This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR and SR TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG FRB or EFRAG FR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG FRB, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Objectives and boundaries of different sections of the annual report

Issues Paper

Overview

> *"Historically, corporate reporting has been centred on financial reporting, but this is just one limited perspective. Financial reports can be likened to an X-ray of a body: a lot can be inferred from an image of a skeleton, but it does not show the whole person. In future, I hope that sustainability reporting will be as helpful as an MRI scan in medicine, providing another image of the company*."- Equity analyst in EFRAG CAP

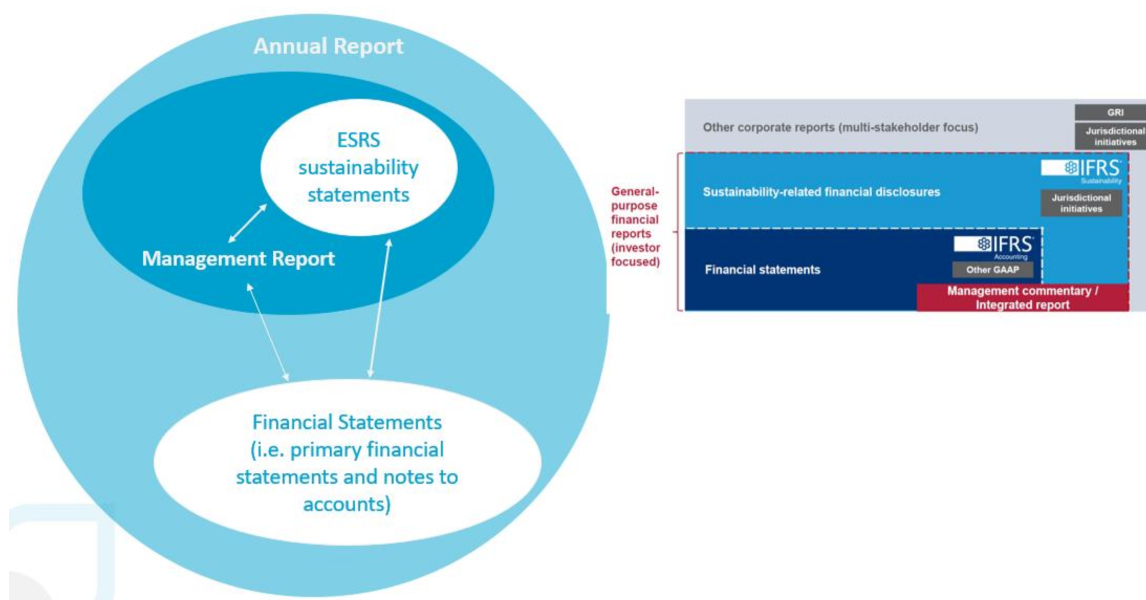
1 As the above quotation and other similar quotations[1] portray, different sections of the corporate report serve different purposes. Relatedly, as depicted in Figure 1 below, with respect to EU companies, the EFRAG research project on connectivity project (connectivity project) aims to illustrate connections between information in the IFRS-based financial statements (i.e., defined[2] in IAS 1.10 as consisting of the primary financial statements and notes to the accounts), sustainability statements in the management report, the rest of the management report, and information included in the sustainability statement by cross-

[1] During the April 2023 IFASS meeting, a participant noted that a financial report and/or a sustainability report cannot tell the entire truth and **each of these reports can only be an excerpt of a company's reality**. Similarly, at the 2023 EFRAG Conference, the Head of ESMA Verena Ross referred to financial statements and sustainability reports as being part of a continuum.

[2] IAS 1.10 states that "A complete set of financial statements comprises: (a) a statement of financial position as at the end of the period; (b) a statement of profit or loss and other comprehensive income for the period; (c) a statement of changes in equity for the period; (d) a statement of cash flows for the period; (e) notes, comprising material accounting policy information and other explanatory information; (ea) comparative information in respect of the preceding period as specified in …; and (f) a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements in accordance with ..."

referencing from any other corporate report (e.g., corporate governance report). The connection of information across IFRS general purpose financial reports[3] for companies outside the EU is also in the scope of the connectivity project.

Figure 1: Connectivity project- what is being connected?



2 Correspondingly, as part of the conceptual scene-setting content for the connectivity project; this paper addresses the objectives and boundaries of the financial statements, sustainability statements, and the rest of the management report. It should be noted that these different reports have differing historical profiles[4] with varied and evolving levels of maturity (e.g., assurance, enforcement, their application by capital market participants, and the availability of an underpinning conceptual framework).

3 The definition of the boundaries of these different reports is important because:

(a) It can inform on the connections that either can or cannot be made across the different reports.

[3] IFRS general purpose financial reports which consist of IFRS financial statements (i.e. primary financial statements and notes to the accounts), management commentary and IFRS sustainability-related financial disclosures.

[4] Though they have evolved over time, financial statements are 100+ years old, and the IASB's predecessor organisation (IASC) was established in 1973. The Management, Discussion and Analysis (MD&A)/management report requirements were introduced in the US in 1968; EU Fourth Accounting Directive with management reporting requirements was published in 1978, Denmark adopted the requirements in 1981 while Italy adopted the requirements in 1991. German GAS 20 was published in 2012. On sustainability disclosures; GRI was formed in 1997, TCFD recommendations published in 2017, and ESRS and IFRS SDS requirements were published in 2023.

(b) As described in agenda paper 02-04 on *Connectivity—Related Principles*, the coherence and complementary nature of information in different reports is an important aspect of connectivity (i.e., allows the telling of a more complete story on the entities' value creation). It resonates with the expectation for sustainability reporting to bridge the gap[5] between users' needs for certain material information and the available financial statements' information (as alluded to by the cited X-ray and MRI analogy). Or, as has been expressed by some stakeholders, "Sustainability reporting starts where financial reporting ends".

4 Connectivity requirements in a corporate reporting context ought to focus[6] on documents that have a well-identified nature, purpose, and established stature. This is part[7] of the reason why the connectivity project focuses on connections between financial statements, sustainability statements/disclosures and the rest of the management report.

5 We note that under the EU corporate reporting framework, there are clear requirements for the location/placement of information across different sections of the annual report (financial statements, sustainability statements in the management report, and the rest of the management report) and this is considered an enabler of connectivity. Outside the EU, even though IFRS S1 requirements are location-agnostic[8], there is also likely to be an overlay of placement requirements imposed by jurisdictional authorities. Thus, there are or are still likely to be clear location/placement requirements for different information sets in the annual report.

6 A clear location is interrelated to the definition of borders albeit there can be grey areas such as those we later highlight in this paper. These grey areas are unlikely to be resolved in the near term. For instance, before eliminating the grey areas, there is a need for the development of a sustainability reporting conceptual framework akin to the one in place for financial reporting. There could also be a need for enhancing either the accounting or sustainability reporting requirements. For instance, if there is ambiguity on where certain disclosures should be located (e.g., it remains unclear whether disclosures of financially

[5] This gap arises due to existing requirements for the recognition and measurement, presentation, or disclosure of information in the financial statements (e.g., the need for a past event for the recognition of liabilities).

[6] This suggested focus is not contrary to the expectation that management's communication of its story should be consistent.

[7] Also, the focus on the aforementioned sections of the annual report allows a manageable scope of the project.

[8] It is noted that the reporting of sustainability disclosures under IFRS S1 requirements will be location-agnostic. As we understand, this means that a sustainability disclosure under IFRS S1 and S2 can be placed in the notes to the accounts.

material net-zero commitments could be located within sustainability disclosures or in the notes to the accounts based on the IAS 1.31 catch-all requirements or both).

7 Appropriately defined borders contribute to distinctive reports, which as outlined in agenda paper 02-04 on *Connectivity—Related Principles,* ought to be self-sufficient for their intended objectives. And as noted in agenda paper 02-04, if useful, for purposes of connectivity, repetition or incorporation by cross-referencing may be necessary.

8 Besides the above, there are other factors related to the boundaries of different reports and the corresponding connectivity of information. These include the interplay between the application of materiality across different reports; the intertemporal aspect of connectivity due to the migration of certain items across different reports over time (e.g., from being disclosed in the management report or sustainability disclosures in a period before translating into financial statement line items in a future period); the grey areas that arise in respect of the suitable location of financially material information. Besides materiality, there are other factors that preclude the inclusion of certain information in the financial statements. This paper highlights these factors by analysing why certain sustainability matters cannot be recognised, presented, or disclosed in the financial statements. Accordingly, the remainder of the paper is organised as follows:

<u>Part 1- Objectives and audience of different sections of the annual report</u>

(a) Objective and audience of financial reporting-IFRS Accounting Standards

(b) Objective and audience of the management commentary/management report

(c) Objective and audience of sustainability reporting- ESRS and IFRS Sustainability Disclosure Standards

(d) Similar aspects of note

<u>Part 2- Interaction of materiality-related considerations and the boundaries of different reports</u>

(e) Application of materiality across different reports

(f) Intertemporal connectivity: Migration of items across different reports over time

(g) Grey areas

<u>Part 3- Boundaries illustration: Distinctive nature of different reports</u>

(h) Why material sustainability-related information may not be recognised, presented, or disclosed in the financial statements.

Appendices

(i) Appendix 1: November 2023 IFRIC consideration of net zero commitment

(j) Appendix 2: Insufficiently clear IFRS Accounting Standards

(k) Appendix 3: EU Accounting Directive, Selected EU Member State Management report objectives

9 As structured, apart from being part of the conceptual scene setting for the connectivity project, the content of this paper can serve as educational material that could help to reduce the expectation gap that exists with respect to the information that can be reported in different sections of the annual report.

PART 1- OBJECTIVES AND AUDIENCES OF DIFFERENT SECTIONS OF THE ANNUAL REPORT

Objective and audience of financial reporting – IFRS Accounting Standards

10 The financial statements of listed EU entities reporting under IFRS Accounting requirements are also within the scope of the minimum requirements of the EU Accounting Directive[9]. According to the IASB's *Conceptual Framework for Financial Reporting* (the 'Conceptual Framework'):

> *The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:*
>
> (a) *buying, selling or holding equity and debt instruments;*
>
> (b) *providing or settling loans and other forms of credit; or*
>
> (c) *exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.*
>
> (Conceptual Framework par. 1.2)

11 The Conceptual Framework describes that these decisions depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases (Conceptual Framework par. 1.3). To help them form these expectations, information is needed about:

(a) the economic resources of the entity, claims against the entity and changes in those resources and claims; and

(b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.

(Conceptual Framework par. 1.4).

Elements of primary financial statements

12 The elements of financial statements, that are linked to the economic resources, claims and changes in economic resources and claims are (Conceptual Framework par. 4.1 and 4.2):

(a) assets, liabilities and equity, which relate to a reporting entity's financial position; and

[9] The EU Accounting Directive (included in the Appendix) outlines high-level principles.

(b) income and expenses, which relate to a reporting entity's financial performance.

13 These elements are defined as follows:

(a) An asset is a present economic resource controlled by the entity as a result of past events (Conceptual Framework par. 4.3).

(b) A liability is a present obligation of the entity to transfer an economic resource as a result of past events (Conceptual Framework par. 4.26).

(c) Equity is the residual interest in the assets of the entity after deducting all its liabilities (Conceptual Framework par. 4.63).

(d) Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims (Conceptual Framework par. 4.68).

(e) Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims (Conceptual Framework par. 4.69).

14 For an item to be included in the financial statements[10], this item should meet the definition of an asset or a liability (or be a residual of or change in these). In addition, the item should meet recognition criteria that are set on a standards level and are different for various types of assets and liabilities.

15 The definitions, for example, mean that an economic resource that is not controlled by an entity cannot be recognised as an asset and future obligations cannot be recognised as liabilities. Having a present obligation requires that the entity has already obtained economic benefits or taken an action and as a consequence will or may have to transfer an economic resource that it would not otherwise have had to transfer[11] (Conceptual Framework par. 4.43).

16 The recognition criteria can result in, for example, an asset not being recognised if its measurement (i.e., the value the asset will be presented at in the financial statements) is

---

[10] The Conceptual Framework is not a Standard and overrides any Standard. Requirements in IFRS Accounting Standards may thus also depart from aspects of the Conceptual Framework. IFRS Accounting Standards do currently not require or allow items, the IASB does not consider meet the definitions of assets and liabilities to be recognised in the financial statements [Insert note about IAS 37 project to reflect the status of this project when the DP will be issued].

[1111] [Reference to the IASB project on Provisions – targeted improvements to be included to reflect the status of the project when the DP is issued]

too uncertain and certain liabilities not being recognised if it is not probable that they will result in an outflow of economic resources.

Notes to the accounts

17 In addition to presenting items on the primary financial statements, information is provided in notes to the financial statements. IAS 1 *Presentation of Financial Statements* [to be amended depending on IFRS 18] states that:

> *Notes contain information in addition to that presented in the statement of financial position, statement(s) of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements. (IAS 1 par. 7)*

18 Paragraph 11 of the IASB guidance[12] for developing and drafting disclosure requirements in IFRS Accounting Standards (which was developed as part of the IASB project, Disclosure Initiative- Targeted Standards-Level Review of Disclosures) states the purpose of the disclosure requirements in an Accounting Standard can be stated as to require an entity to disclose the following types of information in the notes, if such information is useful to users of financial statements:

(a) information that supplements the information presented in the primary financial statements, including:

  (i) disaggregation of information presented in the primary financial statements;

  (ii) information about the nature of, and the risks arising from, recognised assets and liabilities;

(b) information about unrecognised assets and liabilities, including information about their nature and about the risks arising from them;

(c) the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements;

[12] https://www.ifrs.org/content/dam/ifrs/groups/iasb/guidance-for-developing-and-drafting-disclosure-requirements-in-ifrs-accounting-standards.pdf

(d) information about transactions and other events that have occurred after the end of the reporting period; and

(e) forward-looking information relating to the entity's assets or liabilities—including unrecognised assets or liabilities—or equity that existed during or at the end of the reporting period, or to income or expenses for the reporting period."

Objective and audience of the management commentary/ management report

19 To contextualise the information in the financial statements, some jurisdictions also require (or allow) entities to provide a management commentary which, depending on jurisdiction, is also referred to as the management report, MD&A (management discussion and analysis), strategic report etc. The legislative requirements for management commentary vary across jurisdictions including across EU member states[13]. Furthermore, the IASB Management Commentary Practice Statement is voluntary and not endorsed in the EU nor is it applied across several large economies.[14] Nonetheless, the IASB guidance can inspire the prevailing diverse regimes of management reporting requirements.

EU management report

20 The preamble to the EU Accounting Directive states: "*The management report and the consolidated management report are important elements of financial reporting*" (par. (26).

21 Paragraph 1 of Article 19 of the EU Accounting Directive states, "*The management report shall include a fair review of the development and performance of the undertaking's*

---

[13] Rowbottom, N & Schroeder, M 2014, 'The rise and fall of the UK Operating and Financial Review', Accounting, Auditing and Accountability Journal, vol. 27, no. 4, pp. 655-685 notes that

"In June 2003, the EU Accounts Modernisation Directive 2003/51/EC required member states to introduce legislation to ensure that all large and medium sized companies disclose management commentary within their annual reports in a revised Business Review in the Directors' Report (effective by January 2005). Listed companies were expected to make additional non-financial disclosures, to the extent necessary for an understanding of the business, relating to employee and environmental matters in an 'enhanced' Business Review…

The EU Transparency Directive 2004/109/EC, adopted in December 2004, also required listed companies to produce a 'management report' in their interim and annual reports. "

[14] Australian Accounting Standards Board staff paper, May 2021, *Comparison of Narrative Reporting Requirements applicable to Not-For-Profit Entities*. The paper reviewed the narrative reporting requirements of nine jurisdictions (Australia, Canada, Germany, Hong Kong, New Zealand, Singapore, South Africa, United Kingdom and United States) and none of these jurisdictions apply the Practice Statement, and there is diversity across these countries in the extent of the alignment of their requirements to the proposed revised MCPS guidance (included in the 2021 Exposure Draft).

business and of its position, together with a description of the principal risks and uncertainties that it faces.

The review shall be a balanced and comprehensive analysis of the development and performance of the undertaking's business and of its position, consistent with the size and complexity of the business.

To the extent necessary for an understanding of the undertaking's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. In providing the analysis, the management report shall, where appropriate, include references to, and additional explanations of, amounts reported in the annual financial statements."

22 As noted, mandatory requirements differ across jurisdictions. Illustratively, Appendix 3 has a summary of the objectives of the management report requirements in France and Germany. Of note, the EU Directive sets minimum requirements and the jurisdictions develop further specific requirements (e.g., GAS 20 in Germany).

Management commentary as part of IFRS general purpose financial reporting

23 The preface to IFRS Accounting Standards states that the Standards are "*designed to apply to the general purpose financial statements and other financial reporting of profit-oriented entities*" (par. 5). "*Other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improvise users' ability to make efficient economic decisions*".

24 In a similar vein, the IASB's Conceptual Framework for Financial Reporting states that "*The qualitative characteristics of useful financial information apply to financial information provided in financial statements, as well as to financial information provided in other ways (par. 2.3)*.

25 The IASB's existing Practice Statement 1 Management Commentary – A framework for presentation (2010) states that *"[t]he Practice Statement is prepared on the basis that management commentary lies within the boundaries of financial reporting because it meets the definition of other financial reporting in paragraph 7 of the Preface to International Financial Reporting Standards. Therefore management commentary is within the scope of the Conceptual Framework for Financial Reporting*." (par. IN 4)

26 The existing Practice Statement describes the following objective of management commentary:

(a) Provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances but also why it has happened and what the implications are for the entity's future.

(b) Complements and supplements the financial statements by communicating integrated information about the entity's resources, the claims against the entity and its resources, and the transactions and other events that change them.

(c) Explain the main trends and factors that are likely to affect the entity's future performance, position and progress. Consequently, management commentary looks not only at the present but also at the past and the future.

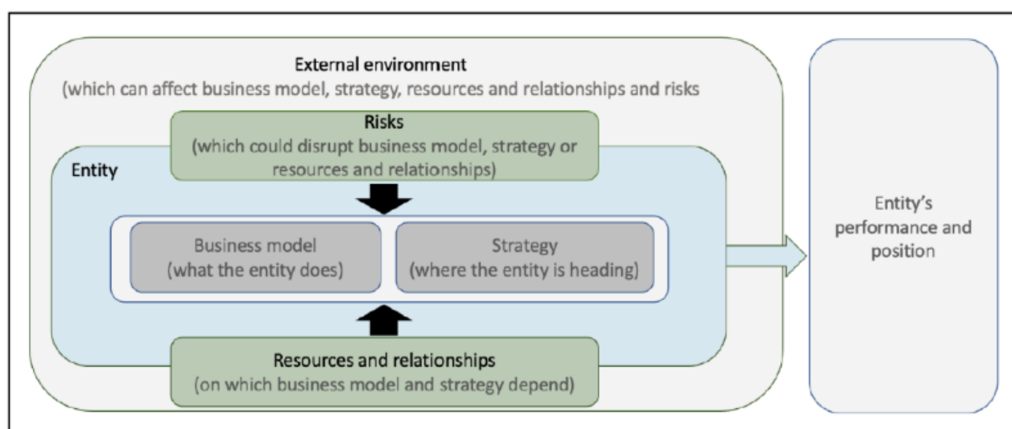
27 The existing Practice Statement is under review and, in 2021, the IASB published an Exposure Draft *Management Commentary* (ED). Following the feedback to the ED, the IASB is in the process of considering how to proceed with the MCPS project including if and to the extent collaboration with the ISSB will occur in finalising the project. As such, the content of the ED may be revised based on the feedback to the ED and in light of the sustainability reporting developments that have occurred since the ED was published. Nonetheless, we note that, in addition to the objectives of the existing practice statement in the above paragraph, Paragraph 3.1 of the 2021 IASB Exposure Draft *Management Commentary* (ED) proposes that an entity's management commentary provide information that:

(a) enhances investors' and creditors' understanding of the entity's financial performance and financial position reported in its financial statements; and

(b) provides insight into factors that could affect the entity's ability to create value and generate cash flows across all time horizons, including in the long term.

28 Figure 2 shows the relationships between disclosure objectives for areas of content within the MCPS ED.

Figure 2: Relationships between disclosure objectives for areas of content within the MCPS ED



29 Entity's financial position and financial performance a content area under the MCPS ED (i.e., one of the six proposed content areas). Hence, a question could arise on the distinction between information on the financial position and financial performance in the management commentary and the notes in the financial statements. In this regard, paragraph 10.3 of the ED states that information in management commentary about an entity's financial performance and financial position complements information provided in the related financial statements. Accordingly, management commentary provides more discussion, analysis, forward-looking information and non-financial information than is included in the entity's financial statements to explain the entity's financial performance and financial position reported in those financial statements.

30 Furthermore, paragraph 10.6 of the ED states that the information about the entity's financial performance and financial position shall enable investors and creditors to understand:

(a) what factors have affected the entity's financial performance and financial position in the reporting period or could affect them in the future, including in the long term;

(b) how management has allocated financial resources in the reporting period; and

(c) how the entity's financial performance and financial position compare with forecasts or targets previously published by the entity, if any.

Objective and audience of sustainability reporting – IFRS Sustainability Disclosure Standards and ESRS

IFRS Sustainability Disclosure Standards

31 IFRS S1.1 states that the objective of IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information is to require an entity to disclose information about its sustainability-related risks and opportunities that is useful to primary users of

general purpose financial reports in making decisions relating to providing resources to the entity.

ESRS

32 In the EU legislation, sustainability reporting standards were considered necessary to:

(a) Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth (Directive EU 2022/2464, preamble par. (2)).

(b) Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues (Directive EU 2022/2464, preamble par. (2)).

(c) Foster transparency and long-termism in financial and economic activity (Directive EU 2022/2464, preamble par. (2)).

33 The legislation explains that (Directive EU 2022/2464, preamble par. (9)):

If undertakings carried out better sustainability reporting, the ultimate beneficiaries would be individual citizens and savers, including trade unions and workers' representatives who would be adequately informed and therefore able to better engage in social dialogue. Savers who want to invest sustainably will have the opportunity to do so, while all citizens would benefit from a stable, sustainable and inclusive economic system. To realise such benefits, the sustainability information disclosed in the annual reports of undertakings first has to reach two primary groups of users. ***The first group of users consists of investors, including asset managers****, who want to better understand the risks and opportunities that sustainability issues pose for their investments and the impacts of those investments on people and the environment. The second group of users consists of* ***civil society actors, including non-governmental organisations and social partners****, which wish to better hold undertakings to account for their impacts on people and the environment. Other stakeholders might also make use of sustainability information disclosed in annual reports, in particular, to foster comparability across and within market sectors.*

The business partners of undertakings, including customers*, might rely on sustainability information to understand and, where necessary, report on their sustainability risks and impacts throughout their own value chains.* ***Policymakers and environmental agencies*** *can use such information, in particular on an aggregate basis, to monitor environmental and social trends, to contribute to environmental accounts, and to inform public policy. Few individual citizens and consumers directly*

consult undertakings' annual reports, but they might use sustainability information indirectly, for example, when considering the advice or opinions of financial advisers or non-governmental organisations.

34 Aligned with these objectives, ESRS 1 *General Requirements* identify two main groups of stakeholders for sustainability information (ESRS 1 par. 22):

(a) affected stakeholders: individuals or groups whose interests are affected or could be affected – positively or negatively – by the undertaking's activities and its direct and indirect business relationships across its value chain; and

(b) users of sustainability statements: primary users of general-purpose financial reporting (existing and potential investors, lenders, and other creditors, including asset managers, credit institutions, and insurance undertakings), and other users of sustainability statements, including the undertaking's business partners, trade unions and social partners, civil society and non-governmental organisations, governments, analysts and academics.

Salient similar features of financial statements and sustainability reporting requirements

35 *Same qualitative characteristics*: Both the ESRS and IFRS Sustainability Disclosures Standards (IFRS SDS) require reporting based on the same qualitative characteristics as the Conceptual Framework of Financial Reporting.

36 *Same basis for preparation* Both ESRS and IFRS SDS also require the same reporting entity and reporting period as the financial statements. These two Standards also have similar approaches for the treatment of events after the reporting date, changes in estimates, and changes in preparation and presentation practices as the financial statements. And they were influenced by IAS 1 *Presentation of Financial Statements*, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requirements, and IAS 10 *Events After the Reporting Period* requirements.

PART 2: INTERACTION OF MATERIALITY-RELATED CONSIDERATIONS AND THE BOUNDARIES OF DIFFERENT REPORTS

37 In Part 2 of this issues paper, we highlight the interaction of materiality-related considerations and the boundaries of different reports. Specifically, the application of materiality across different reports; intertemporal connectivity that arises due to dynamic materiality or due to items that were only financially material for the sustainability statements at a particular reporting period becoming financially material for the financial statements at a future period; and some grey areas on the suitable location of financially material items.

38 That said, besides materiality, there are other factors that have an effect on the boundaries and explain why certain sustainability matters cannot be recognised, presented or disclosed in the financial statements (e.g., due to the recognition criteria of financial statements line items, the lengthier time horizon applied towards sustainability reporting, differing reporting boundaries, the application of operational control in sustainability reporting etc). These other factors are expounded on in the next part of this paper (Part 3).

Application of materiality across different reports

39 Materiality is an overarching concept in corporate reporting, and it is applied as a filter for determining the nature, magnitude, and level of aggregation of information in different reports.

40 Of note, an explanation offered for the often-observed disconnect between the reporting of sustainability (e.g. climate-related) risks and opportunities across different reports has been that these risks and opportunities have been considered immaterial for financial statements albeit being deemed material for the sustainability disclosures.

41 Hence, it has to be underscored that the **application of materiality within each report is in the context of its objective**. By extension, the respective boundary of financial statements, sustainability statements and the rest of the management report (i.e., what information is included in each of these reports) is influenced by the application of materiality in the context of the objectives of these different reports.

Definition of materiality for IFRS financial statements and general purpose financial reporting

42 The Conceptual Framework for financial reporting, IAS 1.7, and IAS 8.5 provide the following definition of materiality

"*Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements [… make on the basis of those financial statements, which provide financial information about a specific reporting entity… the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.*"

43 The IFRS Practice Statement 2 *Making Materiality Judgements* (materiality practice statement) notes that an entity makes materiality judgments when making decisions about recognition, measurement, presentation, and disclosure. Requirements in IFRS Standards only need to be applied if their effect is material to the complete set of financial statements[15]. The materiality practice statement also states that an entity need not provide a disclosure specified by an IFRS Standard if the information resulting from that disclosure is not material. This is the case even if the Standard contains a list of specific disclosure requirements or describes them as 'minimum requirements. Conversely, the entity must consider whether to provide information not specified by IFRS Standards if that information is necessary for users to understand the impact of particular transactions, other events and conditions on the entity's financial position, financial performance and cash flows.

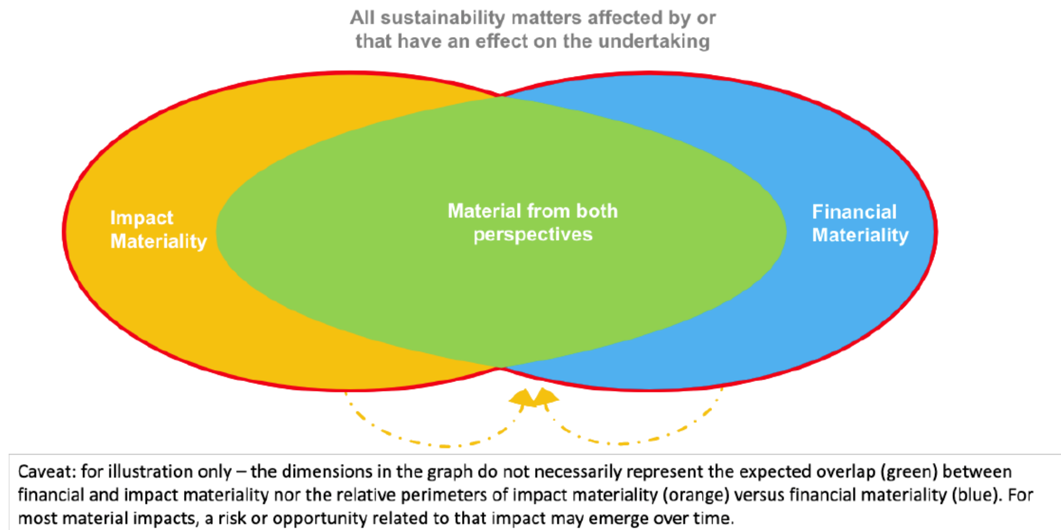
44 The IAS 1.7 definition of materiality is also applied across IFRS general financial reporting that encompasses the financial statements, sustainability-related financial disclosures, and management commentary.

Materiality under ESRS sustainability statements

45 The reporting/preparation of sustainability statements by EU entities under ESRS requirements aims to report on the impacts, risks and opportunities arising from sustainability matters and, as a result of its broad set of users, as depicted in Figure 3, this is done under the double materiality perspective.

Figure 3: Excerpt from the 2023 EFRAG ESRS Materiality Assessment Implementation Guidance

[15] In other words, information needs to be material to the primary financial statements and notes taken together.



Caveat: for illustration only – the dimensions in the graph do not necessarily represent the expected overlap (green) between financial and impact materiality nor the relative perimeters of impact materiality (orange) versus financial materiality (blue). For most material impacts, a risk or opportunity related to that impact may emerge over time.

46 In effect, a sustainability matter is 'material' when it is either impact material or financially material or both (ESRS 1. 28). A sustainability matter is material from a financial perspective (financially material) "*if it triggers or could reasonably be expected to trigger material financial effects on the undertaking* (ESRS 1. 49)". Financial materiality is assessed from the perspective of the primary users of general-purpose financial reports in making decisions relating to providing resources to the entity (ESRS 1. 48). A matter is impact material when it "*[…] pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- or long-term. Impacts include those connected with the undertaking's own operations and upstream and downstream value chain, including through its products and services, as well as through its business relationships. Business relationships include those in the undertaking's upstream and downstream value chain and are not limited to direct contractual relationships. (ESRS 1. 43)*".

47 The December 2023 Draft ESRS Materiality Assessment Implementation Guidance (MAIG) published by EFRAG (see link) includes frequently asked questions (FAQs) related to both impact materiality and financial materiality. FAQs 3, 4 and 5 (and responses) of the guidance address financial materiality and convey that **whilst this concept of materiality does not differ between ESRS and financial reporting standards, the information that is likely to be material under the two sets of standards would differ**.

48 In other words, there are differences between information that is likely to be financially material for financial statements and information that is likely to be financially material for the sustainability statement. For instance, financially material information for sustainability statements would, inter alia, include anticipated financial effects (i.e., financial effects that do not meet the criteria for inclusion in the financial statements at a reporting date) and

information about material risks and opportunities arising from its business relationships, i.e., in the upstream/downstream value chain. This highlighted analysis of the EFRAG ESRS MAIG affirms that what is adjudged to be material information depends on the context and type of report.

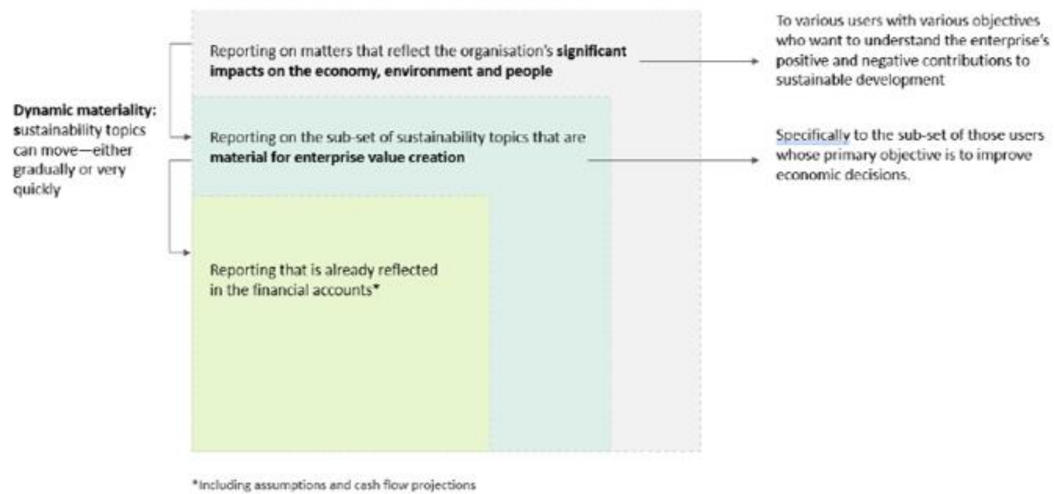
intertemporal connectivity: migration of items across different reports

49 Connectivity has a static dimension (i.e., connectivity of information located in different reports at a particular reporting date). In addition, there can be intertemporal connectivity with a dynamic dimension where there is a change in the reporting location of impacts, risks, or opportunities across different reporting periods (i.e., migration of items across different reports over time). For instance, this could be due to the nature, quantifiability, magnitude/severity, or probability of occurrence of a particular risk or opportunity. Enabling the understanding and monitoring of the noted migration of information across reporting periods is a key element of connectivity as it explains and highlights the evolving nature of the related information. Under ESRS requirements, intertemporal connectivity is captured by forecast information being related to past/present.

50 Migrations of items across different reports can be due to the below.

51 ***Dynamic materiality[16] or rebound effects according to the 2021 EFRAG PTF-NFRS report***: For instance, a sustainability matter that is material (from an impact-materiality perspective) may shift from being a disclosure in the sustainability statement at a particular reporting to becoming financially material and recognised, presented, or disclosed item in the financial statements at a future reporting date. For example, adverse impacts reflected in an entity's sustainability statements at a reporting date may translate to legal risk and fines that are reported in the financial statements at a future reporting date. Figure below depicts the notion of dynamic materiality.

[16] Dynamic materiality recognises that whilst a company may have many positive and negative impacts on people, planet and social prosperity, a subset of those impacts can, in turn, positively or negatively affect the company's business model and therefore create or erode its enterprise value and financial returns to providers of capital.



Corporate Governance Academy

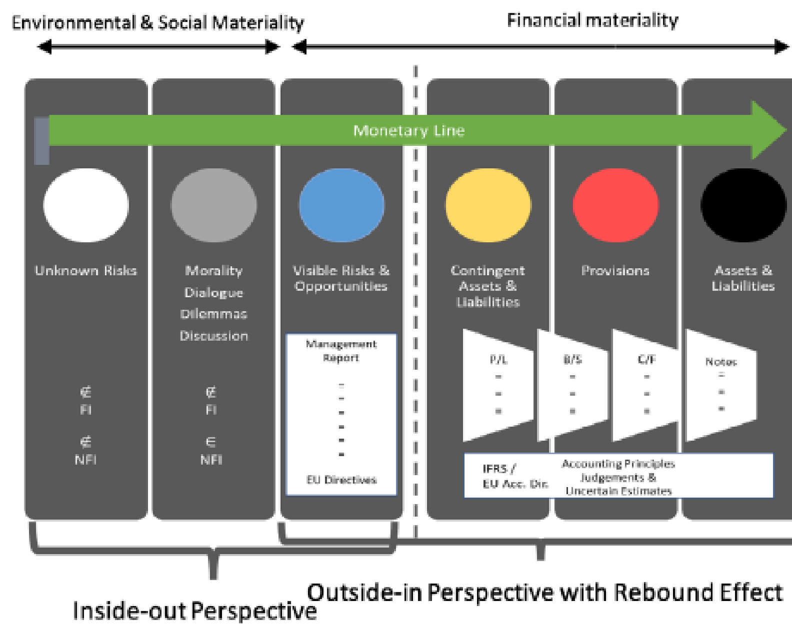
52 ***Financially material information reported outside the financial statements at a particular reporting date may either get recognised, presented, or disclosed item in the financial statements at a future reporting date***. For instance, risks and opportunities disclosed in sustainability statements/disclosures or risk report at a reporting date, may at a future reporting date, be recognised as liabilities/provisions, impairment charges, research and development expenses, assets, or revenue; or be disclosed in the notes to the accounts.

Conceptualisation of where intertemporal connectivity may arise

53 The 2021 PTF-NFRS publication included a high-level depiction (Figure below) and description of items that can be monetised (the so-called monetary line), and items that can be connected to and reported in the financial statements at a future date versus those that cannot. This publication notes that connectivity to the financial statements arises for items that are financially material and earmarked as the blue zone category (i.e., risks and opportunities disclosed in the management report). There could be static connectivity for the blue zone items in the management report (i.e., they can be linked to financial statements at a reporting date). There could also be intertemporal connectivity (i.e., the items could be linked to the statement of financial performance and statement of financial position of a future reporting date).

54 In contrast, the items earmarked as white zone (unknown risks) and grey zone items will be difficult to connect to the financial statements. Items in the grey zone consist of both externalities and risks that companies face that are difficult to quantify. The 'soft law' responsibility to respect human rights is an example of a grey zone item as would be a potential adverse impact of the company not deemed to be a risk to the company by the management.

Figure : 2021 PTF-NFRS Publication Monetary Line (May be updated as part of EFRAG research project)



55 Further and detailed analysis of materiality dynamics can be found in the draft ESRS MAIG and other literature including a Harvard Business School article[17].

Illustration of dynamic materiality

56 Illustratively, the draft ESRS MAIG, Paragraph 37 notes that "For most material impacts, a material risk and/or opportunity may emerge over time. For example:

(a) an oil and gas undertaking identifies a material negative impact from not consulting or reaching an agreement with indigenous' people about land use for extraction and relocation of the community. At the reporting date, the undertaking does not expect protests from the indigenous community. However, the community may later protest, halting the site production, causing material costs due to production days lost or the abandonment of the project;

(b) an undertaking has discriminated based on gender when promoting employees during the current reporting year. At the reporting date, the undertaking does not expect that the employees will pursue legal proceedings. However, the group of employees, individually or as a whole, may sue for financial compensation at a later stage on the grounds of gender discrimination and cause reputational damage to the undertaking."

[17] How ESG Issues Become Financially Material to Corporations and Their Investors

Grey areas

57 As noted above, consideration of whether information is material for financial statements ought to be intertwined with consideration of the objectives of financial statements versus sustainability statements versus the rest of the management report. However, there can be grey areas. The three fact patterns below and the associated questions posed by stakeholders exemplify these grey areas.

58 Fact pattern 1: In investor X's investment portfolio, there is an auto company that is ramping down its production of internal combustion engine vehicles, whose sales are set to be banned in the EU from 2035. It is of interest to investors to know how much of the company's plant and workforce used to manufacture internal combustion engines could be used to manufacture electric vehicles and how much would have to be sold as scrap.

The financial statements did not include any material impairments. Hence, it was not possible for the investment team to estimate the effects of the ban as the company did not provide disaggregated information on its fixed assets by engine type. For an auto parts supplier with most of their business manufacturing petrol parts, is the information of interest to investors material information for financial statements (per IAS 1)?

(a) View 1 – Yes, it is material information for the financial statements as it is useful for valuation purposes.

(b) View 2: No - the time horizon (2035) is after the remaining useful life of all assets and the going concern test. There are no line items on the balance sheet which are impacted by the certain discontinuation of the business from 2035.

59 Fact pattern 2: Even if net-zero commitments do not qualify to be recognised as a provision based on IAS 37 requirements, should information on such commitments that influence users' decision making be disclosed in the financial statements?

(a) View 1: Yes, it is material for financial statements as it influences the investor's decision making. Though IFRS S1, S2 and ESRS have requirements for the disclosure of anticipated financial effects, these requirements may be construed by some stakeholders as not explicitly encompassing constructive obligations.

(b) View 2: No, this information does not relate to recognised line items, there is no past event (see Appendix 1 for IFRIC agenda decision), they do not meet the threshold of the IAS 37 specific disclosure requirements, IAS 1.125 (disclosures of estimation uncertainty on carrying values) requirements need to be considered in the context of recognised line items, and the application of IAS 1.31 (catch-all requirements) may

be constrained by consideration of possible disclosure overload. Besides, why repeat information that should be disclosed in sustainability disclosures?

60 *Fact pattern 3: Whilst exploring possible incremental disclosure requirements on anticipated financial effects for the forthcoming Oil and Gas, and Mining sector Standards; the EFRAG SR pillar's Secretariat reviewed relevant academic literature and conducted a desktop review of the reporting of environmental and decommissioning liabilities[18]by a sample of companies. Their analysis reflected in an October 2023 agenda paper for the joint EFRAG FR and SR TEG meeting (see link) points to the limitations in the related IFRS Accounting requirements (IAS 37 and IFRIC 21) along with the inadequacies in the observed companies' disclosures (diversity in practice and missing useful information). For instance, the reviewed companies did not disclose the triggering event of the decommissioning provisions, the disclosure of the estimated retirement date was missing, and it was difficult to identify the asset for which an asset retirement obligation or decommissioning provision is recognised. Concurrently, the enacted sector-agnostic ESRS do not require this information. Should these disclosures be in the financial statements or sustainability statements?*

[18] The financial statements of six Oil and Gas companies (BP, Equinor, Eni, Repsol, Shell and TotalEnergies) were reviewed by the SR pillar's EFRAG Secretariat.

PART 3- BOUNDARIES' ILLUSTRATION: DISTINCTIVE NATURE OF DIFFERENT REPORTS

61 The preceding parts have laid out the objectives and audiences of different reports and the effects of materiality-related considerations on the boundaries of different reports. This part illustrates the distinctive nature of different reports (and financial statements in particular) by expounding on why information may not be reflected or perceived as not being reflected in the financial statements, and going beyond the application of materiality that is discussed in detail in part 2.

Why material sustainability-related information may not be recognised, presented, or disclosed in the financial statements?

62 Various thematic reviews[19] of financial statements have highlighted a disconnect between the reporting of climate risk across different reports as well as the often inadequate, high-level, and largely qualitative reporting of climate risks in the financial statements. Hence, some stakeholders expressed concerns that material climate-risk information is not being reported in the financial statements.

63 This concern was also conveyed during the 2021 IASB agenda consultation, and it motivated the IASB's commencement of a project on 'Climate-related and other uncertainties in the financial statements.' Thereafter, the findings of a root-cause-analysis-oriented outreach (reflected in the September 2023 IASB staff paper and a September 2023 EFRAG Secretariat Briefing: Climate-related Risks in Financial Statements) pointed to an expectation gap on what should be reported in the financial statements. This gap contributes to the aforementioned concern. Hence, an analysis of why material sustainability-related information may not be recognised, disclosed, or presented in the financial statements can shed light on the connectivity of information and possibly lessen the expectation gap.

64 Below is a summary of why certain material sustainability-related information may not be recognised, presented, or disclosed in financial statements:

---

[19] September 2023 EFRAG Secretariat Briefing: Climate-related Risks in Financial Statements. The briefing summarises reviews of EU companies' reporting by AMF- France, ESMA, Mazars, MAB (Netherlands Paper), and the Norwegian regulator- Finanstilsynet.

ESMA- October 2023, Climate-related matters in the Financial Statements

https://www.esma.europa.eu/sites/default/files/2023-10/ESMA32-1283113657-1041_Report_-_Disclosures_of_Climate_Related_Matters_in_the_Financial_Statements.pdf

UKEB, September 2023, A Study in Connectivity: Analysis of UK Company 2022 Annual Reports

(a) Sustainability-related information may be embedded in financial statements' line items;

(b) There could be differences in the level of aggregation in financial statements versus sustainability statements;

(c) Certain sustainability-related information cannot be recognised or disclosed in the financial statements;

(d) Possible gaps in IFRS Accounting requirements;

(e) IFRS Accounting requirements may not be sufficiently clear;

(f) Other factors.

Sustainability-related information may be embedded in financial statements' line items

65 Sustainability-related matters are only a subset of the multiple factors that may affect an entity's financial performance, finance position and future cash flows as reflected in the financial statements. For instance, climate risk could be one amongst multiple macroeconomic and business risk factors affecting a bank's loan portfolio default risk and its recognised expected credit loss (ECL) under IFRS 9 *Financial Instruments*. As a result, it may be difficult for such a bank to separately identify and disclose the climate risk effects in the notes to the accounts in a manner that such information can be connected to related sustainability disclosures. In effect, in some situations, while disclosing a sensitivity analysis related to changes in measurement, it can be difficult to attribute the effects of climate risk separately from other measurement inputs.

66 Another example would be whenever climate-related risk is part of the risk adjustment under IFRS 17 *Insurance Contracts*. The best estimate in accordance with IFRS 17 requirements should include all risks and opportunities. As required under IFRS 13, this risk should also be part of either the observable market prices or the internal fair value estimate of assets held by entities subject to climate-related risks.

Differences in the level of aggregation in the presentation or disclosure of information in financial statements versus aggregation in sustainability statements

67 There could be differences in unit of account and level of aggregation/disaggregation of information disclosed/presented in financial statements versus information disclosed in the sustainability statements/disclosures. For instance, physical risk (assets vulnerable to physical risk) may be disclosed by location in the sustainability statements but not similarly disaggregated in the financial statements. The EFRAG ESRS Materiality Assessment Implementation guidance (FAQ 19) outlines examples of where connections cannot be

made due to differences in the level of aggregation in the financial statements relative to disaggregation in the sustainability statements (e.g. IAS 8 segments in the financial statements differing from disaggregation of related risks (e.g. water-stressed levels) at site level).

Certain sustainability-related information cannot be recognised or disclosed in the financial statements

68 Below is a non-exhaustive list of why certain disclosed sustainability-related information cannot be recognised, disclosed or presented in the financial statements.

69 **Differing materiality thresholds applied for sustainability disclosures versus financial statements**: As noted in Part 2 of this paper, the application of materiality is in the context of the objective of the report, there can be information items disclosed under an impact materiality lens that would not be financially material for the financial statements. However, such items may become financially material during future reporting periods (i.e., the concept of dynamic materiality is at play in practice).

70 Some sustainability reporting stakeholders have expressed an expectation that, at least in the long run, financial statements ought to reflect climate-related “inside-out” impacts (e.g., an adjustment of the statements of financial position and financial performance for a company’s negative impacts including its GHG emissions). These stakeholders have pointed to the nascent initiatives[20] conceptualising the monetisation and internalisation of these impacts/externalities into financial reporting. However, many stakeholders support retaining the current distinctive purposes of financial statements and sustainability reporting.

71 **Sustainability-related risks may not meet the criteria for recognition of provisions and liabilities**: After assessing the three criteria for recognising provisions under IAS 37 (i.e., present obligation as a result of past events, probable outflow of economic resources, and reliable measurement), the 2021 PTF-NFRS report concluded that there are unlikely to be recognised provisions from sustainability-related matters. The report notes the low likelihood of obligations from sustainability-related matters meeting the present obligation criteria. There is also the challenge of establishing that a transfer of economic resources has occurred (i.e., probable outflow of economic resources) for sustainability-related

[20]Cohen,R and Serafeim,G. 2020, How to Measure a Company’s Real Impact, Harvard Business Review https://hbr.org/2020/09/how-to-measure-a-companys-real-impact. Stakeholders have shared examples of initiatives in certain jurisdictions on how to monetise and incorporate CO2 into financial reporting standards (e.g., expenses and carbon liabilities). The PTF-NFRS publication Chapter lists several other experimental initiatives

matters. The report surmises there could be an increased reflection of sustainability-related matters as liabilities if more legal/regulatory measures were taken (e.g. pricing of negative externalities similar to the EU ETS, adoption of mandatory Human Rights Due Diligence laws, and prohibition of activities with above-threshold GHG emissions).

72 Appendix 2 of the 2021 PTF-NFRS publication also highlights several positive and negative externalities (i.e., impactfully material) and information that may be financially material within sustainability disclosures and the rest of the management report but do not meet the definition of assets and liabilities within the financial statements. These items include:

(a) Adverse nature/environmental impacts caused by the company's products (e.g., impacts of microplastic in groundwater, seawater; oil spills) without the company having restoration obligations.

(b) Potential liabilities for potential health problems caused by the company's products (e.g., alcohol, tobacco, medicine, hormonal damages), waste, and emissions (e.g., Nitrogen dioxide and Sulphur dioxide from plants and vehicles).

(c) Value of potential reuse of materials (circular economy).

(d) The potential future value from sustainability-related research and development activities that are not recognised as intangible assets.

73 Similarly, at the April 2023 IFASS meeting, the AcSB representative noted that, in comparing IAS 37 guidance with related sustainability disclosure guidance in IFRS S1 and S2, two key connectivity concerns arise when a) determining when the information disclosed under IFRS S1 and S2 triggered disclosure or recognition in the financial statements; b) the different approaches to the disclosure of commercially sensitive information.

74 It was noted that both IFRS S1 and IAS 37 contain exemptions from disclosing commercially sensitive information where disclosure could be expected to seriously prejudice the entity's position. However, the exemption in IFRS S1 was asymmetric (i.e., only applies to opportunities and not risks), whereas the exemption in IAS 37 was symmetric (i.e., applies to contingent assets as well as provisions and contingent liabilities). Hence, even if an entity was exempt from disclosing commercially sensitive information on sustainability-related risks in its financial statements it would still be required to provide such information in its sustainability disclosures. When users see such information, they could question why there was no corresponding financial statement disclosure.

75 In November 2023, IFRIC discussed a submission received related to a net zero commitment with the questions posed including: *does the public statement of a net zero*

transition commitment create a constructive obligation as defined in IAS 37? Does a constructive obligation created by a net zero transition commitment meet the criteria in IAS 37 for recognising a provision? The Committee agreed with the IASB staff conclusions (illustrated through a manufacturer publishing a commitment to reduce its emission targets by 60% in the next nine years and to thereafter purchase and retire carbon credits for remaining emissions and emissions made after nine years).

76 The IASB staff concluded that a constructive obligation does not necessarily exist at the time of publication of a net zero commitment and a constructive obligation would not result in the recognition of a provision when there is no present obligation as a result of a past event (i.e., if the commitment is not independent of the entity's future actions. For instance, if the commitment is to revamp manufacturing processes to attain the target). The staff did conclude that, in nine years, a provision could be recognised for the commitment to purchase the carbon credits (see Appendix 1 for further details). We note that at the time of writing this paper, neither was the IFRIC agenda decision finalised nor has the IFRIC analysed and redeliberated upon the feedback received.

77 **Constraints in reporting sustainability-related economic opportunities**: Stakeholders have noted that many firms are adapting their business models to capitalise on the profit-generating activities arising from the transition to a low-carbon economy (i.e., opportunities). However, under current IFRS Accounting Standards' recognition and measurement requirements, these opportunities (that could be deemed potential assets) cannot be recognised[21] as line items in the primary financial statements. However, opportunities are sometimes incorporated into sensitivity analysis disclosures.

78 **Differing reporting boundaries**: The scope of financial statements' information is the reporting entity, but sustainability reporting encompasses impacts, risks, and opportunities across the value chain. For example, sustainability disclosures may include investments in opportunities across the value chain related to the transition to net-zero emission targets.

[21] Paragraph 5.7 of the Conceptual Framework for Financial Reporting conveys that an asset or liability is recognised only if such recognition provides users of financial statements with information that is useful (**relevant** and **a faithful representation**). Paragraph 5.12 conveys that recognition of relevant information may not provide relevant information if, for example: a) it is **uncertain whether an asset or liability exists; b) an asset or liability exists, but the probability of an inflow of economic benefits is low**. Paragraph 5.18 conveys that whether a faithful representation can be provided may be affected by the level of **measurement uncertainty** associated with the asset or liability or by **other factors** (e.g., to avoid a misleading depiction of income, expenses and changes in equity; and whether related assets and liabilities are recognised).

Such investments may not be reconcilable to the investments reported in the financial statements.

79 **Differences and effects of the time horizons typically**[22] **applicable to sustainability disclosures and financial statements information**: The time horizon for climate risk can be much longer than that typically[23] applied in the recognition, measurement and disclosure of financial statements information. As such, climate and other sustainability-related risks may be included in sustainability disclosures earlier than can be recognised or disclosed in the financial statements. This could be due to how some stakeholders interpret a) the applicable time horizon for disclosure of estimation uncertainty under IAS 1; and b) the time horizon for impairment testing under IAS 36. See the discussion further below (limitations of IFRS Accounting Standards).

80 Furthermore, due to the typical long-term nature of climate and other sustainability-related risks, the effect of discounting these risks is that their impact on the values reported in the financial statements is often immaterial. In addition, low-probability long-term risks may not be reflected as liabilities or provisions due to failing to meet the IAS 37 recognition criteria (i.e., a probable outflow of economic resources, and can be reliably measured).

81 **Extent to which forward-looking information is incorporated**: Both financial statements and SR have forward-looking estimates. However, financial statements information is primarily focused on the future consequences of past actions whereas sustainability-related also encompasses future consequences of future actions. That said, financial statements information can also reflect future consequences of future actions (e.g., goodwill impairment tests that necessitate estimates of the terminal value of groups of cash-generating units).

82 **Extent of use of non-monetary units of measurement and aggregation:** Sustainability reporting information predominantly comprises non-monetary metrics, which in turn affects the level of aggregation that is possible, whereas financial statements information is primarily comprised of monetary metrics and easier to derive aggregated measures such as profit.

---

[22] Financial reporting information ought to be able to reflect all time horizons. In practice, one of the reasons provided for climate-related risks not being reflected is the long-time horizon associated with these risks.

[23] There are no limits to the time horizon applicable for FR information

83 **Role of accruals:** As outlined in an academic paper (*Wagenhofer*[24], 2023), unlike for financial statements, there is no "stocks and flows" representation and accruals of the information in sustainability disclosures.

84 **Financial control versus operational control:** Financial control is the criterion for the recognition of assets and consolidation of subsidiaries in the financial statements. It is also sometimes applied as the criterion for the consolidation of sustainability-related metrics (e.g., GHG emissions). However, the notion of operational control (i.e., when the reporting undertaking has the power to direct operational policies of an entity or assets), which is in some cases applied for the consolidation of sustainability-related metrics (e.g., GHG emissions) does not exist under IFRS Accounting requirements.

Possible gaps in IFRS Accounting Requirements highlighted during EFRAG and IASB Outreach

85 Both the IASB and EFRAG outreach on the climate-related and other uncertainties in the Financial Statements project shows that stakeholders consider that IFRS Accounting Standards are mostly sufficient albeit that they do not explicitly address climate-related and other sustainability-related risks. However, there are perceived limitations of some IFRS Accounting Standards (e.g. IAS 1 and IAS 36 impairment testing requirements) as enumerated below.

86 **Perceived limitations of IAS 1 requirements**: IAS 1.125[25] does not require an entity to disclose the sources of estimation uncertainty that could have a material impact on the financial statements in more than 12 months. Hence, IAS 1 may be perceived to prohibit disclosures that affect carrying amounts of assets and liabilities for periods beyond the next 12 months.

87 **Perceived limitations of IAS 36 requirements**: Following the feedback gotten from outreach on challenges associated with the IAS 36 impairment testing requirements, and the decision made by the IASB thereafter to explore the raised matters with IFRIC, the IASB staff paper[26] for the November 2023 IFRIC meeting notes that entities may not be adequately factoring climate-related risks over extended time horizons into impairment calculations. The IASB staff paper notes challenges arising from IAS 36.35 which states that,

[24] Alfred Wagenhofer (2023): Sustainability Reporting: A Financial Reporting Perspective, Accounting in Europe

[25] IAS 1.125 states "An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year."

[26] [ap03-climate-related-uncertainties-ias-36.pdf (ifrs.org)]

when estimating the recoverable amount of an asset, an entity can use cash flow projections for a period longer than five years if management is 'confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period'. A few stakeholders said some entities interpret this requirement as prohibiting them from forecasting cash flows for a longer period when calculating value in use. This perceived prohibition can result in entities calculating a terminal value based on cash flows expected in year five, even when those cash flows are not indicative of profitability in the long term.

88 In addition, the EFRAG outreach (reflected in the September 2023 EFRAG Secretariat Briefing) indicated there are difficulties in determining the treatment of incremental/improvement capex versus maintenance capex under current IAS 36. The Green Deal and transition to a green economy necessitates significant incremental capex (future investments to reduce emissions including upgrades to existing facilities, replacing energy sources, changing production processes, and new product lines), yet it is often unclear whether or not this incremental capex has to be/or has been reflected in the impairment testing.

Some IFRS Accounting Requirements may be insufficiently clear

89 The September 2023 IASB staff paper on findings of outreach related to the climate-related risks in the financial statements projects identified several areas where IFRS Accounting requirements may be insufficiently clear (i.e., IAS 2, IAS 12, IAS 36, IAS 38, IFRS 7, IFRS 9 and IFRS 17) (see Appendix for more details).

90 In respect of IAS 36 impairment testing, the IASB staff paper for the November 2023 IFRIC meeting notes that when measuring the value-in-use of an asset using the traditional approach, entities may not properly consider that cash flows (or discount rates) used should represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset rather than a single most likely, minimum or maximum possible amount. (IAS 36.38).

91 Relatedly, EFRAG's outreach showed that the diversity of practice arises due to the interpretation of 'management's best estimate of the range of conditions that will exist over the remaining useful life of the asset' under IAS 36.33. Specifically, whether such an estimate is management's judgment, a market-based estimate, or an estimate derived under an assumption of alignment with policy goals (e.g., an estimate based on the entity's conformance to Paris-aligned goals). For instance, a study that reviewed the reporting of

88 Dutch entities noted the limited reference made to whether assumptions are Paris-aligned.

Other factors

92 **Misapplication of qualitative materiality guidance:** As seen in two ESMA enforcement actions, material information on climate-related risks is sometimes excluded by reporting entities. Furthermore, a September 2023 UKEB publication highlighted that feedback from stakeholder groups indicated that preparers and auditors interpreted the IAS 1 requirements as a reason for excluding information to avoid unnecessary disclosures. Accordingly, some stakeholders suggested the development of application guidance for IAS 1 materiality requirements (i.e., IAS 1.29-31).

93 Relatedly, EFRAG outreach indicated users face difficulties in understanding entities' assessment of the materiality of long-term risks, and these users have suggested the IASB consider requiring an entity to disclose how it has performed the materiality assessment. Similarly, outreach by UKEB showed investors were of the view that the definition of materiality was not being consistently applied to climate-related risks and pointed to challenges in assessing how material risks were reflected. Some users conveyed expectations of a statement of immateriality.

94 In effect, there is a situation of inadequate guidance and misaligned expectations between preparers and users on the application of qualitative materiality. Incidentally, EFRAG's outreach in response to the IASB exploring developing examples to facilitate the application of materiality showed that there is either limited awareness or limited application of the IASB Materiality Practice Statement, which includes two examples (i.e., Example C- materiality judgements that lead to the disclosure of information in addition to specific disclosure requirements; and Example K- influence of external qualitative factors on materiality judgment).

95 **Difficulties and constraints in assessing and measuring climate-related risks:** These difficulties arise for the following reasons:

(a) Complex calculations and estimations are associated with climate-related risk. Illustratively, the study by Van der Tas, Aggarwal, and Maksimovic (2022) noted the challenges in applying IFRS 13 guidance by entities with exposure to climate risk. When these entities assess fair value less cost of disposal for assets, a market participant perspective needs to be taken. In assessing the fair value, the market data of the potential effect of climate on energy demand and prices as well as

emission rights and other regulations can differ significantly from one source to the other.

(b) There is limited data availability for entities to assess and report on climate-related risks, particularly for physical risks.

(c) There are inadequate risk management systems and inadequate skills to identify and manage climate-related risks.

(d) The prevalence of siloed organisations limits the interdepartmental collaboration (e.g., between finance, sustainability, environment, and strategy departments) required for the effective identification, assessment and reporting of climate-related risks.

APPENDICES

Appendix 1: November 2023 IFRIC consideration of net zero commitment

IASB Staff analysis and recommendations to IFRIC

1 **Fact pattern analysed:** A manufacturer of household products publishes/states its commitment to reduce targets by 60% at a future date (in nine years) and to offset remaining emissions at the future date and thereafter by buying carbon credits and retiring them. The entity details its plans to modify its manufacturing methods to achieve the set target and management conveys this will be done profitably. Below is an analysis of two of the three questions posed.

2 **Question 1** - does the public statement of a net zero transition commitment create a constructive obligation as defined in IAS 37?

3 Based on the requirements in IAS 37.10 and 20[27], for the fact pattern analysed, the IASB staff concluded that though other parties are involved as the entity's obligation is to the affected public at large, a net zero commitment does not necessarily create a constructive obligation. The staff notes entity's management would need to judge whether such a commitment has created a valid expectation before concluding there is a constructive obligation.

4 **Question 2** - does a constructive obligation created by a net zero transition commitment meet the three criteria in IAS 37.14 for recognising a provision? Specifically,

(e) **the present obligation criterion** – the entity has a present obligation as a result of a past event, which has to exist independently of the entity's future actions (IAS 37.18-19);

[27] **IAS 37.10** defines a constructive obligation as: "An obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities."

IAS 37.20 states that: "[…] Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities."

(f) **the probable outflows criterion** – it is probable that an outflow of resources will be required to settle the obligation;

(g) **the reliable measurement recognition criterion** – a reliable estimate can be made of the amount of the obligation.

5 The IASB staff concluded that, for the fact pattern analysed, even if there is a constructive obligation, such a constructive obligation does not meet the present obligation criterion and therefore a provision is not recognised at the time the commitment is published. There is no present obligation at the date the entity publishes the commitment because the costs of meeting this commitment (i.e., modifying manufacturing methods and purchasing carbon credits) are costs that will/need to be incurred to operate in the future. Financial statements deal with the financial position at the reporting date and not its possible position in the future and the obligations do not exist independently of the entity’s future actions as required by IAS 37.18-19. However, the IASB staff notes that, at some point, the entity will incur a present obligation to pay for resources it purchases for modifying its manufacturing methods (e.g., new plant or equipment) but only when it receives those resources. It will also have a present obligation to purchase carbon credits only if and when it emits greenhouse gases in nine years and thereafter.

6 On the ‘probable outflows’ criterion, the IASB staff concluded that the entity’s commitment to reduce emissions in nine years does not satisfy this criterion because it will receive resources (e.g., a new plant) in exchange for the costs of modifying its manufacturing methods. Conversely, the commitment to offset remaining emissions in nine years satisfies this criterion as the entity will not receive any resources in exchange for its purchase of carbon credits.

7 Taken together, the staff concluded that the entity could not recognise a provision for the commitment to invest in modifying its manufacturing methods. However, in nine years, a provision could be recognised for the commitment to purchase the carbon credits. IFRIC agreed with the IASB staff's conclusions.

Appendix 2: Insufficiently clear IFRS Accounting Standards

Objective

1 The table below outlines areas where there are insufficiently clear IFRS Accounting Standards.

Insufficiently clear IFRS Accounting Standards identified by the IASB staff

IFRS Accounting Standard	Perceived problem	IASB staff view
IAS 1	It is unclear whether entities are required to provide disaggregated information about the financial statements line items impacted by climate-related risks. For example, entities do not always disaggregate property, plant and equipment or costs by exposure to climate-related risks.	IASB staff concluded in the September 2023 Staff paper 14B “Given the interplay between these causes, we think individual actions could help address multiple issues discussed in this section. Possible actions could involve making changes that focus on providing additional detail to strengthen particular general requirements (for example, strengthening requirements in IAS 1 on disclosures about assumptions). Alternatively, the IASB could add specific requirements to particular IFRS Accounting Standards (for
IAS 1 in interaction with IAS 36	Although IAS 36.130g requires entities to disclose information about the discount rate used in previous estimates of the recoverable amount of an asset for which an impairment loss has been recognised, it is unclear whether, in applying IAS 1.31, an entity is required to disclose similar information about other assumptions used in preparing financial statements.	
IAS 2	IAS 2 does not specifically require an entity to provide information about the reasons—which might include climate-related risks—for a write-down of inventory.	
IAS 8	It is unclear whether in applying the requirement in IAS 8.39 to disclose ‘the nature and amount of a change in an accounting estimate’, entities should also provide information about the reason for a change in estimates.	
IAS 12	IAS 12 does not specifically require an entity to provide information about the reasons for a write-down of deferred tax assets.	
IAS 36	IAS 36 does not specifically require an entity to disclose information about how risk factors—such as those related to climate—have been reflected in assumptions made (for example, in the discount rate used for impairment testing purposes) or about the effects of those factors on an estimated amount (for example, the recoverable amount).	

IAS 37	it may be unclear in some circumstances whether in applying IAS 37 a commitment would result in the recognition of a provision. For example, it may not be clear whether making a commitment to offset future greenhouse gas emissions in itself gives rise to a present obligation for an entity and therefore requires the recognition of a provision.	example, requiring an entity to disclose the reason for inventory write-downs applying IAS 2, or to disclose assumptions used to test for impairment of cash-generating units without goodwill applying IAS 36)."
IAS 38	An entity may incur research and development expenditure in managing climate-related risks. However, IAS 38 can be read as requiring the entity to disclose the aggregate amount of expenditures, rather than disaggregate the expenditures by their purpose.	
IFRS 7 and IFRS 17	IFRS 7 and IFRS 17 do not specifically require an entity to provide information about climate-related risks affecting financial instruments and insurance liabilities.	
IFRS 9	for some financial instruments, it may not be clear how to consider the effects of climate-related risks when applying the requirements in IFRS 9 for example: • assessing whether the contractual cash flows of financial assets with interest rates linked to environmental, social or governance (ESG) targets are solely payments of principal and interest on the principal amount outstanding (SPPI); and • the own-use exception to physical power purchase agreements for the delivery of renewable energy.	

Appendix 3: EU Accounting Directive - details

EU Accounting Directive Accounting Principles

1 Paragraph 3 of Article 4, "*The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.*"

2 Paragraph 1 of Article 6, "*Items presented in the annual and consolidated financial statements shall be recognised and measured in accordance with the following general principles:*

the undertaking shall be presumed to be carrying on its business as a going concern;

(a) *accounting policies and measurement bases shall be applied consistently from one financial year to the next;*

(b) *recognition and measurement shall be on a prudent basis, and in particular:*

(i) *only profits made at the balance sheet date may be recognised,*

(ii) *all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and*

(iii) *all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss;*

(c) *amounts recognised in the balance sheet and profit and loss account shall be computed on the accrual basis;*

(d) *the opening balance sheet for each financial year shall correspond to the closing balance sheet for the preceding financial year;*

(e) *the components of asset and liability items shall be valued separately;*

(f) *any set-off between asset and liability items, or between income and expenditure items, shall be prohibited;*

(g) *items in the profit and loss account and balance sheet shall be accounted for and presented having regard to the substance of the transaction or arrangement concerned;*

(h) *items recognised in the financial statements shall be measured in accordance with the principle of purchase price or production cost; and*

(i) *the requirements set out in this Directive regarding recognition, measurement, presentation, disclosure and consolidation need not be complied with when the effect of complying with them is immaterial."*

Management report objectives across a selection of EU jurisdictions

France

3 The French commercial code issued by the Ministry of Finance incorporates the transposed requirements of the EU Accounting Directive[28]. paragraph[29] 2 of Article L232-1 of the French commercial code[30], "The management report describes the company's situation during the past financial year, its foreseeable development, significant events occurring between the end of the financial year and the date on which the report is drawn up, and its research and development activities. Existing branches are mentioned".

Germany

4 Both the German commercial code[31] and GAS 20[32] refer to:

(a) Course of business and position: Article 289, "*The management report is to present accurately the business development, including the business performance of the share capital company and its position, in keeping with its actual circumstances ...";*

(b) Future development: Article 289, "*Furthermore, the management report is to assess the company's likely future development ...";* and

(c) Risks and opportunities: Article 289, "*material opportunities and risks it faces and is to provide an explanation thereof"*

[28] https://www.legifrance.gouv.fr/loda/id/JORFTEXT000030920982

[29] As translated by this paper's authors

[30] https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000037313425

[31] https://www.gesetze-im-internet.de/englisch_hgb/englisch_hgb.html#p1236

[32] https://www.drsc.de/en/pronouncements/gas-20/

5 GAS 20 separately refers to:

(a) The use of resources by management: "*The objective of group management reporting under this Standard is to report on the use of the group's resources by management*";

(b) User needs: *"[the objective of the group management report is] to provide information that enables a knowledgeable user to obtain a suitable understanding …*"; and

(c) Takeovers: "*The objective of the takeover-related disclosures is to enable a potential offeror to obtain a comprehensive picture of the potential offeree entity and its structure, as well as any barriers to takeovers, before making a takeover bid*".