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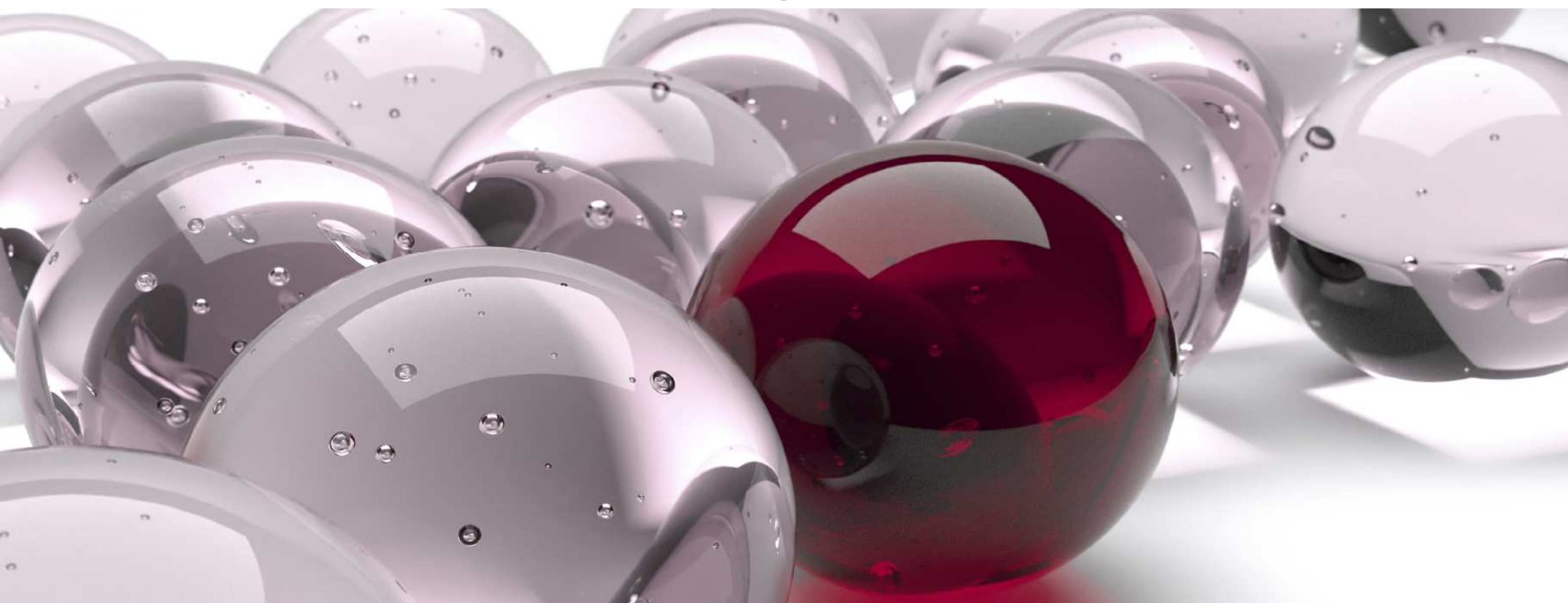
Mazars' newsletter on accounting standards



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Editorial

As autumn comes around again, it is time for ESMA's annual publication on its priorities for 2015 financial statements. This year it is focusing on two key topics: the impact of financial market conditions (interest rates, commodities prices, country-specific risks) on issuers' financial situation, and the statement of cash flows, which is key to understanding and assessing issuers' performance.

ESMA has also taken the opportunity to remind issuers of the need to improve the quality of financial statements and other financial reporting. With this in mind, ESMA simultaneously published a 'Public Statement' entitled *Improving the Quality of Disclosures in the Financial Statements*. Coincidentally, the IASB published its draft 'Practice Statement' on the application of materiality to financial statements around the same time.

Hopefully, these various initiatives should encourage issuers to rethink their financial statements and the layout and content of the notes…

Enjoy your reading!

Michel Barbet-Massin Edouard Fossat

IFRS Highlights

Effective date of IFRS 16 tentatively set at 1 January 2019

At its October meeting, the IASB (tentatively) decided to set the effective date of the IFRS 16 – *Leases* standard at 1 January 2019. Early application will be permitted, provided that the entity also applies IFRS 15 – *Revenue from Contracts with Customers.* As a result, any entity may opt to apply IFRS 16 in 2018, and entities may apply the standard from 2017 if they are also opting for early application of IFRS 15 from the same date. All of this is subject to adoption by the European Union.

Shortly after announcing this decision, the IASB staff then published a document entitled '*Lease Project Update*' on 29 October. This document provides an overview of how a lease will be defined in the IASB's new leases Standard, and includes a working draft of the application guidance and accompanying illustrative examples. All of these elements are expected to be included in the future standard. The document complements a previous project update on the same theme, which was published by the IASB staff last February.

Beyond the GAAP will review the content of this document in a future issue. In the meantime, readers who wish to cast an eye over the document can find it at the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/Definition-of-a-Lease-Oct-2015-FINAL.pdf

IASB consults on the application of materiality to financial statements

As part of its '*Disclosure Initiative*' (see the 'A Closer Look' feature in our December 2014 issue), the IASB is seeking comments on its draft '*Practice Statement*' on the application of materiality to financial statements. The Practice Statement was published on 28 October 2015.

The document begins with a reminder of the definition of materiality under IFRS, and its application to the complete set of financial statements (including the notes). It then goes on to review how the needs of the users of financial statements should be taken into account when assessing materiality.

The materiality of information depends on qualitative as well as quantitative considerations, and should be assessed both individually and collectively. Moreover, it is not simply a case of deciding whether information should be included in the financial statements, but also how it should be presented and whether it should be aggregated or disaggregated, in both the primary financial statements and the notes.

The document refers back to IAS 1, which states that entities:

- may omit disclosures required by IFRS if the resulting information is not material; and
- shall provide information that is not specifically required by IFRS if that information is material.

Finally, the IASB emphasises the importance of reviewing the notes on an annual basis, and provides additional detail on practical expedients used in record-keeping and measurement, as well as on misstatements and omissions.

We will take a closer look at the document in a future issue.

Comments should be sent to the IASB by 26 February 2016. The document can be downloaded from the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/Disclosure-Initiative/Materiality/Exposure-Draft-October-2015/Pages/default.aspx

IASB publishes draft interpretation on uncertain tax positions (IAS 12)

The IFRS IC has decided to draw up an interpretation on the accounting treatment of uncertainty over income taxes (as defined in IAS 12). The Committee was asked for guidance on when a tax asset should be recognised if an entity is required to pay an additional charge to the tax authorities following a tax examination, but intends to dispute this additional charge.

In the November 2014 *IFRIC Update,* the IFRS IC presented some observations and tentative decisions relating to the proposed future interpretation (cf. the November 2014 issue of Beyond the GAAP).

After presenting its draft interpretation to the IASB in April 2015, the IFRS IC decided to expand the scope of the interpretation to all tax assets and tax liabilities covered by IAS 12, including deferred tax assets and liabilities.

On 21 October 2015, the IFRS IC published the draft interpretation *Uncertainty over Income Tax Treatments.* The exposure draft is available here: http://www.ifrs.org/Current-Projects/IASB-Projects/IAS-12-Measurement-income-tax-uncertain-tax-position/Draft-Interpretation-October-2015/Pages/default.aspx

Comments on the draft interpretation should be sent to the IFRS IC by 19 January 2016.

IASB publishes draft interpretation on foreign currency transactions including advance consideration (IAS 21)

On 21 October 2015, the IFRS IC published a draft interpretation entitled *Foreign Currency Transactions and Advance Consideration.*

IAS 21– *The Effect of Changes in Foreign Exchange Rates* states that a foreign currency transaction shall be recognised using the spot exchange rate at the date of initial recognition of the transaction. When an entity pays some or all of the consideration in advance, it recognises a non-monetary asset in its statement of financial position, representing its right to receive goods or services. When the goods or services are delivered, the non-monetary asset is derecognised and the related asset or expense is recognised as appropriate. The converse applies to advance consideration received by the entity.

This raises the question of what exchange rate should be used to recognise the goods acquired or the expense representing the services provided. Should the date of initial recognition of the transaction be the date when the advance payment was made, or the date when the goods or services were recognised?

The draft interpretation proposes that entities should use the exchange rate at the date when the advance payment is made. If multiple advance payments are made at different times, a different exchange rate shall be used for each advance payment. The exchange rate used for recognition of the asset or expense would thus be the weighted average of these exchange rates.

The comment period is open until 19 January 2016.

The draft interpretation can be downloaded from the IASB's website via the following link:
http://www.ifrs.org/Current-Projects/IASB-Projects/date-of-transaction-identifying-applicable-exchange-rate-revenue-recognition/Draft-Interpretation-October-2015/Documents/ED_IFRIC_ForeignCurrencyTransactionsandAdvanceConsideration.pdf

European Highlights

ESMA encourages companies to improve quality of disclosures in financial statements

On 27 October 2015, ESMA published a 'Public Statement' encouraging issuers of financial statements to improve the quality of disclosures. It is following in the footsteps of the French market regulator, the AMF, which published its *Guide to the Relevance, Consistency and Readability of Financial Statements* last June (see the June 2015 issue of Beyond the GAAP).

In the document, ESMA identifies the following five key principles for improving disclosures:

– **Tell the entity's own story**: avoid boilerplate language and provide disclosures that are as specific to the entity's own situation as possible;

– **Provide relevant information in an easily accessible way**, e.g. by indicating the main revenue streams and their relative contribution to total revenue;

– **Think about the materiality of the information**, to improve the clarity and conciseness of the financial statements, particularly by removing information that is no longer relevant or that is immaterial (for more on the subject of materiality, see the item on page 2 about the IASB's draft *Practice Statement*);

– **Improve readability of the financial statements**, by writing them as clearly and concisely as possible, ensuring that relevant information is not lost amid a mass of irrelevant information, and making them easy to use (e.g. by putting related information in the same place, cross-referencing, changing the layout);

– **Provide consistent information within annual reports**, e.g. the financial statements should be consistent with the management report, particularly if they are published at the same time.

ESMA encourages early application of elements from the IASB *Disclosure Initiative*, where permitted. This includes the amendments to IAS 1 which were published in December 2014 (cf. Beyond the GAAP, December 2014) but which have not yet been adopted by the EU.

Finally, ESMA encourages all stakeholders to continue working to improve disclosures. Issuers should endeavour to improve the quality of disclosures in their own financial statements; auditors should encourage companies in this process; and enforcers will continue to encourage best practice.

ESMA's Public Statement is available via the following link:
http://www.esma.europa.eu/news/ESMA-urges-companies-improve-quality-disclosures-financial-statements?t=326&o=home

EU will not adopt theIFRS 14 interim standard on rate-regulated activities

The European Commission has decided not to launch the endorsement process for the interim standard IFRS 14 – *Regulatory Deferral Accounts*. It will await publication of the final standard.

Readers will remember that this interim standard, which was published by the IASB in January 2014, is limited in scope as it only concerns first-time adopters.

IFRS 14 allows an entity which is a first-time adopter to continue to account for regulatory deferral account balances in accordance with its local GAAP. If it does so, it must present regulatory deferral account balances as separate line items in the statement of financial position,

and movements in those account balances as separate line items in the statement of profit or loss and other comprehensive income. This will enhance comparability with the financial statements of entities that already apply IFRS and that do not recognise amounts from rate-regulated activities.

European Parliament publishes four studies as part of EU adoption process for IFRS 9

The Economic and Monetary Affairs Committee of the European Parliament (ECON) published four studies in October, which it had commissioned to inform its endorsement decision on the adoption of IFRS 9 by the European Union. The four studies were:

- **IFRS endorsement criteria in relation to IFRS 9**
  This study, which was carried out by researchers at the University of Mannheim, concludes that IFRS 9 cannot reasonably be rejected on grounds of the qualitative adoption criteria, the 'true and fair view' criterion, or the 'European public good' criterion. The authors state that IFRS 9 does not go any further than the Accounting Directives in permitting or requiring fair value accounting;
- **Expected-loss-based accounting for the impairment of financial instruments: the FASB and IASB IFRS 9 approaches**
  This study, which was carried out by researchers at the University of Lancaster, compares the two approaches to measuring impairment, discusses possible effects of the differences between the two approaches, and presents the pros and cons of each approach.
- **Impairment of Greek government bonds under IAS39 and IFRS9**
  This paper, which was written by Günther Gebhardt, a member of the EFRAG TEG, highlights the discretion that preparers had under IAS 39 when assessing the impairment of Greek government bonds. This resulted in delayed and insufficient recognition of credit losses. Under IFRS 9, impairments will be recognised somewhat earlier, but will still be delayed and low when compared to the fair value losses, as the standard relies more on management expectations.

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- **The significance of IFRS 9 for financial stability and supervisory rules**
  This research, which was carried out by an academic at the University of Lancaster, analyses the IFRS 9 expected credit loss model. The new standard is expected to mitigate the procyclical tendencies of IAS 39, as it is more closely aligned with bank regulatory requirements and should result in earlier recognition of larger loss allowances. Thus, if combined with improved transparency, it could contribute to financial stability. However, the potential benefits of the standard are dependent on appropriate and consistent application by companies.

These studies are available on the 'Supporting analyses' page of the ECON Committee's website (uploaded 15 October 2015):
http://www.europarl.europa.eu/committees/en/econ/supporting-analyses.html?action=0

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A Closer Look

IFRS 15: TRG considers more practical implementation issues

It is now more than a year since the Transition Resource Group (TRG) began its work on the practical analysis of IFRS 15 on Revenue Recognition. The fifth meeting of the TRG was held on 13 July, with the following items of interest to IFRS preparers on its agenda:

- Accounting for restocking fees and related costs for sales with a right of return;
- Circumstances under which an entity should consider the guidance on consideration payable to a customer and its interaction with the guidance on the estimation of (and constraint on) variable consideration;
- Interaction between the portfolio practical expedient and the estimation of variable consideration using the expected value method;
- Allocation of variable amounts in the case of a series of distinct goods or services corresponding to a single performance obligation;
- Conditions for applying the practical expedient for measuring progress towards complete satisfaction of a performance obligation;
- Use of several methods of measuring progress when multiple goods or services are included in a single performance obligation;
- The concept of "completed contracts" at transition;
- Revenue recognition for commodities.

Following the recent publication of the official summary of issues discussed at the July 2015 meeting, Beyond the GAAP here presents an overviewof the main topics discussed.

1) Interaction between the portfolio practical expedient and the estimation of variable consideration using the expected value method

Under IFRS 15, variable consideration in a contract (for example, a bonus) must be estimated using one of the two following methods: the expected value or the most likely amount. An entity must assess the relevance of using one method rather than the other. Further, in every case, the estimate obtained must be limited (concept of constraint) so that it is highly probable that resolution of any uncertainties about the variable consideration will not result in a significant downward adjustment of the cumulative revenue recognised to date under the contract.

Two questions were analysed by the staff:

Question 1: Does an entity automatically apply the portfolio practical expedient when it estimates variable consideration using the expected value method?

The staff and the TRG are of the opinion that even if an entity needs to use information collected for (potentially large numbers of) similar contracts in order to apply the expected value method, this does not necessarily amount to applying the portfolio expedient. The explicit application of the portfolio approach (that is, opting to use the practical expedient) requires entities to demonstrate that they can reasonably expect that the impact on the financial statements of applying IFRS 15 to the portfolio will not significantly differ from the effect of applying the standard to each contract (or to each performance obligation) in the portfolio.

Question 2: Can the estimated transaction price under the expected value method be an amount that is not a possible outcome under the terms of a contract?

Two views were analysed by the staff and the TRG:

- View A: The transaction price should be constrained to the highest amount that is both a possible outcome of the contract and a highly probable outcome. For example, in the case of sale with a right of return that expires after a year, if an entity has reliable historical data suggesting that these sales result in returns of 40% spread over the year, and since the probability that an individual product will not be returned is 60%, the constraint would have to be applied to all the revenue under the contract in question, and only recognised when the right of return has expired.
- **View B:** The transaction price is not automatically reduced by the constraint on variable consideration. In other words, the application of the constraint should not automatically negate the result obtained in application of the expected value method to bring the estimated revenue down to an amount corresponding to a possible outcome under the contract.

The TRG expressed a preference for view B, although view A cannot be completely excluded, given the terms of the standard, which requires the transaction price to be estimated for an individual contract. In practice, the majority of members of the TRG therefore concluded that

the estimated transaction price to be recognised might not be a possible outcome in an individual contract.

The TRG's discussions also demonstrated that it is not always obvious where the expected value method should be used. Is it always relevant to use such a method for a contract that presents, on a discrete manner, several possible outcomes? In their report of these discussions the staff remind readers that the determination of which method to use in estimating variable consideration will require judgment.

Finally, the TRG reiterated the general principle for estimating the transaction price under IFRS 15, namely that an entity must recognise the amount of consideration to which it expects to be entitled in exchange for these goods or services.

Key points

1. The use of the expected value method for estimating variable consideration in an individual contract may require entities to consider the data for a portfolio of contracts. However, in doing so, the entity is not necessarily applying the portfolio practical expedient.
2. Once an estimate has been reached using the expected value method, the application of the constraint (only recognising revenue that is highly probable) can lead to the recognition of an amount of revenue that does not correspond to a possible outcome of the contract in question.

2) Allocation of variable amounts in the case of a series of distinct goods or services corresponding to a single performance obligation

Three questions were submitted to the TRG:

- **Question 1:** in order to apply the guidance on series (IFRS 15.22(b)), how should entities consider whether the distinct goods or services in the series (constituting a single performance obligation) are "substantially the same"?
- **Question 2:** if there is an undefined quantity of outputs (for example, an undefined quantity of transactions in a data processing contract) but the contractual rate per unit of output is fixed, is the consideration variable?
- **Question 3:** in order to meet the requirements in IFRS 15 and condition 85(b) in particular, when allocating the whole of variable consideration to a performance obligation in a contract or to a distinct good or service within a performance obligation (in the case of a series), is the allocation to be made on a relative standalone selling price basis?

In the case of the first of these issues, the TRG agreed with the staff view that "daily activities" do not need to be identical in order to be "substantially the same", meaning that the guidance on series can be applied to repetitive services that correspond in practice to a stand-ready obligation or to an commitment to deliver an undefined quantity of services over a given period of time. However, the TRG noted that the facts and circumstances were very important and that situations could be complex in practice. Preparers should therefore exercise judgment case by case.

There was little discussion of questions 2 and 3. If there is an undefined quantity of outputs in a contract but the contractual rate per unit of output is fixed, the consideration is variable. Finally, the staff took the view that the allocation of a standalone selling price to a distinct good or service is not essential to meet the objective of the standard, where variable consideration is allocated to distinct goods or service in a series. This method is nevertheless an acceptable way to evidence the reasonableness of the allocation (see example 35 in the standard).

Key points

1. Where a contract is for the delivery of the same service over time, or where it concerns a stand-ready obligation, the series provisions may be applied even if the tasks carried out are not all identical.
2. If there is an undefined quantity of outputs in a contract but the contractual rate per unit of output is fixed, the consideration is variable.
3. Allocation based on the relative standalone selling price is not the only method possible when variable consideration is allocated to distinct goods or service in a series.

3) Conditions for applying the practical expedient for measuring progress towards complete satisfaction of a performance obligation

For the purposes of choosing a method for measuring progress (in the case of performance obligations satisfied over time) IFRS 15 offers the following practical expedient: where an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance to date (for example under a services contract under which the entity invoices an amount for each hour of service delivered), an entity may recognise revenue from ordinary activities for the amount that it has a right to invoice (IFRS 15.B16).

Questions have been raised by stakeholders about how to assess whether the invoiced amount directly corresponds to the value to the customer of the performance obligations fulfilled to date. In particular, how to assess contracts with rates that change during the contract term while the goods and services remain the same (for example, a contract for the continuous supply of electricity at a price per MWh that changes over the years)?

In general, TRG members said that it was not vital for prices to remain the same throughout a contract in order to apply the practical expedient, provided these prices reflected the value to the customer of the performance obligations fulfilled to date. Staff and TRG members also acknowledged that judgment will be required about whether the practical expedient can be applied to fact patterns that include upfront and back-end fees. Further, TRG members believed that this practical expedient could also be applied in the case of a series of distinct goods or services corresponding to a single performance obligation.

Key point

An entity can opt for the practical expedient offered by IFRS 15 enabling it to recognise over time as revenue the amounts it is entitled to invoice to customers even if prices change over the term of contract, on condition that these prices reflect the value to the customer of the performance obligations fulfilled to date.

4) Use of several methods of measuring progress when multiple goods or services are included in a single performance obligation

The guidance of IFRS 15 on the identification of performance obligations allows entities, under certain conditions, to consider that several goods or services promised in a contract correspond to a single performance obligation and should therefore be accounted for as a whole. If the non-distinct goods and services making up the single performance obligation are transferred to the customer at different rates, is it possible to apply multiple methods of measuring progress?

TRG members agreed with the staff view that IFRS 15 clearly requires a single measure of progress for each performance obligation; an entity must apply one single method when measuring progress towards satisfying the performance obligation. The TRG nevertheless recognised that in some circumstances the choice of method would be tricky. If applying a single method of progress measurement to a performance obligation including several goods or services seems not to reflect the economic substance of the transaction, this suggests that the entity should recognise not one but several performance obligations. Preparers need to exercise significant judgment on the basis of the facts and circumstances of each contract concluded with a customer.

Key point

For each performance obligation fulfilled over time, an entity must apply one single method when measuring progress.

5) The concept of "completed contracts" at transition

The transitional provisions for IFRS 15 define a completed contract as a contract for which the entity has transferred all the goods or services identified in accordance with IAS 11 *Construction contracts,* IAS 18 *Revenue* and the associated interpretations (IFRS 15.C2(b)).

Now IFRS 15 stipulates that where the alternative transition method is used (restatement at the date of first application, *a priori* 1 January 2018), IFRS 15 may only be applied to contracts not yet completed at the date of initial application.

During its deliberations on IFRS 15 in March 2015, the IASB also tentatively decided to give entities an additional practical expedient for transition purposes, enabling them, when using the full retrospective method this time, to apply IFRS 15 retrospectively only to contracts not yet completed at the beginning of the earlier reporting period presented. This proposal remains to be confirmed after the consultation of stakeholders (see the exposure draft on IFRS 15 published in July 2015, the comment period f which expired on 28 October).

What is a completed contract?

It is therefore essential to be able to define exactly what constitutes a "completed contract". Two views were presented by the staff and discussed by the TRG:

- **View A:** the contract is considered as completed when the entity does not have to transfer any additional goods or services (even if the all revenue has not been recognised in application of the preceding standards);
- **View B:** the contract is not considered as complete if the entity still has to recognise revenue, in accordance with the preceding standards.

This topic was the subject of lively exchanges between TRG members. No consensus was reached as to the definition of a "completed contract". There was no agreement on which standard to apply in order to determine whether the goods or services had been "transferred" to the customer on the date in question. The majority view appeared to be that this transfer should be assessed on the basis of the existing standards (i.e. IAS 11 and IAS 18).
However, these standards are not based on the notion of the transfer of control, which creates a tension with IFRS 15 where a completed contract is defined as one for which an entity has "transferred" all the goods or services identified. Some members considered that judgment is required to determine whether all the goods or services have been delivered, taking account of the existing standards.

How should an entity account for the sums received after a contract is completed?

A second question discussed by the TRG relates to the case of completed contracts, i.e. contracts in which all the goods or services identified have been transferred to the customer, but for which the recognition of revenue is not yet complete in accordance with the standards that preceded IFRS 15. What should be done with these as yet unrecognised amounts (and any cash received subsequently)? Two views were discussed:

- **View A:** an entity should continue to account for residual revenue in accordance with the former standards, after the adoption of the new standard on revenue recognition;
- **View B:** an entity should not continue to recognise revenue for "completed contracts" after adoption of IFRS 15.

American members of the TRG seemed to have totally excluded view A, refusing any "mixed model" after the date of adoption of the new standard on revenue recognition. However, TRG members on the IFRS side seem not to have excluded this solution.

Observing that the answer to question 2 depended directly on the answer to question 1, and given the disagreements between TRG members, the meeting referred this issue to the IASB and the FASB.

The FASB decided to propose to amend the definition of a completed contract in Topic 606 to clarify that this is a contract for which all or almost all the associated revenue has been accounted for in accordance with the previous standards on revenue. The comments period on this amendment ran until 16 November 2015.

In the September 2015 meeting the IASB decided not to go down that path and has retained the existing IFRS 15 definition of a completed contract. According to the staff, the concept of "transfer" relates to the delivery of goods (or the rendering of services) under IAS 18. Thus, a contract would be completed if, under the existing standard, an entity had delivered all the goods or rendered all the services that it had identified under this same standard, even if revenue had not been recognised for reasons such as uncertainties as to collectability.

Key points

Significant differences of opinion appeared between American and IFRS members of the TRG on the definition of a completed contract and on the consequences when all the revenue has not been accounted for on the date of initial application of IFRS 15 according to the existing standards.

The decisions taken in the area by the IASB and the FASB are likely to lead to divergence between IFRS 15 and Topic 606. Nonetheless, this divergence only affects transition to the new standard, and its impact should therefore quickly disappear.

6) Revenue recognition for commodities

When entities deliver a commodity to their customers (gas, electricity, etc.), it is not always obvious whether the related performance obligation is satisfied over time (the revenue then also being accounted for over time) or at a point in time.

Criteria are provided in the standard for demonstrating that the transfer of control to the customer occurs over time. One of these criteria is that the customer receives and simultaneously consumes the benefits provided by the entity's performance as the entity performs (IFRS 15.35(a)).

The TRG was asked what factors must be taken into account to determine whether this criterion is satisfied in a contract to deliver a commodity:

- **View A:** an entity should consider only the inherent characteristics of the commodity, i.e. whether or not it can be stored;
- **View B:** an entity should consider all relevant facts and circumstances, including the inherent characteristics of the commodity, the contract terms, and information about infrastructure or other delivery mechanisms.

The TRG agreed with the staff that all relevant facts and circumstances should be considered to determine whether the delivery of a commodity should be recognised as a single performance obligation satisfied over time, or whether it is actually a succession of performance obligations satisfied at a given point in time.

Key points

All the relevant facts and circumstances should be considered to determine whether the delivery of a commodity should be recognised as a single performance obligation satisfied over time, or whether it is actually a succession of performance obligations satisfied at a given point in time.

7) An uncertain future for the TRG

The final scheduled meeting of the TRG took place on 9 November 2015. No official statement has so far been made as to the continuation of the TRG's work following this meeting. It appears that the IASB and the FASB have divergent intentions on this subject, the first preferring to set aside the TRG on the grounds that the main topics have been addressed, the latter preferring to maintain the TRG active as long as preparers have questions to raise, even very specific.

In a future edition, Beyond the GAAP will present a summary of the topics discussed during the TRG's last meeting of 2015.

A Closer Look

What are ESMA's priorities for 2015 financial statements?

On 27 October, ESMA published its enforcement priorities for 2015 financial statements:

https://www.esma.europa.eu/system/files/2015-1608_esma_public_statement_-_ecep_2015.pdf

The enforcement priorities relate to the accounting impact of financial market conditions, the statement of cash flows, and fair value measurement.

In the introduction to the document, the enforcer also emphasises the importance of improving the quality of financial reporting and financial statements. ESMA reminds preparers that disclosures should be relevant, consistent and readable, and refers them to its guide on *Improving the Quality of Disclosures in the Financial Statements,* which was published on 27 October 2015 (see 'European Highlights' above).

Beyond the GAAP presents the key priorities that preparers should address in the 2015 financial statements.

1) Recommendations relating to the accounting impact of financial market conditions

High volatility and/or significant falls in certain key economic drivers (interest rates, oil, etc.) may have had a negative – or positive – impact on an entity's financial position. Moreover, some issuers may have suffered the consequences of measures taken by countries in which macroeconomic conditions have deteriorated significantly, e.g. limits on the free movement of capital.

In this context, ESMA recommendsthat companies with significant exposure to these risks should present all the disclosures on their exposures and the associated risks in a single note (or include cross-references within the financial statements) to make it easy for users to read and understand the issues.

On this topic, the French regulator also insists on the fact that companies which are not exposed to a specific risk should disclose this, particularly if previous financial reporting may have led users to think otherwise.

These general recommendations on market conditions are complemented by specific recommendations on interest rates, commodities and other specific risks.

1.1 Interest rates

EMSA reminds issuers that they are required under IFRS to present disclosures on key assumptions, including the discount rate, used for pension obligations (IAS 19 – *Employee Benefits*) and impairment tests (IAS 36 – *Impairment of Assets*), if a reasonably possible change in a key assumption could result in the book value of the item or group of items exceeding its recoverable amount. In this situation, the entity must also present a sensitivity analysis for each assumption.

ESMA notes that long-term provisions are also extremely sensitive to interest rates, and recommends that entities with substantial long-term provisions should present the key assumptions, including the discount rate; the reasoning behind these assumptions; and a sensitivity analysis of the potential impact of changes in interest rates.

In the context of sensitivity analyses and determining what is considered a reasonably possible change in interest rates, issuers should take account of the economic and financial market context.

On this topic, the French regulator noted the fact that, in the past, the magnitude of the rate change has often differed significantly from the assumption used in sensitivity analyses.

The European enforcer urges entities to adapt their sensitivity analyses to the market conditions at year-end, by considering the interest rate's variability in the past when deciding what constitutes a reasonably possible change in the assumptions.

Finally, ESMA emphasises that it is important to use assumptions that are mutually compatible when determining defined-benefit pension obligations.

Specifically, it recommends that entities should disclose the approach used to calculate salary increases, and ensure these increases are consistent with the other assumptions used. For example, salary increases should not be substantially lower than the expected long-term inflation level for that region.

1.2 Commodities

ESMA notes that some industries have significant exposure to commodity prices and volatility.

ESMA recommends that these entities should:

- be transparent on any significant impacts of changes in commodity prices on the financial statements (e.g. on key sub-totals in the primary financial statements);
- disclose any changes in their operations resulting from their exposure to commodity risk (e.g. cancellation or postponements of projects;

- disclose information on the main assumptions used for the measurement of assets (e.g. for the initial measurement of assets acquired in a business combination, or for accelerated amortisation or impairment of intangible assets, property plant and equipment, inventories, or goodwill), and
- when a commodity price is used as a key assumption in the valuation of relevant assets, disclose the closing price and, where relevant, a sensitivity analysis on the changes to these key assumptions.

1.3 Foreign exchange rate and country risk

Some companies have exposure to countries facing various different uncertainties: e.g. financial challenges (Greece), substantial political tensions (Syria, Ukraine, etc.), exchange rate risk (Venezuela) with limitations on trade in some cases (Russia).they must.

ESMA recommends that entities with significant exposures should:

- take these risks into account when determining the assumptions to be used in the measurement of assets and liabilities (impairment tests, provisions, contingent liabilities, etc.);

- if the entity has significant exposure to a country in which more than one foreign exchange rate exists (e.g. Venezuela), it should disclose information about the exposure, the foreign exchange rate used, the process and judgement used to decide on the appropriate exchange rate, and, where necessary, a sensitivity analysis of the impact of choosing a different exchange rate;
- if there are significant restrictions that affect assets and liabilities, the entity should disclose the nature and extent of such significant restrictions, as well as the amount of significant cash and cash equivalent balances held by the entity that are not available to the group.

2) Statement of cash flows

The statement of cash flows is key to understanding and assessing an entity's performance. However, ESMA notes that there are a number of problems in the application of the IFRS requirements, in particular in terms of consistency with the other primary financial statements.

It is therefore not surprising to see this issue addressed in ESMA's recommendations.

ESMA makes the following general recommendations regarding the statement of cash flows:

- ensure consistency in the classification of the items between the statement of cash flows and the other elements of the financial statements (statement of financial position, statement of comprehensive income and notes); and
- provide cross-references to the relevant related notes.

2.1 Classification of cash flows ESMA makes the following recommendations on cash flows:

- check that cash flows are classified correctly. Cash flows that do not meet the definition of cash flows from financing or investing activities are classified as cash flows from operating activities;
- where classification decisions require the use of judgement, the entity should disclose the accounting policy used. In particular, this applies to cash flows of an operator in a service concession arrangement, interest and dividends received, and additional consideration in a business combination.

ESMA notes that, in a context of pressures on liquidity, working capital management is an increasingly popular alternative to bank loans and public offerings. The enforcer therefore wanted to draw attention to liability management mechanisms such as supplier chain financing (SCF) arrangements (also called "reverse factoring") for trade payables. Reverse factoring is not initiated by the creditor, but by the client on behalf of its supplier. The entity's debt becomes payable to the financial institution, instead of the supplier.

This raises an accounting issue relating to the presentation and classification of the trade payable in the statement of financial position, and hence, in the statement of cash flows: should it be classified as bank debt (financing cash flows) or continue to be classified as a trade payable (operating cash flows)?

Changes to disclosures in the notes are also likely to be required if the entity makes significant use of reverse factoring.

ESMA recommends issuers to :

- disclose the accounting policy applied to the classification;
- indicate the judgements made by the management (e.g. in assessing the substance of the arrangements);
- describe the relevant provisions of those arrangements;
- disclose the quantitative impact of these transactions on the financial statements and how the arrangements are used to manage the liquidity needs.
-

2.2 Cash and cash equivalents

ESMA also reminds issuers of the following key principles:

- For a financial instrument to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value;
- transactions that do not generate cash flows should not be included in the statement of cash flows;
- with the exception of certain specific cases, cash flows should be presented gross in the statement of cash flows.

3) Fair value measurement

In its recommendations, ESMA notes that there is still room for improvement in disclosures on fair value measurement.

On this topic, ESMA reminds issuers that:

- it is important to maximise the use of observable inputs and minimise the use of unobservable inputs; and
- quoted market prices should not be adjusted.

As regards disclosures, ESMA recommends that issuers should:

- disclose information that is relevant to fulfil the objectives of IFRS 13;
- disclose a description of the valuation technique, and the assumptions used for Level 2 and 3 measures;
- present disclosures on any changes in valuation technique and the reasons for these changes;
- if the use of non-financial assets differs from the highest and best use, disclose this fact.

4) Recommendations relating to recently-published standards that are not yet effective (IFRS 9 and IFRS 15)

ESMA draws issuers' attention to the potential impact of recently-published standards that are not yet effective, i.e. IFRS 15 – *Revenue from Contracts with Customers* and IFRS 9 – *Financial Instruments.* The enforcer urges issuers to start addressing this issue as soon as possible, to ensure that the information and/or reporting systems are adapted and ready.

ESMA recommends that issuers should present disclosures on:

- their progress in implementing the new standards; and
- qualitative information on the accounting policies that will potentially change, if this is available.

A Closer Look

ESMA publishes Guidelines on Alternative Performance Measures

On 5 October, ESMA published its Guidelines on Alternative Performance Measures (APMs).

The document aims to promote:

- a common approach to the use of APMs; and
- transparency of APMs.

ESMA believes that issuers who provide APMs should do so in a way that is appropriate and useful for users' decision-making, easily comprehensible, and consistent over time.

These guidelines apply to APMs disclosed by issuers from 3 July 2016. They are available on ESMA's website in all EU languages, via the following link: http://www.esma.europa.eu/content/ESMA-Guidelines-Alternative-Performance-Measures-1

1) Scope

These guidelines apply to issuers, other than States, whose securities are admitted to trading on a regulated market and who are required to publish regulated information as defined by the Transparency Directive.

The guidelines apply to APMs disclosed by issuers (including, for example, management reports disclosed to the market), with the exception of:

- APMs disclosed in annual or half-yearly financial statements, or supplementary recurrent financial reporting drawn up in accordance with the applicable financial reporting framework;
- APMs disclosed in accordance with other applicable legislation that sets out specific requirements governing the determination of such measures.
  Therefore, these guidelines do not apply to APMs disclosed in prospectuses, for which the specific requirements of the prospectus regime apply (e.g. pro forma financial information, related party transactions, profit forecasts, etc.), or to prudential measures.

2) What is an APM?

In its guidelines, ESMA clarifies the meaning of the term APM: "a financial measure of historic or future performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework".

ESMA states that APMs are usually based on financial statements drawn up in accordance with the applicable financial reporting framework, usually by adding or subtracting amounts from the figures presented in financial statements.

ESMA indicates that examples of APMs include:

- operating earnings,
- cash earnings,
- earnings before one-time charges,
- earnings before interest, taxes, depreciation and amortisation (EBITDA),
- net debt,
- organic growth or similar terms denoting adjustments to line items in the statement of comprehensive income, statement of financial position, or statement of cash flows.

In accordance with this definition, these guidelines are not applicable to:

- measures defined or specified by the applicable financial reporting framework, such as revenue, profit or loss, or earnings per share;
- physical or non-financial measures such as number of employees, number of subscribers, sales per square metre (when sales figures are extracted directly from financial statements), or social and environmental measures (greenhouse gas emissions, breakdown of workforce by contract type or geographic location);
- information on major shareholdings, acquisitions or disposals of own shares, and total number of voting rights;
- information to explain compliance with an agreement or a legislative requirement, such as lending covenants or the basis for calculating remuneration of directors and executives.

3) What principles are issuers expected to comply with if they use APMs?

The guidelines for issuers that use APMS include both qualitative and quantitative principles. They fall under the following headings:

- Disclosure principles;
- Presentation;
- Reconciliations;
- Explanation on the use of APMs;
- Prominence and presentation of APMs;
- Comparatives;
- Consistency;
- Compliance by reference.

Below, we list the key principles highlighted by ESMA with which issuers must comply:

- define APMs, their components and the basis of calculation used (including details of any material hypotheses or assumptions used);
- indicate whether the APM or any of its components relate to the performance for the past or future reporting period;
- disclose the definitions of all APMs used, in a clear and easily understandable way;
- use meaningful labels reflecting the content and basis of calculation of the APMs, to avoid conveying misleading messages to users;
- disclose a reconciliation of the APM to the most directly reconcilable line item (sub-total or total), identifying and explaining the material reconciling items;
- present the most directly reconcilable line item (sub-total or total) presented in the financial statements relevant for that specific APM;
- explain why APMs have been used, so that users can understand their relevance and reliability;
- present comparatives and reconciliations for the corresponding previous periods;
- if an APM is redefined, the issuer should explain the changes and the reasons why these changes result in more reliable and relevant financial information, and provide restated comparative figures;
- if an APM is no longer used, the issuer should explain why it considers that this APM no longer provides relevant information.

Events and FAQ

Frequently asked questions

IFRS

- Assessing whether a contract for the sale of trade receivables is deconsolidating
- Transfer of rights in a joint operation, resulting in a loss of joint control
- Assessing whether the fund manager has control over a real estate fund
- When should revenue be recognised under Incoterm EXW?
- Recognition, in an investor's accounts, of a convertible bond which is classified wholly as an equity instrument by the issuer
- Accounting treatment of work carried out by the owner on behalf of the lessee under IAS 17
- Accounting for service concession arrangements under IFRIC 12

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IFRS		EFRAG	
IASB	Committee	Board	TEG
14-18 December	12-13 January	16 December	3-4 December
18-22 January	22-23 March	14 January	27-29 January
15-19 February	10-11 May	11 February	24-26 February

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