# Application of new reporting standards in 2019

The rules governing the valuation and determination of the result of financial instruments (IFRS 9) and the recognition of revenue (IFRS 15) changed with effect from 1 January 2018. IFRS 16 'Leases' came into effect on 1 January 2019. In 2019, the AFM followed up its previous thematic reviews[1] of the application of IFRS 9, IFRS 15 and IFRS 16 in the reporting of Dutch listed companies. The primary focus was on the application of IFRS 16, 'Leases', since we had established in 2018 that this standard would have the most effect on the reporting of many companies.

As a result of our thematic review of IFRS 16, the AFM sent a letter to 24 of the 60 companies reviewed to urge them to clearly disclose the transition to IFRS 16 in their 2019 financial statements. In addition, we put questions to a number of companies regarding the application of IFRS 9 and IFRS 15 as part of our regular supervisory activities. We list our key observations regarding each standard below.

Besides this report, we refer to ESMA's European Common Enforcement Priorities[2] for the coming year, which assign a prominent place to these new standards.

## Practical examples for good introduction of IFRS 16 'Leases'

IFRS 16 'Leases' came into effect on 1 January 2019. The AFM has reviewed how the transition to this new standard and the changed accounting policies is disclosed in the half-year financial statements for 2019.

## Methodology

Based on the financial statements for 2018, we selected the 2019 half-year financial statements of around 60 listed companies that were expected to be most affected by IFRS 16. For example, retailers with numerous branches. We reviewed these half-year financial statements in order to establish how the transition to IFRS 16 and the changed accounting policies had been disclosed. The thematic review identified several good examples that can be of assistance to parties in the proper implementation of this new standard. These are described below.

## Disclosure of transition approach clarifies the introduction of IFRS 16

IFRS 16 allows implementation of the system change in the opening statement of financial position for the reporting period in which IFRS 16 is applied for the first time. In most cases, this is 1 January 2019. For this, a company has to provide a number of disclosures, for example the relationship between the amount of operating leases reported on 31 December 2018 and the 'Leases' item in the

[1] See https://www.afm.nl/~/profmedia/files/onderwerpen/financiële-verslaggeving/nieuwe-ifrs.pdf
[2] See https://www.afm.nl/nl-nl/nieuws/2019/okt/esma-aandachtspunten-verslaggeving-2019.

opening statement of financial position. We note that a number of companies also included a disclosure of their approach to the transition in their 2019 half-year financial statements. This makes it much easier to follow the system change in the half-year financial statements.

## Wider disclosure makes the effects clearer

A number of companies not only disclose the effects of the introduction of IFRS 16 on their assets and result; they also disclose other effects such as the effect on their EBITDA and operating cash flow. Good disclosure of these effects provides users with a clear understanding of the effects on the financial statements. The introduction of the standard can affect valuations using multiples based on EBITDA or free cash flow, so transparency is important.

## Keep the figures comparable

Some companies provide this transparency by adjusting the reported IFRS figures in accompanying press releases or the management report (‘adjusted for the effects of IFRS 16’). This approach keeps the various figures comparable with previously reported figures. We would however note that these are Alternative Performance Indicators that therefore must be reported and designated as such[3].

## Give a transparent explanation of the choice made

IFRS 16 offers a number of practical expedients. Users of reporting benefit from an explanation by companies of which of these expedients have been used in the transition, and separately, which expedients have been applied to the general accounting policies.

## Implications for loan covenants is an important disclosure

A number of companies disclose the effects of IFRS 16 on their loan covenants. This is an important disclosure for investors, certainly for companies whose financing and related covenants are of material importance.

## Take account of sub-leases

Lastly, we wish to draw attention to the effect of this standard on the classification of sub-leases. Under the new standard, a sub-lease is possibly more likely to be a financial lease for the sub-lessor, since the term of the original lease is relevant for its designation rather than the useful economic life of the leased asset.

[3] See https://www.esma.europa.eu/system/files_force/library/2015/10/2015-esma-1415nl.pdf

## Disclosure of IFRS 15 ‘Revenue from Contracts with Customers’ generally clear

Our thematic review revealed that the disclosures of the system change and the application of IFRS 15 in these financial statements are generally clear. We do however point out that some disclosures relating to IFRS 15 could be improved, for example the disclosure of disaggregation of revenue and making the statement of accounting policies more company-specific.

## Methodology

In 2018 we selected around 20 companies whose reporting was expected to be significantly affected by IFRS 15. This mainly concerns the timing of revenue recognition and the capitalisation of contract assets. We assessed the 2018 financial statements of these companies with regard to the application of this standard.

## Results

- In cases where valuation principles are clearly described, we note that the 5-step model of IFRS 15 provides good insight into how and when revenue is recognised. Clear disclosures provide insight into contractual performance obligations. Not all companies disclosed this principle in a company-specific manner.
- We note that disclosure of the development of the item contractual obligations is essential for proper understanding of the links between backlogs, contractual obligations and revenue. In cases where this applies, the contract positions in the statement of financial position are material.
- The provisions relating to agent/principal in IFRS 15 have changed. The decisive factor is now control. We held discussions with a couple of companies regarding the application of these provisions in relation to their business model.
- One of the new disclosure requirements in IFRS 15 concerns a further disaggregation of revenue. This disaggregation has to provide insight into how the nature, amount, timing and size of the revenue is affected by economic factors. We note that companies are not yet following this disclosure requirement with much consistency.
- We expect all companies to provide more detailed or different specification of the various revenue flows than they provide for the flows that have to be stated in the segment reporting, given the different requirements for and the purpose of segment reporting versus this new disclosure requirement.
- Finally, we wish to point out that it is a requirement to state the connection between the disaggregation of revenue and the segment reporting.

## Limited financial impact of IFRS 9 'Financial Instruments' on Dutch banks

Our review in 2018 showed that the organisational and administrative impact of the introduction of IFRS 9 was felt mainly by the banks. Our thematic review accordingly focused specifically on the reporting of the banks. We note that ultimately, the financial effects on Dutch banks have been quite limited. This is partly due to the current positive economic conditions, in which the macroeconomic inputs are more positive than originally expected.

## Methodology

We assessed the financial statements of nine listed banks with regard to the application of IFRS 9.

## Results

- In most of the 2018 financial statements by the banks, we see mainly qualitative disclosures on the determination of a significant increase in credit risk and the scenarios and weighting of macroeconomic inputs and forward-looking information that are used for the modelling of loan loss provisions.
- This provides users with limited insight into the application of IFRS 9 and does not enable them to make their own estimation with respect to the bank's short-term forecasts. One bank provided a sensitivity analysis as well as disclosing the key macroeconomic inputs. This accords with the principle that a mix of qualitative and quantitative disclosures provides the required insight and thereby sets a good example.