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Connectivity considerations & Boundaries of different Annual Report sections

This paper is an interim deliverable of the EFRAG project on connectivity between financial reporting and sustainability reporting, which is part of EFRAG's proactive research workplan. The project's main deliverable will be a Discussion Paper that will be issued at a future date for public consultation. The purpose of this interim deliverable paper is to raise awareness of the main definitions and conceptual foundations of the notion of connectivity as primarily reflected in the ESRS and ISSB Standards' connectivity/connection requirements. Other objectives are to raise awareness of the boundaries of different parts of the Annual Report and to highlight the pivotal role of connectivity in ensuring the coherence and complementarity of the information within the boundaries of different reports. The content of this interim deliverable paper will be incorporated into the Discussion Paper that will be later issued for consultation.

The content of this interim deliverable paper is the result of the technical discussions held by the EFRAG Connectivity Advisory Panel (EFRAG CAP), EFRAG FR and SR TEGs and EFRAG FRB and SRB along with a review of the literature including the ESRS 1 *General Requirements* and IFRS Sustainability Disclosure Standards (IFRS S1 *General Requirements* for Disclosure of Sustainability-related Financial Information), other reporting guidance, various publications by EFRAG and NSS, various regulatory thematic reviews; and insights from the discussions held on connectivity by EFRAG-organised panels.

This interim deliverable paper does not have authoritative stature. And the deliverables of the EFRAG research project (i.e., this interim deliverable paper and the forthcoming Discussion Paper) should not be understood to be part of EFRAG's European sustainability reporting standard-setting activity nor should they be read as ESRS implementation guidance. As noted, EFRAG is only issuing this interim deliverable paper and will issue a Discussion Paper as part of its proactive research activities, whereby the objective is to stimulate public debate and influence corporate reporting developments.

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INTRODUCTION

Objective and scope

1 The EFRAG proactive research project on connectivity between financial reporting and sustainability reporting (EFRAG connectivity project) has multiple objectives including to:

(a) influence the ongoing jurisdictional and international standard setting consistent with the objectives of the EFRAG proactive research workplan;

(b) serve as an educational resource and support practice through illustrative examples;

(c) contribute to research/thought leadership on the topic of connectivity, which is a nascent and high-priority area for stakeholders in corporate reporting.

2 A Discussion Paper with illustrations of connectivity will be the main deliverable of the EFRAG connectivity project. This interim deliverable paper addresses the following interrelated aspects:

(a) **Section 1: Connectivity considerations,** and

(b) **Section 2: Boundaries** of the different Annual Report sections.

3 In this regard, this Interim Deliverable paper reflects both the technical discussions held so far within EFRAG (including by the EFRAG CAP[1]) as well as the insights drawn from the review of relevant literature. In Section 1 (Connectivity considerations), this paper outlines what connectivity means, why it is important, what is being connected in the EFRAG connectivity project, and the underpinnings of the ESRS and IFRS Sustainability Disclosure Standards connectivity requirements and other connectivity-related concepts. In Section 2, the boundaries of different corporate reports (as defined by their objectives, audience, application of materiality, and several other factors) and how these relate to connectivity are addressed. Notably, the boundaries of different reports both necessitate and affect the connectivity of reported information. This content sets the scene for the illustrations of connectivity in the forthcoming Discussion Paper. It is also intended to be an educational resource for stakeholders as connectivity is a nascent concept within mandated reports

[1] The EFRAG CAP is a 23-person multi-stakeholder group (consisting of preparers, users, academics, auditors, enforcers, and consultants) with financial reporting, sustainability reporting, and cross-sectoral expertise. Its remit is to provide advisory input to the governance bodies supervising the EFRAG connectivity project (EFRAG Technical Expert Groups and EFRAG FRB) and actively contribute to the development of the EFRAG connectivity project deliverables (Discussion Paper and any interim deliverables). This contribution includes guiding and participating in the EFRAG Secretariat's development of conceptual scene setting content, development of illustrations of connectivity, and formulating any recommendations.

(i.e., addresses objectives stated in paragraphs 1 b and 1c). The content of this interim deliverable paper should not be construed as being either an alternative or additional guidance on how to apply connectivity in reporting.

4 As laid out in Section 1.2 (what is being connected), the EFRAG connectivity project primarily focuses on the information in the Annual Report; specifically, the connectivity between financial statements, the sustainability statement/disclosures in the management report, and the rest of the management report. Based on the Transparency Directive and International Standards of Auditing (ISA) 720 definitions of the Annual Report (see Appendix 3), and cognisant that its components vary across jurisdictions, for the purposes of the EFRAG connectivity project, the Annual Report refers to the document that is mandatorily filed annually and, which at a minimum, consists of the financial statements[2] (primary financial statements and notes within the financial statements) and the management report. As detailed in Section 1.2, in the EU, the management report includes the sustainability statement if an entity falls within the scope of the Corporate Sustainability Reporting Directive (CSRD). Depending on jurisdiction, other reports within the Annual Report can include the corporate governance report, remuneration report, risk report, and country-by-country tax transparency report. As noted, the focus will be on the connectivity between financial statements, the sustainability statement/disclosures in the management report, and the rest of the management report.

Overview of corporate reporting evolution and the pivotal role of connectivity

> *"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,*

[2] 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 ...

providing another image of the company."- Equity analyst who is a member of the EFRAG Connectivity Advisory Panel

"*Sustainability reporting starts where financial reporting ends*"- EFRAG SRB Chair

"A financial report and/or a sustainability report cannot tell the entire truth. Each of these reports can only be an excerpt of a company's reality" - IASB Chair at the April 2023 IFASS meeting

"There is no longer an assumed primacy of financial reporting over sustainability reporting, but rather these are two pillars of the same continuum which are there to tell a consistent story" - Chair of ESMA at the November 2023 EFRAG Conference

5 As the above quotes portray, financial reporting has traditionally been the bedrock of communicating an entity's value creation[3] story but that is changing with the increased demand for and ongoing enhancement of sustainability reporting, which has distinctive information and is complementary and expected to bridge the gaps arising from constraints[4] in reflecting information in the financial statements. *Where does connectivity fit into all this?* That is what the remainder of this paper endeavours to address.

6 *Corporate reporting evolution*: Different parts of the annual report (which include the financial statements, the management report, and the sustainability statement/disclosures) have differing historical profiles[5] and varied levels of maturity (i.e., in their level of assurance, enforcement, application by capital market participants, and the

[3] Financial reporting has been used for other purposes including monitoring stewardship, determining dividends, tax and to assess entity's solvency.

[4] As detailed later in this paper, 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) are underpinned by the objective of financial statements.

[5] Though they have evolved over time, financial statements are 100+ years old and the origins of modern financial accounting including double entry accounting can be traced as far back as the 15th century, 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 Sustainability Disclosures Standards were published in 2023.

extent of development of an underpinning robust, conceptual framework). At the same time, as noted above, there is an ongoing evolution of corporate reporting that is going beyond a focus on the financial drivers of value creation and also addressing the sustainability dimensions of a business' activities. A key step in the evolution of corporate reporting (i.e. over and above the ongoing development and amendments of IFRS Accounting Standards and local GAAP) has been the rollout of mandatory sustainability requirements within the EU and across many other jurisdictions (e.g., those that will adopt ISSB[6], and other jurisdictional requirements including the US SEC Climate rule, New Zealand Climate Disclosures, Japan Sustainability Reporting Standards, and Korean Sustainability Reporting Standards).

7 Within the EU, the enhancement of sustainability reporting requirements to provide high-quality (i.e., relevant/material, reliable, comparable, and consistent) company-reported information on sustainability impacts, risks, and opportunities is a core plank of the EU public policy objectives within the March 2018 European Commission's Action Plan on Financing Sustainable Growth and European Green Deal. The aforementioned policy aims to stimulate sustainable investment, and create both sustainable businesses and a sustainable economy, and it has underpinned the revision of the Non-Financial Reporting Directive (NFRD) via the enactment of the Corporate Sustainability Reporting Directive (CSRD) (effective from January 2024). The CSRD requires eligible entities in the EU to prepare a sustainability statement under the European Sustainability Reporting Standards (ESRS). An espoused objective of the CSRD is to have mandatory, robust, comparable, and assured sustainability reporting that has the same footing as financial statements' information.

8 *Pivotal role of connectivity*: The elevated prominence of sustainability reporting within the EU (and elsewhere) and its complementary nature to the financial statements underlie the pivotal role of connectivity (which incidentally was also one of the principles of the 2013

[6] https://www.ifrs.org/news-and-events/news/2024/04/progress-towards-adoption-of-issb-standards-as-jurisdictions-consult/ This IFRS Foundation update indicates that Australia and Malaysia have consulted on ISSB Standards; Canada, Japan and Singapore are consulting on ISSB Standards; and Brazil, Costa Rica, Sri Lanka, Nigeria, and Turkey have announced decisions to adopt or otherwise use ISSB standards.

Integrated Reporting-IR framework and the updated 2021 IR framework[7]). Pointedly, in the preparatory work that preceded the sector-agnostic ESRS development, the EFRAG February 2021 Project task force of Non-financial Reporting Standards (PTF-NFRS) publication (*Proposals for a Relevant and Dynamic EU Sustainability Reporting Standard Setting*) (hereafter referred to as the PTF-NFRS main publication) considered establishing connectivity requirements to be one of the six prerequisite concepts for robust standard setting in the EU.

9 The PTF-NFRS main publication noted the absence of a formal interconnection between different sections of the annual report could lead to potential gaps, overlaps (i.e. duplication), and a lack of coherence in reported information. Relatedly, during EFRAG CAP discussions and at the May 2023 EFRAG-hosted European Accounting Association- EAA symposium on connectivity (see report-*Multi-stakeholder perspectives on Connectivity*), concerns about overlaps/duplicative information also came to the fore. These include the burden of double reporting by preparers and the risk of double counting during the valuation of companies by users.

10 The PTF-NFRS main report recommended connectivity from a two-way perspective (i.e., sustainability statement/disclosures to financial statements and vice versa). Specifically, it suggested that:

(a) sustainability reporting standards should define anchor points to create connectivity to financial reporting together with the necessary reconciliations or cross-references. Anchor points may be direct when a monetary sustainability disclosure is derived[8] from accounting data, and they may be indirect when sustainability disclosures simply need to be coherent with financial disclosures;

(b) conversely, financial reporting standards should consider anchor points from sustainability reporting, for instance when financial accounting standards require forward-looking estimates or risk disclosures.

11 In addition to the PTF-NFRS main report's call for connectivity, its supplemental report-*Appendix A4 Interconnection between Financial and Non-Financial Information* (hereafter

[7] In this paper, the reference to connectivity in the context of the IR framework **is limited to the external reporting aspects** (i.e., external reporting that aims to show a holistic picture of the combination, interrelatedness, and dependencies between different items of information). We are not referring to integrated thinking.

[8] An example of information derived from accounting data would be European Taxonomy KPIs.

referred to as the PTF-NFRS connectivity publication) detailed key connectivity considerations (e.g., potential connectivity approaches such as direct and indirect connectivity, location considerations, and boundaries of IFRS Standards).

12 The importance of connectivity was also underscored as the connectivity project was the top-ranked project during the 2021 EFRAG proactive research agenda consultation. And it was one of the seven recommendations of the October 2021 EFRAG European Lab project report (*Towards Sustainable Business: Good Practices in Business Model, Sustainability Risks and Opportunities Reporting in the EU*) following the review of a selection of EU companies' reporting practices. This report highlighted many companies' failure (i.e., at the time) to disclose/quantify the financial effects of sustainability risks and opportunities. Moreover, following EFRAG's outreach related to the IASB project on climate-related and other uncertainties in the financial statements, the September 2023 *EFRAG Secretariat Briefing: Climate-related Risks in Financial Statements* conveyed the lack (and importance) of connectivity between information within and outside the financial statements. In a similar vein, at the November 2023 EFRAG- *European Corporate Reporting- Two Pillars for Success* Conference connectivity panel session (see summary report), the preparer panellist emphasised connectivity as being about getting a complete picture, and the user panellist conveyed that it is about understanding the financial effects of sustainability-related matters.

13 The call for connectivity articulated in the PTF-NFRS publications paved the way for the incorporation of connectivity requirements into ESRS 1 *General Requirements.* Moreover, from an EU perspective, the findings in ESMA's October 2023 report on Disclosures of Climate-related matters in the Financial Statements and other regulatory and stakeholder publications[9] (AMF, Norway Finanstilsynet, Mazars, Dutch MAB) based on thematic reviews of the reporting of climate risk in the financial statements by European companies along with the views expressed by EFRAG CAP and EFRAG events on connectivity underpin the

[9] a) ESMA, March 2023, *Report- 2022 Corporate reporting enforcement and regulatory activities*

b) Finanstilsynet, March 2023, *Report on Information on climate-related matters in annual financial reports*.

c) Autorité des Marchés Financiers -AMF, 2022, *Overview of the information provided in the 2021 financial statements on the effects of climate change and the commitments made by companies*.

d) Leo van der Tas, Yukti Aggarwal, and Danijela Maksimovic, September 2022, *Effects of climate change on financial statements of entities listed in the Netherlands*, MAB- Maandblad voor Accountancy en Bedrijfseconomie.

e) Mazars, January 2024, Financial reporting of European companies on climate issues- Findings from 2022 financial statements.

need for two-way connectivity (of information in both financial statements and sustainability reporting). A European Systemic Risk Board (ESRB) April 2024 publication *Climate-risks and accounting* notes that failing to ensure connectivity between accounting and sustainability standards can have a negative effect on the quality of information disclosed to capital markets, with potentially system-wide consequences. Section 1.4 expands on other benefits of connectivity.

14 A similar emphasis on connectivity has occurred internationally with the establishment of the ISSB as part of the IFRS Foundation and with the incorporation of requirements for connection of information in IFRS Sustainability Disclosure Standards- (IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*). Moreover, the IASB workplan (active and pipeline projects) consists of several connectivity-related projects (e.g., Management commentary, Climate-related and other uncertainties in the financial statements, and Pollutant pricing mechanisms). We also note that, in April 2024, though the ISSB decided not to pursue a project on integration in reporting following the feedback to its 2023 Agenda Consultation, both the IASB and ISSB pledged to continue supporting the use of the IR framework (of which connectivity is a key principle) as a resource that drives high-quality corporate reporting and contributes to a cohesive information package for investors. Connectivity has also been a recurrent discussion theme at recent International Forum of Accounting Standard Setters (IFASS) meetings (see January, April and September 2023 IFASS reports with presentations on connectivity by the AASB, AcSB, EFRAG, FRC-UK, IASB, ISSB and UKEB; AASB and EFRAG also presented on connectivity and boundaries at the April 2024 IFASS meeting). Some of the non-EU NSS (AASB, FRC-UK, UKEB, New Zealand-XRB) have issued publications[10] and/or hosted events (e.g. AASB webinar[11]) related to climate-related reporting in the financial statements and connectivity.

Summary of the content in the rest of the document

Section 1: Connectivity considerations and related concepts

15 ***Section 1.1 (what connectivity means)*** outlines the broad aspects of connectivity (i.e., in reports, in standard-setting, and in processes) as well as the distinction between

[10] FRC UK, July 2023, CRR Thematic review of climate-related metrics and targets

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

NZ XRB staff guidance, November 2023, Climate-related matters in Financial Statements

[11] March 2024 AASB webinar on Connectivity and Boundaries of the Annual Report

connectivity and integration of reporting. The latter was deemed a lower priority for some stakeholders including EFRAG (i.e., based on the feedback to the 2023 ISSB Agenda consultation).

16 ***Section 1.2 (what is being connected)***- We note the similarities and differences between the EU corporate reporting framework and general purpose financial reporting under IFRS. Of note, the EU has clear requirements for the placement of sustainability reporting information, which apart from facilitating navigability and ease of access, can be seen as an enabler of connectivity of information. While illustrating connections, the EFRAG connectivity approach will also take a GAAP-agnostic approach albeit primarily focusing on financial statements prepared under IFRS Accounting requirements.

17 ***Section 1.3 (connectivity categories and concepts)*** – unlike the ESRS and IFRS Sustainability Disclosure Standards connection requirements, IFRS Accounting Standards have no explicit connectivity requirements. Thus, we highlight overarching considerations for developing financial statements and sustainability reporting that would facilitate two-way connectivity (SR to FR and vice versa). We point to constraints in applying some of the ESRS and IFRS Sustainability Disclosure Standards connection requirements (e.g., legal risk of incorporating forward-looking information by reference, and disclosure overload) when connecting information located in the financial statements. Ultimately, the IASB is responsible for considering and possibly developing connection requirements for the information in the financial statements.

18 Finally, we illustrate that applying connectivity-related techniques (reconciliation, incorporation by reference, consistency of assumptions, similar basis of preparation, and coherent presentation) supports the provision of information conforming to the qualitative characteristics of decision-useful information.

19 ***Section 1.1 (why connectivity is important)*** we reiterate the earlier stated complementary nature of SR and FR information and outline other benefits of applying connectivity (e.g., reducing the expectation gaps, and reducing greenwashing). A key message is that connectivity enables holistic communication of the entity's value-creation story, and this is done by linking the business model to both FR and SR reporting outcomes.

Section 2: Boundaries of different annual report sections

20 Section 2 has an analysis of the boundaries of different annual report sections as this is essential to identifying the connections that either can or cannot be made between different reports. An understanding of the boundaries of different corporate reports can

also help to reduce the expectation gap on the information that ought to be contained within different corporate reports. **Section 2.1 lays out the objectives and audiences** of different corporate reports.

21 **Section 2.2 also highlights the application of materiality** across different reports, and the dynamic dimension of connectivity (i.e., migration of reported items from one report at a point in time to another report at a future date) stemming from changes in the nature, quantifiability, magnitude, and probability of occurrence of particular risks and/ or opportunities.

22 Also analysed in **Section 2.2 are some grey areas (i.e., where there may be duplicated or missing information across the reports and/or where there are diverse views on the best location of certain information)** faced when determining the suitable location of reporting certain information deemed financially material (e.g., whether disclosures of net-zero commitments that are likely to result in the recognition of provisions at a future date and/or have future cash flow consequences should either be disclosed in the financial statements or the sustainability statement/disclosures or both. And if disclosed in the sustainability statement, how should they be measured). The development of a sustainability reporting conceptual framework akin to the one in place for financial reporting could help resolve several challenges that stem from the differing nature of sustainability and financial reporting information. For instance, it could address the placement of information and the triggers for the expected migration of items from sustainability reporting to the financial statements. It could also address how to measure financial effects in the sustainability statement/disclosures.

23 Finally, to illustrate the distinctive nature of financial statements and lessen the expectation gap, **Section 2.3 has an analysis of why certain sustainability matters may also sometimes not be reflected in the financial statements**. Of note is the March 2024 IFRS IC agenda decision which gave reasons why constructive obligations arising from net-zero commitments are not recognised as provisions (and the need for a present obligation/past event and outflow of economic resources prior to their recognition as provisions). The content of Section 2.3 is not intended to negate or contradict the objectives of issued IASB educational articles on why/how climate risk should be reflected in the financial statements.

SECTION 1. CONNECTIVITY CONSIDERATIONS

24 Section 1 addresses some foundational questions related to connectivity with a focus on the following:

(a) What is connectivity (Section 1.1)

(b) What is being connected (i.e., in the context of the EFRAG connectivity project) (Section 1.2)

(c) Connectivity categories and related concepts (Section 1.3)

(d) Why connectivity is important (Section 1.4)

1.1. WHAT IS CONNECTIVITY

Stating what is meant by connectivity is important because it is a new concept in mandated reporting, and also because it is often applied in varied and possibly confusing fashion as it is a multi-dimensional concept.

<u>Both a new and familiar concept:</u> **Connectivity is a nascent concept within authoritative requirements (included in ESRS in the EU and IFRS Sustainability Disclosure Standards in adopting non-EU jurisdictions). The term is not explicitly included in the IFRS Accounting requirements and any other legal requirements that were applicable before the 2024 reporting year.**

At the same time, connectivity is a familiar concept as it is one of the seven guiding principles of the 2013 and updated 2021 International Integrated Reporting Council ('IIRC')- integrated reporting (IR) framework. That said, the IR framework's application for external reporting is not in the scope of the EFRAG connectivity project nor is integrated thinking. The latter is excluded because the focus of the EFRAG project is primarily around the connectivity of externally reported information.

We also note that notions associated with connectivity such as the consistency of information across reports were already baked into other authoritative requirements including the Transparency Directive and auditor guidance (EU Accounting Directive Article 34 par.1 (a) (i) and ISA 720). And coherence was included as one of the characteristics of useful information in the 2021 Exposure Draft to revise the Management Commentary Practice Statement.

<u>To avoid the possibly confusing use of the term as it is multi-dimensional:</u> **Multiple notions are associated with connectivity including complementarity, coherence, consistency, communication, and integrated reporting. Some of these terms (e.g., coherence) are sometimes used as synonyms for connectivity. Other times, these terms are applied as only being elements of connectivity. And still, at other times, some of the terms (coherence, integrated reporting) are described as being distinct notions from connectivity. Hence, to avoid confusion and cross-purpose communication, it is important to clarify what the term connectivity means in the context of the EFRAG Connectivity project. This is done below by clarifying that integration is a different and broader notion than connectivity. Section 1.3 addresses connectivity categories and related concepts in more detail.**

Broad aspects of connectivity

25 A 2023 IFRS Foundation article makes a helpful distinction between three broad categories of connectivity, namely; connectivity in reports (information), connectivity in standard-

setting products (reporting requirements), and connectivity in process. We expand on these categories below.

26 **Connectivity in information (reports):** Relatedly, section 1.3 fleshes out the related ESRS and IFRS Sustainability Disclosure Standards connectivity/connection requirements for sustainability reporting information. Pre-dating the aforementioned requirements, the 2021 IR framework also included connectivity of information as one of the seven guiding principles for the preparation of an integrated report. The IR framework points to the connectivity between

(a) The content elements: The integrated report connects the Content Elements12 into a total picture that reflects the dynamic and systemic interactions of the organisation as a whole (e.g., linking organisation strategy and business model with changes in its external environment)

(b) The past, present and future

(c) The capitals including the interdependencies and trade-offs between the capitals and how their availability, quality, and affordability affect the ability of the organisation to create value.

(d) Financial and other information (e.g., the impact of customer relationships and customer satisfaction on revenue and profit growth)

(e) Quantitative and qualitative information- both are necessary to represent an organisation's ability to create future value and to contextualise each other.

(f) Management information, board information and information reported externally.

(g) Information in the integrated report, information in the organisation's other communications, and information from other sources.

27 **Connectivity in reporting requirements (standard-setting products):** This refers to consistency in required standards and the basis of preparation of reported information within the financial statements and sustainability reports. And <u>the imperative of ensuring connectivity in standard-setting products falls upon standard-setting bodies (e.g. IASB. ISSB, EFRAG SR Pillar/EC, and other National Standard Setters)</u>.

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[12] The content elements include a) organizational overview and external environment; b) governance; c) business model; c) risks and opportunities; d) strategy and resource allocation; e) performance; f) outlook; and h) basis of preparation.

28 Related to this type of connectivity, both the ESRS and IFRS Sustainability Disclosure Standards require the same reporting entity and reporting period as the financial statements. These requirements 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. Both IFRS S1 and ESRS requirements 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. Furthermore, the qualitative characteristics of information of IFRS Accounting Standards, IFRS Sustainability Disclosure Standards and ESRS are based on the Conceptual Framework for Financial Reporting.

29 **Connectivity in process**: The term connectivity is also applied in the context of processes of providing guidance and preparing reporting information. Hence it captures institutional connectivity within and across the organisations responsible for financial reporting and sustainability reporting standard setting (e.g. IFRS Foundation[13] and other jurisdictional standard setters). It also captures the idea of different functional teams working together within organisations. It is beyond the scope of the EFRAG connectivity project to assess or illustrate connectivity in process. Nonetheless, the development of the EFRAG research project deliverables with input from a multi-stakeholder advisory panel and with collaboration between the EFRAG FR and SR pillars is itself an embodiment and recognition of the value of connectivity in process.

Connectivity versus integration in reporting

30 The May 2023 ISSB Request For Information (RFI) *Consultation on Agenda Priorities* framed 'connectivity or connection in reporting' as being a distinct and narrower notion than 'integration of reporting'. The RFI states that "*Integration in reporting takes the concept of connectivity a step further. Integration in reporting not only encompasses where, what and how information on value creation can be connected through conceptual and operational linkages (for example, in terms of compatibility of language and assumptions), but also*

[13] The importance of connectivity in the work of the IASB and ISSB is further highlighted in the ISSB Agenda Consultation feedback summary on connectivity (paragraph 9 page 3). In paragraph 11 of page 4, stakeholders' calls for "interconnected standards" instead of simply "compatibility and avoiding potential conflicts". Other relevant suggestions are being made in paragraphs 22-24 (pages 8-9) of the same document. https://www.ifrs.org/content/dam/ifrs/meetings/2024/january/iasb-issb-joint/ap2b-feedback-summary-connectivity.pdf

includes the collective consideration of the interdependencies, synergies and trade-offs between:

(a) the various resources and relationships reported on in general purpose financial reports; and

(b) how the value that an entity creates for itself and for its investors is inextricably linked to the value the entity creates for other stakeholders, society, and the natural environment."

31 EFRAG's August 2023 comment letter response to the ISSB agenda consultation noted the need to further clarify the definition of integration in reporting in paragraph 23 and that the immediate priority for the ISSB and IASB should be connectivity rather than integration in reporting. Of note, three-quarters of the respondents to the consultation either considered integration a lower priority than other projects or did not rank its relative priority.

32 EFRAG's comment letter also_called for the development of a sustainability reporting conceptual framework akin to the one in place for financial reporting before a project on integration in reporting is undertaken. We note various concepts are idiosyncratic to sustainability reporting (e.g., applying the notion of operational control whilst calculating environmental metrics, the absence of constraints in incorporating forward-looking information etc) and these could benefit from further development of underpinning conceptual principles. At the same time, it is acknowledged that ESRS 1, IFRS S1, the 2021 PTF-NFRS report, various IFRS Accounting Standards (IAS 1, IAS 8, and IAS 10), and the Conceptual Framework for Financial Reporting collectively provided a sufficient conceptual underpinning for the development of the initial authoritative sustainability standard setting deliverables (ESRS and IFRS Sustainability Disclosure Standards). Moreover, given the workplan and competing priorities of the ISSB and EFRAG SR pillar, based on the issues raised by stakeholders in response to ISSB agenda consultation, the development of a comprehensive conceptual framework for sustainability reporting may not be considered an immediate goal.

1.2. WHAT IS BEING CONNECTED?

Connectivity of information can go beyond[14] information in the annual report to include connectivity with information in the organisation's other communications and information from other sources. That said, consistent with EFRAG's mandate, the focus of the EFRAG connectivity project is on connections between the sections of the Annual Report with established stature (i.e., are subject to assurance, are enforceable, and have robust underpinning guidance) and complementary objectives. In this regard, the focus is on the connection of information in the financial statements, the sustainability statement/disclosures in the management report, and the rest of the management report.

This section outlines the connections to be respectively made across these reports under the EU corporate reporting and IFRS general purpose financial reporting requirements. In so doing, we also point to the salient differences between these two requirements (i.e., the extent to which the objective of sustainability reporting differs from that of the financial statements and the related factors of audience and materiality perspective, and clarity on the location of sustainability reporting).

33 Consistent with EFRAG's mandate related to authoritative requirements (i.e., influencing IFRS Accounting Standards and developing ESRS in its role as the technical adviser to the EC), the focus of the EFRAG connectivity project is on connections between sections of the annual report that have complementary objectives and a well-identified nature, purpose, and established stature (i.e., are subject to assurance, are enforceable, and have robust underpinning guidance). Specifically, the focus is on connections across the financial statements, the sustainability statement/disclosures in the management report, and the rest of the management report.

34 Such a focus neither negates the expected need for consistency in management's communication of the company's story across all channels including outside the annual report (press releases, management presentations) nor does it preclude that there may be connections made (e.g., to financial statements) in the non-authoritative information communicated by management and in other mandated reports (country-by-country reports, regulatory reports etc).

[14] For instance, as described in Section 1.1 (Paragraph 26-g), the IR framework considers the scope of applying connectivity includes connectivity between the integrated report, information in the organisation's other communications and information from other sources.

EU Context

35 *Location considerations*: As shown in Figure 2 below, in an EU context, the EFRAG connectivity project focuses on the connection of information across the financial statements of EEA-companies prepared under IFRS Accounting requirements, sustainability statement (including Taxonomy-Article 8 disclosures) in the management report under ESRS, and rest of information in the management report guided by the Accounting Directive.

36 The EFRAG connectivity project also considers connectivity based on the nature rather than placement of information. Hence, relevant information within other sections of the annual report (e.g., remuneration report, corporate governance report) is in scope to the extent that such information has been incorporated in the sustainability statement by referencing as allowed[15] by ESRS 1.

37 *Connectivity is considered from a GAAP-agnostic prism*: Though the focus is on connections to (and from) financial statements prepared under IFRS Accounting requirements (as that affects EU-listed companies and EFRAG's influencing working on financial reporting is related to IFRS), there are similarities in underlying concepts and elements of IFRS and local GAAP. Thus, it is unlikely that there would be significant differences in the connectivity

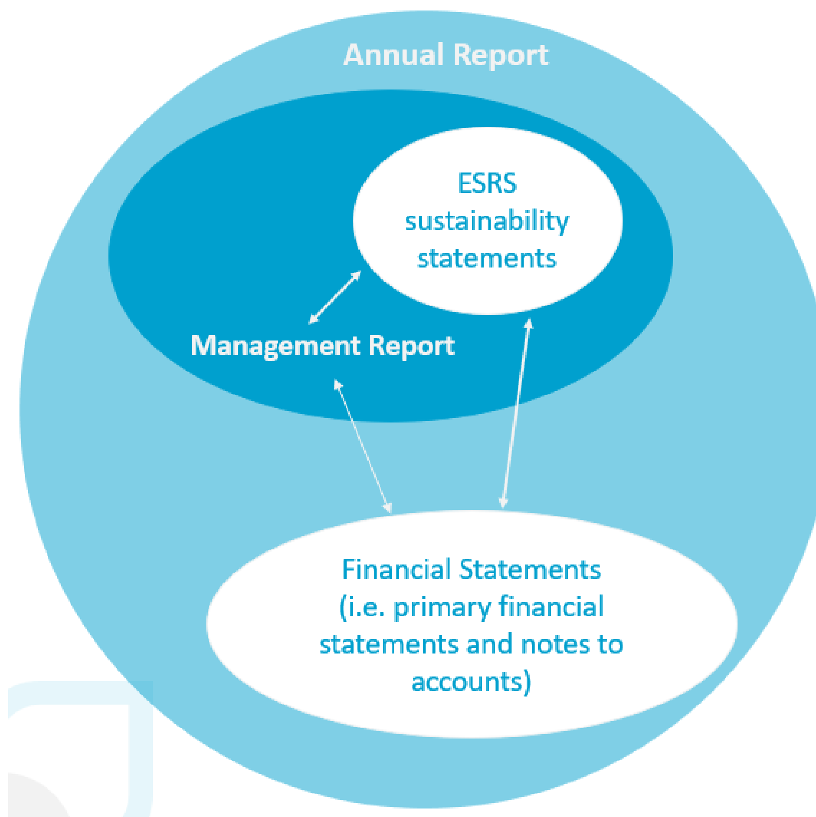
[15]ESRS 1.119-122 state the requirements for incorporation by reference. Paragraph 119 conveys that information including a datapoint prescribed by a Disclosure Requirement of an ESRS, may be incorporated in the sustainability statement by reference to*: a)* another section of the management report; b) the financial statements; c) the corporate governance statement (if not part of the management report); d) the remuneration report; e) the universal registration document; and f) public disclosures under Regulation (EU) of the European Parliament and of the Council (Pillar 3 disclosures). If the undertaking incorporates by reference information from Pillar 3 disclosures, it shall ensure that the information matches the scope of consolidation used for the sustainability statement by complementing the incorporated information with additional elements as necessary.

Paragraph 120 states the conditions for disclosures being incorporated by reference. Specifically that they a) should constitute a separate element of information and are clearly identified in the document concerned as addressing the relevant Disclosure Requirement or its prescribed relevant specific datapoint; b) are published before or at the same time as the management report; c) are in the same language as the sustainability statement; d) are subject to at least the same level of assurance as the sustainability statement; and e) meet the same technical digitalisation requirements as the sustainability statement. Paragraph 122 requires that when incorporation by reference is done, the undertaking shall consider the overall cohesiveness of the reported information and ensure that the incorporation by reference does not impair the readability of the sustainability statement.

considerations related to financial statements prepared under local GAAP versus those prepared under IFRS. For instance, the similarities between IFRS and EU Accounting Directive principles can be seen in the 2017 publications from ANC (France) (Elements for a European Conceptual Framework and European criteria for the endorsement of IFRS standards and their compatibility with the Conceptual Framework). The reference to the aforementioned publications is only[16] to show that stakeholders consider local GAAP requirements to be proximate to IFRS requirements.

38 *Audience and materiality*: As detailed in Section 2 of this paper, the reporting under ESRS is done from a double materiality perspective (both financial and impact materiality perspectives) and is targeted at a broad set of users (including investors).

Figure 2: Connectivity project- what is being connected under the EU reporting



[16] The mandate of EFRAG's FR pillar and therein EFRAG research projects is influencing IFRS Accounting Standards and the reference to the ANC publication is not an expression of EFRAG's position on European financial reporting.

IFRS General purpose financial reporting

39 The connection of information across IFRS general purpose financial reports for companies outside the EU is also in the scope of the EFRAG connectivity project. IFRS general purpose financial reports as defined by the IFRS Foundation consist of IFRS financial statements, management commentary and IFRS sustainability-related financial disclosures (depicted in dark blue, light blue and red in **Figure 3 below**).

Figure 3: EFRAG Connectivity project- what is being connected under IFRS general purpose financial reporting

40 *Location-agnostic sustainability-related financial disclosures*: Similar to ESRS, IFRS Sustainability Disclosure Standards allow[17] including information by cross-reference. However, unlike the CSRD/ ESRS clear placement requirements for the sustainability statement within the management report, the IFRS Sustainability Disclosure Standards' sustainability-related financial disclosures are location-agnostic. As we understand, this means that a sustainability-related disclosure under IFRS Sustainability Disclosure Standards could be located in the notes within the financial statements. That said, jurisdictional authorities within non-EU jurisdictions that adopt IFRS Sustainability

[17] IFRS S1.B45 states that "*Information required by an IFRS Sustainability Disclosure Standard might be available in another report published by the entity. For example, the required information could be disclosed in the related financial statements. Material information can be included in an entity's sustainability-related financial disclosures by cross-reference, provided that: a) the cross-referenced information is available on the same terms and at the same time as the sustainability-related financial disclosures; and b) the complete set of sustainability-related financial disclosures is not made less understandable by including information by cross-reference.*"

IFRS S1.B47 states that "*If information required by an IFRS Sustainability Disclosure Standard is included by cross-reference: a) the sustainability-related financial disclosures shall clearly identify the report within which that information is located and explain how to access that report; and b) the cross-reference shall be to a precisely specified part of that report.*"

Disclosure Standards may also have placement requirements for the information reported outside the financial statements in a manner that may or may not be comparable to EU placement requirements.

41 *Objectives of SR (i.e., sustainability-related financial disclosures)*: The objectives of sustainability-related financial disclosures are closely interlinked with the objectives of the financial statements and the management commentary (see Section 2 for more details). In contrast, under ESRS, which would be part of jurisdictional initiatives depicted in the grey section of **Figure 3**, sustainability reporting (i.e., the sustainability statement under ESRS) has objectives that are distinct from that of financial statements and it includes both the information that would be under sustainability-related financial disclosures (light blue) and that which would be in the light grey section (other corporate reports with a multi-stakeholder focus).

42 *Audience and materiality of SR*: IFRS general purpose financial reports (including sustainability-related financial disclosures) have investors as their primary audience and are prepared under the same materiality definition/perspective as financial statements and management commentary. There is an assumption that investors are focused on general purpose financial reports. This contrasts with the sustainability statement under ESRS requirements, whose audience is broader stakeholders (including investors) and is based on a double materiality perspective (as noted earlier).

43 In addition to the above-articulated EU reporting and IFRS general purpose financial reporting requirements, Appendix 1 highlights how digital tagging and the role of technology would support connectivity regardless of the placement of information.

1.3. CONNECTIVITY CATEGORIES AND RELATED CONCEPTS

This section provides a summary of the connectivity categories and related concepts that are encompassed across the different guiding literature (e.g. ESRS, IFRS Sustainability Disclosure Standards, and several regulatory publications including ESMA, Norwegian securities regulator-Finanstilsynet). As connectivity is a nascent idea, there are multiple notions associated with the term (i.e., consistency, coherence, complementarity, communication). This chapter shows the interrelatedness of these dimensions of connectivity. This is done by:

-conveying the description of connectivity within the ESRS and IFRS Sustainability Disclosure Standards and incorporating other concepts raised in several regulatory and NSS publications (coherence);

-as there are no explicit IFRS accounting connection requirements for the connection of financial statements information, considering if/how the aforementioned sustainability reporting connection requirements could be applied for connecting information from inside to outside the financial statements;

-outlining how connectivity contributes to information adherent to the qualitative characteristics of decision-useful information.

Overarching concepts

44 **Connectivity in standards (consistent basis of preparation) and process contributes to the connectivity of information**: Both the ESRS and IFRS Sustainability Disclosures require reporting of information with qualitative characteristics consistent with those of the IFRS conceptual framework. These standards also require the same reporting entity and reporting period as the financial statements. And they 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. They were influenced by IAS 1, IAS 8, and IAS 10.

45 The consistent basis of preparation contributes to the connectivity of information at a point in time and over time. That said, while the above contributes to connectivity, as detailed in Section 2.3, there are multiple differences between the requirements for financial statements and sustainability reporting that preclude connectivity (e.g., the recognition and measurement criteria).

46 **Clear and concise** disclosures as required by both IFRS S1 and ESRS contribute to the connectivity of information (i.e., understandability). The ESMA report[18] also considered “simple and clear” and “organised and well formatted” as principles for selecting examples. **Avoiding unnecessary duplication** including through the use of cross-referencing is part of clear and concise communication.

47 **Self-sufficiency of each corporate report per its stated purpose**: As noted earlier and in Section 2.1, these different corporate reports have distinctive[19] objectives albeit complementary objectives (i.e., the reports capture different versions of an entity’s reality, and a user needs different reports to build the mosaic of the company’s value creation story). In tandem, as alluded to by the October 2023 ESMA report, these reports are expected to be self-sufficient in providing information related to their distinctive objectives. And this may either necessitate repetition (albeit this should be done with tailoring/giving a flavour suited for the objective of the report) or incorporation by cross reference.

Connectivity categories within ESRS and IFRS Sustainability Standards requirements

48 **Explanation of strategic and value-creation-oriented relationships and effects**. As noted in ESRS1.123, this includes the linkage between strategy, business model and an entity’s financial performance, financial position and other metrics and targets. IFRS S1.B44 states that connection can include a) an explanation of the combined effects of the entity’s sustainability-related risks and opportunities and its strategy on its financial position, financial performance, and cash flows over the short, medium and long term; b) a description of the alternatives that an entity evaluated in setting its strategy in response to its sustainability-related risks and opportunities, including a description of the trade-offs between those risks and opportunities that the entity considered. Below are several related concepts:

49 **Complementarity in disclosure of complementary narrative and quantitative information)** –Complementarity is not explicitly stated but it is encompassed/implicit within the ESRS 1.123 and IFRS S1.B44 requirements, which include the following examples:

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[18] ESMA, October 2023, The Heat is on: Disclosures of Climate-related matters in the financial statements

[19] For example, if company Y does a tax transparency report for NGOs particularly interested in tax transparency and establishing whether companies pay their fair share of tax. This report is an independent report and whilst it may pull numbers and narrative from other reports is stands on its own for these users.

(a) ESRS 1.123 example*: to allow users to assess connections in information, the undertaking might need to explain the effect or likely effect of its strategy on its financial statements or financial plans, or on metrics and targets used to measure progress against performance. Furthermore, the undertaking might need to explain how its use of natural resources and changes within its supply chain could amplify, change or reduce its material impacts, risks and opportunities. It may need to link this information to the potential or actual effects on its production costs, to its strategic response to mitigate such impacts or risks, and to its related investment in new assets. This information may also need to be linked to information in the financial statements and to specific metrics and targets.*

(b) IFRS S1. B44 examples: *An entity might face decreasing demand for its products because of consumer preferences for lower-carbon alternatives. The entity might need to explain how its strategic response, such as closing a major factory, could affect its workforce and local communities, and the effect of such a closure on the useful lives of its assets and on impairment assessments.*

(c) *An entity might need to explain the potential effects of its decision to restructure its operations in response to a sustainability related risk on the future size and composition of the entity's workforce.*

50 **Direct and indirect connectivity (linkage of monetary and other quantitative data points)**: ESRS connection requirements also specify **direct and indirect connectivity** that could be construed as linkage of quantitative datapoints done through cross-referencing and reconciliation for indirect connectivity. Examples include;

(a) revenue amount in the GHG intensity metric can be directly linked to IFRS 15 revenue through cross-reference in the sustainability statement.

(b) reconciliation of revenue amount in GHG intensity metric to IFRS 15 revenue amount when it cannot be directly linked. This reconciliation will be in the sustainability statement.

51 It is expected the overarching concept of clear and concise communication will underpin disclosures of direct or indirect connectivity.

52 **Consistency[20] of data, assumptions, and narrative information** (as reflected in ESRS 1.127-128 and IFRS S1.23). This includes relating forecasts to information of past and present and disclosing information about **significant differences between data and assumptions used**. We note that audit guidance requires an assessment of consistency (i.e., ISA states there should not be an inconsistency and there is a need to explain any significant differences). Similarly, the enforcers' thematic reviews often monitor the consistency of reporting.

53 **Intertemporal dimension of connectivity**: Connectivity has a static dimension (i.e., connectivity of information located in different reports at a particular reporting date). It also has an intertemporal dimension where there can be a change in the reporting location of impacts, risks, or opportunities across different reporting periods (i.e., migration of items across different sections of the Annual Report over time). For instance, this could be due to the change in nature, quantifiability, magnitude/severity, or probability of occurrence of a particular risk or opportunity. It can also be due to impacts disclosed in one period becoming financially material at a future period (i.e., dynamic materiality). 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. It can also highlight the potential evolution of an item from the management report or sustainability statement/disclosures to the financial statements as the risks and opportunities materialise.

54 **Linking forecast information to past/present reported information**: Under ESRS requirements, another aspect of linkage across periods is captured by forecast information being related to past/present reported information.

Connection of information from inside to outside the financial statements

55 Reciprocal/two-way connectivity (i.e., information in sustainability reporting to the financial statements, and from information inside to outside the financial statements) is expected by stakeholders including EFRAG CAP members and it was also recommended as important by the PTF-NFRS main report (see introduction). For this reason, the EFRAG connectivity project is considering, and the forthcoming Discussion Paper will include

[20] The notion of consistency is included in existing auditor guidance, and it is also the transparency directive. Furthermore, this notion has been the focus of different regulators (AMF, ESMA, Finanstilsynet and UK FRC) in their thematic reviews of trends in the reporting of climate-related risks in the financial statements (including whether there is a disconnect with versus the information outside the financial statements).

illustrations of two-way connectivity. However, unlike ESRS and IFRS Sustainability Standards, there are no explicit IFRS Accounting connection requirements related to information in the financial statements. Therefore, in the EFRAG connectivity project, there has been discussion of if/how the SR connection requirements (e.g., including information by cross reference; the concepts of direct and indirect connectivity; and consistency of assumptions, data, and narrative) can be analogously applied while assessing or developing illustrations (i.e., in the forthcoming Discussion Paper) of the connectivity of information from inside to outside the financial statements.

56 In that regard, there are aspects of the SR connectivity requirements (e.g., explaining relationships, and the consistency requirements) that can be deemed readily applicable for financial statements. At the same time, the EFRAG discussions have shown that compared to the management report or the sustainability statement/disclosures, **there are restrictions in incorporating information into the financial statements by reference**. For instance,

(a) as noted earlier, ESRS 1 allows the incorporation of sustainability-related information in other reports by reference (and the same is the case with IFRS Sustainability Disclosure Standards). In contrast, IFRS Accounting Standards allow incorporation of required financial statements' information by reference only in very specific cases (i.e., IFRS 7.21B for hedge accounting disclosures and IFRS 7.35C for credit risk disclosures). That said, as we understand, there are no explicit prohibitions to either signposting supplemental (i.e., not material for financial statements) information[21] (e.g., from management commentary) or incorporating material information by cross reference. Of note, in March 2024 IASB discussions held on its project on climate-related and other uncertainties in the financial statements, a suggestion was made that, for a presented line item in the financial statements, a disclosure long the lines of "*this information includes the total amount of assets disclosed as more vulnerable to transition risk as disclosed in accordance with IFRS S2*" could be added. Moreover, the March 2024 IASB staff paper (see link) on the development of examples related to the IASB project on climate-related and other uncertainties in the financial statements indicates that it will be considered to present at a future IASB meeting

[21] We note that in BC paragraphs 50-53 of the Conceptual Framework, the Board discussed and promised to address this as part of phase E of the Conceptual Framework on disclosure principles, but it never did so.

whether and how to illustrate in draft examples the use of cross-references (i.e., cross reference in the financial statements to other general purpose financial reports).

(b) the discussions have highlighted there could be legal risk associated with the incorporation of forward-looking information into the financial statements by referencing.

57 We also note that within the EFRAG CAP, a view has been expressed that indirect connectivity (e.g., through the use of reconciliations) may be more applicable for linking sustainability reporting information to financial statements than the other way around. The disclosure of a reconciliation between a monetary amount in the financial statements to an amount in the sustainability statement/disclosures in the notes within the financial statements could be seen as obscuring other material information (i.e., contributing to disclosure overload) in the financial statements.

58 Finally, it must be reiterated that notwithstanding the observations made in paragraphs 56 and 57 and the forthcoming Discussion Paper's intended inclusion of illustrations of connected information from inside to outside the financial statements, the EFRAG connectivity project is not providing guidance on connection requirements for the information in the financial statements. Ultimately, the IASB is responsible for considering and possibly developing the aforementioned requirements.

Connectivity-related concepts in other publications

59 **Coherent explanation and presentation[22]:** Coherence was included in the 2021 IFRS Practice Statement Exposure Draft for Management Commentary (MCPS ED) where it was noted that coherence contributes to the completeness, clarity and comparability of information. The MCPS ED conveyed that if a matter discussed for one area of content has implications for other areas of content, information is included to allow investors and creditors to understand the implications. Similarly, a November 2023 New Zealand XRB[23] staff paper noted coherence requires entities to present disclosures in a way that explains the context and relationships with other disclosures so that users can make connections between the two sets of information.

[22] The ESMA and Norwegian Finanstilsynet publications refer to coherence but without defining the term. This term was also one of the attributes of useful information in the 2021 EFRAG PTF-RNFRO report where it is stated that the term connotes clear links between reports.

[23] NZ XRB staff guidance, November 2023, Climate-related matters in Financial Statements

60 **Complementarity through illustrating correlation**: Another illustration of complementarity in the reported information could be disclosing the correlations and causal links of information in the different reports. This was the case when *SAP outlined the correlated links between financial and non-financial information in its 2021 Integrated report. The interactive chart showed the effect of changes in employee engagement on profitability*.

Outcomes of applying connectivity requirements- information adherent to qualitative characteristics of decision-useful information

61 The application of ESRS connectivity requirements for the sustainability statement/disclosures and, in a reciprocal manner connecting information from inside to the outside of the financial statements is expected to contribute to **information adherent to the qualitative characteristics of the conceptual framework** (i.e., relevance, faithful representation, verifiability, understandability, and comparability) as noted below:

(a) *Relevance*: Connectivity via an explanation of linkage between strategy and business aims to tell a more complete story of the entity's value creation and in so doing provides relevant information.

(b) *Faithful representation*: Consistent assumptions across different reports, linkage of narrative information to current financial effects, and reconciliation of interrelated amounts could ensure faithful representation and lessen greenwashing.

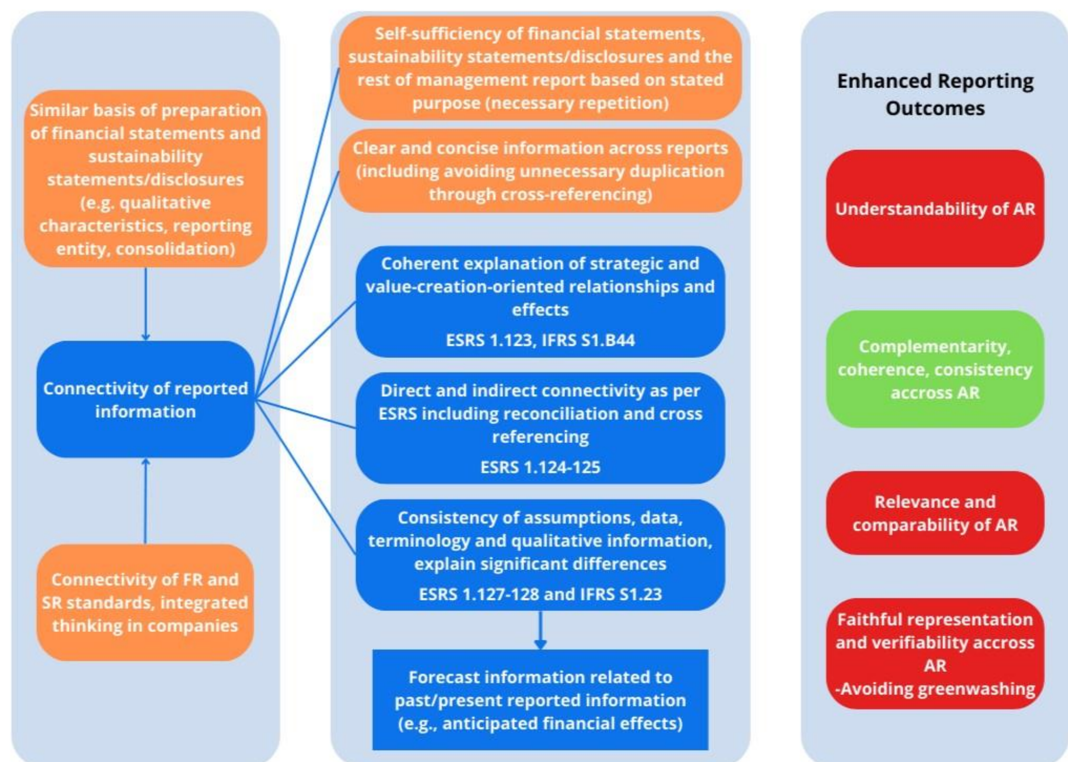
(c) *Verifiability*: linkage of narrative information to current financial effects, and reconciliation of interrelated amounts could ensure faithful representation and lessen greenwashing.

(d) *Understandability*: Connectivity by applying consistent assumptions contributes to understandability because any inconsistency between the two reports would confuse the reader. Cross-referencing between the various sections of the annual report helps ensure the ease of navigation through the information provided in the annual report. And avoiding unnecessary duplication avoids the obscuring of material information.

(e) *Comparability*: Comparability can be enhanced to the extent entities share common assumptions (benchmark references, carbon prices, timelines related to sustainability matters) and there is a consistency of assumptions underpinning the related sustainability disclosures and the measurement of assets and liabilities

62 In addition to the above, connectivity contributes to the **complementarity and coherence of the different sections of the annual report.** Figure 3 below visually depicts the categories of connectivity and connectivity-related concepts, and how these contribute to reporting that is adherent to the required qualitative characteristics of the information.

Figure 3: Connectivity concepts and outcomes (Blue- Types of connectivity identified from ESRS and IFRS Sustainability Disclosure Standards; Orange- Overarching principles that contribute to connectivity of information; coherence and complementarity of AR sections is an outcome of applying connectivity, Conceptual framework qualitative characteristics resulting from the application of connectivity concepts)



1.4. WHY CONNECTIVITY IS IMPORTANT

The introduction lays out the pivotal role of connectivity. In a similar vein, section 1.3 outlines how connectivity enhances reporting outcomes (i.e. reported information conforming to the qualitative characteristics of the conceptual framework). This section builds on the content in these preceding sections and sums up the different reasons why connectivity is important.

Connectivity builds bridges and fosters complementarity in the communication of value creation

63 As highlighted in the introduction and detailed in Section 2.1, the financial statements and the sustainability statement/disclosures have defined, distinctive objectives. Though these reports are distinctive and ought to be self-sufficient based on their stated objective (as asserted in Section 1.3), they are also meant to collectively inform about the entity's performance and value creation. As such, these different reports can be seen as complementary parts of a single Annual Report package that communicates a reporting entity's value-creation story. In turn, connectivity between these different reports fosters their overall complementarity. This view was reflected in the 2022 Basis for Conclusions for Draft ESRS 1 (BC 42) which stated, "*Connected information establishes clear links between the management report, sustainability statements and financial statements and provides a holistic view between all the factors that affect value creation.*"

64 As highlighted in the introduction, the PTF-NFRS main publication noted that the absence of a formal connection could lead to potential gaps, overlaps (i.e. duplication), and a lack of coherence in reported information, which impairs its relevance. Conversely, connectivity lessens these concerns.

65 In essence, connectivity helps to build bridges between the two distinctive reporting systems within the EU[24] reporting framework while respecting their boundaries and underpinning concepts. At the same time, we acknowledge there are several initiatives[25] aiming to monetise impacts/externalities (e.g., environmental impacts) and to thereafter potentially broaden the current boundaries of financial statements. Consideration of these initiatives is not within the scope of the EFRAG connectivity project (and this interim

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[24] As noted in Section 1.2, the IFRS sustainability-financial disclosures are part of the IFRS general purpose financial reporting.

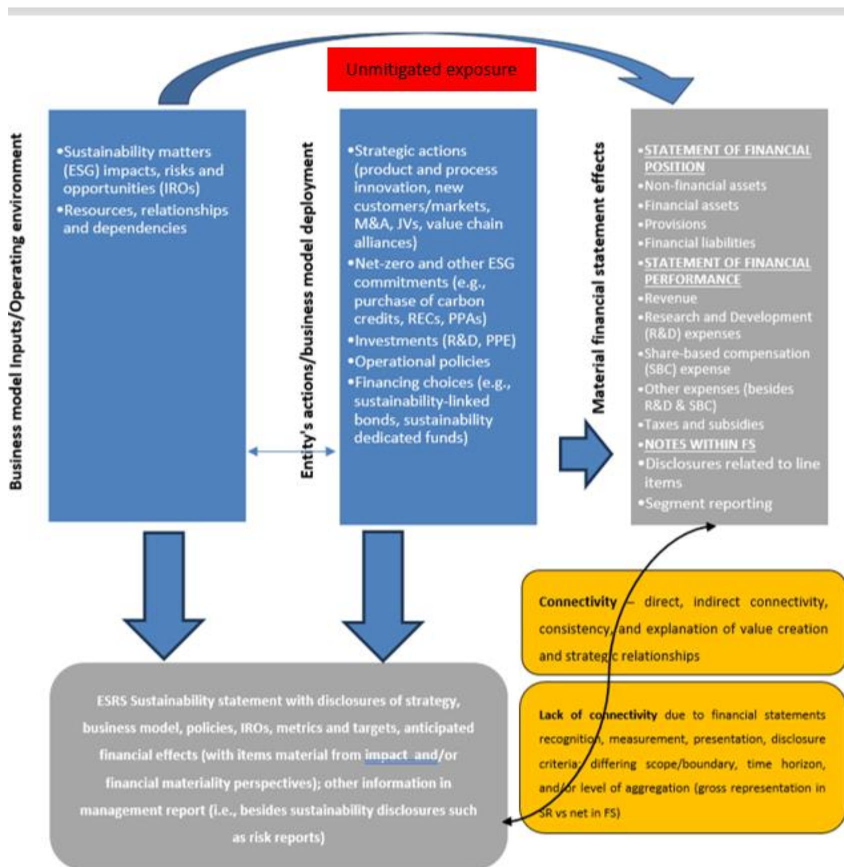
[25] Cohen,R and Serafeim,G. 2020, How to Measure a Company's Real Impact, Harvard Business Review https://hbr.org/2020/09/how-to-measure-a-companys-real-impact. Stakeholders have shared examples of initiatives in certain jurisdictions on how to monetise and incorporate CO2 into financial reporting standards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

deliverable paper) nor are these initiatives encapsulated with the definitions of connectivity provided in this paper.

Connectivity can link the depiction of the business model to sustainability and financial reporting

66 Figure 4 below depicts how an entity's business model inputs and operating environment, and its actions and business model deployment have effects on the information in different corporate reports; and consequently, the types of connectivity or reasons for lack of connectivity between different reports that can arise. This Figure underscores the role of connectivity in communicating the entity's business model and its link to value creation and how this is reflected in sustainability and financial reporting. The Figure also provides a segue to the discussion on the boundaries of different corporate reports in Section 2.

Figure 4: Role of connectivity in communicating entity's value creation

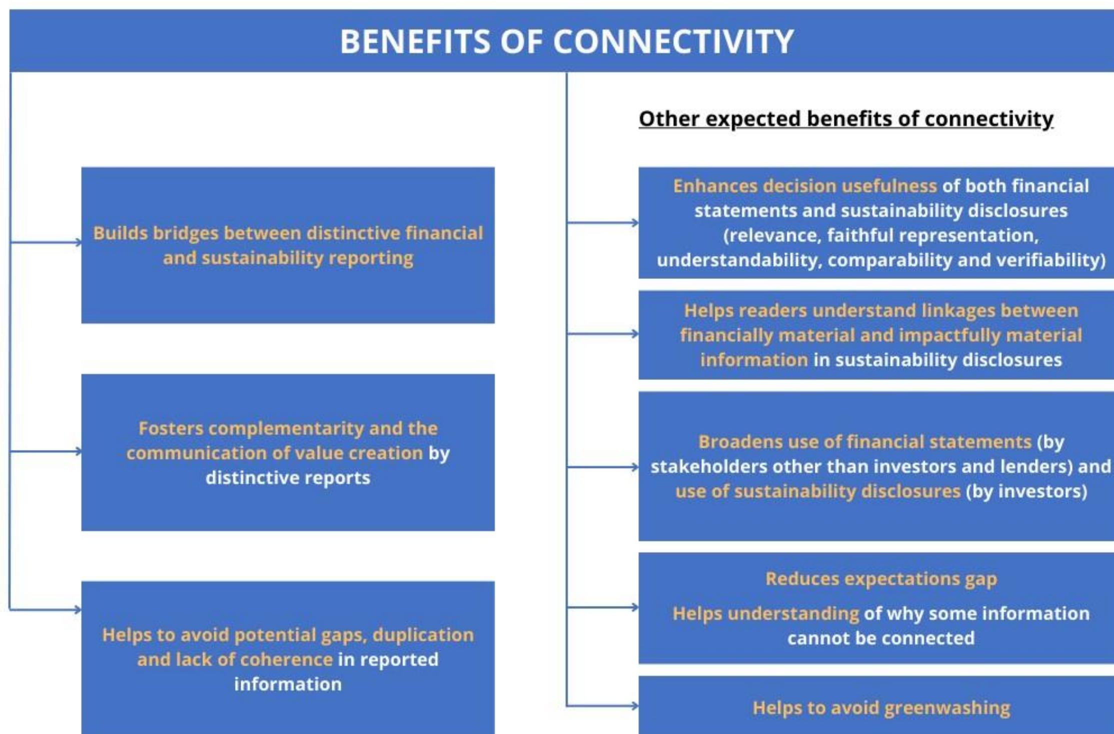


Summary of expected benefits of connectivity

67 Figure 5 below summarises the benefits expressed above in paragraphs 63 to 65, in the introduction (pivotal role of connectivity), in Section 1.3 (outcomes of applying connectivity

requirements), and other expected benefits of connectivity conveyed by stakeholders including EFRAG CAP members.

Figure 5: Expected benefits of connectivity (Diagram Developed by EFRAG based on engagement with stakeholders including EFRAG CAP)



SECTION 2: BOUNDARIES OF DIFFERENT ANNUAL REPORT SECTIONS

67 Analogous to the boundary of a geographical territory, the boundary of a particular corporate report connotes a dividing line between what is included and excluded within that report. As noted in the introduction, due to their differing objectives and levels of evolution, there is a need for clear boundaries across different corporate reports. In tandem, connectivity is pivotal to the complementarity and coherence of these different corporate reports and the overall annual reporting package. Moreover, an understanding of the boundaries of different corporate reports is essential to identifying the connections that either can or cannot be made between sustainability reporting, the rest of the management report, and the financial statements. Such an understanding can also help to reduce the expectation gap on the information that ought to be contained within different corporate reports.

68 *How can a boundary be defined?* This paper's articulation of the dimensions of the boundaries of different corporate reports considered the related analysis done in the PTF-NFRS connectivity publication (*Appendix A4 Interconnection between Financial and Non-Financial Information)*. We also took account of related academic literature. Notably, based on a review of multiple voluntary guidelines for sustainability reporting and mandated requirements for financial statements, Bayne[26] (2022) conceptualises 10 dimensions that are necessary to describe a reporting boundary. These include:

(a) the **reporting entity** (extent of financial versus sustainability control/influence). Relatedly, Girella[27] (2018) describes the evolution of what is circumscribed within the reporting entity including the scope for consolidation of the financial statements. This author further notes the uptake (transplanting) of a similar concept of reporting entity by the multitude of the then-prevailing voluntary sustainability reporting frameworks.

(b) **target users** (extent of investor versus wider stakeholder focus**)**,

(c) **materiality** (extent of financial versus impact materiality),

(d) **boundary description** (extent of entity-wide versus topic boundary definition),

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[26] -Bayne, L. (2022), "Understanding reporting boundaries in annual reports: a conceptual framework", *Accounting, Auditing & Accountability Journal*, Vol. 35 No. 5, pp. 1316-1348. https://doi.org/10.1108/AAAJ-01-2020-4387

[27] Girella, L. (2018). The Boundaries in Financial and Non-Financial Reporting- A Comparative Analysis of their Constitutive Role. Routledge- Taylor and Francis Group

(e) **impact** (external versus inward impact),

(f) **outward impact** (extent of direct versus indirect outward impacts),

(g) **time horizon** (extent of historic versus future focus),

(h) **performance** (extent of financial versus sustainability focus),

(i) **value** (extent of entity versus wider stakeholder value focus), and

(j) **purpose of report/disclosure**.

69 The above 10 boundary dimensions (Bayne, 2022) are based on guidance pre-dating the mandated sustainability requirements (ESRS) and IFRS Sustainability Disclosure Standards. Nonetheless, they are a useful reference point and, along with the factors considered in the PTF-NFRS connectivity publication, are encapsulated within this paper's analysis of boundaries below with a focus on:

(a) **Objectives and audiences of different sections of the annual report (Section 2.1).** In this section, in addition to the distinct objectives of different reports, we highlight the similarities in the basis of preparation including the reporting entity across the ESRS, IFRS Sustainability Disclosure Standards, and IFRS Accounting requirements.

(b) **Materiality-related considerations (Section 2.2)** including the intertemporal dimensions of connectivity due to the shift of items from being financially material outside the financial statements at a reporting date to being financially material for the financial statements at a future date. Also addressed are grey areas (e.g., where there is diversity in views on the appropriate location of financially material information and/or areas where duplicated reporting in the financial statements and the sustainability statement/disclosures may arise).

(c) **Why certain sustainability matters may not be reflected (i.e., recognised, measured, disclosed or presented) in the financial statements (Section 2.3).** This section illustrates the boundaries of the financial statements and touches on other dimensions of a boundary of reporting information besides materiality. The content in this section is not meant to suggest that sustainability matters cannot or should not be reflected in the financial statements.

2.1. OBJECTIVES AND AUDIENCES OF DIFFERENT ANNUAL REPORT SECTIONS

This section details the respective objectives/purpose and audiences of the financial statements, management report/management commentary, and the sustainability statement/disclosures. And included within these descriptions are the other dimensions of the boundary suggested by Bayne (2022) (value, impact on company, outward impact, and reporting entity).

The analysis shows that relative to the sustainability disclosures, there are more constraints in including information in the financial statements' information. For instance, the information in financial statements focuses on reflecting an entity's present rights to future economic benefits (assets) and present obligations to transfer economic resources (liabilities) predicated on the occurrence of a past event and with the entity having control over the assets (i.e., power to direct). Financial statements reflect the financial position and financial performance at the reporting date. This differs from the sustainability statement/disclosures that include anticipated financial effects over the short, medium and long term (i.e., related to the entity's potential/future financial position and financial performance). Sustainability reporting also allows concepts that are not applied for the preparation of financial statements (e.g., allowing the application of the notion of operational control whilst calculating metrics).

Moreover, based on the underpinning double-materiality perspective and the broader set of users (i.e., not only financial capital providers), the sustainability statement prepared under ESRS also includes information that is material from an impact materiality perspective. Such information facilitates the assessment of an entity's impacts on people and the planet. Materiality is further addressed in Section 2.2.

Objective and audience of financial statements reported under IFRS Accounting Standards

70 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[28]. 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

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

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)

71 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

72 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

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

73 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).

74 For an item to be included in the financial statements[29], 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.

75 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[30] (Conceptual Framework par. 4.43).

76 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 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

77 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:

[29] 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].

[3030] [Reference to the IASB project on Provisions – targeted improvements to be included to reflect the status of the project when the DP is issued]

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)

78 Paragraph 11 of the IASB guidance[31] 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;

(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."

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

Objective and audience of the management commentary/ management report

75 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[32]. Furthermore, the IASB Management Commentary Practice Statement is voluntary and not endorsed in the EU nor is it applied across several large economies.[33] Nonetheless, the IASB guidance can inspire the prevailing diverse regimes of management reporting requirements.

EU management report

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

77 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 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.

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[32] 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. "

[33] 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).

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."

78 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

79 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*".

80 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)*.

81 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)

82 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.

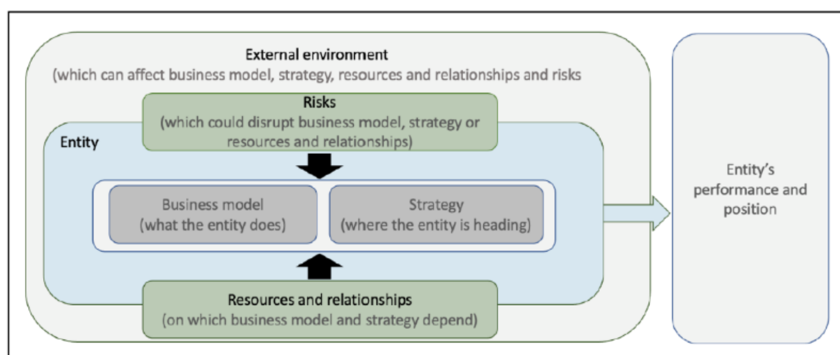
83 The existing Practice Statement is under review and, in 2021, the IASB published an Exposure Draft *Management Commentary* (ED). Following the feedback to the ED, the IASB is in the process of considering how to proceed with the MCPS project including if and to the extent collaboration with the ISSB 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.

84 Figure 6 shows the relationships between disclosure objectives for areas of content within the MCPS ED.

Figure 6: Relationships between disclosure objectives for areas of content within the MCPS ED



85 An entity's financial position and financial performance was a content area under the MCPS ED (i.e., it was 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.

86 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

87 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

88 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)).

89 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 <u>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</u>. The second group of users consists of* ***civil society actors, including non-governmental organisations and social partners****, which wish to <u>better hold undertakings to account for their impacts on people and the environment</u>. 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.*

90 The information disclosed in accordance with ESRS enables users of the sustainability statement to understand the undertaking's material impacts on people and environment

and the material effects of sustainability matters on the undertaking's development, performance and position (ESRS 1 para. 2).

91 Aligned with these objectives, and in line with the concept of double materiality 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 the sustainability statement: 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 the sustainability statement, including the undertaking's business partners, trade unions and social partners, civil society and non-governmental organisations, governments, analysts and academics.

Other similarities between financial statements and sustainability reporting requirements

92 *Similar qualitative characteristics*: The qualitative characteristics of the ESRS and IFRS Sustainability Disclosures Standards (IFRS Sustainability Disclosure Standards) are largely in common with those of the Conceptual Framework of Financial Reporting[34].

93 *Similar basis for preparation (reporting entity and reporting period)* Both ESRS and IFRS Sustainability Disclosure Standards also require the same reporting entity and reporting period as the financial statements.

94 *Similar basis for preparation (other aspects)* Both ESRS and IFRS Sustainability Disclosure 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, IAS 8, and IAS 10 requirements.

Other differentiating factors

95 Besides materiality that is addressed in the next section (Section 2.2), there are other factors addressed in Section 2.3 affecting the boundaries of the financial statements (e.g.,

[34] Under ESRS, specific adjustments have been introduced to reflect impact materiality.

constraints imposed by the recognition, measurement, presentation, and disclosure criteria for financial statements). Moreover, as detailed in Section 2.3, there can be a lack of connectivity between financial statements and sustainability reporting due to:

(a) differing level of aggregation between these corporate reports;

(b) the lengthier time horizon typically applied towards sustainability reporting;

(c) the extent to which forward-looking information is incorporated;

(d) extent of reporting non-monetary metrics (i.e., much greater in SR) along with the difficulties of translating non-monetary metrics into monetary values;

(e) incorporation of value chain information in sustainability reporting; and

(f) the application of operational control whilst calculating metrics in sustainability reporting.

2.2. MATERIALITY-RELATED CONSIDERATIONS

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. As noted earlier[35], materiality is one of the dimensions of defining boundaries and it impacts connectivity of different reports in both a static and dynamic sense. Thus, this section addresses:

- **the application of materiality across different reports.**
- **the intertemporal/dynamic dimension of connectivity (i.e., migration across reports over time) which can result from either dynamic materiality (impact material items becoming financially material) or the shift of items from being financially material outside the financial statements at a reporting date to being financially material for the financial statements at a future date.**
- **grey areas of financially material items (i.e., where there may be double reporting, missing information across different reports; and/or where there are diverse views and no explicit requirements where particular information should be reported).**

In the next section (i.e. Section 2.3), we also note that several publications and EFRAG's recent outreach have identified the misapplication of qualitative materiality as one of the contributing factors for climate risk not being reflected in the financial statements (and lack of connectivity with climate disclosures outside the financial statements). In Section 2.3, we also outline other factors related to the boundaries of the financial statements.

Application of materiality across different reports

96 An explanation offered for the often-observed disconnect between the reporting of sustainability (e.g. climate-related) risks and opportunities in the financial statements relative to the management report and sustainability disclosures has been that these risks and opportunities have been considered immaterial for financial statements albeit being deemed material for the sustainability disclosures.

97 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 boundaries of financial

[35] In the preface, we note that Baynes (2022) identified 10 dimensions needed to define boundaries including materiality.

statements, the sustainability statement and the rest of the management report (i.e., what information is included in each of these reports) are influenced by the application of materiality in the context of the objectives of these different reports.

Definition of materiality for IFRS general purpose financial reporting

98 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."*

99 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. The materiality practice statement contains three key elements, namely: a) an overview of general characteristics of materiality; b) four steps of the materiality judgments process; and c) materiality judgments in specific circumstances (such as prior-period information, errors, covenants, and interim reporting). The four-step process consists of the following:

(a) *Identify* information that can be considered material within the requirements of IFRS Accounting Standards while taking into consideration the needs of primary users of the financial statements,

(b) *Assess* whether the identified information is, in fact, material by considering both quantitative and qualitative factors related to the entity and its external environment,

(c) *Organise* the information within the draft financial statements; and

(d) *Review* the draft financial statements whether all material information has been considered.

100 The materiality practice statement also states that requirements in IFRS Standards only need to be applied if their effect is material to the complete set of financial statements[36]

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

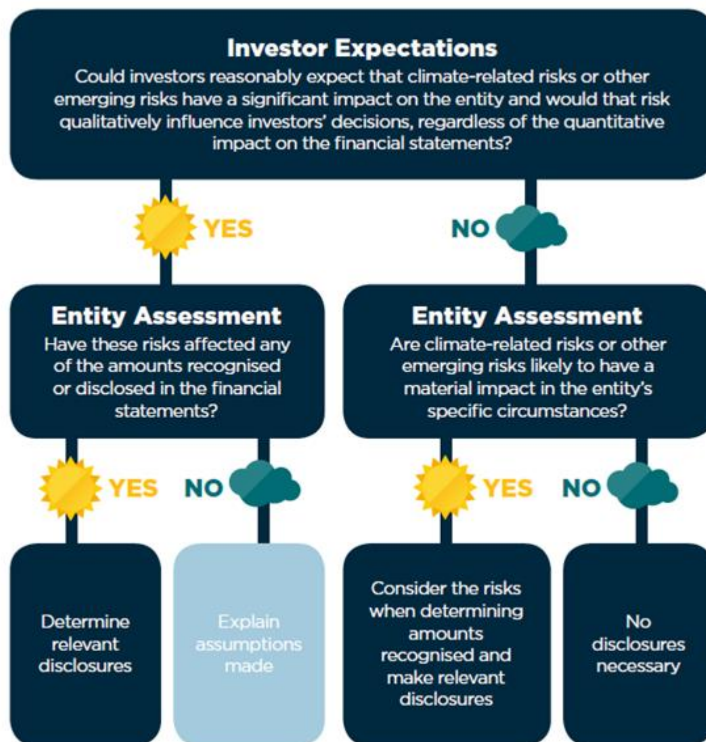
and an entity need not provide a disclosure specified by an IFRS Standard if the information resulting from that disclosure is not material. This is the case even if the Standard contains a list of specific disclosure requirements or describes them as 'minimum requirements'. Conversely, the entity must 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.

101 In 2018, consequential amendments to IAS 1 and IAS 8 emphasised the application of materiality depends on the nature or magnitude of information. In other words, an entity is required to assess whether the information, either separately or in aggregate with other information, is material in the context of the financial statements. 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.

102 Pointedly, Figure 7 below from a 2019 AASB publication[37] summarises key considerations related to assessing the materiality of climate risks and other emerging risks in financial statements.

Figure 7: Key considerations in assessing materiality

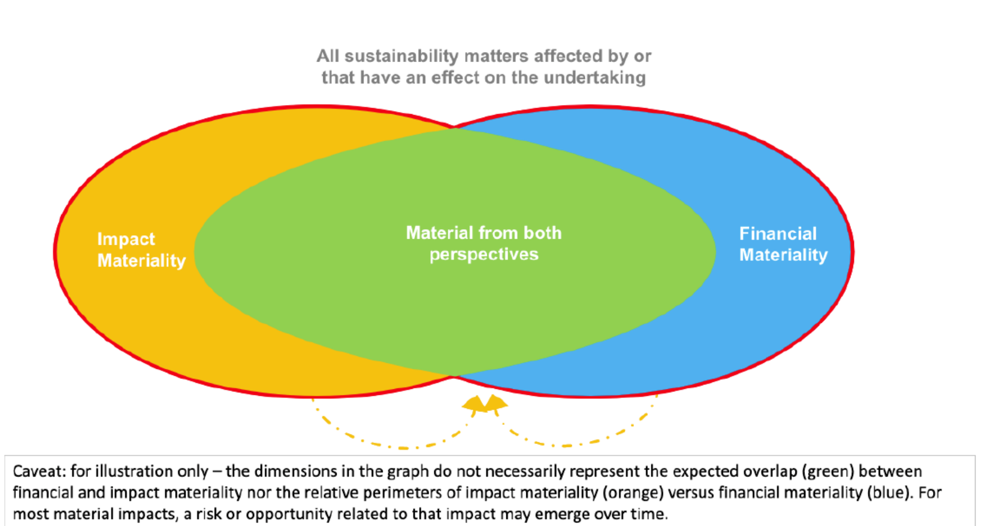
[37] AASB, 2019, Climate-related and other emerging risks disclosures- assessing financial statement materiality using AASB/IASB materiality Practice Statement 2.



Materiality under ESRS

103 The reporting/preparation of the sustainability statement 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 8, this is done under the double materiality perspective.

Figure 8: Excerpt from the 2023 EFRAG ESRS Materiality Assessment Implementation Guidance



104 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)".*

105 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 the concept of financial 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**.

106 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 the sustainability statement 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 dimension of connectivity: migration of items across different reports

107 Connectivity has a static dimension (i.e., connectivity of information located in different reports at a particular reporting date). In addition, there can be an intertemporal/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.

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

109 ***Dynamic materiality***[38]: 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 statement at a reporting date may translate to legal risk and fines that are reported in the financial statements at a future reporting date. Relatedly, a Harvard Business School article [39]conceptualises how ESG risks become financially material.

110 Under ESRS, with the consideration of the long-term horizon, most of the matters that are material for impacts are also material financially (i.e., virtually all the impacts translate into reputational risks though the timing in which they ultimately get reflected in the statements may vary). Said differently, it is hard to find items that would exclusively be in the orange part of the Venn diagram in Figure 6 above (i.e., only material for impacts).

111 ***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 the sustainability statement/disclosures or risk report at a reporting date, may at a future reporting date, be recognised as assets, liabilities including provisions, revenue; impairment charges, research and development expenses, other expenses in the primary financial statements; or be disclosed in the notes within the financial statements.

[38] 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.

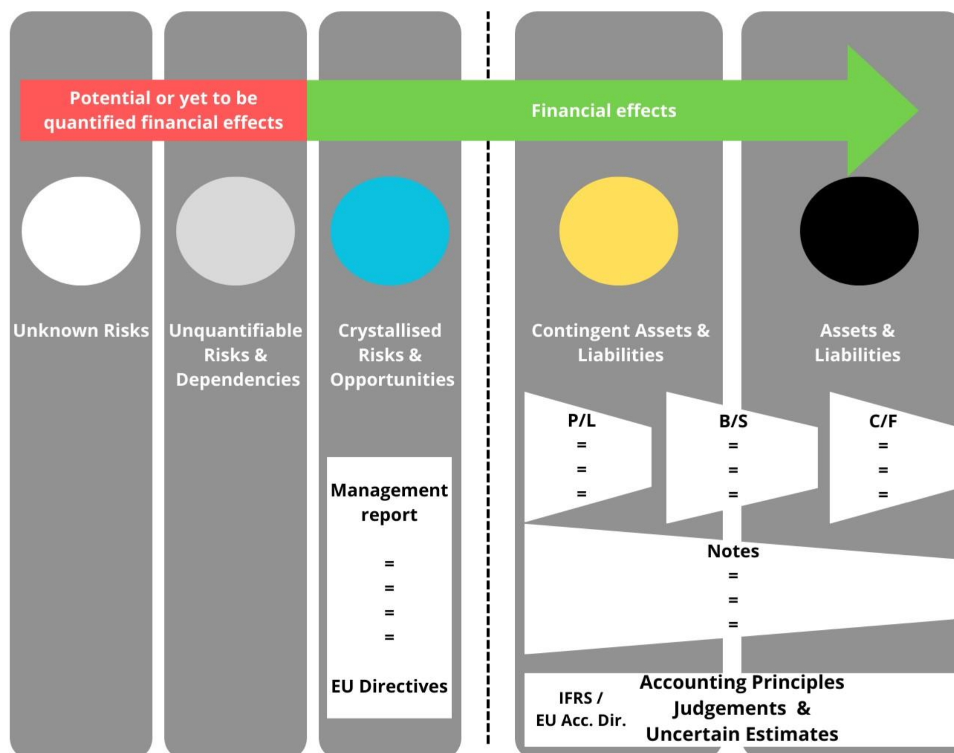
[39] How ESG Issues Become Financially Material to Corporations and Their Investors

Conceptualisation of where the intertemporal dimension of connectivity may arise

112 Figure 9 below which is modified from the PTF-NFRS connectivity publication is a high-level depiction of items that can be connected to and reported in the financial statements at a future date versus those that cannot. Connectivity to the financial statements arises for items that are financially material and earmarked as the blue zone category (i.e., crystallised 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 an intertemporal dimension of connectivity (i.e., the items could be linked to the statement of financial performance and statement of financial position of a future reporting date).

113 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. Human rights in certain jurisdictions could be perceived as an example of a grey zone item as it is an actual or could be a potential adverse impact of the company that is not deemed to be a risk to the company by the management.

Figure 9: Continuum of financial effects (adapted from 2021 PTF-NFRS Publication)



114 Further analysis of materiality dynamics can be found in the draft ESRS MAIG and the earlier mentioned Harvard Business School article.

Illustration of dynamic materiality

115 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.”

Grey areas in the location of information

116 As noted above, consideration of whether the information is material for financial statements ought to be intertwined with consideration of the respective objectives of financial statements, the sustainability statement/disclosures, and the rest of the management report. The fact patterns below and the associated questions posed by stakeholders exemplify grey areas (i.e. *where there is duplication or missing information across the package of reports, where there could be diverse perspectives on the best location of information*).

117 ***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, the investment team could not 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.

118 ***Fact pattern 2 (location of net-zero commitments disclosures)****: Even if net-zero commitments do not qualify to be recognised as a provision based on IAS 37 requirements, should information (i.e., related to possible future outflows) for such commitments be disclosed in the financial statements?*

119 We note that in response to the November 2023 IFRIC agenda decision, stakeholders made suggestions for enhancing disclosures on a) management's assumptions; and b) information about capital expenditure projects required to fulfil climate-related commitments, and capital already committed to purchasing assets to fulfil those commitments.

120 Moreover, during the outreach done by EFRAG so far, users have indicated a disclosure of a time series of likely costs would be useful even if provisions are not recognised. It has also been expressed that it should be clear when items migrate from the sustainability statement/disclosures to the financial statements (i.e., what are the triggers for the recognition of provisions or contingent liabilities). Another suggestion has been that, if material for the purposes of the financial statements, information disclosed in the sustainability statement/disclosures could be included in the financial statements by cross reference. Below are arguments underpinning the views in support and against disclosing the aforesaid information in the financial statements.

(a) **View 1 (supportive view): Yes, information (i.e. related to possible future outflows) should be disclosed if material for financial statements based on user expectations.**

(i) As noted in Section 1.3, financial statements should be self-sufficient and complete with material information for investors in the context of their objectives. In this regard, a January 2023 Corporate Reporting Users Forum (CRUF) article- *Getting visibility on the financial statement effects of climate*

change outlines the expected respective roles of sustainability disclosures and financial statements by users. This article opines that, instead of substituting financial statements' information, sustainability reporting information could create awareness of information missing in the financial statements (also described as the expected nudge effects of forthcoming sustainability disclosures).

(ii) Some stakeholders expect IAS 1.31 requirements to be applied to reflect disclosures beyond the disclosure requirements of specific Standards. That said, we note diverse views exist on the applicability of this paragraph. For instance, other stakeholders[40] have noted that applying this paragraph to include net-zero commitments would be too-liberal an interpretation of the requirements as they observe that the application of IAS 1.31 is rare in practice. Yet other stakeholders do not rule out the applicability of the paragraph in cases where there is a disconnect between the management report and financial statements in the portrayal of how climate-related risks affect the entity's overall prospects. Thus, the IASB project on climate-related and other uncertainties of which an Exposure Draft-ED (is expected later in 2024) may help to address the expectation gaps. The ED will propose illustrative examples including those related to the application of IAS 1.31 requirements.

(iii) Related to IAS 1, as noted in Section 2.3, there is a concern that a qualitative materiality assessment which includes investor expectations on material information is not always sufficiently done during the preparation of financial statements (see **AASB report**[41] and **UKEB September 2023 report**).

(iv) Though IFRS S1, S2 and ESRS have requirements for the disclosure of anticipated financial effects, these SR requirements may not explicitly capture information stakeholders expect to be reported and which they could consider

[40] April 2024 IFASS member discussions during breakout groups.

[41] AASB, October 2023, Auditors' Perspectives: The Impacts of Materiality Practice Statement 2- Making Materiality Judgements; this report notes that anecdotal evidence from audit partners, and academic research, reveal the materiality concept to be applied by report preparers and auditors largely in a mechanical fashion, without the sufficient nuance or systemic context required to appropriately make materiality judgements that provide decision-useful information to report users.

to be suited to be disclosed in the financial statements (e.g., capital expenditures).

(v) The information could be in both the sustainability disclosures and financial statements. The information disclosed on the financial implications of transition plans in the short, medium, and long term disclosed in sustainability could be included by cross-reference into the financial statements. As noted, in section 1.3, there is no explicit prohibition of either incorporating material into the financial statements by cross-reference or signposting in the financial statements, supplemental information (that may not be material for the financial statements) that is disclosed in the management report (including sustainability disclosures).

(vi) Related to the preceding paragraph, required information on future outflows (including by cross-reference from SR) can be seen as akin to risk disclosures under IFRS 7, which allows incorporation of credit risk and hedge-accounting-related disclosures by cross-reference albeit that, as noted in Section 1.3, this is a rare case of required information being incorporated by cross-reference.

(b) View 2a (Against): disclosure in the financial statements should only relate to defined elements of financial statements (including contingent liabilities),

(i) As clarified in the March 2024 IFRIC discussion, unless there is a past event, even if commitments meet the IAS 37 definition of a constructive obligation, they do not meet the definition of either provisions or contingent liabilities and therefore the specific IAS 37 disclosure requirements do not apply.

(ii) Why should constructive obligations arising from climate-related commitments be treated differently from other constructive obligations?

(iii) IAS 1.125 (disclosures of estimation uncertainty on carrying values) requirements need to be considered in the context of existing/defined assets and liabilities.

(iv) The application of IAS 1.31 requirements may be constrained by consideration of possible disclosure overload. Moreover, this requirement[42] could be interpreted as relating only to transactions, events and conditions affecting the current financial position and financial performance, and not to possible future financial position and financial performance items.

(v) Why repeat information that should and will likely be disclosed in the sustainability statement/disclosures under ESRS E1 and IFRS S2 requirements? This can lead to redundancy and may impose a double reporting burden.

(vi) Though there is no explicit prohibition to including information by cross-reference in the financial statements, the information needs to be subject to the same level of assurance and there can be concerns about legal risk from incorporating information of a forward-looking nature. Moreover, excessive cross-referencing can impair the understandability of information in the financial statements.

(vii) It could be assumed that users are agnostic on the location of where material information is disclosed and that they view disclosure of material information in the context of the annual reporting package rather than expecting material information to always be in the financial statements (i.e., financial statements are not self-sufficient and have to be read with other sections of the Annual Report). And during EFRAG's engagement with stakeholders thus far including with EFRAG CAP members, some users have expressed that they are agnostic on the location of material information.

(viii) Other users have indicated that, though they are not location agnostic and expect material information necessary to understand the financial position and financial performance to be in the financial statements (e.g., due to the level of assurance of the financial statements), they distinguish between an entity's mere intentions (which though important to understanding the entity's prospects) ought to be in the management report versus actual obligations for outflows which should be reported in the financial statements.

[42] IAS 1.31 states that "… an entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance."

(c) **View 2b (Against in a most restrictive way): disclosures in the financial statements should only relate to recognised financial statement line items**

(i) Such a view assumes the commitment has to qualify to be a recognised provision before any disclosure. We note that the Recommendations and Feedback statement (see link) to the EFRAG's Discussion Paper *Better Information on Intangibles* indicates that in response to Question 9 on the placement of information, some stakeholders expected disclosures should only relate to recognised line items in the financial statements. That said, other views on the matter were also expressed in the Recommendations and Feedback statement.

(ii) Moreover, this view would seem inconsistent with existing IFRS requirements. For instance, there are disclosure requirements for unrecognised assets and liabilities (e.g., contingent liabilities disclosure requirements under IAS 37.86). And, as mentioned in Section 2.1, the guidance for developing and drafting disclosure requirements (developed after the completion of the '*Disclosure Initiative- Targeted Standards Level Review of Disclosures*' project) indicated disclosures can include information about unrecognised assets and liabilities including information about their nature and the risks arising from them.

121 ***Fact pattern 3 (Anticipated financial effects- possible duplication):*** *ESRS and IFRS S1 and S2 have requirements for the disclosure of the anticipated financial effects of sustainability-related risks and opportunities over the short, medium, and long term. In turn, short-term anticipated financial effects may relate to how sustainability-related risks and opportunities present a significant risk of a material adjustment to the carrying amounts of assets and liabilities reported in the financial statements within the next financial year. In such a case, it may duplicate the financial statements' disclosure requirements under IAS 1.125 requirements[43]. This duplication could be avoided by including the information by cross reference.*

122 ***Fact pattern 4 (location of missing disclosures related to environmental liabilities):*** *Whilst exploring possible incremental disclosure requirements on anticipated financial effects for*

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[43] IAS 1.125 requires an entity to provide "…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 amount of assets and liabilities within the next financial year.

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[44]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 and considered as part of IAS 37 amendments?

123 The above fact patterns are indicative rather than being an exhaustive description of the so-called grey areas (i.e*. where there is duplication or missing information across the package of reports, where there could be diverse perspectives on the best location of information*). For instance, debates among stakeholders on the suitable location of disclosed information have also occurred with respect to a) disclosures related to synergies arising during business combinations, and b) disclosure of unrecognised intangibles (see Paragraph 119-c that refers to the feedback on the EFRAG research project- *Better Information on Intangibles* related to the placement of unrecognised intangibles).

[44] 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.

2.3. REASONS WHY CERTAIN SUSTAINABILITY ITEMS MAY NOT BE REFLECTED IN FINANCIAL STATEMENTS

As part of the description of boundaries, building on the unique objectives of the different corporate reports outlined in Section 2.1, this section illustrates the distinctive nature of the information in the financial statements relative to information that is disclosed in sustainability reporting. The specific focus on why certain sustainability matters may not be reflected (i.e. recognised, measured, disclosed, or presented) in the financial statements can also explain why there may be a lack of connectivity between the financial statements and sustainability reporting.

We emphasise that the content in this section is not meant to convey that sustainability matters cannot or should not be reflected in the financial statements. To that effect, the preamble to this section has a recap of the reasons why climate-related and other uncertainties can be reflected in the financial statements (as reflected in 2020 and 2023 IASB educational articles) and the observed inadequacies in reporting practices that motivated an IASB project on "*Climate-related and other uncertainties in the financial statements*". We note that outreach by both the IASB and EFRAG in respect of the IASB project indicated that, due to an expectation gap on what and when information can be reflected in the financial statements. And it can be inferred that there are sometimes perceived (rather than real) inadequacies in the reporting of climate risks in the financial statement.

The content of this section can help lessen the expectation gap on what is reported in the financial statements and, as noted, is not in contradiction with the objectives of the IASB education articles. For instance, the analysis below includes the March 2024 IFRS IC agenda decision which gave reasons why constructive obligations arising from a net-zero commitment are not recognised as provisions (and the need for a present obligation/past event prior to their recognition as provisions).

Climate-related and other uncertainties can be reflected in the financial statements

124 As noted in a 2019 IASB education article and (updated in a 2023 IASB educational article- *Effects of climate-related matters in the financial statements*), IFRS Accounting Standards have implicit requirements for entities to either reflect material climate risk and any other risk or to explain why a matter expected to be material by investors was not reflected in the financial statements. Climate-related matters may be material for significant judgments and estimates management has made while preparing the financial statements. In addition, qualitative external factors, such as the industry an entity operates in, may lead to the need for disclosures in the financial statements, regardless of the quantitative

impact of such factors. Furthermore, companies should consider whether investors could reasonably expect that climate-related and other matters affect the financial statements.

125 These considerations can be reflected in various IFRS Standards. Below is a non-exhaustive list of requirements related to climate-related matters:

(a) *IAS 1:* This Standard includes overarching disclosure requirements for information not presented elsewhere in the financial statements but is relevant for their understanding. Entities will therefore need to consider whether to provide additional disclosures to enable investors to understand the impact of climate-related matters on the company. In addition, climate-related matters may give rise to estimation uncertainty and other significant judgements made.

(b) *IAS 2:* The selling price of inventories or their completion cost.

(c) *IAS 12:* Estimates of future taxable profits and the recognition of deferred tax assets.

(d) *IAS 16/38:* Climate-related matters may prompt expenditure to adapt operations (including R&D). They may affect the recognition of costs as assets and estimations pertinent to residual values and useful lives of assets.

(e) *IAS 36:* Estimates of recoverable amounts, impairment assessment for assets and goodwill, impairment indicators, and disclosures of key assumptions leading to the recognition of impairment.

(f) *IAS 37:* The recognition, measurement and disclosure of liabilities, the nature of provisions or contingent liabilities, and any uncertainties on the timing or amount of outflows of economic benefits.

(g) *IFRS 7:* The nature and extent of risks and the concentration of market risk for types of financial instruments.

(h) *IFRS 9:* Climate-related contractual terms may affect the classification and measurement of financial instruments and the measurement of expected credit losses (ECL).

(i) *IFRS 13:* Fair value measurement of assets and liabilities and related disclosures.

(j) *IFRS 17:* Assumptions used to measure insurance contract liabilities and disclosures about significant judgements and risk exposure.

126 Nonetheless, as noted in the introduction, various thematic reviews (ESMA, AMF, Norway Finanstilsynet, Mazars, FRC-UK and UKEB) 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, stakeholders have expressed concerns that material climate-risk information is not being reported in the financial statements.

127 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.

Why certain material sustainability-related information may sometimes not be reflected in the financial statements

128 Below is a summary of why certain material sustainability-related information may not be reflected (i.e., recognised, measured, presented, or disclosed) in the financial statements:

(a) Sustainability-related information may be embedded (and therefore not separately presented) in financial statements' line items;

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

(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

129 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 within the financial statements 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.

130 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 the sustainability statement

131 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 statement/disclosures. For instance, physical risk (assets vulnerable to physical risk) may be disclosed by location in the sustainability statement 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 statement (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, disclosed or presented in the financial statements

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

133 **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 for the financial statement during future reporting periods (i.e., the concept of dynamic materiality is at play in practice).

134 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[45] 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.

135 **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 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 on human rights and environment, and prohibition of activities with above-threshold GHG emissions).

136 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.

[45] 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

(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.

137 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.

138 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.

139 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).

140 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 concluded that, in nine years, there may be circumstances under which a provision would be recognised due to: a) the entity having emitted (and there being a past event) and b) its commitment to purchase the carbon credits would result in a net outflow of resources (see Appendix 2 for further details). Following a public consultation, in March 2024, IFRIC confirmed its November 2023 agenda decision. It also agreed with staff analysis in response to a second submission on whether entities should apply the disclosure requirements for a contingent liability[46] to constructive obligations that have not been recognised as provisions, and where the IASB staff assessed that this should not be the case under the fact patterns that were presented as no past event had occurred. In April 2024, the IASB approved the IFRIC agenda decision.

141 **Constraints related to measurement basis:** Besides recognition criteria, sometimes information (e.g. climate-related loss of value) cannot be connected due to the measurement basis of recognised assets and liabilities (e.g., historical cost versus fair value).

142 **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[47] as line items in the primary financial statements. However, opportunities are sometimes incorporated into sensitivity analysis disclosures.

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[46] IAS 37.10 states that: "A contingent liability is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
(b) a present obligation that arises from past events but is not recognised because:
  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  (ii) the amount of the obligation cannot be measured with sufficient reliability."

[47] 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).

143 **Coverage of value chain information**: 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. Such investments may not be reconcilable to the investments reported in the financial statements.

144 **Differences and effects of the time horizons typically[48] applicable to sustainability disclosures and financial statements information**: The time horizon for climate risk can be much longer than that typically[49] 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 some stakeholders interpreting the applicable time horizon for disclosure of estimation uncertainty under IAS 1.125 to be 12 months and this is an aspect where the IASB is exploring whether to undertake Standard Setting activity (i.e., as per the March 2024 IASB staff papers on project direction). We also note that in March 2024, IASB staff developed draft illustrative examples (see example 4 related to IAS 1.125 in related IASB staff paper and the IASB staff indicated they interpret that the time horizon referred to in IAS 1.125 could be longer than 12 months[50]. EFRAG's outreach on the draft illustrative examples showed that stakeholders interpret IAS 1.125 literally as referring to the next year/12 months. In addition, some stakeholders have pointed to a lack of clarity on the time horizon for impairment testing under IAS 36 and we note that this was identified as a cause for concern by the IASB and EFRAG during the May to September 2023 outreach (See the discussion further below on the limitations of IFRS Accounting Standards).

145 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 currently reported carrying values in the financial statements is often not material. In addition, low-probability long-term risks may not be reflected as liabilities or provisions due to failing to

[48] 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.

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

[50] 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."

meet the IAS 37 recognition criteria (i.e., a probable outflow of economic resources, and can be reliably measured).

146 **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. Another example would be the incorporation of future, committed restructurings in the value-in-use calculation).

147 **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 calculation of sustainability-related metrics (e.g., GHG[51] emissions) does not exist under IFRS Accounting requirements. There could be challenges in connectivity related to some items outside of the financial statements reporting entity (i.e., value chain items outside the entity's financial control).

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51 The GHG Protocol, which when developed aimed for consistency of its consolidation approaches with accounting requirements, is aligned with IFRS requirements in the application of the notion of financial control (i.e., there is 100% consolidation of the GHG emissions of the entities whose financial statement line items are fully consolidated). However, there are differences. For instance,

- the GHG Protocol also allows consolidation based on whether the reporting undertaking has operational control but no financial control of an investee (i.e., 100% consolidation when the reporting undertaking has the power to direct operational policies of an entity that is not part of the consolidated accounting group) but IFRS requirements do not have the notion of operational control;
- the GHG Protocol also allows an equity market share approach (*de facto* proportionate consolidation) whereas IFRS requirements no longer allow proportional consolidation for joint arrangements; and
- IFRS requirements have the notion of significant influence over investees (e.g., for associates) and the application of the equity method of accounting, but the GHG Protocol does not have the notion of significant influence, nor does it have the equivalent of equity method accounting.

As a result of the above differences, it is not always clear whether there will always be consistency between financial statements treatment and GHG consolidation approaches on investee entities or assets that are not part of a legal entity.

148 **Extent of use of non-monetary units of measurement and aggregated measures:** 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.

149 **Role of accruals:** As outlined in an academic paper (*Wagenhofer*[52], 2023), unlike for financial statements, there is no "stocks and flows" representation along with accruals of the information in sustainability disclosures.

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

150 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.

151 **Perceived limitations of IAS 1 requirements**: As noted in paragraph 144, several stakeholders interpret IAS 1.125 as not requiring 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. That said, as noted in paragraph 144, the IASB may explore standard setting activity on IAS 1.125. Moreover, in March 2024, IASB staff developed draft illustrative examples (see Example 4 related to IAS 1.125). These examples may be included in an Exposure Draft and potentially included in the IASB illustrative examples thereafter.

152 **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[53] 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,

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

[53] 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 indicated they interpret this requirement as prohibiting entities from forecasting cash flows for a longer period when calculating value in use. And consequently, this perceived prohibition can result in some 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. That said, some other stakeholders have disagreed with this interpretation of IAS 36 requirements (i.e., perceived prohibition of cash flows after five years).

153 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. That said, we note that Paragraph 33-b of the March 2024 ED *Business Combinations- Disclosures, Goodwill and Impairment*- proposes[54] removing the prohibition from including cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance whilst performing the IAS 36 value-in-use calculation.

Some IFRS Accounting Requirements may be insufficiently clear

154 The September 2023 IASB staff paper conveying the findings of outreach related to the climate-related and other uncertainties in the financial statements project identified several areas where IFRS Accounting requirements may be insufficiently clear. During meetings with EFRAG stakeholders, scepticism was expressed about this characterisation with the view that the absence of explicit mention of climate risk in a Standard does not

[54] (BC205) notes the IASB view that this change would reduce complexity because: stakeholders said that can be challenging for management to distinguish maintenance capital expenditure from expansionary capital expenditure and identify which cash flows need to be excluded because they relate to expansionary capital expenditure.

make it unclear. EFRAG has not done any outreach to interrogate why some stakeholders considered the standards mentioned in the IASB paper to be insufficiently unclear.

155 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).

156 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

157 **Possible narrow definition of materiality not taking account of qualitative materiality:** 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).

158 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 highlighted in the September 2023 publication 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.

159 In effect, there is a situation of inadequate guidance and possible 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). Similarly, the October 2023 AASB research on materiality, showed that a large proportion of auditors are unaware of and cannot explain the content of the IASB Materiality Practice Statement.

160 **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 data for physical risks.

(c) Some entities with limited resources may have 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.

161 Of note, the ESRB April 2024 publication *Climate-risks and accounting* points out that it may be operationally difficult for banks and insurers to incorporate climate-related risks in their models. The publication notes that for banks, expected credit loss models typically forecast three years ahead, which may be too short a horizon to cater for most climate-related risks.

APPENDICES

APPENDIX 1 - Role of technology in fostering connectivity

2 Technology has a role in fostering connectivity albeit it needs to be seen as primarily a tool of reflecting the underlying principles of connectivity. The 2021 EFRAG European Lab publication on Good Practices in Business Model, Risks and Opportunities Reporting in the EU (hereafter referred to as the 2021 PTF-RNFRO report[55]) included findings from a survey to preparers, which show they consider technology as having a role in creating links within and between different reports. The report also highlights:

(a) the use of interactive technology (visualisation and hyperlinks) to facilitate the connection of information. The report provides an illustrative company example;

(b) the use of natural language processing to identify the co-occurrence of information; and

(c) the use of XBRL to tag financial and non-financial information as a way of attaining connectivity.

(d) Similarly, at the 2023 EFRAG Conference, the Head of ESMA underscored the use of digital tools as a mechanism of connectivity.

3 As noted above, and alluded to briefly in agenda paper 03-03, XBRL technology and tagging of both financial statements and the sustainability statement/disclosures present an opportunity to attain connectivity at a grassroots level. Specifically, the machine-readable format of the sustainability reporting is a required deliverable under the CSRD and the availability of the three taxonomies [IFRS Accounting Taxonomy for the financial statements, and ESRS and Article 8 (Taxonomy legislation) XRBL Taxonomies for the sustainability reporting information], which are embedded into the ESEF Regulation will create an ecosystem of accessible public data through the European Single Access Point (ESAP). In this context, technology plays an important role in supporting the connectivity of corporate reporting information. Some potential aspects to be focused on are:

[55] Towards Sustainable Business: Good Practices in Business Model, Sustainability Risks and Opportunities Reporting in the EU. Examples are in the Supplementary Document: Good Reporting Practices.

(a) the creation of individual elements or even their specific data type classification [i.e. monetary elements such as "assets at physical risk"] within the sustainability taxonomy will facilitate the access and usability of data connected to the financial statements.

(b) potential creation of interoperability between the aforementioned financial reporting and sustainability reporting related taxonomies [e.g., through the reuse of elements from the accounting taxonomy, e.g. Revenue/Turnover and Assets].

(c) The presentation of anticipated financial effects of sustainability matters (ESRS), by combining financial statement line items with an ESRS dimension.

(d) The reconciliation between financial statement items and operating segments with ESRS Sectors and related data points (e.g. Revenue in ESRS SBM-1).

4 Moreover, at the May 2023 EFRAG-hosted EAA symposium (see report- Multi-stakeholder perspectives on Connectivity), it was noted that in the context of the IFRS Foundation's work on connectivity, the digital taxonomy of the Sustainability Disclosure Standards would be informed by the taxonomy used for the Accounting Standards to help achieve connectivity in the Standards.

5 XBRL could provide connection points as the need to tag information requires the use of shared terminology, such as on the definitions of revenue, provisions, segments and entity and it enables the use of consistent terminology.

6 From an analysis of information standpoint, XBRL and tagging in tandem with the use of AI to retrieve and consume information could help users to process both financial and sustainability information. However, it was noted that though useful, AI can sometimes lead to the loss of the context surrounding the information. Therefore, humans will still be needed to perform the tasks to ensure all material information is captured.

Appendix 2: 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[56], 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,

(a) **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);

[56] **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."

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

(c) **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. In March 2024, IFRIC agreed to finalise the agenda decision.

8 In addition, in March 2024, a second submission was made that if management concludes that a provision is not to be recognised for a 2030 commitment, the entity should **disclose the information required for contingent liabilities** under IAS 37.86, unless the possibility of any outflow in settlement is remote.

9 The IASB staff analysis considered that the definition of a contingent liability in IAS 37.10 requires that:

(a) it is at least possible (even if not certain) that the entity has a present obligation as a result of past events; and

(b) a 'possible obligation' exists when there is uncertainty or dispute about the facts or how a law or statement applies to those facts.

10 The IASB staff noted that in the fact patterns described in the agenda decision and second submission, there is no uncertainty or dispute about whether events that create a present obligation have occurred—these events have not yet occurred. The event that gives rise to a present obligation is not the statement of a net zero transition commitment, it is the action to which the commitment applies (for example, the emission of greenhouse gases that the entity has committed to offset). Until that action has occurred, there is not even the possibility that the entity has a present obligation, so the definition of a contingent liability is not met. Accordingly, the disclosure requirements for contingent liabilities in IAS 37.86 do not apply. IFRS IC agreed with the IASB staff analysis.

Appendix 3: Annual Report Definitions

1 As noted in the main body of this interim deliverable paper, we are addressing boundaries within the Annual Report, which depending on jurisdiction, is also referred to as the Integrated Annual Report, Universal Registration Document etc. Paragraph 2 of Article 4 of the Transparency Directive (Directive 2004/109/EC) indicates that the Annual Financial Report comprises the audited financial statements; the management report; and statements[57] related to the information made by the responsible issuing persons.

2 Similarly, paragraph 12 of International Standards of Auditing (ISA) 720 (*Revised*) *The Auditor's Responsibilities Related to Other Information and Related Conforming Arrangements* defines an Annual Report as *"a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements. An annual report contains or accompanies the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters*."

3 Paragraph A3 of ISA 720 notes that depending on law, regulation or custom in a particular jurisdiction, one or more of the following documents may form part of the Annual Report: Management report or similar reports by those charged with governance (e.g., a directors' report); Chairman's statement; Corporate governance statement; Internal control and risk assessment reports. Paragraph A5 gives examples of reports that when issued as standalone documents, are not typically part of the combination of documents that comprise an annual report (subject to law, regulation or custom). These include separate industry or regulatory reports (e.g., capital adequacy reports), diversity and equal

[57] Statements to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole and that the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face and, where appropriate, that it is prepared in accordance with sustainability reporting standards.

opportunity reports; product responsibility reports; labour practices and working conditions reports; human rights reports; and corporate social responsibility reports.

Appendix 4: 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[58]. paragraph[59] 2 of Article L232-1 of the French commercial code[60], "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[61] and GAS 20[62] 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"

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

[59] As translated by this paper's authors

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

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

[62] 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".*