indeed simplified the task of preparers, while preserving the quality of information for users.

The deadline for submitting replies to the RFI is **28 January 2022.**

Key points to remember

- In September 2021, the IASB issued a Request For Information (RFI) for the first phase of the post-implementation review of IFRS 9 (PIR), which focuses on the classification and measurement section of the standard. The IFRS 9 PIR phases relating to impairment and hedge accounting requirements will be carried out at a later date.
- This process allows the IASB to assess the impact of the implementation of a recently issued standard on the various stakeholders, and to determine whether the objectives of the standard have been achieved and whether entities apply the standard consistently.
- After consultation with the stakeholders, the IASB has identified seven topics for analysis by respondents:
    - the business model for managing financial assets;
    - the contractual cash flow characteristics of debt instruments (SPPI test);
    - the accounting treatment of equity instruments;
    - accounting for own credit risk on financial liabilities designated at fair value by option;
    - accounting for modifications to contractual cash flows of debt instruments;
    - practical implementation of the effective interest method; and
    - transitional reliefs available when first applying the standard.
- The RFI is only the first step, and depending on the feedback received it could be followed by proposals f to amend the standard, or by educational materials to make it easier to apply.
- The deadline for submitting replies to the RFI is 28 January 2022.

ESMA recommendations for the 2021 annual financial reports

On 29 October, the European Securities and Markets Authority (ESMA) published its European common enforcement priorities for the 2021 annual financial reports. ESMA emphasises the importance of taking account of these recommendations when management and supervisory bodies undertake their respective responsibilities in relation to the 2021 annual financial reports and when discussing them with their auditors.

Observing that the links between **environmental risks** and the financial statements will be of increasing importance in the coming years, ESMA's annual recommendations **focus on the inclusion of these risks in financial reports** in order to bring this key issue to the attention of preparers and their auditors. This is probably just a start, as the work and the analysis are complex and evolving.

In addition, the health crisis continued to have its impact on the 2021 financial year, no doubt in a way that varied across sectors and geographies. The COVID-19 crisis could still have had a profound impact in some cases. In this environment of persistent uncertainty, and faced with very different situations depending on the company, it is no surprise that **monitoring the financial impacts of the pandemic** has once again been included in the common priorities for the 2021 annual financial reports.

On the subject of electronic reporting, and again as a reminder, an optional one-year deferral was granted to companies at the end of 2020 to allow them to apply the ESEF (European Single Electronic Format) on a mandatory basis only as of financial years beginning after 1 January 2021. The publication of the **first annual financial reports in XHTML format** is now mandatory for companies listed on a regulated market and is subject to the European Transparency Directive. The regulator recalls the existence of dedicated areas on its website addressing all the issues related to this obligation and draws attention to practical application difficulties (e.g. file format when filing, use of negative and positive values when tagging, etc.).

The European common enforcement priorities also include a section on **non-financial statements.** These recommendations on the non-financial aspects of the annual report mainly focus on environmental issues, monitoring the impacts of the COVID-19 pandemic and the June 2020 taxonomy regulations, and the associated reporting obligations.

This study will summarise ESMA’s main recommendations that relate solely to financial statements under IFRS.

All ESMA’s 2021 European common enforcement priorities can be found here.

Assessment and description of the financial impacts of environmental risks

Against a background of increased stakeholder attention to climate change risks and the consequent heightened expectations in terms of financial statement disclosure, ESMA observes that the level of disclosure should be appropriate to the challenges and materiality of climate change. In this context, the authority urges entities to consult the educational resource published by the IASB in 2017 and entitled *IFRS Practice Statement 2: Making Materiality Judgements,* which may help them to estimate materiality. This document clarifies that a materiality analysis has both quantitative and qualitative aspects, but

also emphasises that in some cases, **a subject may influence users of financial statements simply by its nature, regardless of its magnitude.** This is the case for the subjects closely scrutinised by users of the financial statements independently of the amounts represented, and applies to the financial impacts of environmental risks.

Work to be carried out and link between financial and non-financial information

All entities – however they are impacted by climate issues – are encouraged to **identify the impacts** on their financial performance and their financial statements **of both climate change and the measures and commitments introduced** in response to these changes. Given the global nature of these issues and the regular regulatory changes, the work of identifying the impacts requires the involvement of all the departments concerned, as well as governance bodies and the statutory auditors.

Finally, ESMA stresses the **importance and the need to ensure consistency and connectivity between the information given in the financial statements and that given in other financial reports** such as the management report, including the statement of non-financial performance, or the risk factors. The need for consistency is all the greater for entities that are already committed to carbon neutrality within a given time frame, or to alignment with the objectives of the Paris Agreement or the European climate law.

Financial information to be provided: general principles

While IFRS standards do not specifically address the accounting consequences of environmental risks, the regulator points out that **their effects on the financial statements must be taken into account when preparing the accounts**, in accordance with the general provisions of the standards.

In particular, IAS 1 contains provisions on the content of the notes to the financial statements, including:

- providing disclosures which are not presented elsewhere in the financial statements, but which are relevant for understanding them. This information supplements the information required by the other IFRSs (IAS 1.112 (c));
- disclosing the main judgments that management has made in the process of applying accounting policies, and which have the most significant effect on the financial statements (IAS 1.122);
- providing disclosures on the assumptions that management makes about the future, and other major sources of estimation uncertainty at the reporting date (IAS 1.125).

Consistently with the requirements of IAS 1, ESMA recommends that all entities disclose in the financial statements **the major sources of uncertainty and the judgments made in relation to climate risks**, ensuring that these assumptions are consistent with the information presented in other financial reporting. Furthermore, issuers should also clearly explain why apparently significant climate-related risks for which they already made some commitments, have not had a material impact on the financial statements.

Finally, to enhance the readability and clarity of the financial statements, and to facilitate access to information increasingly expected by users, entities are encouraged to **group the information related to the**

financial impacts of environmental issues in a single note, or to **use cross-references** to link the different notes dealing with this subject.

Particular points of analysis and information to be presented in the financial statements

ESMA draws issuers' attention to the fact that, in November 2020, the IASB published educational material entitled *Effects of climate-related matters on financial statements* illustrating the potential impacts of climate issues, standard by standard. Entities are urged to take this educational material into account when assessing the potential impacts and risks of climate change in their financial statements.

A special point of attention concerns the **useful lives and the estimated residual values of non-financial assets.** These may be affected by environmental issues which could, for example, make some assets obsolete or restrict their access through new regulations. In addition, to determine whether there is an indication that an asset may be impaired, IAS 36 (IAS 36.12) requires **consideration of significant changes in the environment** (technological, economic, legal or market) that have **an adverse effect on the entity** during the period, or in the near future.

Companies that are likely to be significantly impacted are recommended to take climate issues into account to **analyse whether there is a need to revise the useful lives** of non-financial assets, and to **determine whether there is any indication of impairment** related to these issues, or to climate-related commitments that have been made. Where indicated, additional testing must be carried out.

When performing these impairment tests, ESMA invites entities to **ensure that the risks and impacts related to environmental issues are taken into account in the underlying key assumptions**, and to specify how this has been done (business plans, growth rates, discount rates) where applicable. For example, climate risks may impact on long-term growth targets through a declining market.

The authority also draws attention to the **relevance of performing sensitivity analyses on the basis of new climate risk variables.** This could be achieved, for example, by introducing new variables such as a slippage of key deadlines in the climate strategy pursued.

Issuers are also urged to be transparent when financing or investing in **"green" financial instruments**: a description of their main characteristics and the accounting treatment applied is expected (pending clarifications that may be provided following the post-implementation review of IFRS 9).

Turning to **emission rights linked to pollutant emission plans** (such as greenhouse gas emission quotas or energy efficiency certificates), IFRS standards do not specifically address these issues. The regulator therefore recommends that companies that are significantly affected should indicate the accounting treatment used and the amounts involved in the notes to the financial statements.

Finally, ESMA draws issuers' attention to the application of IAS 37: **climate issues and related regulatory developments could give rise to provisions or contingent liabilities**, for example, due to new taxes imposed by governments in the event of non-compliance with certain climate-related targets, or the need to restructure certain activities to meet new environmental targets.

Monitoring the impacts of COVID-19

As the pandemic continues through 2021, ESMA recalls that **the messages set out in its 2020 annual recommendations are still relevant.**

Impairment tests

Once again, the regulator highlights the importance of impairment tests in its recommendations for the 2021 financial statements.

ESMA reminds entities of the IFRS requirements that could affect companies that have returned to growth and where the question of reversing certain previously recognised impairments may arise. It emphasises that an impairment loss can be reversed **if, and only if, there has been a change in the estimates used** to determine the recoverable amount of the asset since the last impairment loss was recognised (IAS 36.114). Moreover, **impairment cannot be reversed solely because of the passage of time** (which increases the present value of future cash flows as they approach (IAS 36.116)).

In addition to the general transparency expected in the description of the judgements, estimates and assumptions made and how they may have changed, ESMA again stresses the importance of **explaining the changes in the key assumptions underlying impairment tests**, particularly operational assumptions, since the last test was performed.

Finally, ESMA calls for **transparency on the criteria and assumptions underlying the recognition of deferred tax assets** arising from the carry forward of tax losses and tax credits due to the COVID19 pandemic. It therefore urges issuers to consult the Public Statement it published in July 2019 setting out its expectations regarding recognition, measurement and disclosure.

Liquidity risk management, cash flows and finance operations

The authority again calls for **transparency** regarding key judgements on going concern, leverage and liquidity risk, but also on cash equivalents and the comments on the cash flow statement. This is because t**his information continues to be important** in light of the ongoing crisis and the resulting increased liquidity risk.

In the case of going concern, ESMA draws attention to the educational material published by the IASB in January 2021 and entitled *Going concern, a focus on disclosure*, which it encourages companies to consult. It also highlights two aspects of this guidance:

- the 12 months from the end of the reporting period is the **minimum period** over which going concern assumptions should be assessed. Therefore, if relevant to an entity, going concern may need to be assessed beyond the 12 months period;
- information about an entity's judgements must be disclosed if there were significant doubts about its ability to continue as a going concern for at least 12 months after the reporting date. These disclosures are expected, **even if the analysis finally concluded that these uncertainties were not significant.**

Factoring and reverse factoring

The health and economic crisis has led to an increase in the number of factoring and reverse factoring transactions as companies have sought liquidity and/or ways to optimise their cash flow.

When companies are significantly involved in this type of transaction, ESMA highlights the **need for transparency in the information provided**, which must include: a **description of the transactions** (context, reasons, characteristics, and conditions), the **accounting treatment** (in particular, classification in the statement of financial position and in the statement of cash flows) and the **analysis** underlying this treatment.

In the special case of reverse factoring arrangements, ESMA draws attention to the IFRS IC decision *Supply Chain Financing Arrangements – Reverse factoring*, published in December 2020. This clarifies which IFRS requirements apply to these transactions in terms of disclosures and presentation in the statement of financial position and the cash flow statement. Entities are also reminded of the importance of **distinct presentation in the statement of financial position** if the impacts are significant.

Government grants and assistance

Companies that are significantly affected by aid schemes and other government measures are recommended to **indicate, by category of aid received** (loans, tax relief, etc.):

- the nature and the main characteristics of the aid received;
- the accounting policy adopted, including classification in the statement of financial position and the income statement; and
- the amounts involved, including in the cash flow statement.

Finally, ESMA expects issuers to **make a link between the information reported on government grants and measures and the disclosures of liquidity risk and going concern assumptions.** The expected evolution of the aid from which the company has benefited (expected duration, reimbursement, capping conditions, etc.), and the related uncertainties, indicating the expected growth drivers, can provide relevant information for readers.

Credit institutions

The following recommendations supplement and/or clarify the 2020 recommendations in relation to credit risk and related disclosures in the financial statements (available here).

IFRS 9 impairments: in-model and post-model adjustments

In response to the health crisis, banks have changed their IFRS 9 expected credit loss models both by modifying certain parameters and/or assumptions (in-model adjustments) and by applying adjustments outside the models (post-model adjustments).

Each type of material adjustment, whether in-model or post-model, should be disclosed in a manner that provides an understanding of the extent of the adjustment, the rationale (e.g. to address model limitations), the change from the previous year, the methodology applied including adjustments to inputs and assumptions, and the classification stages involved (i.e. stage 1, 2 or 3 of the expected credit loss model under IFRS 9)

These disclosures should be provided at an appropriate level of granularity, for example by indicating the exposures to which the adjustments relate, grouping them by type of products, economic sectors or geographic areas.

IFRS 9 impairments: forward-looking information

ESMA welcomes the enhancement of the banks' disclosures in relation to the forward-looking aspects required by IFRS 7.35G(b).

Nevertheless, in line with the 2020 recommendations, it calls on banks to continue their commitment to transparency.

ESMA encourages 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.

It also recommends that credit institutions disclose quantitative information on the macroeconomic variables considered for each scenario detailed by main geographical areas and/or sectors.

Finally, it emphasises the importance of providing sufficiently granular disclosures on the sensitivity analyses (e.g. regarding each scenario) to enable readers to understand the quantitative impact of this analysis on the ECL and, where appropriate, on staging.

IFRS 9 Impairments: significant increase in credit risk

ESMA recommends banks to expand the quantitative and qualitative disclosures required by IFRS 7.35F and 35G on the assessment of significant increase in credit risk. To do so, it recommends providing information on the probability of default triggers (broken down by portfolio if significant differences exist), explaining the length of the "cure" period before re-transfer between each stage by major type of instrument, detailing the approach and criteria used to group financial instruments in the case of a collective approach, and indicating how macroeconomic scenarios are taken into account in assessing the significant deterioration in credit risk since origin.

More specifically in relation to the health crisis, ESMA recommends indicating the possible impacts of government measures on staging (significant judgements used, recent late payment trends observed, new types of indicators, level of assessment i.e. counterparty/sector/type of financial instrument etc). More generally, ESMA recalls that any material changes in the assessment of significant increase in credit risk or as to whether a financial asset is credit-impaired must be explained.

Finally, on the application of the low credit risk expedient, ESMA recommends issuers to disclose the qualitative and quantitative criteria used to define its scope and the portfolios and/or transactions concerned.

Credit quality

ESMA recommends that issuers present quantitative credit risk information, i.e. exposures and expected losses, broken down by stage and in a sufficiently granular manner to assess its quality and allow the reader to identify areas of risk concentration. Thus, ESMA recommends that sufficiently fine-grained default probability categories be used, especially for the highest risk categories. This quantitative information will be accompanied by comments on significant variations.

For the tabular reconciliation of expected credit loss movements over the period, ESMA recommends that it should be disaggregated by instrument typologies with similar risk profiles, while presenting funding and guarantee commitments separately. ESMA encourages the joint presentation of exposures with expected credit losses, noting that IFRS 7.35I requires explanations of how significant

changes in the exposures contributed to changes in expected credit losses.

Effect of climate-related risk on the expected credit loss measurement

ESMA expects entities to disclose, where relevant, how they take account of climate-related and environmental risks in credit risk management, including information about the related significant judgements and estimation uncertainties. When these risks are incorporated in the calculation of expected credit losses, ESMA recommends them to clarify how these risks were taken into account, the amount of exposures concerned, their level of concentration regarding those climate-related risks and the impacts recognised in the financial statements.

Key points to remember

- As expected, ESMA's recommendations for the 2021 annual financial reports place great emphasis on the inclusion of environmental issues in financial statements, a fast-evolving topic attracting increased attention from stakeholders.
- While the impacts may vary, particularly from one business sector to another, all entities are encouraged to begin work now to identify the impacts of climate change on their financial performance and financial statements. This work will undoubtedly be extended over the coming years.
- It is also essential to ensure consistency and connectivity between the information given in the financial statements and that given in other company reports, such as the statement of non-financial performance.
- Although IFRSs do not specifically address climate change issues, they do allow some impacts to be reflected in the accounts, for example as a result of changes in environmental regulations or decisions taken as part of a transition plan towards a climate-neutral business.
- Given the ongoing impact of the pandemic through 2021, ESMA observes that the messages set out in its previous annual recommendations are still relevant.
- However, certain topics are the subject of specific recommendations for this reporting period:
    - impairment testing of non-financial assets,
    - going concern and liquidity risk management issues,
    - accounting for factoring and reverse factoring transactions, and
    - accounting for government grants and measures.

Key points to remember

For the credit risk of financial institutions:

- IFRS 9 impairments: in-model and post-model adjustments:

  The information disclosed on each type of material adjustment should be disaggregated by financial instrument, exposure, economic sector and/or geographical area, in a manner that provides an understanding of the extent of the adjustment, its rationale (e.g. to address model limitations), its change from the previous year, the methodology applied, and the classification stages involved.

- IFRS 9 impairments: forward-looking information

  ESMA encourages the banks to provide detailed information on the definition of scenarios and the determination of their weighting, the changes that occurred over the period, and the macroeconomic assumptions used for each scenario broken down by sector and geographical area. It is also required to present sensitivity analyses at a sufficient level of granularity.

- IFRS 9 impairments: significant increase in credit risk

  ESMA recommends that the required quantitative and qualitative disclosures be expanded, for example by detailing the deterioration thresholds for probability of default and the approach and criteria used to group financial instruments in the case of a collective approach, and by indicating the possible impact of government measures on staging.

- Credit quality

  ESMA recommends that quantitative information be presented at a sufficiently fine level of disaggregation to show areas of credit risk concentration, including within each stage of classification of exposures. This quantitative information will be accompanied by comments on significant variations.

  For the tabular reconciliation of expected credit loss movements over the period, ESMA recommends that it should be disaggregated by instrument typologies with similar risk profiles, while presenting funding and guarantee commitments separately.

- Effect of climate-related risk on the expected credit loss measurement

  Where relevant, credit institutions will explain how they take climate-related and environmental risks into account in credit risk management, in the related significant judgements and estimation uncertainties, including in the calculation of expected credit losses.

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[1] Where permitted under applicable country laws

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