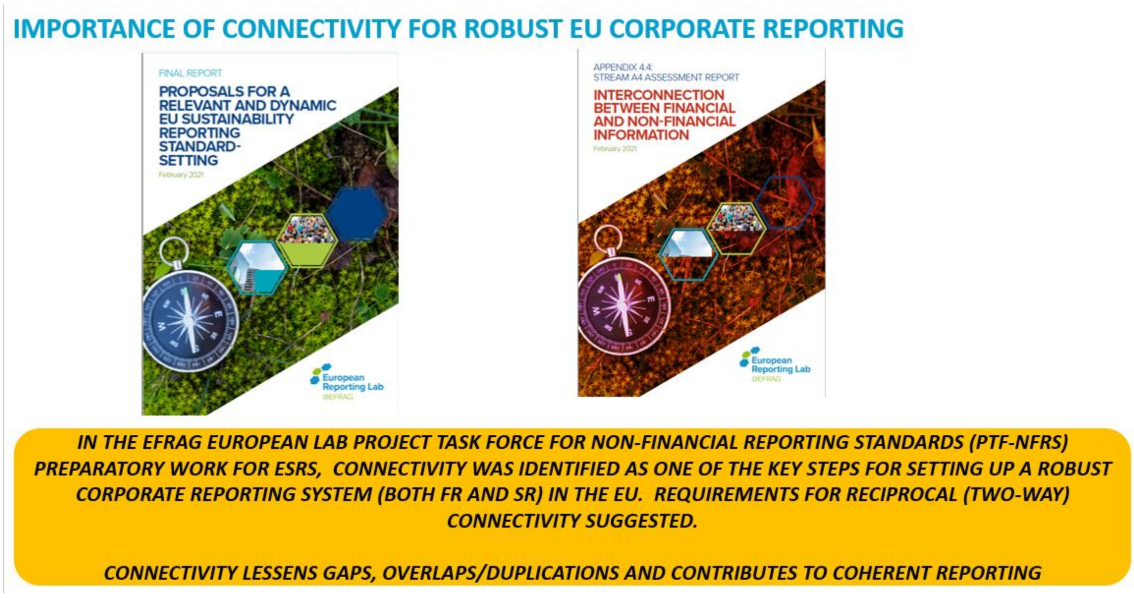
# Draft Interim Deliverable Paper- *Summarised version*

*Connectivity considerations & Boundaries of different Annual Report sections*

## EFRAG SRB MEETING – 4 JUNE 2024

## PIVOTAL ROLE OF CONNECTIVITY IN CORPORATE REPORTING

1 The Introduction to the Interim Deliverable Paper (IDP) outlines the pivotal role of connectivity in the evolving corporate reporting system and it draws attention to a raft of EFRAG publications and events, along with other EU-focused and international publications advocating for connectivity to be embedded within the corporate reporting system.



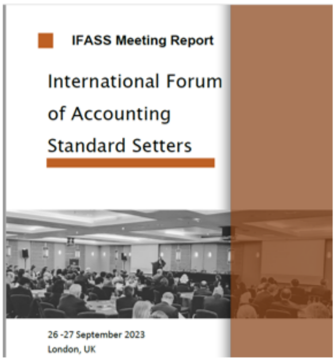

## IMPORTANCE OF CONNECTIVITY HIGHLIGHTED IN OTHER RECENT PUBLICATIONS ON EUROPEAN REPORTING




***FAILING TO ENSURE CONNECTIVITY BETWEEN ACCOUNTING AND SUSTAINABILITY STANDARDS CAN HAVE NEGATIVE EFFECT ON THE QUALITY OF INFORMATION DISCLOSED TO CAPITAL MARKETS, WITH POTENTIALLY SYSTEM-WIDE CONSEQUENCES- ESRB REPORT***

## IMPORTANCE AND RELATED ISSUES ALSO COVERED IN MULTIPLE NSS, REGULATOR AND OTHER STAKEHOLDER PUBLICATIONS AND IFASS MEETINGS

- NSS publications- AASB, UKEB, FRC-UK, NZ-XRB
- Other audit firm publications- E&Y, KPMG
- Other EU enforcer publications France AMF, Norway Finanstilsynet
- TCFD Implementation reports
- Academic articles (Sellhorn & Ormazabal; Van der Tas)
- Carbon tracker- Flying blind February 2024





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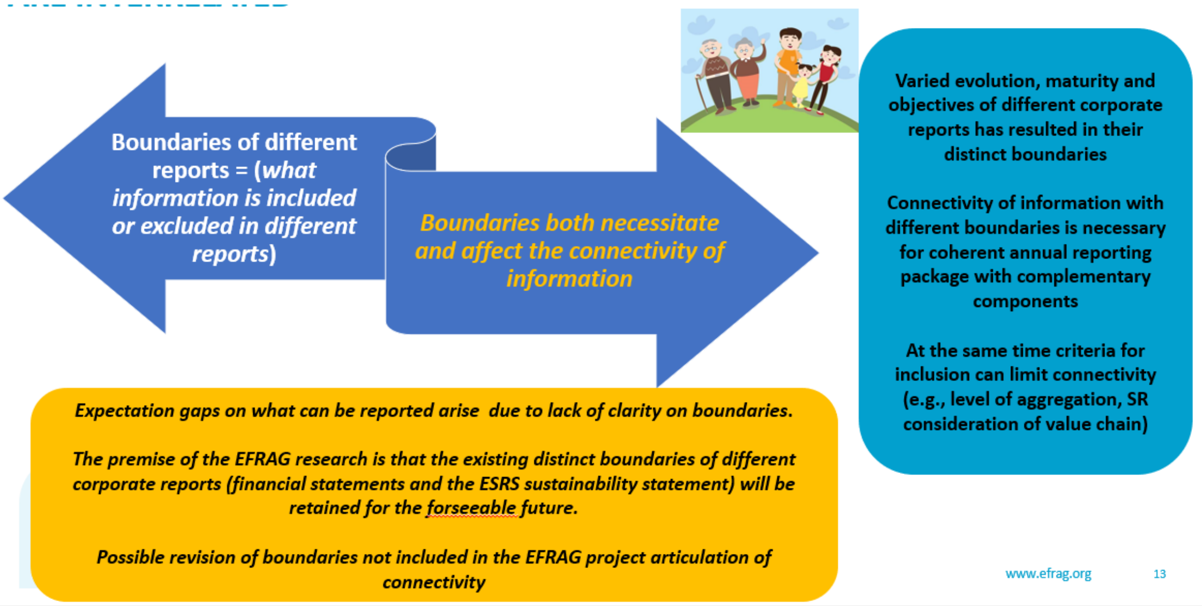
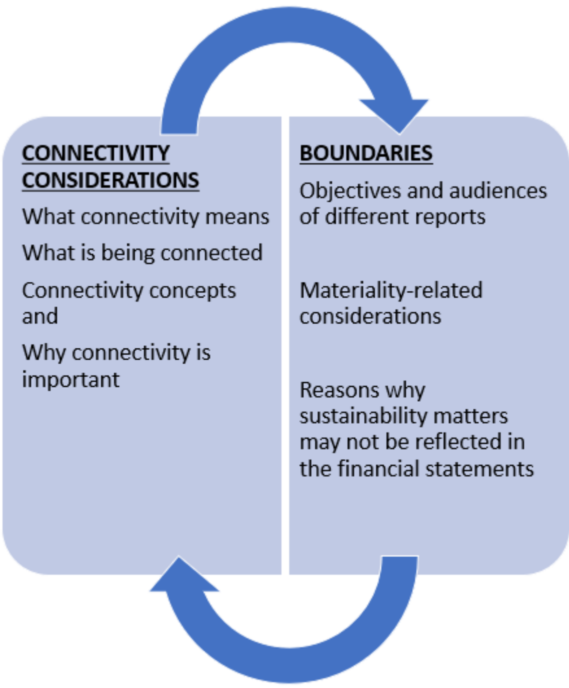
## CONNECTIVITY AND BOUNDARIES OF DIFFERENT CORPORATE REPORTS ARE INTERRELATED

2 The IDP (as depicted in the figure below) highlights the high-level relationship between connectivity and boundaries of different annual report sections (also referred to as different corporate reports).




## IDP STRUCTURE

3 The Figure below outlines the structure of the IDP content after the introduction



## SUMMARY OF THE IDP CONTENT

*Section 1: Connectivity considerations and related concepts*

4 ***Section 1.1 (what connectivity means)*** The IDP conveys that connectivity is a nascent[1] and multi-dimensional concept with multiple views among stakeholders on what the term means and no commonly accepted definition so far. Nonetheless, it is a pivotal concept for enhancing the evolving corporate reporting system. Notably, there are explicit connectivity/connection requirements in both ESRS and IFRS Sustainability Disclosure Standards and it was included as an attribute of useful information in the preparatory work that preceded these Standards (i.e., the 2021 PTF-NFRS publications and IFRS Foundation TRWG prototype document). It is also embedded in the 2013 and 2021 IR framework (as one of the guiding principles) and was implicitly included in the 2017 TCFD recommendations (with the recommendation of disclosure of the financial impact of climate-related risks and opportunities on the organisation). Moreover, as per the analysis in Section 1.3, connectivity contributes to reporting information adherent to the qualitative characteristics of useful information that are stated in the Conceptual Framework for Financial Reporting.

5 Consistent with the articulation in a 2023 IFRS Foundation article, a broad distinction can be made between the connectivity of information across different corporate reports, the connectivity of the requirements/guidance for preparing different corporate reports, and the connectivity of the process of either preparing different corporate reports or undertaking related standard-setting activities. In this regard, we note that the EFRAG connectivity project primarily focuses on the connectivity of information across different reports. With sustainability reporting acquiring a prominent role in corporate communication and envisioned to be on the same footing with financial reporting (i.e., as per the CSRD), **connectivity is the attribute of high-quality information that supports the provision of a holistic and coherent set of information within and across different corporate reports**.

6 The Figure below depicts the key categories of connectivity that are detailed in Section 1.3

[1] It is not one of the characteristics of useful information in the Conceptual Framework for Financial Reporting but it is included in several pieces of guidance related to information outside the financial statements. Moreover, coherence (presentation and disclosure of information in a manner that depicts a more complete picture and allows user to understand the interrelatedness of overall reported information) can be seen as an aspect of connectivity and it was included in the 2021 IASB MCPS ED as an attribute of useful management commentary information.

**Communication/depicting the connection between strategic choices, value creation factors, and financial effects**

- Entity's explaining how their SBM, risks and opportunities are linked to financial position, financial performance, cash flows, other metrics and targets in short, medium and long term (ESRS 1.123 and IFRS S1.35 and IFRS S1.B44)
- Linking disclosures of risks entities face from reliance on resources/ dependencies to entities actions/strategy to mitigate these risks and disclosed related current and anticipated financial effects (ESRS 1.123 and IFRS S1.B 43)
- Explaining trade-offs between risks and opportunities faced when setting strategy (IFRS S1.B44)
- Presentation and disclosure of information within and across different corporate reports in a manner that gives a more complete picture of an entity's value creation while depicting the interrelatedness of the overall reported information (i.e. coherence) (Derived from IASB MCPS ED)

**Techniques/methods for connecting interrelated quantitative, narrative information**

- Linking quantitative via cross-referencing (direct connectivity as per ESRS) (ESRS 1.124-125)
- Linking quantitative information via reconciliations (indirect connectivity as per ESRS) (ESRS 1.124-125)
- Qualitative disclosures stating financial statements line items affected by disclosed risks and opportunities if unable to disclose quantitative current and anticipated financial effects (IFRS S1.40)
- NON-MANDATORY ELEMENTS BELOW
- Not required, stakeholders have also suggested explaining why information cannot be connected (e.g., due to differing level of aggregation) could be useful
- Correlation and cause and effect links (voluntary practice, e.g., SAP past reports)

**Consistency**

**(ESRS 1.127-128 and IFRS S1.23)**

- Consistent data, narrative/qualitative disclosures, assumptions and units of measurement (presentation currency) across SR and the financial statements
- Disclosure and explanation of lack of consistency

**Connectivity at a point in time** *(including current financial effects)* ***(ESRS 2.48, IFRS S1.34-35)***

***vs***

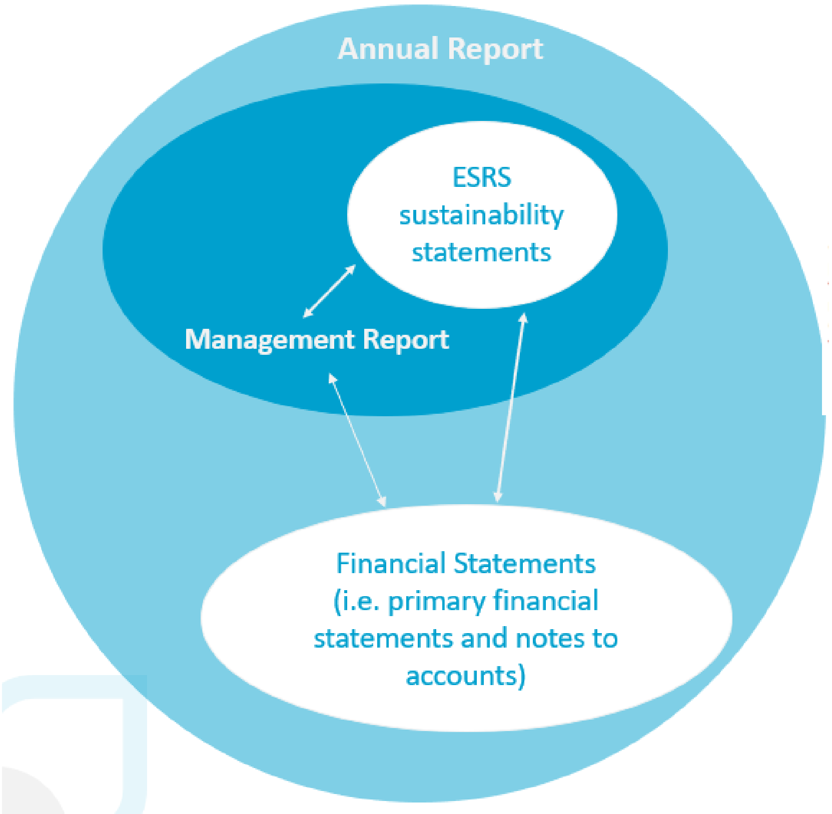
**Intertemporal connectivity (over time)** *(including anticipated financial effects (ESRS 2.48, IFRS S1.34-35)*

*and disclosures that enable users to understand migration of items across reports over time- IFRS S1.B40-c)*

7 In section 1.1, the IDP also distinguishes between connectivity and integration of reporting. The latter is a broader notion than connectivity and it was deemed a lower priority for some stakeholders including EFRAG (i.e., based on the feedback to the 2023 ISSB Agenda consultation).

8 ***<u>Section 1.2 (what is being connected)</u>***- The IDP notes 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.

EFRAG Connectivity project- what is being connected under the EU reporting



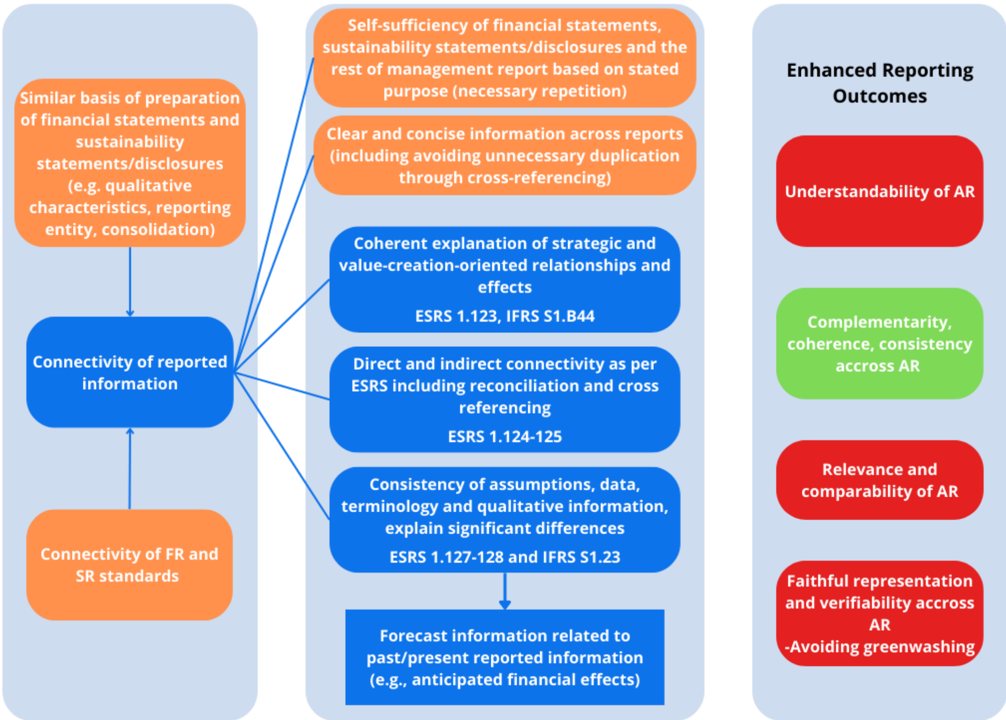

EFRAG Connectivity project- what is being connected under IFRS general purpose financial reporting

9 ***Section 1.3 (connectivity categories and concepts)*** – The IDP details the main connectivity categories and related concepts within ESRS and IFRS Sustainability Disclosure Standards and other publications related to information outside the financial statements (e.g. the 2021 Management Commentary Revised Practice Statement Exposure Draft- MCPS ED).

10 It highlights that, unlike the ESRS and IFRS Sustainability Disclosure Standards connectivity/connection requirements, **IFRS Accounting Standards do not have similar explicit requirements**. The IDP considers that some of the SR connectivity requirements can apply to financial statements' information (e.g., how strategic choices and other entity actions in response to risks and opportunities have current period financial effects, and the consistency of assumptions and narrative in FS relative to SR). However, it also points to the constraints in applying some of the ESRS and IFRS Sustainability Disclosure Standards connectivity/connection requirements towards information in financial statements (e.g., the option to incorporate information from another report by reference, and the reconciliation of quantitative amounts). Specific challenges include the legal risk that could arise from incorporating forward-looking information by reference, impediments to incorporating SR information by cross-reference due to the limited assurance of such information, disclosure overload and impaired understandability that may arise from excessive cross-referencing, and it not being applicable to reconcile starting from an amount in the financial statements to an amount outside the financial statements. The IDP emphasises that the IASB is ultimately responsible for enhancing the connectivity of IFRS financial statements' information including by possibly developing connection requirements and illustrative examples (and this could be done as part of the IASB project on climate-related and other uncertainties in the financial statements).

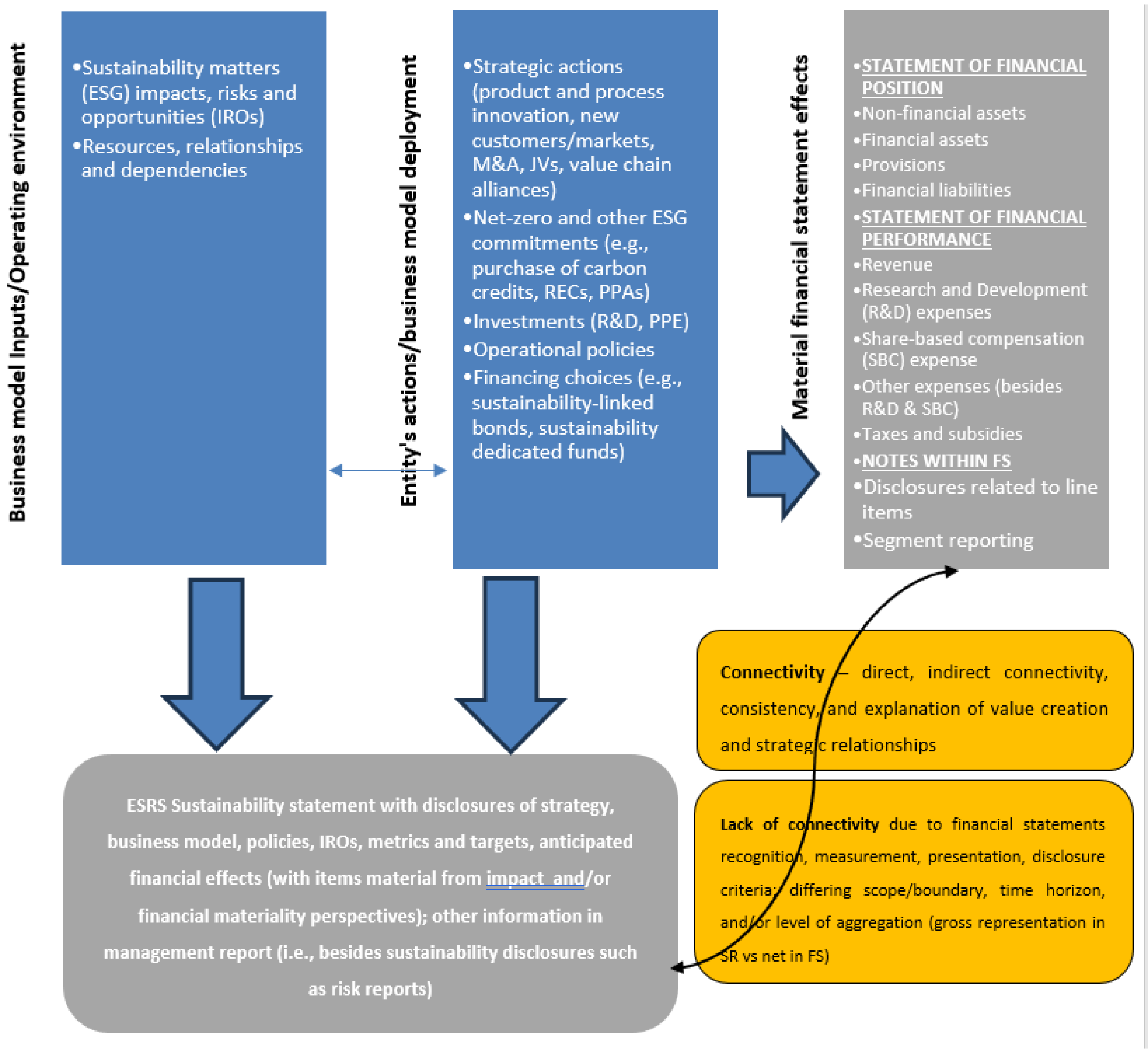
11 The IDP illustrates that applying connectivity-related techniques (reconciliation, incorporation by reference, consistency of assumptions, similar basis of preparation, and coherent presentation) supports the provision of information conforming to the qualitative characteristics of decision-useful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

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)

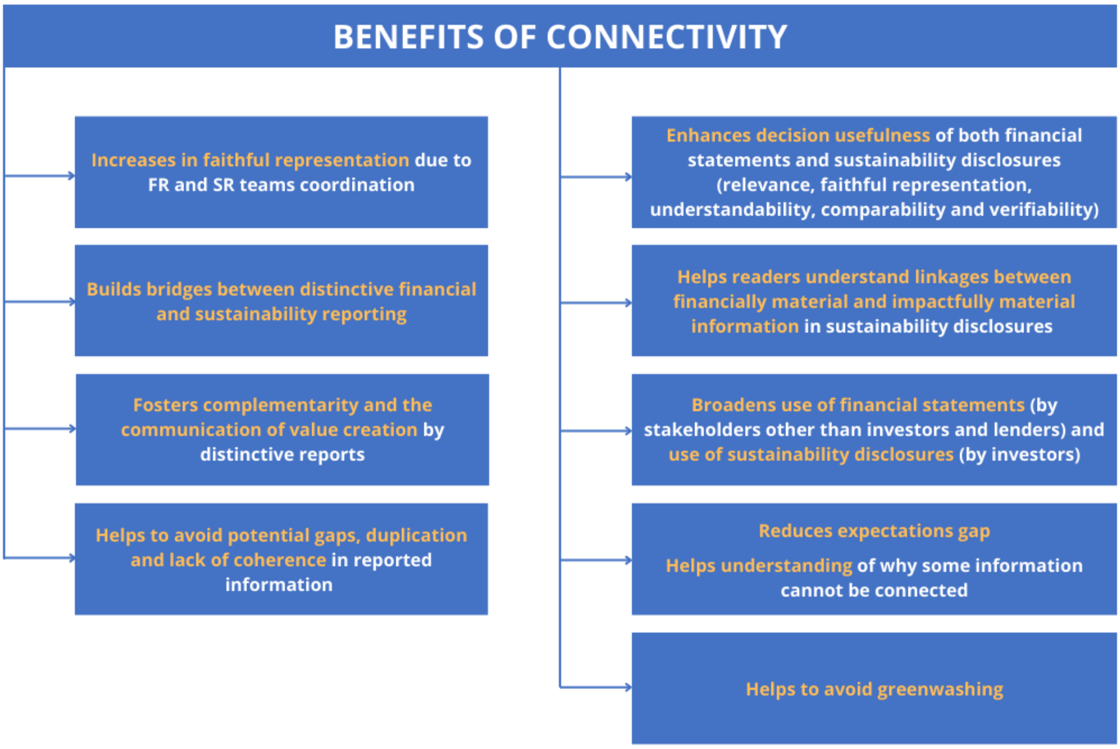



12 ***Section 1.1 (why connectivity is important)*** the IDP reiterate the earlier stated complementary nature of SR and FR information (building bridges) and outlines other benefits of applying connectivity (e.g., reducing the expectation gaps, and reducing greenwashing). The IDP underscores the key message that connectivity enables holistic communication of the entity's value-creation story, and this can be done by linking the strategic choices in response to value-creation factors (risks, opportunities, resources and relationships) to the financial effects and other metrics and targets.

Role of connectivity in communicating entity's value creation



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

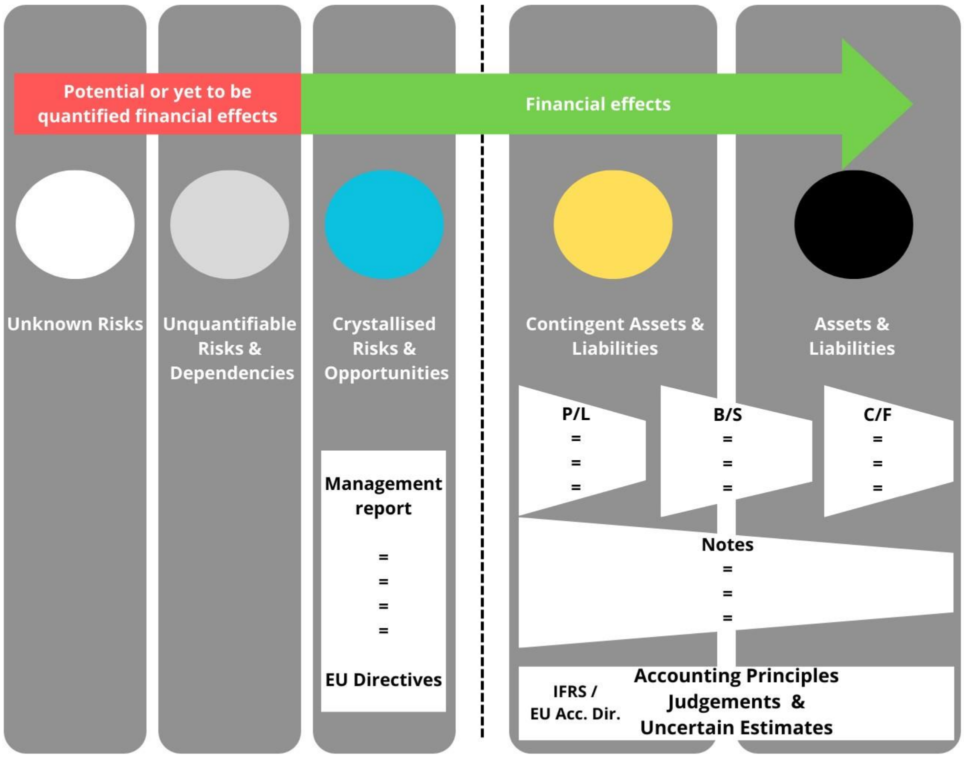



## *Section 2: Boundaries of different annual report sections*

13 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 of the IDP lays out the objectives and audiences** of different corporate reports.

14 **Section 2.2 of the IDP 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.

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




15 Also analysed in **Section 2.2 are some grey areas on the location of material information (**i.e., <u>where there may be duplicated or missing information across the reports and/or where there are diverse stakeholder views on the best location of certain information</u>). For example, 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 IDP notes other topics (unrecognised intangibles, synergies that arise during business combinations) where there is diversity of views on whether these should be disclosed in the financial statements or management report.

16 The development of a <u>sustainability reporting</u> <u>conceptual framework akin to the one in place for financial reporting could help resolve several challenges that stem from the differing nature and objectives of sustainability and financial reporting information.</u>

17 Moreover, the IDP notes that other non-sustainability-related value-creation factors (e.g., certain intangibles and non-sustainability-related risks and opportunities) are disclosed in the management report. In tandem, there are instances where there is no consensus on whether certain items within such information should be in the management report or financial statements (e.g., disclosure of synergies during business combinations, and

disclosure of unrecognised intangibles). Hence, to foster connectivity and lessen expectation gaps and uncertainty on the boundaries of different corporate reports, it would also be useful for the respective responsible authorities to enhance their guidance on management commentary/the management report. In a similar vein, the IASB ought to update its management commentary guidance. This could include more clearly defining what information ought to be in the scope and further specifying the role management commentary (MC) fulfils in enhancing the connectivity of information across IFRS general purpose financial reports (i.e., <u>clarify how MC can serve as the connective tissue of IFRS general purpose financial reporting</u>).

18 The IDP also highlights that during several discussions on whether certain information should be disclosed in the financial statements or management report (e.g., information on net zero commitments that is indicative of potential liabilities), there have been indications that some users are location agnostic. At the same time, a reason posed by other users for their preference of disclosure in the financial statement is the associated current higher level of assurance. Thus, <u>an enhancement in the level of assurance for information outside the financial statements could contribute to some users becoming more location-agnostic than they currently are</u>, and this could potentially lessen the expectation gap (e.g., on what information should be in the financial statements). It is also clear from the discussions so far at EFRAG that <u>further outreach to educate stakeholders on the boundaries of different corporate reports and to identify information needs in the context of different corporate reports could lessen the expectation gap</u>.

19 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.

20 The Appendix of the IDP also highlights the **<u>role of technology in fostering connectivity</u>** including through the use of interactive technology, XBRL tagging of information, and the possible combined use of AI and XBRL tagged information. We also note that three taxonomies under development (IFRS Accounting, ESRS, and Article 8-EU taxonomy)

present an opportunity to enhance the connectivity of information (e.g., the reconciliation of financial statement line items and operating segments with ESRS sectors and related data points).

21 The Figure below summarises the steps that may lessen the expectation gap on the boundaries of different corporate reports and foster connectivity.