European Securities and Markets Authority

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IFRS enforcement in Europe
Report Impairment of non-financial assets

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ESMA – IFRS enforcement in Europe

Outline

1. **The European Financial Supervisory Architecture**

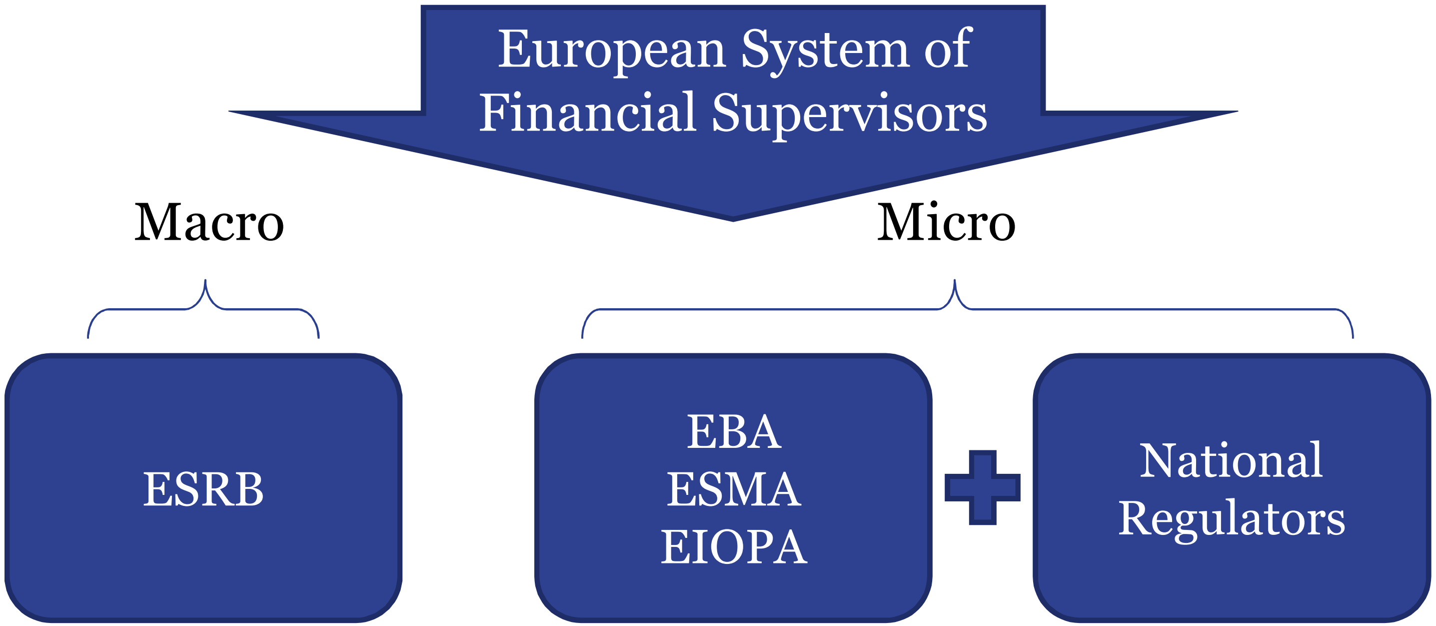
2. ESMA's role in financial reporting in Europe

3. European and International Co-operation

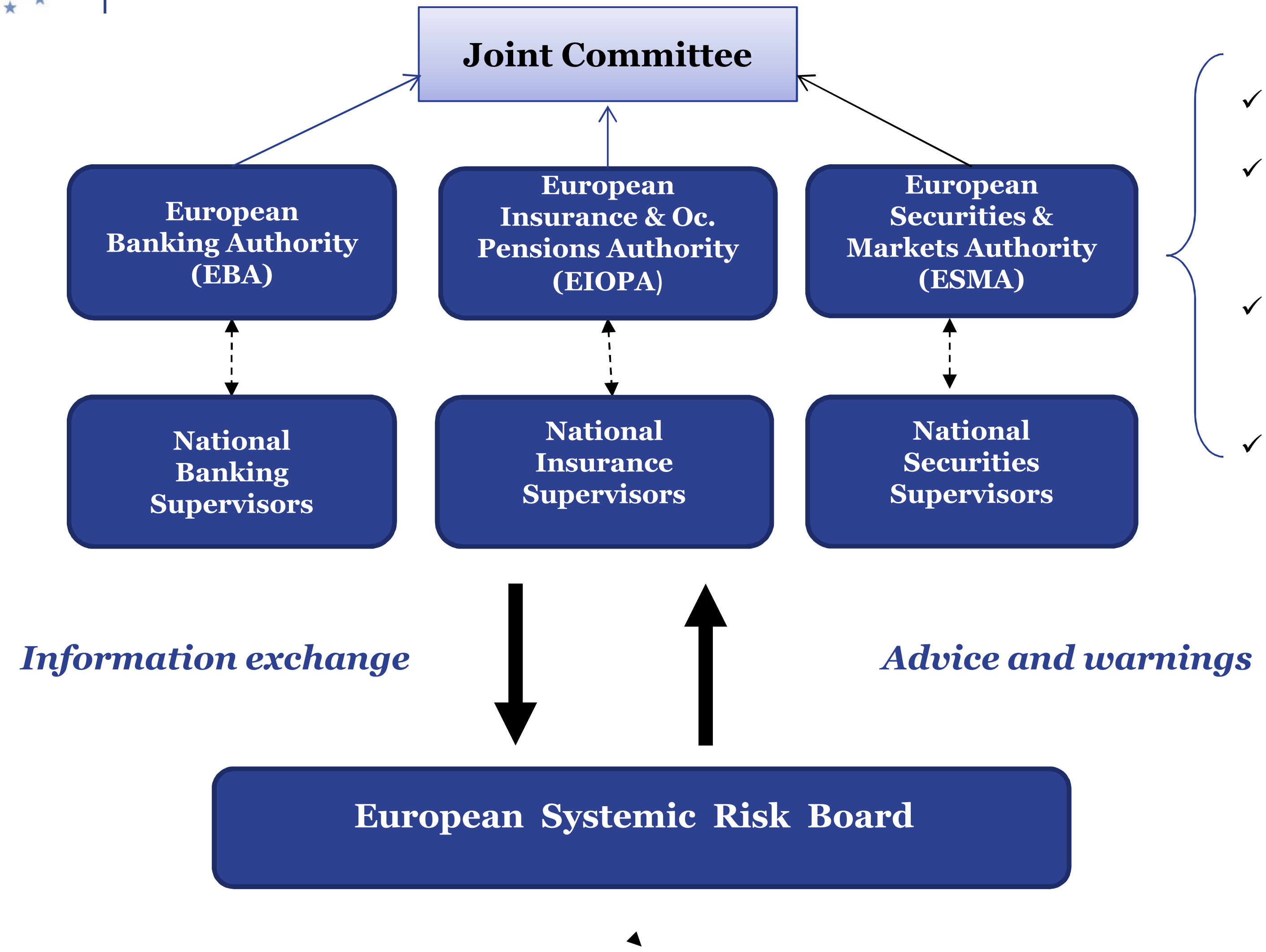
New EU Financial Supervision Framework

Lesson from the crisis: Jacques de Larosière's High Level Group Report in 2009

Macro-prudential supervision (systemic stability oversight) and micro-prudential supervision (institutions and markets) require better pan-EU coordination. Therefore, as from 1 January 2011…



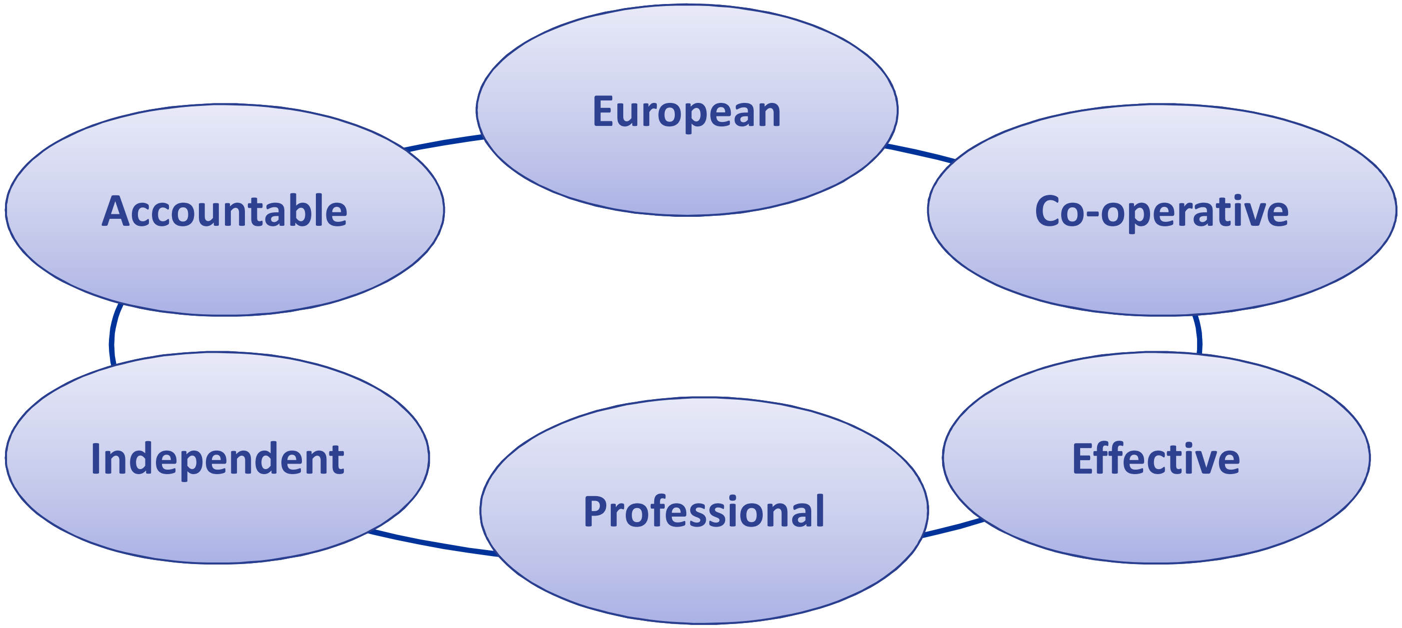
European System of Financial Supervision



- ✓ Legal personality under EU Law
- ✓ Coordinated approach of cross-sectoral issues (Joint Committee)
- ✓ Stakeholder liaison through SMSG, CWG and consultations
- ✓ New powers

ESMA- Mission statement and key characteristics

ESMA's mission is to enhance the protection of investors and reinforce stable and well functioning financial markets in the European Union. As an independent institution ESMA achieves this mission by building the single rule book for EU financial markets and ensuring its consistent application and supervision across the EU. ESMA contributes to the supervision of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.



Outline

1. The European Financial Supervisory Architecture

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ESMA's role in financial reporting

- According to European Regulation no 1095/2010, ESMA shall act in the field of financial reporting, to ensure the effective and consistent application of European Securities and Markets legislation
- Permanent Standing Committee in the Investment and Reporting Division composed of NCAs from all EU member states
- The SC is responsible for Accounting, Auditing and Periodic Financial Reporting issues and has 2 permanent operational groups: the IFRS Project Group and the European Enforcement Coordination Sessions (EECS)

ESMA is also

- Observer at the EU's Accounting Regulatory Committee, Audit RC, EFRAG TEG
- Member of the IFRS and XBRL Advisory Council
- Providing advice to the European Commission on the equivalence of third country GAAPs at European Commission request…

Contribution to the standard setting process (1/2)

ESMA's contribution to the development of the new IFRSs is mainly done through the **IFRS Project Group**, composed of 10 experts preparing input to the IASB to ensure high-quality accounting standards

Objectives

- Contribute to single rule book in Europe by ensuring high-quality enforceable accounting standards in Europe

Activities

- Discuss and provide comment letters to exposure drafts or other projects issued by the IASB and IFRS IC
- Closely cooperate with EFRAG and provide regulators/enforcer point of view
- Monitor the European IFRS endorsement process through participation to the Accounting Regulatory Committee

Contribution to the standard setting process (2/2)

Comment letters provided aim at improving decision-usefulness of financial statements and the transparency and the enforceability of IFRS

Main messages

- Importance of having clear principles and definitions accompanied by appropriate application guidance;
- Importance of consistency between standards and the conceptual framework;
- Importance of requirement for providing relevant disclosures to enable users to evaluate the approach of the entity and the degree of conservationism or aggressiveness in assumptions
- The basis for conclusions are not endorsed in the EU (no legal value, lack of enforceability)

European enforcement coordination (1/2)

ESMA's contribution to the coordination of enforcement is mainly done through **EECS,** a forum of 38 members from 29 countries in which national enforcers are brought together by ESMA to exchange views and experience relating to enforcement of IFRS

- Direct supervision of financial statements is carried out at national level, as required by the Transparency Directive
- ESMA/CESR issued in 2003/2004 two standards on enforcement and coordination of enforcement. The standards are currently under revision. The changes will build on experience gained and take into account the latest developments in the supervisory environment

Objectives

- To promote consistency amongst enforcers in decisions taken when reviewing IFRS financial statements
- To contribute to the harmonization of the application of IFRS in EEA

European enforcement coordination (2/2)

EECS main activity

- EECS provides a tool to foster ex-ante and ex-post coordination on enforcement decisions
- Analysis and discussion of individual IFRS decisions and emerging issues brought by NCA
- Identification of issues which are not covered by IFRS or which may be affected by conflicting interpretations for referral to the IASB and FRS IC;
- Identification of common enforcement priorities in Europe
- Exchange of views and experiences on methods for supervising the financial information of companies offering publicly securities and/or having these securities listed on an EEA regulated market;
- Compilation of decisions into the enforcement database and publication of a selection of enforcement decisions on a regular basis.

EECS in figures

- EECS are held 8 times a year since 2005

- EECS had 11 meetings with representatives of the IFRS IC

- Enforcement decisions are entered into an European database, which is available for consultation by NCA. All decisions are discussed in the EECS meetings. As of 31 October 2012, the database contained:

  - 230 emerging issues (description of cases discussed during EECS before a decision is taken at national level)

  - 600 decisions entered into the EECS database since its creation.

- 137 decisions have been published and are also included in the IOSCO database

ESMA – Main achievements on enforcement coordination(1/2)

ESMA's work on sovereign debt

- In July 2011 ESMA issued a Statement focusing on the need of enhanced transparency in relation to Greek sovereign bonds.
- ESMA together with the NCAs performed a fact finding exercise and discussed individual cases of around 50 financial institutions
- In November 2011 ESMA published a Statement and an Opinion published together by ESMA on 25 November 2011
- ESMA submitted a formal request to the IASB to alert them on the difficulties arising from the existing wording in IAS 39 dealing with modification vs. de-recognition of financial assets
- In July 2012 ESMA published the review of accounting practices and disclosures related to Greek sovereign bonds in the 2011 IFRS financial statements.

ESMA – Main achievements on enforcement coordination(2/2)

Studies performed on specific issues

- November 2009 – Review of the application of disclosure requirements related to financial instruments in the 2008 financial statements
- October 2010 - Follow-up of the impact of enforcement actions on the disclosures made by the companies with respect to financial instruments in the 2009 financial statements
- November 2011 - Review of IFRS implementation of IFRS 8 based on enforcement activities
- November 2011 – Consultation paper on materiality
- January 2013 - Review of disclosures related to impairment of non-financial assets
- Planned for 2013 – Review of certain aspects of IFRS 3

Results of European enforcement in 2011

ESMA publishes yearly an **activity report** providing an overview of EECS activity and the IFRS enforcement activities at national level.

Results of the review process in 2011

- European enforcers supervise around 7 000 IFRS listed issuers
- Around 850 companies reviewed covering 12% of listed accounts in Europe
- Main themes selected for partial review: impairment of assets, financial instruments disclosures, operating segments, going concern, consolidation

Enforcement actions in 2011

- 18 actions required issuance of revised financial statements
- 150 cases required public corrective notes or other public announcement
- 420 actions required corrections in future financial statements

Overall conclusions from enforcement activities

- Evidence of improvement in the level of quality of IFRS reporting every year
- Still room for improvement
- Market development tested many of the business assumptions used by issuers
- Enforcers drew attention to disclosures of risks and uncertainties
- Need for increased level of transparency in the description of specific entity facts and circumstances instead of using boiler-plate language
- Areas deserving more attention:
  - Disclosure related to fair value hierarchy of financial instruments,
  - Consolidation: Scope of consolidation and interaction with IFRIC 17
  - Business combination under common control
  - Impairment of non-financial assets : interaction with IFRS 8, determination of discount rate

Enforcers common priorities for 2012

ESMA published the common enforcement priorities of enforcers for the review of 2012 annual financial statements:

- Financial assets with particular focus on modified loans as part of forbearance practices and application of criteria for “significant or prolonged”
- Impairment of non-financial assets
- Defined benefit obligations; and
- Provisions, contingent liabilities, and contingent assets.

ESMA and the NCAs will monitor the application of the specific IFRS as outlined, with NCAs incorporating them into their reviews.

ESMA will collect data on how European listed entities have applied the IFRS requirements in relation to these topics and will publish the results.

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ESMA brings its contribution to the standard setting process:

Contribution directed to the IASB

- The IFRS Project Group discusses projects issued by the IASB and submit comments letters
- Participation to the “fatal flaw” review process

Contribution to the IFRS IC activities

- EECS hold 2 informal meetings with IFRS IC representatives every year
- Objective: discussion of complex issues identified by EECS members for which there is no specific guidance or where widely diverging interpretations exist
- Provide feedback to outreaches launched by the IFRS IC

ESMA also had bilateral meetings with the IASB staff.

Enforceability issues submitted to the IFRS IC

Some examples:

- Letter on the modification versus de-recognition as part of the Greek Sovereign Debt
- Other issues related to IAS 39: application of AG5, derivatives
- Issue on the interaction of IFRS 2/IFRS 3 scope
- Clarification on IAS 34 – meaning of the “financial report”
- IAS 1 – meaning of the realistic alternative to continue as a going concern
- Recognition of losses for joint operations accounted under equity method-interaction IAS 28 and IAS 31

Regular meetings and on-going dialogue

- Regular meetings with US SEC based on memorandum signed in 2006 (twice physical meetings and regular conference calls)

- Developing on-going dialogue with Japanese FSA in 2011 and 2012

- Developing on-going dialogues with Chinese and Indian enforcers as part of the equivalence exercise

- International seminars on IFRS enforcement (December 2009 and 2011): participation of IASB and IAASB Chairs and representatives from around 35 countries

Moving forward

- ESMA to contribute on assessing diversity in accounting practices based on its enforcement experience

- Increased dialogue on enforceability issues both as part of the standard setting process and as part of discussions on implementation of existing standards

- Enhance cooperation with third country regulators

- Increased dialogue with investors and other stakeholders

Questions?

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Report Impairment of non-financial assets

Outline

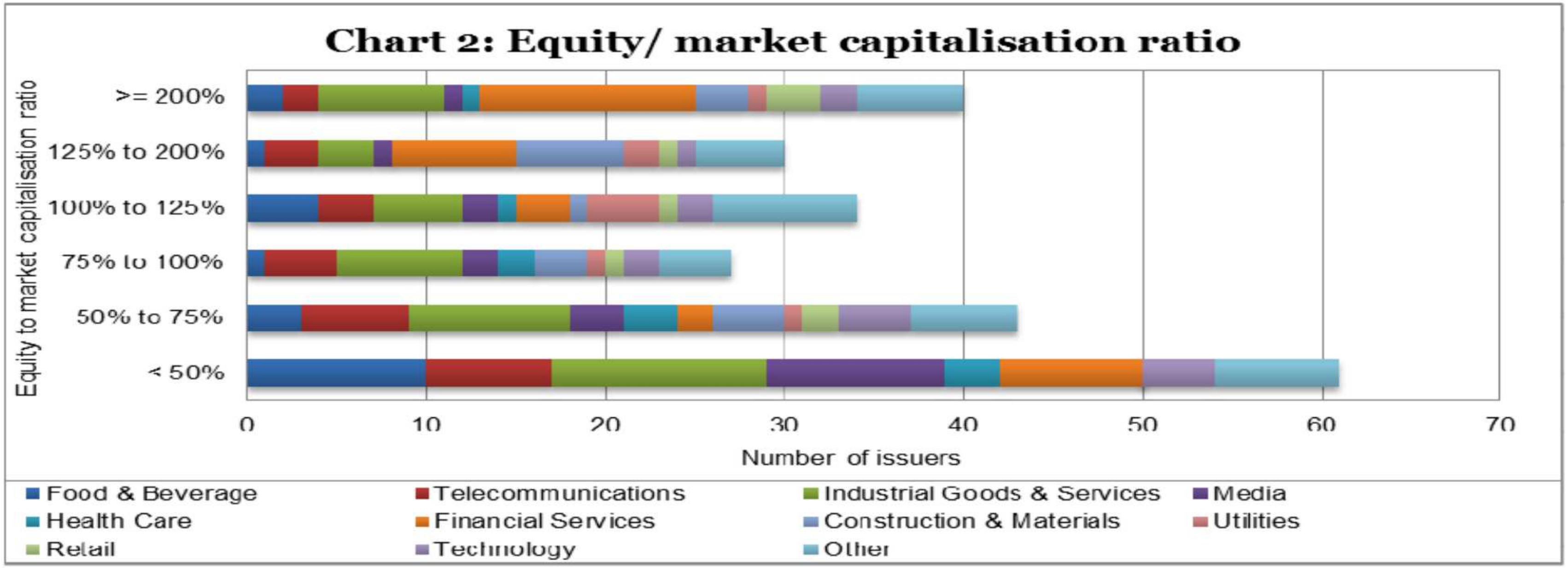
1. Objective and scope of the report

2. Findings
   - General information
   - Recoverable amount determination
   - Parameters in the DCF calculation
   - Sensitivity

3. Next steps

Objectives and scope of the report (1/2)

- Background
  - Financial and economic crisis: assets generate lower cash-flows than expected
  - Average equity/market capitalisation ratio rose from 100% in 2010 to 145% in 2011
  - Limited significant impairment losses of goodwill in 2011
  - European enforcers frequently identify infringements in relation to impairment tests: EECS decisions published in October 2012 highlight some shortcomings



Objectives and scope of the report (2/2)

- Scope
  - 2011 annual IFRS financial statements
  - 235 issuers from 23 jurisdictions with significant amounts of goodwill (around 800 € billion) and intangibles with indefinite life (150 € billion)
  - Review based solely on the information publicly available in the IFRS financial statements

Table 1: Goodwill recognised per industry in 2011 (in Euro million)

Industry	Amount of goodwill recognised in million of Euro	Number of issuers
Food & Beverage	131,898	21
Telecommunications	129,969	25
Industrial Goods & Services	119,940	43
Media	74,485	19
Health Care	74,069	10
Financial Services	59,099	32
Construction & Materials	44,536	17
Utilities	42,193	9
Retail	39,775	10
Technology	21,152	15
Other	57,848	34
Total	**794,964**	**235**

1. Objective and scope of the report

2. Findings
   - **General information**
   - **Composition of CGUs**
   - **Determination of the recoverable amount**
   - **Parameters in the DCF calculation**
   - **Sensitivity analysis**

3. Next steps

General information on impairment losses

Industry	Goodwill impairment recognised in 2011	Amount of goodwill recognised at the end of 2010	2011 Impairment rate
Financial Services	19,183	76,076	25.2%
Retail	3,128	38,314	8.2%
Technology	1,594	19,810	8.0%
Telecommunications	9,712	138,477	7.0%
Utilities	1,202	43,182	2.8%
Media	1,724	74,592	2.3%
Construction & Materials	714	45,890	1.6%
Industrial Goods & Services	1,545	112,546	1.4%
Food & Beverage	363	127,784	0.3%
Health Care	21	65,386	0.0%
Other	1,225	47,578	2.6%
Total	**40,410**	**789,635**	**5.1%**

– Events and circumstances leading to recognition of impairment losses were vague and generic for most issuers: "worsening economic outlook, slowdown of the demand, competitive environment…"

– They were specific only for few issuers: "significant deterioration of the economic conditions in country X", "impacts on the forecast cash flows due to political situation in country X"

⇒ One third of issuers with impairment losses did not comply with IAS 36.130(a)

Composition of CGUs

- 36% of the sample recognized impairment losses on goodwill in 2011

⇒ Does the impairment level reflect the effects of the economic crisis?

- Composition of CGUs
  - 86% of the issuers provide information on the level at which CGUs are defined
    - Link between level of CGU for impairment testing and operating segments for 75% of the sample
  - 13% of the sample changed the way CGUs were defined in 2011
    - All issuers provided some explanation but 70% of them merely mentioned that the change was due to " internal changes"

⇒ Improve narrative information when describing events and circumstances leading to impairment

⇒ Provide enhanced qualitative explanations for changes in definition of CGUs

Determination of the recoverable amount

- Basis for determination mentioned by 92% of the sample:
    - 80% - Value in use;
    - 6% - Fair value less costs to sell ;
    - 14% - Both values

- Fair value less costs to sell
    - Comparable transactions used for 19% of the sample
    - A majority used discounted cash flows

⇒ When fair value is determined with discounted cash flows: cash flows should be based on market's assumptions (i.e. more weight given to external sources versus entity-specific assumptions)

⇒ Improve disclosures for fair value less costs to sell

⇒ Be more specific when disclosing the basis for determining recoverable amounts

⇒ When both value in use and fair value less costs to sell are used: indicate which methodology was used for significant/sensitive CGUs

Discount rate

- Specific or average disclosed by 92%
  - 66% specific rate for each CGU
  - 25% an average discount rate (66% - one average rate, the rest - a range)
- Pre or post tax discount rate disclosed only by 78 %
  - 48 % pre-tax discount rate: between 8% and 11%)
  - 22 % post-tax discount rate: between 7% and 10%
  - 8% both pre and post tax discount rate
- Other information
  - 13% of the sample disclosed further aspects of the discount rate
    - Risk free rate, country risk premium, market risk premium, …
  - 2/3 of the sample presented comparative information

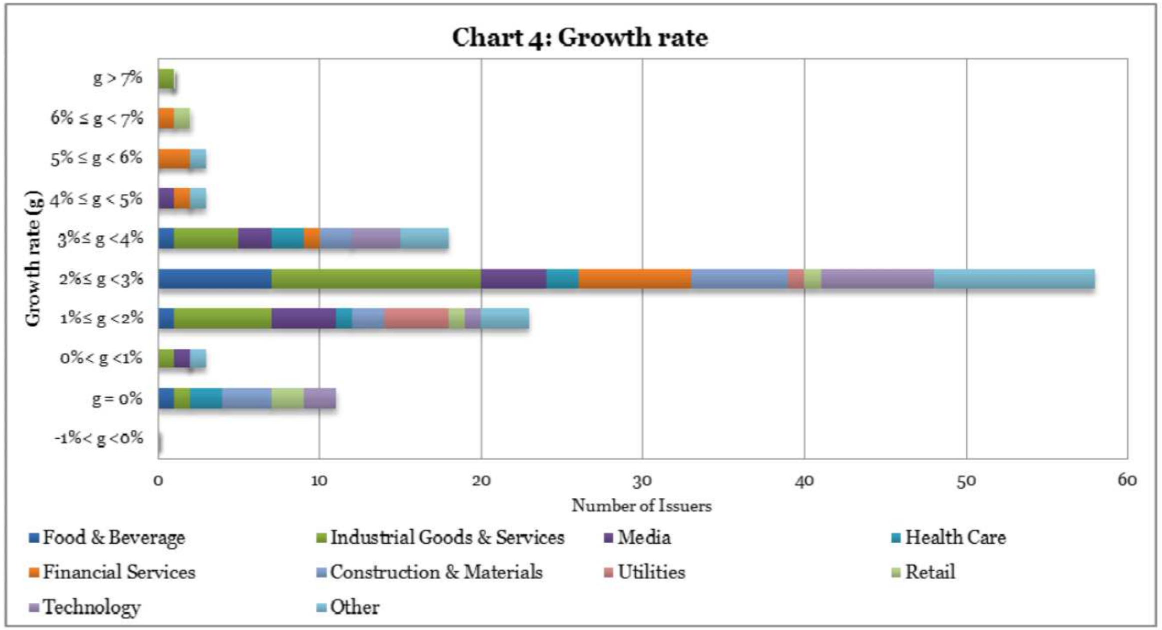
⇒ Use separate discount rates when the risk profiles of the CGUs differ

⇒ Disclosing an average rate obscures information that may be relevant

⇒ Disclose comparative information for all amounts reported (IAS 1.38)

Terminal growth rate disclosed by 83%

- The majority presented a specific growth rate by CGU
- 25% disclosed a range
- Comparative information provided for less than half of the sample



⇒ In some cases, terminal growth rate might appear to be too optimistic compared with the long term expectations of investors reflected in the market capitalisation

⇒ 20% of issuers with a growth rate > 3% : use of a long term growth rate > 3% in mature markets appears very ambitious and may create doubts as to the approach followed

⇒ Issuers should provide realistic estimates of future growth rates that correspond to current predictions of economic growth

⇒ Issuers should disclose comparative information for all amounts reported (IAS 1.38)

Period covered by cash flows

- Mentioned by 88% of the issuers
  - Periods of 5 years or less for 80% (the great majority using 5 years)
  - Periods of 6 to 10 years for 14% and periods exceeding 10 years for 3 issuers
    - 61% disclosed the basis for the chosen period

⇒ When using periods > 5 years, provide explanations and ensure that projections are reliable

⇒ Disclosures should be entity specific and explain the facts pattern which will enable users to assess whether the longer forecast period is reasonable

Key assumptions

- 56% of the issuers stated that projections were consistent with past experience and forecasts of external sources of information
  - Less than half can be considered as compliant (IAS 36 Example 9)
  - Quality of explanations varied
    - Measures such as EBITA, EBITDA, operating cash flows, …
    - Some provided generic sentence: cash flows forecasts based on budget approved by management

⇒ Improve disclosures on the key assumptions in number and type

⇒ Major area since disclosures of key assumptions are aimed to assist users evaluate the reliability of the impairment tests

Reminder: IAS 36 example 9

Key assumption	Basis for determining value(s) assigned to key assumption
Gross margin during the budget period	Average gross margins achieved in period immediately before the budget period, increased for expected efficiency improvements. Values assigned to key assumption reflect past experience, except for efficiency improvements. Management believes improvements of 5% per year are reasonably achievable.
Raw materials price inflation during the budget Period	Forecast consumer price indices during the budget period for North American countries from which raw materials are purchased. Value assigned to key assumption is consistent with external sources of information.

Sensitivity analysis

- 25% disclosed all required variables
  - Amount of headroom, value of the key assumptions, amount by which the values of assumptions must change for the headroom to disappear
    - Analysis limited to discount rate and terminal growth rate for the majority
    - 1/3 disclosed the sensitivity on other assumptions (EBIT, gross margin)
- 40% disclosed one or two of the required disclosures
  - Most often values of key assumptions and amount of headroom
  - Indication that no reasonable possible change in key assumptions could cause any impairment loss for 50% of the issuers
- Information on an aggregated basis for 50% of issuers
  - Should be disclosed for each CGUs

⇒ Confirmation that no reasonable change in key assumptions would lead to an impairment is widespread: neither the amount of headroom nor what is considered to be a reasonably possible change can be determined

⇒ Disclose clearer information on the sensitivity to changes in the key assumptions

⇒ A sensitivity analysis that is vague or not understandable is not useful

⇒ Sensitivity analysis should be provided also for key “operational” assumptions

Outline

1. Objective and scope of the report

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   - Sensitivity analysis

3. **Next steps**

Next steps

- Follow up in 2013 throughout the reviews carried on by national enforcers
- ESMA will focus on:
  - Improving the rigour issuers apply in the impairment test of goodwill and other intangible assets;
  - Monitoring the application and compliance with IAS 36, and in particular:
    - the reasonableness of cash flows forecasts;
    - key assumptions used in the impairment test;
    - the relevance and appropriateness of the sensitivity analysis provided (e.g. in circumstances when market capitalisation fall below the book value of net assets; and
  - Considering whether issuers have provided sufficient and relevant disclosures in this area.

Questions?

Thank you!