European Securities and Markets Authority

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PUBLIC STATEMENT

Sovereign Debt in IFRS Financial Statements

As a result of recent sovereign debt[1] developments and the increased market interest in this area, there has been a lot of focus on the accounting practices of listed companies, and financial institutions in particular, with respect to their exposures to sovereign debt.

On 28 July 2011 ESMA issued a Statement[2] stressing the need for enhanced transparency and the importance of applying the relevant International Financial Reporting Standards (IFRS). ESMA also encouraged issuers to provide information on their exposures to sovereign debt on a country-by-country basis in their financial statements.

Since then ESMA conducted together with national competent authorities a fact-finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements based on a sample of financial institutions listed in EU regulated markets.

The consistent application of IFRS, which covers standards for recognition, measurement and disclosure, is important for the proper functioning of financial markets. ESMA publishes this Statement to promote consistent application of European securities and markets legislation, and notably of IFRS. It contains two Sections:

— Section 1 discusses accounting issues related to sovereign debt in IFRS annual financial statements ending 31 of December 2011. The Section highlights elements that should be considered by issuers and their auditors in relation to exposure to sovereign debt when preparing their financial statements for the upcoming year-end.

— Section 2 is an ESMA Opinion "*Accounting for Exposure to Greek Sovereign Debt – Considerations with respect to IFRS Interim Financial Statements for Accounting Periods ended on 30 June 2011.* The Opinion provides a summary of the outcome of the fact-finding exercise together with elements that should have been considered by issuers and their auditors as part of the IFRS interim financial statements for periods ended 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

[1] Sovereign debt, for the purpose of this statement, refers to bonds issued by and loans given to central and local government and governmental bodies.
[2] http://www.esma.europa.eu/popup2.php?id=7685

ESMA • 103 Rue de Grenelle • 75007 Paris • France • Tel. +33 (0) 1 58 36 43 21 • www.esma.europa.eu

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Section 1: Sovereign Debt in Annual IFRS Financial Statements

ESMA would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided for in IFRS. This Section should not be understood as constituting guidance or recommendations on how to apply IFRS, but rather as assisting issuers in preparing their annual financial statements.

Issuers having securities traded on an EU regulated market and that have material exposure to sovereign debt should consider the following elements as part of the preparation of their year-end IFRS financial statements:

Existence of impairment for sovereign debt related financial assets

The assessment of objective evidence that a financial asset is impaired should be based on the criteria in paragraph 59 of IAS 39 – *Financial instruments: Recognition and Measurement* such as: financial difficulty of the obligor, breach of contract, concession granted to the borrower, disappearance of an active market or decrease in the estimated future cash flows. IAS 39 paragraph 60 specifically notes that a credit downgrade is not, of itself, evidence of impairment, nor is a decline in the instrument's fair value, although it may be evidence of impairment when considered with other available information. In addition, when assessing the existence of a loss event, consideration should also be given to the fact that default risk is related to the obligor and not to a specific financial instrument issued by that party.

Therefore, ESMA emphasises that issuers should carefully analyse facts and circumstances at the reporting date. They should provide in the IFRS financial statements all relevant disclosures related to the criteria used in assessing the existence of objective evidence of impairment for financial assets and present all the assumptions and uncertainties regarding the impact on future estimated cash-flows.

Measurement of financial assets related to sovereign debt exposure

ESMA reminds issuers of the following IAS 39 measurement principles regarding the different accounting categories of financial assets:

— For financial assets classified as held to maturity or loans and receivables:

  Sovereign debt classified as held to maturity or loans and receivables are measured at amortized cost using the effective interest rate method[3]. If there is objective evidence that assets are impaired, an estimate of impairment losses should be determined based on appropriate reassessment of expected future cash-flows using the original effective interest rate. In cases where a restructuring plan is in place, such estimation should be based using details from the plan, unless a derecognition of the original asset has taken place and a new financial asset is recognised. Where a restructuring plan exists (see also below the paragraph on *Greek sovereign debt – specific accounting matters*), but it is not yet in place and/or the details are still unknown, issuers should ensure that a best estimate is determined based on all the information available, including any further indications of material losses in addition to those induced by the plan.

[3] In case the bonds have been reclassified out of the fair value through profit or loss category or the available for sale category the effective interest rate calculated at the moment of the transfer should be used.

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— For financial assets classified as available-for-sale or held-for-trading

Sovereign debt classified as available-for-sale or held for trading is recognized in the statement of financial position at fair value. If there is objective evidence that assets are impaired, an impairment loss has to be recognised in the profit or loss account for the assets classified at available-for-sale. In order to determine the fair value, issuers should analyse whether a financial instrument is regarded as quoted in an active market or not at the reporting date by analysing whether quoted prices are readily and regularly available for each instrument (by issuance) and whether those prices represent actual transactions between willing parties on an arm's length basis. In this context we believe that the literature provided by the IASB Expert Advisory Panel – *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*[4] constitutes relevant guidance. Though IFRS 13 (*IFRS 13 – Fair Value Measurement*) is not endorsed in the European Union it could be relevant as part of that analysis.

When a market for a financial instrument is active, issuers should use the quoted prices, which are defined as level 1 fair value measurements under IFRS 7 – *Financial Instruments: Disclosures*. For those instruments for which the market is not active, level 2 measurements should be applied by using models which make maximum use of market inputs, such as inputs from observable similar or linked instruments, such as other bonds, preferably issued by the same sovereign state, with similar maturities.

Disclosures in the year-end IFRS financial statements

ESMA would like to stress the importance for issuers to provide all relevant disclosures related to exposure to sovereign debt in order to comply with the requirements of IFRS 7. ESMA would also like to underline that in order to achieve a fair presentation, as stated under IAS 1 – *Presentation of Financial Statements,* issuers are required to provide any additional disclosures when compliance with IFRS 7 does not suffice to enable users to understand the impact of sovereign debt to the financial position and performance of the issuer. This is particularly important for areas in which management judgement is applied, as allowed by IFRSs.

In addition, ESMA believes that in the case where a market is not active for a specific instrument, the issuer should provide supplementary disclosures explaining the underlying rationale, assumptions and the sources used as inputs to the valuation.

Moreover, ESMA would encourage providing quantitative and qualitative information on sovereign debt related instruments such as credit default swaps (CDS) and other instruments, directly referencing to sovereign debt such as financial guarantees, forward contracts, options and other derivatives. This could include the level and the risks to which the issuer is exposed, as well as the estimated level of protection in case a CDS was acquired by an issuer.

Greek sovereign debt - specific accounting matters

As a result of significant financial and economic difficulties experienced by Greece, a particular focus is given to Greek sovereign debt. European leaders proposed in July 2011 a financial assistance package for Greece in which private bondholders would be asked to contribute towards the relief of Greece's debt burden via a voluntary bond exchange (known as the Private Sector Involvement). That proposal would have resulted in a 21% net present value loss for private bondholders based on an assumed discount rate of 9% and a significant extension in the overall maturity profile of the country's debts.

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[4] http://www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf

The economic situation in Greece has continued to deteriorate and on 26 October 2011 European leaders proposed changes to the plan for Private Sector Involvement. At the date of this release the specific terms of the participation to the plan are unknown and negotiations are still ongoing, but based on the Euro Summit Statement we understand that the plan would request private bondholders to accept a 50% reduction in the nominal value of the bonds.

ESMA together with national competent authorities conducted a fact finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements of a wide sample of financial institutions listed in EU regulated markets. Based on this review, there is evidence that accounting practices of financial institutions with regard to sovereign debt exposures varied, in particular with respect to the extent of debt exposures subject to impairment losses, the methods for calculation of impairment losses and methodologies used for fair value measurement. Therefore, the second Section of this Statement contains an Opinion regarding accounting for exposure to Greek Sovereign debt in the IFRS interim financial statements for accounting periods ended on 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

Future actions

ESMA will, together with national competent authorities, continue to strictly monitor the application of IFRS and consider whether further actions are needed in order to ensure the appropriate accounting treatment of exposure to sovereign debt by European issuers.

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Section 2: Opinion – Accounting for Greek Sovereign Debt – Considerations with respect to IFRS interim financial statements for accounting periods that ended on 30 June 2011

I. Introduction and legal basis

1. As a result of recent developments in the area of sovereign debt and the increased market interest in this area, ESMA issues an opinion to promote the effective and consistent application of European securities and markets legislation and notably of International Financial Reporting Standards and relevant sectoral legislation.

2. ESMA's competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EC) No 1095/2010 (the "Regulation"). In accordance with Article 44(1) of the Regulation the Board of Supervisors has adopted this opinion.

II. General observations

3. As part of its objective to coordinate European enforcement activities, ESMA has collected information from National Competent Authorities (NCAs) with respect to IFRS half-year financial statements ended on 30 June 2011, published by listed European financial institutions. On this basis, there is evidence that some accounting practices of issuers with regard to Greek sovereign debt exposures varied across the European Economic Area.

4. The main identified divergences for the 53 financial institutions included in our fact-finding exercise relate to the following:

   — It has been observed that there are differences regarding recognition or non-recognition of impairment losses. Data collected show that for example two financial institutions which had decided not to participate in the July International Institute of Finance plan (the "July IIF plan") did not recognise any impairment. Another difference relates to bonds with maturities after July 2020, for which some financial institutions indicated recognition of impairment losses and some did not.

   — Regarding bonds classified as held to maturity, 10 out of 23 financial institutions with investments in this category used the estimation of the 21% "haircut" on the face value of the bonds provided in the July IIF plan as the estimation for the impairment loss. Some banks used the original effective interest rate resulting in impairment losses between 17% and 23% while others used the new discount rate indicated in the July IIF plan for calculating the impact on the estimated future cash-flows.

   — Other differences appeared with respect to financial assets classified as available for sale (AFS), for which different valuation methods have been used by issuers. Out of 34 financial institutions with AFS instruments, 20 used fair values based on market data corresponding to level 1 valuation as defined by IFRS 7. Other financial institutions judged that the markets for the investments in their portfolio were not active and therefore used level 2 (3 financial institutions) presumably because they thought either that there were no transactions taking place or because the transactions that were taking place were not orderly transactions. Four

issuers used level 3 measurements. For another 4 issuers it was not possible to identify the measurement method used. Finally 3 issuers did not recognise any impairment losses, but only a decrease in value accounted for in other comprehensive income.

— It appeared that there were some cases in which the consequences of different accounting practices could be assessed as non-material.

III. Description of accounting considerations

5. While ESMA acknowledges that the supervision of financial reporting and necessary potential enforcement actions that may arise rests with NCAs, it is important that consistent application of IFRS is achieved in the European Union. To achieve that goal, the existing European IFRS Enforcement Coordination Mechanism (EECS) provides ESMA with a very valuable tool.

6. The present opinion is based on discussions that took place between ESMA and NCAs within EECS in order to coordinate the enforcement activities in the particular area of accounting for exposures to Greek sovereign debt. EECS has been specifically mandated to consider all technical issues related to this matter, including but not limited to: the arguments used by issuers relating to triggering events when recognising an impairment loss, measurement methods used in compliance with the fair value hierarchy, and determination of criteria for assessing whether markets are active or inactive. This Opinion forms an element for NCA's when considering an enforcement decision.

7. ESMA acknowledges that materiality plays an important role in identifying the appropriate type of enforcement action to be considered by NCAs where a misstatement is identified in the IFRS financial statements. When a material misstatement in the financial information is detected enforcers should take appropriate action to achieve appropriate disclosure of such a misstatement and, where relevant, public correction of the misstatement.

8. In ESMA's opinion, the following elements should have been considered by issuers and their auditors when preparing their IFRS interim financial statements published for periods that ended on 30 June 2011. Some of these elements might also be relevant for issuers and their auditors when preparing or auditing future financial statements.

9. Regarding the existence of objective evidence of impairment and determination of an asset being impaired, it is ESMA's opinion that:

— There was objective evidence of impairment of Greek sovereign bonds as of 30 June 2011, based on at least two of the criteria to be considered according to paragraph 59 of IAS 39 – *Financial Instruments: Recognition and Measurement*: significant financial difficulty of the debtor and decrease in the fair value of the investment. The European Council's decision on 21 July 2011 with respect to the private sector initiative is indicative of a concession granted by private investors and confirms the significant financial difficulty of the debtor as of 30 June 2011 and raises concerns about whether the bonds would be paid in full. Issuers should have provided indications on the facts and circumstances and the conditions that existed at that date in their reports.

- The conditions existing as of 30 June 2011 had an impact on the estimated future cash-flows that could be reliably estimated. Indicators of the possible impact on contractual cash flows were available as part of the haircut indicated in the July IIF plan, in which a number of financial institutions confirmed their participation. In some circumstances, transactions observed in the market were also indicative of the fact that future estimated cash flows will be impacted, even if other scenarios than the implementation of the July IIF plan were taken into account by market participants. Consequently financial assets related to exposure to Greek sovereign bonds with maturities before July 2020 were impaired.
- Regarding Greek bonds with maturities after July 2020, which were not included in the July IIF plan, the facts considered above should have been analysed as indicating that the contractual cash-flows were at risk of being impacted by the financial difficulties. Default risk is related to the debt issuer and not to a financial instrument issued by the debt issuer. The estimation of the size of such an impact on the future cash flows is a matter of judgement.

10. With regards to the measurement of exposure to Greek Sovereign bonds, it is ESMA's opinion that:

- For their interim financial statements issuers should have determined impairment losses on the Greek sovereign bonds classified as held-to-maturity using the original effective interest rate[3], notwithstanding whether they expressed their participation in the plan put forward by the IIF or not. According to IAS 34 paragraph 41, the preparation of interim financial reports generally requires a greater use of estimation methods than annual reports. Taking into consideration the uncertainties that existed at the time the interim financial statements were prepared, the 21% haircut could be accepted in some circumstances as being a possible estimate based on reasonable judgement for measuring impairment losses for financial assets measured at amortised cost. It could be regarded as a practical expedient, assuming that the assessment of expected cash flows at the original effective interest rate would have resulted in materially the same level of impairment.
- Greek sovereign bonds classified as available for sale or held for trading should have been reported at fair value using the fair value hierarchy as outlined in paragraph 27A of IFRS 7 – *Financial Instruments: Disclosures*. In order to determine the fair value, issuers should analyse whether a market is active or not at the reporting date. This means analysing whether quoted prices are readily and regularly available for each instrument (by maturity, and where relevant by issuance) and whether those prices represent actual and regularly occurring market transactions on an arm's length basis (paragraph 71 of Appendix A to IAS 39). Based on trading data obtained from the Bank of Greece, it is ESMA's opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others. Issuers should consequently have used level 1 fair value measurement as defined under IFRS 7 for instruments with active markets. For those instruments for which the market was not active, a level 2 measurement method should have been applied (using models which include observable market data from similar instruments, such as Greek bonds with close maturities or prices for credit default swaps, if relevant). The same fair value measurement considerations also apply when assets are reclassified from available for sale to loans and receivables.

11. Regarding disclosures of exposure to Greek Sovereign bonds, in line with the statement published by ESMA on 28 July 2011 it is ESMA's opinion that issuers should have included all information required under IAS 34 – *Interim Financial Reporting*. This means that, as a minimum, the issuer should have provided: the level of exposure to Greek Sovereign debt as of 30 June (including details

about maturities), the accounting treatment applied for the debt and its impairment losses together with a description of key judgments used in the assessment of whether the asset was impaired or not and key assumptions underpinning the assessment of the impairment losses for each class of instruments (IAS 34 paragraph 15B).

12. This opinion will be published on ESMA's website.

Done at Paris, 24 November 2011

Steven Maijoor

ESMA Chair

For the Board of Supervisors

Notes to editors

1. ESMA is an independent EU Authority that was established on 1 January 2011 according to EU Regulation No. 1095/2010 as published on December 15, 2010, in the Official Journal of the European Union (L 331/84). The Authority contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).

2. ESMA's work on securities legislation contributes to the development of a single rule book in Europe. This serves two purposes; firstly, it ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. Secondly, it promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. As part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. Where requested in European law, ESMA undertakes the supervision of certain entities with pan European reach.

3. ESMA also contributes to the financial stability of the European Union, in the short, medium and long-term, through its contribution to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises.

For further information contact:

Reemt Seibel
Communications Officer
Tel: +33 (0) 158 36 42 72
Email: reemt.seibel@esma.europa.eu