CHAPTER 2

ESMA enforcement decisions

This article aims to:

- Discuss the essence of the key decisions published in the 27th extract from the European Enforcers Coordination Sessions (EECS's) database of enforcements.

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On 29 March 2023, the European Securities and Markets Authority (ESMA) published the 27th extract from the EECS's Database of Enforcement (ESMA report). The report is an extract from its confidential database of enforcement decisions on financial statements. These decisions are taken by 38 European enforcers from all European Economic Area (EEA) countries with responsibilities in the area of enforcement of financial information.

The ESMA report has been published to strengthen supervisory convergence and provide companies and users of financial statements with relevant information on the appropriate application of the International Financial Reporting Standards (IFRS). This is likely to help compliance with IFRS and contribute to the consistent application of the standards.

In this article, we will discuss the key decisions published in the ESMA report. Some of the important decisions are in relation to:

- Financial instruments
- Climate related matters, and
- Other considerations – operating segments revenue, leases

Financial instruments

a. Reclassification of financial assets

IFRS 9, *Financial Instruments* highlights that the reclassification of financial assets is required if, and only if, the objective of the entity's business model for managing those financial assets changes. Such changes are expected to be infrequent and should be determined by the entity's senior management based on external or internal changes. These changes must be significant to the entity's operations, demonstrable to external parties and is only possible if the entity begins or ceases to perform an activity that is significant to its operations (e.g., acquires, disposes or terminates a business line).

ESMA report reiterated the guidance of the IFRS 9 and mentioned IFRS 9 establishes high hurdles for a change in the business model that would require a reclassification of financial assets.

b. Exposure to credit risk

There is a need to provide sufficient transparency on the impact, the changing economic environment has on the Expected Credit Loss (ECL) calculation. These disclosures would enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows along with an explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance.

IFRS 7, *Financial Instruments: Disclosure* requires entities to explain their credit risk management practices and how they relate to the recognition and measurement of ECL. In particular, an entity should disclose how it determines whether the credit risk of financial instruments has increased significantly since initial recognition. The ESMA enforcer considered this and reiterated that additional information should have been provided on the Significant Increase in Credit Risk (SICR), such as quantitative criteria applied to stage transfers (transfer from stage 1 to stage 2, in particular for restructured exposures) as well as the existence of a probation period for transfers back from stage 2 to stage 1.

Further, ESMA report highlighted that companies should ensure consistency between credit risk disclosures and amounts presented on the statement of financial position and in the income statement.

Climate related matters

ESMA enforcers highlighted that there is a significant room for improvement in disclosures of climate related matters by companies in their financial statement. The ESMA enforcer highlighted that the disclosures related to impairment tests and its exposure to climate risks were not sufficient to meet the requirements of IAS 36, *Impairment of Assets*.

When assessing the materiality of the missing disclosures, the ESMA enforcer considered qualitative and quantitative factors such as:

i. The amount of goodwill and intangible assets within definite useful lives which was material in the issuer's financial statements,

ii. The issuer's high exposure to climate risks, and

iii. The lack of consistency and coherence between the commitments disclosed in the non-financial section of the management report and the information disclosed in the financial statements.

Basis the requirements of paragraph 134 (f) of IAS 36, the ESMA report also highlighted that the sensitivity analysis of the recoverable amounts to a reasonable variation of the assumptions used which were related to climate change should be disclosed. Considering the deficiency discussed above, the ESMA report highlighted that the missing disclosures constituted a material departure from IFRS requirements.

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IAS 1, *Presentation of Financial Statements* deals with the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. Further IAS 1 requires specific disclosures on significant accounting policies, judgements and sources of estimation uncertainty considered by management in preparing the financial statements. In this regard, ESMA report also reminded companies that they need to disclose whether and how climate-related matters have affected the significant estimates and judgements used in testing non-financial assets for impairment. The companies should also consider the corresponding impact of exposure to climate risks on the useful lives and residual value of non-current assets. It is imperative for companies to ensure consistency and coherence between the commitments disclosed in the non-financial section of the management report and the information disclosed in the financial statements.

Other considerations

a. Aggregation of operating segments

ESMA enforcers emphasised that the companies should make an assessment of both the economic characteristics of operating segments (such as long-term average gross margin) and the qualitative criteria (such as nature of product, nature of production process, type of customers, etc.) when aggregating operating segments into one reportable segment.

b. Disaggregation of revenue from contract with customers

Emphasising on the importance of the revenue-related disclosures in enabling investors to understand a company's profitability and in estimating the future cashflows, ESMA enforcers indicated the significance of revenue disaggregation in the financial statements. It accentuated that the following factors need to be carefully evaluated when selecting the type of category (or categories) to use to disaggregate revenue:

- Economic factors that drive revenue in each category
- How information about an entity's revenue is presented for other purposes including information disclosed outside the financial statements (for example, in earnings releases, annual reports, or investor presentations).

c. Disclosures related to IFRS 16, *Leases*

The companies should provide a breakdown of the lease payments in the notes to the financial statements separately disaggregating

i. Variable payments,

ii. Short term leases payments,

iii. Low value leases, and

iv. Rent concession leases

Further, the companies should disclose additional qualitative and quantitative information that helps users of financial statements assess future cash outflows to which the lessee is potentially exposed to and that are not reflected in the measurement of lease liabilities. This includes exposure arising from variable lease payment.

Additionally, ESMA enforcers empahsised that the issuer should separately disclose the amount recognised in profit or loss for the reporting period (in accordance with paragraph 60A of IFRS 16) to reflect changes in lease payments that arise from rent concessions to which the lessee has applied the practical expedient.

Conclusion

With the increasing stakeholders' interests on the impact of climate related matters on the entity's business model, financial position, financial performance and cash flows, the exposure of climate-related risks needs to be carefully evaluated such that it might have an impact on an entity's operations and financial performance. Considering this ESMA, in its recent enforcement decisions also highlighted that companies should provide more information in relation to climate-related matters in the notes to the financial statements as required by the provisions of IAS 1.

Needless to say, the management of the companies needs to ensure that the financial statements provide information that users need through clear, meaningful and specific disclosures. Further, it is critical to ensure consistency and coherence between the non-financial information disclosed in the management reports and the judgements and estimates disclosed in the financial statements.

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