Beyond the GAAP

Mazars' newsletter on accounting standards

Contents

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Editorial

Since the beginning, our mission for Beyond the GAAP has been to keep you informed of accounting developments and to provide clarification and insight, in an environment where changes to accounting frameworks and regulators' activities require constant vigilance from businesses and their auditors.

The launch of our new brand provides an opportunity for us to renew our commitment to this mission, as we present the new visual identity for Mazars and Beyond the GAAP. We are proud of our wide readership and will continue to apply our expertise and analysis to shed light on accounting news.

This month, Beyond the GAAP helps to elucidate the key recommendations from the European regulator for 2020 annual financial reporting. Unsurprisingly, the key messages once again relate to the quality of financial information during the ongoing public health and economic crisis.

IFRS highlights

Third compilation of IFRS IC agenda decisions published

On 14 October, the IFRS Foundation published the third compilation of IFRS Interpretations Committee (IFRS IC) agenda decisions, published between April 2020 and September 2020.

They cover the following topics:

- IFRS 16 – *Leases*: "Sale and Leaseback with Variable Payments" (cf. Beyond the GAAP no. 145, June 2020);
- IAS 12 – *Income Taxes*: "Multiple Tax Consequences of Recovering an Asset" and "Deferred Tax related to an Investment in a Subsidiary" (cf. Beyond the GAAP no. 145, June 2020);
- IAS 38 – *Intangible Assets*: "Player Transfer Payments" (cf. Beyond the GAAP no. 145, June 2020).

The document is available on the IASB's website here.

IASB reaches tentative decisions on proposed amendments to IAS 12, "Deferred Tax related to Assets and Liabilities arising from a Single Transaction"

As a reminder (cf. Beyond the GAAP no. 135, July-August 2019), the IASB publicshed an exposure draft (ED) of proposed amendments to IAS 12 – *Income Taxes* in July 2019. The ED aimed to clarify the accounting treatment of deferred tax related to assets and liabilities arising from a single transaction (as in the case of leases under IFRS 16 or decommissioning obligations).

The proposed amendments were intended to establish a general principle for the accounting treatment of deferred tax related to leases, and thus to reduce diversity in practice. To achieve this, the IASB proposed modifying the "initial recognition" exemption set out in paragraphs 15 and 24 of IAS 12, such that it would not apply to transactions for which an entity recognises both an asset and a liability, resulting in equal amounts of taxable and deductible temporary differences.

At its meeting on 28 October 2020, the IASB provisionally decided, after reviewing the comment letters received, that it would continue to develop the amendments along the lines set out in the exposure draft and described above. However, it has also provisionally decided to make the following changes to the proposals set out in the exposure draft:

- the amount of deferred tax liabilities will not be "capped" at the amount of the deferred tax assets recognised on the transaction (as this was felt to be too complicated, and in most cases unnecessary);
- the accounting treatment to be used, in the case of leases, for advance lease payments and initial direct costs will be presented in the form of an illustrative example (i.e. it will only appear in the Basis for Conclusions).

The IASB has also provisionally decided on the transition requirements for different circumstances:

- retrospective application, with the cumulative effect of first-time application recognised at the beginning of the earliest comparative period presented, for leases accounted for under IFRS 16 and decommissioning obligations;
- prospective application to transactions occurring on or after the beginning of the earliest comparative period presented, for transactions other than IFRS 16 leases and decommissioning obligations.

The IASB will discuss the effective date of the amendments at a future meeting.

European highlights

Adoption of IFRS 16 amendment on Covid-19-related rent concessions

On 9 October, the European Commission adopted the amendment to IFRS 16 on Covid-19-related rent concessions, meaning the amendment can now be applied by companies that prepare their accounts in accordance with IFRSs as adopted by the European Union.

Readers will remember that the amendment permits lessees (but not lessors) to elect not to assess whether a Covid-19-related rent concession is a lease modification. A lessee that applies this practical expedient would then account for Covid-19-related rent concessions as if they did not constitute lease modifications, provided that they meet certain criteria, and would recognise the impact of these concessions in profit or loss for the period.

Commission Regulation (EU) 2020/1434 was published in the OJEU on 12 October 2020 and came into effect on the following day. It is available here.

IASB rate-regulated activities project: EFRAG seeks input from users of financial statements

EFRAG (European Financial Reporting Advisory Group) is inviting users of the financial statements of rate-regulated entities to contribute to preliminary analysis of the likely impacts of the IASB's ongoing project by filling in an online questionnaire by 7 December 2020. The survey will enable EFRAG to gain a better understanding of users' needs.

The IASB is currently putting the finishing touches to a new accounting model for rate-regulated activities. The objective is to provide users of financial statements with better information on the rights and obligations arising from these rate-regulated activities. An exposure draft is scheduled for early 2021.

EFRAG's questionnaire is available here.

ESMA publishes recommendations for 2020 financial reporting

On 28 October, ESMA published its recommendations for 2020 financial reporting on its website.

Unsurprisingly, the recommendations primarily concern **issues related to the current public health and economic crisis**. The key topics addressed include: the presentation and relevance of financial statements (including going concern issues); measurement of non-financial assets; liquidity risk issues and working capital requirements; and topics specific to credit institutions (which Beyond the GAAP will cover briefly).

The recommendations for 2020 also include **points relating to IFRS 16 – *Leases***, specifically regarding the application of the amendment recently published by the IASB (the May 2020 amendment on Covid-19-related rent concessions), and disclosures required in the notes under IFRS 16. Furthermore, although it does not make any specific recommendations, the regulator reiterates its call for issuers to clearly communicate the potential impacts of **Brexit**, where relevant.

Moreover, as issuers prepare to publish their **first annual financial reports in XHTML format** (under the European Single Electronic Format), ESMA reminds issuers that documentation is available on its website to help them to better understand the requirements, including support materials published by the IFRS Foundation, in particular the *Preparer's Guide*.

ESMA also made recommendations focusing specifically on **non-financial performance**. These recommendations on the non-financial sections of the annual report primarily relate to the impact of the Covid-19 pandemic on non-financial information, and disclosures on social and employee matters.

This study focuses on accounting topics and thus does not address the recommendations relating to non-financial information.

ESMA's recommendations for 2020 financial reporting are available here.

Presentation and relevance of financial statements

Going concern assumptions

For entities exposed to going concern risks over the twelve months following year-end, ESMA recommends **presenting the assumptions used** to draw up the financial statements on a going concern basis and **the associated uncertainties** (e.g. considering reduced market demand for products or services).

If the entity has concluded that there are no material uncertainties, it must provide a **detailed and entity-specific description of the judgements made** in reaching this conclusion.

Information provided in support of the conclusion could include, for example, the existence of undrawn credit lines or the receipt of government grants or public support measures.

Moreover, the regulator reminds issuers that the information supporting the assessment of going concern should be consistent with other information disclosed in the financial statements regarding in particular liquidity and other financial risks.

Significant judgements and estimation uncertainty

As the current public health and economic crisis is creating a lot of uncertainty, the regulators emphasise the need for issuers to provide specific and detailed information on topics that are useful for understanding the financial statements and the situation of the individual company. Given the increased need for users to be able to understand the assessments carried out by businesses and the risks to which they are exposed, **transparency of financial information** is essential to bolster market confidence in financial reporting.

Particular attention should be paid to information on **key judgements and estimates with high levels of complexity and uncertainty**. In this context, ESMA although strongly encourages issuers to disclose information about the **sensitivity of carrying amounts** to the methods, assumptions and estimates made that underlie calculations. To identify specific issues at 31 December, the regulator recommends **taking account of discussions that have taken place with management, auditors and/or the regulator**, as well as topics highlighted by the company in its description of risk factors and/or by the auditors in their report of key audit matters.

In addition, **assumptions should be consistent** across the various estimates presented by the company and the various types of information published in the annual report (notes to the financial statements, management report, risk factors, and other elements of financial reporting).

Presentation of the impacts of the Covid-19 pandemic

In line with its recommendations for the 2020 interim financial statements, ESMA reminds companies of the principle of consistency of presentation of financial statements set out in IAS 1.

Thus, to ensure comparability and to facilitate understanding of the entity's performance, the regulator still recommends that entities **should not change the presentation in the income statement** to separately present the impacts of the Covid-19 pandemic. Qualitative and quantitative information should be disclosed on the significant impacts of Covid-19, and the regulator insists on the importance of specifying the **methodology used to identify and measure** these impacts. Moreover, if such disclosures to explain the Covid-19 impacts are provided in multiple notes, ESMA encourages issuers to clearly cross-reference the relevant notes.

Measurement of non-financial assets

Impairment testing requirements

IAS 36 requires entities to carry out annual impairment testing of cash generating units (CGUs) to which goodwill has been allocated. The test can be carried out at any point in the year, provided that it is the same point every year.

Thus, ESMA reminds companies that even if they carried out impairment tests at the half-yearly closing of accounts as a result of the current crisis, they may still need to carry out their annual impairment testing if this is usually done at year-end. The regulator emphasises that **all underlying assumptions used for impairment testing (both financial and operational) need to be updated**.

As regards tangible and intangible assets that are to be amortized, ESMA underlines the importance of **identifying any indications of impairment at year-end**, as there is an increased likelihood that impairment indicators will be triggered by the current crisis. If there are indications of impairment, the entity must carry out the annual impairment test, even if testing was carried out at the half-yearly closing of accounts.

Disclosures on assumptions and sensitivities

ESMA recommends that entities should provide transparency of the estimates and thus include a **description of the key assumptions used**, particularly operational assumptions, in the notes to the financial statements, along with explanations of any changes in these assumptions since 30 June. For example, it would be useful to present the assumptions regarding if and when the entity considers to be realistic to return to pre-crisis cash-flows levels, and the time horizon considered in relation to post-Covid-19 scenarios.

Moreover, given the current high uncertainty and difficulty of forecasting, ESMA recommends that entities should **give greater weight to external evidence** when determining the key assumptions used for impairment testing. If there are discrepancies between the assumptions used and external information or past experience, an explanation must be provided.

As regards the **sensitivity analyses** required under IAS 36, the regulator emphasises the need to **select the most relevant variables**. For example, it may be useful to provide analyses of the sensitivity to new assumptions that reflect the current health crisis, such as changes in the time horizon for the return to pre-crisis levels of economic activity.

Entities may also need to **take account of a potential increase in the scale** of reasonably possible changes in assumptions, given the current high levels of uncertainty.

Even if an entity concludes that no reasonably possible change in key assumptions would give rise to impairment, **quantitative data on these reasonably possible changes should still be presented** considering requirements under IAS 1.129.

Finally, a sensitivity analysis is still useful and relevant **even if the asset is already impaired.** This allows users to assess the likelihood of any further impairment in the event of changes in key assumptions.

Liquidity risk disclosures and working capital requirements

Liquidity risk disclosures

ESMA emphasises that in the current context of high uncertainty, which has led to increased financing needs coupled with potentially greater difficulty in accessing financing, the liquidity risk disclosures required by IFRS 7 are all the more useful and necessary to the reader to allow them to assess **the nature and extent of the entity's liquidity risk** and how the entity manages this risk.

With this in mind, the regulator expects issuers to provide **detailed and specific disclosures** on **debt renegotiations** or **new significant amounts of financing**, as well as **banking covenants**. Furthermore, ESMA underlines the importance of disclosing a maturity analysis of the financial liabilities and the financial assets, when applicable, used to manage liquidity risk.

Management of working capital requirements

The Covid-19 crisis may lead companies to make increased use of working capital management strategies (such as factoring and/or reverse factoring) in order to maintain liquidity levels. Disclosures on these strategies are particularly useful, as they help readers of the financial statements to assess the entity's liquidity risk.

ESMA thus recommends that entities that have put in place material arrangements for optimising working capital requirements present transparent, high-quality disclosures including a **description of the arrangements, the accounting analysis carried out and the accounting treatment applied, the amounts involved** (the total amount involved, the amount of associated receivables and payables, the amount of guarantees if applicable) and the **classification in the financial statements** (balance sheet, income statement and statement of cash flows).

Credit institutions

ESMA recommends that credit institutions should present disclosures in their financial statements on **the impacts of the Covid-19 crisis on the identification, management and measurement of credit risk**.

It also reminds issuers that the expected credit losses model involves a lot of assumptions and estimates. Given the material uncertainties associated with expected credit losses, the regulator recommends that entities should **provide detailed disclosures on the calculation of ECLs**, including qualitative and quantitative information on the macroeconomic assumptions used in the scenarios considered.

It also encourages issuers to expand on the disclosures required under IFRS 7 on credit risk exposures and changes in expected credit losses. Thus, it recommends presenting **a breakdown of gross amounts and the associated impairment** for each stage, broken down by type of credit and by type of customer or counterparty.

IFRS 16 – *Leases*

Accounting for rent concessions granted by lessors in the context of Covid-19

Readers will remember that on 28 May 2020, the IASB published an amendment to IFRS 16, introducing a practical expedient that allows lessees to immediately recognise Covid-19-related rent concessions in profit or loss (cf. Beyond the GAAP no. 144, May 2020, Covid-19 supplement). The amendment is applicable for financial periods commencing on or after 1 June 2020. Early application is permitted.

Therefore, the regulator reminds issuers of disclosure requirements of the amendment. Indeed, entities that apply the amendment in their 2020 financial statements should **disclose that they have done so**, and present the disclosures required by the amendment, i.e. **the amounts recognised in profit or loss for the period** arising from rent concessions covered by the practical expedient.

Finally, for both lessees and lessors that are materially impacted by rent concessions granted or benefitted from, ESMA recommends that they should **provide clear disclosures, including the accounting treatment used** for these rent concessions.

Disclosures in the notes and presentation of financial statements

Disclosures relating to profit or loss

ESMA reminds issuers of the requirements of the standard, which stipulates that entities that are materially impacted should **disclose the depreciation charges and lease expenses recognised in profit or loss** for the period, **broken down by type** (variable lease payments, short-term leases accounted for by applying the exemption, leases of low-value assets accounted for by applying the exemption, income from subleases).

Lease liabilities and lease payments

IFRS 16 requires entities to disclose enough information to enable users to assess future cash outflows relating to leases and thus to assess their impact on the entity's liquidity position. ESMA therefore recommends that companies should **provide more information on maturity analysis of lease liabilities and future cash outflows relating to leases**. This information should include exposures arising from variable lease payments, extension and termination options, residual value guarantees and leases not yet begun to which the lessee is committed.

Other disclosures

IFRS 16 specifies that issuers must disclose additional information if this is necessary for users to assess the impact of leases on the financial statements.

As issuers prepare for the second year of applying IFRS 16, the regulator recommends that they should consider the potential **utility and relevance of disclosing additional information**, such as specific disclosures on variable lease payments. Indeed, especially in the context of the Covid-19 pandemic, such information may complement with relevance disclosures already available to help users of financial statements to understand the impact of the crisis on an issuer's financial position, performance and cash flows.

Key points to remember

- Unsurprisingly, the recommendations from ESMA for 2020 financial reporting are closely related to the ongoing public health and economic crisis resulting from Covid-19. They are also **consistent with the recommendations already published for the interim financial statements**.
- The key topics addressed include: the presentation and relevance of financial statements (including going concern issues); measurement of non-financial assets; liquidity risk issues and working capital requirements; and topics specific to credit institutions.
- ESMA reminds entities that separate presentation of impacts of the Covid-19 crisis in the income statement would make it more difficult for users to understand an entity's financial performance. However, qualitative and quantitative information on the impacts of the Covid-19 is expected, with details on the methodology used to identify and quantify these impacts.
- As 2020 is the **second year of applying IFRS 16 – *Leases***, ESMA expects to see more detailed disclosures in the notes to the financial statements.

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[1] Where permitted under applicable country laws

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