Accounting Enforcement Priorities
for 2021 Year Ends

by Maurice Barrett

The Irish Auditing and Accounting Supervisory Authority (IAASA) is the accounting enforcer in Ireland. IAASA publishes a paper each September highlighting areas that companies should give extra attention to when preparing their annual financial statements in the coming year. IAASA's most recent such paper – Observations on selected financial reporting issues – years ending on or after 31 December 2021 is available on www.iaasa.ie. While the paper is prepared with listed companies in mind, the messages are equally relevant to all companies.

The European Securities and Markets Authority (ESMA) is the Europe-wide body responsible for safeguarding the stability of the EU's financial system. Co-ordination of accounting enforcement across the EU is part of ESMA's activity. One element of ESMA's accounting enforcement role is the publication of a Public Statement each October establishing the common enforcement priorities (CEPs) for the annual financial reports of listed companies.

This article draws out the common themes of these two documents.

Objectives

Our accounting enforcement regime is developed in accordance with the EU Transparency Directive, which aims to ensure that companies provide high quality financial reports to the public.

ESMA's statement is directed at the approximately 4,000 listed companies across the EU including the circa 130 companies under IAASA's remit.

While directed primarily at this limited population of companies, the topics covered in the two documents are relevant to most companies. The Observations paper and the ESMA statement are written primarily from an International Financial Reporting Standards (IFRS) perspective; however, most of the topics covered apply equally to companies applying Irish standards.

As such, IAASA recommends that preparers, management, audit committees, directors and auditors consider the messages in both documents when preparing, approving and auditing financial statements.

Emerging trends

The ESMA CEPs statement highlights the importance of non-IFRS-based priorities. Of the seven areas included in the CEPs statement, only three refer to IFRS requirements. This is considered significant and is indicative of the direction of travel of corporate reporting and accounting enforcement at the European level. It reflects a trend to consider corporate reporting from a more holistic point of view and a much wider perspective than the more traditional approach of considering only the monetary amounts and disclosures in the IFRS financial statements. Over the coming months and years, IAASA's role will continue to expand into areas other than IFRS financial statements, in particular, in the area of sustainability reporting.

We know that the EU is developing climate change and sustainability reporting requirements, a project that is advancing at pace. However, the IAASA and ESMA documents note that companies should not be waiting for those European changes to be agreed and implemented; rather, disclosures are required now.

The International Accounting Standards Board (IASB) is active in this area also and has published educational material Effects of climate-related matters on financial statements highlighting how IFRSs require entities to consider climate-related matters when the impact is material to their financial statements.

Companies, particularly those in the most affected sectors such as extractive industries, aviation and transport, should disclose how they have assessed climate risks when considering significant judgements and major sources of estimation uncertainty. Companies should also carefully consider whether any provisions or liabilities could arise. Perhaps from the potential for future regulatory requirements to remediate environmental damage, contracts that may become onerous or restructurings to redesign products or services to achieve climate-related targets.

Common themes

In addition to both documents focusing on climate change, there are other common themes running through both the IAASA paper and ESMA's CEPs statement. These themes include:

- expected credit losses (ECLs) – IFRS 9 Financial Instruments,
- alternative performance measures (APMs); and
- the impact of Covid-19.

Expected credit losses (ECLs) – IFRS 9 Financial Instruments

ECLs feature prominently in both documents, reflecting the significance of expected credit losses. It is important to note that these requirements don't just apply to banks; they apply to all companies.

Economic support and relief measures continue to be provided by governments to offset the impact of Covid-19 restrictions. The depth and duration of the impact of Covid-19 and the trajectory of any recovery remain uncertain. However, relief and supports, including debt warehousing, are being unwound over the next couple of months and only then will the longer-term impacts on ECLs become apparent. Companies should distinguish between measures and reliefs that have an impact on the credit risk of financial instruments over the expected life of financial assets and those which address temporary liquidity constraints of borrowers and apply IFRS 9 accordingly in preparing their financial statements.

Post model adjustments (or 'management overlays') have been made to supplement model-based ECL calculations. These post-model adjustments should be considered to ensure that ECLs are measured in a way that reflects an unbiased and probabilityweighted amount that is determined by evaluating a range of possible outcomes.

Companies must disclose the macro-economic information used when determining the ECL. It is likely that there may be significant changes to macro-economic assumptions due to Covid-19 restrictions and the subsequent recovery, the impact of supply chain constraints and the uptick in inflationary pressures; for some companies, the uncertainties over the Northern Irish Protocol and the impact on cross-border trade flows may be substantial. Companies should disclose and clearly explain any significant changes in macro-economic assumptions used in ECL measurement during the reporting period and the reasons for changes.

Companies are required to disclose the basis for the inputs and assumptions and the estimation techniques used to determine whether there is a significant increase in credit risk (SICR) of financial instruments since initial recognition. IFRS 9 does not define SICR. It is a judgmental area and a company will need to identify relevant factors that indicate a significant increase in credit risk based on the facts and circumstances specific to the financial asset and how the company manages credit risk; this involves both quantitative and qualitative assessments. Companies need to explain how relief measures (i.e. forbearance) have impacted the assessment of SICR.

Looking at climate change, companies should disclose clearly how material climate-related and environmental risks are incorporated into the ECL calculations.

Alternative performance measures (APMs)

Both the IAASA paper and the ESMA statement address the use of APMs by companies. APMs are where companies adjust the IFRS numbers in some way and use those adjusted numbers in their commentary, typically in the front, narrative section of the annual report. These numbers are not audited and, therefore, it is important that users are clear on what the differences are between these APMs and the audited financial statement numbers.

The ESMA CEPs statement urges caution if entities adjust APMs used or develop new APMs with the sole objective of depicting the impact that Covid-19 has on financial performance. ESMA contends that, in most instances, the Covid-19 impact should not be presented separately in APMs.

IAASA continues to identify issues relating to APMs and reminds companies that:

- APMs should not be presented with more prominence and emphasis or authority than the numbers from the audited financial statements
- APMs must be reconciled to the audited IFRS numbers
- companies must use correct labels to describe APMs (e.g. the expression 'Adjusted EBITDA' is used rather than 'EBITDA')
- APMs must be defined and the basis of the calculation applied
- Use of APMs must be clearly explained, and
- APMs must also include comparative prior year amounts.

Impact of Covid-19

The ESMA CEPs statement notes that the impact of Covid-19 has been severe and the path to recovery may be prolonged. The statement sets out the need for a careful assessment of the longer-term impacts of Covid-19 on a company's activities, financial performance, financial position and cash flows (such as going concern assumptions, significant judgements, estimation uncertainty, presentation of financial statements and impairment of assets). It also reminds companies to provide transparent disclosures of arrangements that take the form of supply chain financing and calls for transparency on the criteria and assumptions used in the recognition of deferred tax assets arising from the carry forward of unused tax losses and unused tax credits due to the Covid-19 pandemic.

IAASA's paper addresses Covid-19 in a number of places and, amongst other matters, emphasises the need for disclosures to be entity specific and to provide sufficient detail to allow users to understand the impact that the Covid-19 restrictions have on the company's current and future financial performance, financial position, cash flows and risks.

IAASA's paper and ESMA's CEPs statement reminds companies to provide a description of the nature and extent of any significant public support measure received by category (e.g. loans, tax relief, compensation schemes).

Conclusion

The priorities for financial reporting in the short to medium term mirror what most of us are likely to be most concerned with in our personal lives also, being the recovery (hopefully!) from Covid-19 and climate change. We all hope that we are seeing an end to the pandemic, though there is much talk of the 'new normal' and how our personal and consumer behaviours have changed for the long-term.

There is a strong drive from the public and from governments for both of these things. There is also a cultural shift amongst the investor community requiring more information so that that can make more qualitative decisions about the types of companies they want to invest in – with a desire to ensure that those companies, as well as the supply chain of those companies, are behaving in an ethical and climate friendly way.

To ensure that investors can fully understand and respond to the above, it is vital that the annual reports of companies provide true and fair information about these matters.

Applying the adage 'together is better', when preparing, approving and auditing financial statements, the contents of both documents should provide helpful pointers to preparers, management, Audit Committees, directors and auditors and thereby contribute to higher quality financial reports.

IAASA's Observations document is available at http://iaasa.ie/getmedia/5423b3c0-6cef-4d75-a383-69f7a03d42af/IAASA-Observations-paper-2021.pdf?ext=.pdf

ESMA's Public Statement on Common Enforcement Priorities is available at https://www.esma.europa.eu

ESMA's Guidelines on Alternative Performance Measures is available at https://www.esma.europa.eu/sites/default/files/library/2015/10/2015-esma-1415en.pdf

The International Accounting Standards Board's educational material Effects of climate-related matters on financial statements is available at https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf)

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The views expressed here are his own and do not necessarily reflect IAASA's official positions.