CONNECTIVITY & BOUNDARIES IN REPORTING

ESMA ISC Corporate Reporting Consultative Working Group

14 NOVEMBER 2024

EFRAG CONNECTIVITY PROJECT MILESTONES

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23-PERSON EFRAG CONNECTIVITY ADVISORY PANEL (CAP) CONSTITUTED & ACTIVE FROM 2H 2023

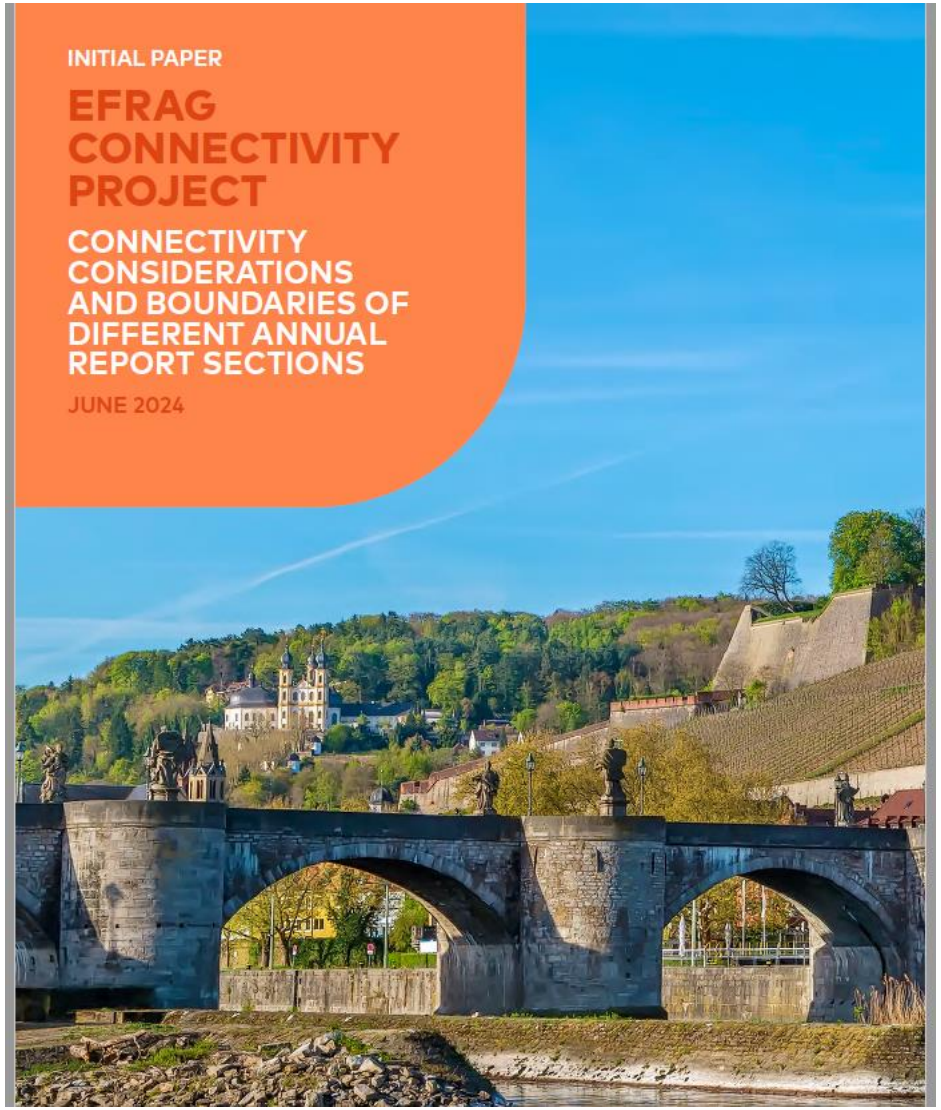
INITIAL PAPER PUBLISHED ON 28 JUNE 2024

‘Connectivity considerations and boundaries of different Annual Report sections’

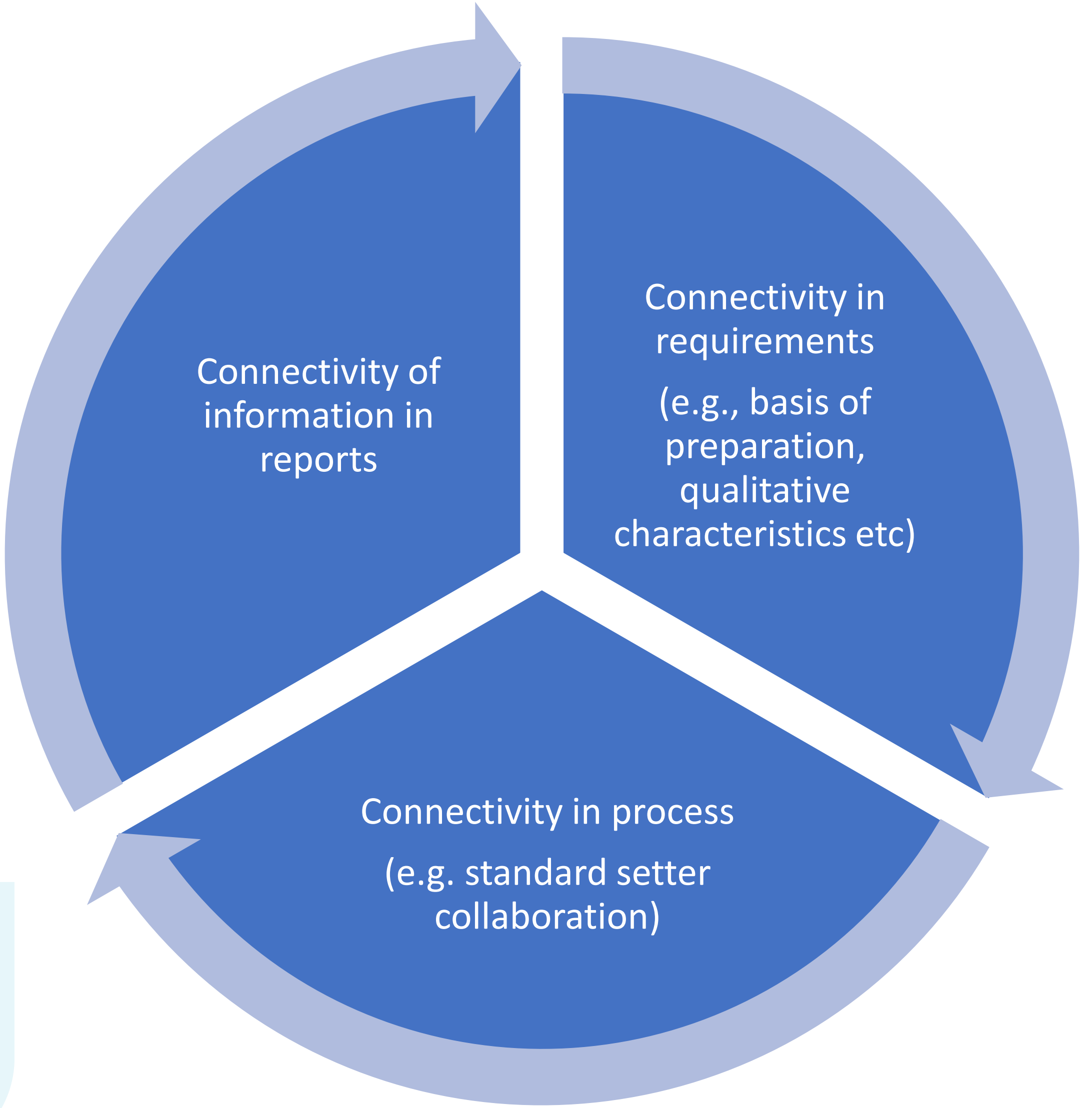
Video **providing initial paper’s key takeaways from the perspective of EFRAG CAP leaders**

A DISCUSSION PAPER EXPECTED IN H1 2025 WILL INCLUDE

- **Conceptual issues and suggested solutions**
- **Practical illustrations and techniques of connectivity (mix of real world and mock-up illustrations)**
- **Questions for constituents**



BROAD NOTIONS OF CONNECTIVITY



Integration in reporting (as per ISSB agenda consultation) is a broader notion than connectivity

CONTEXT OF CONNECTIVITY UNDER EU CORPORATE REPORTING

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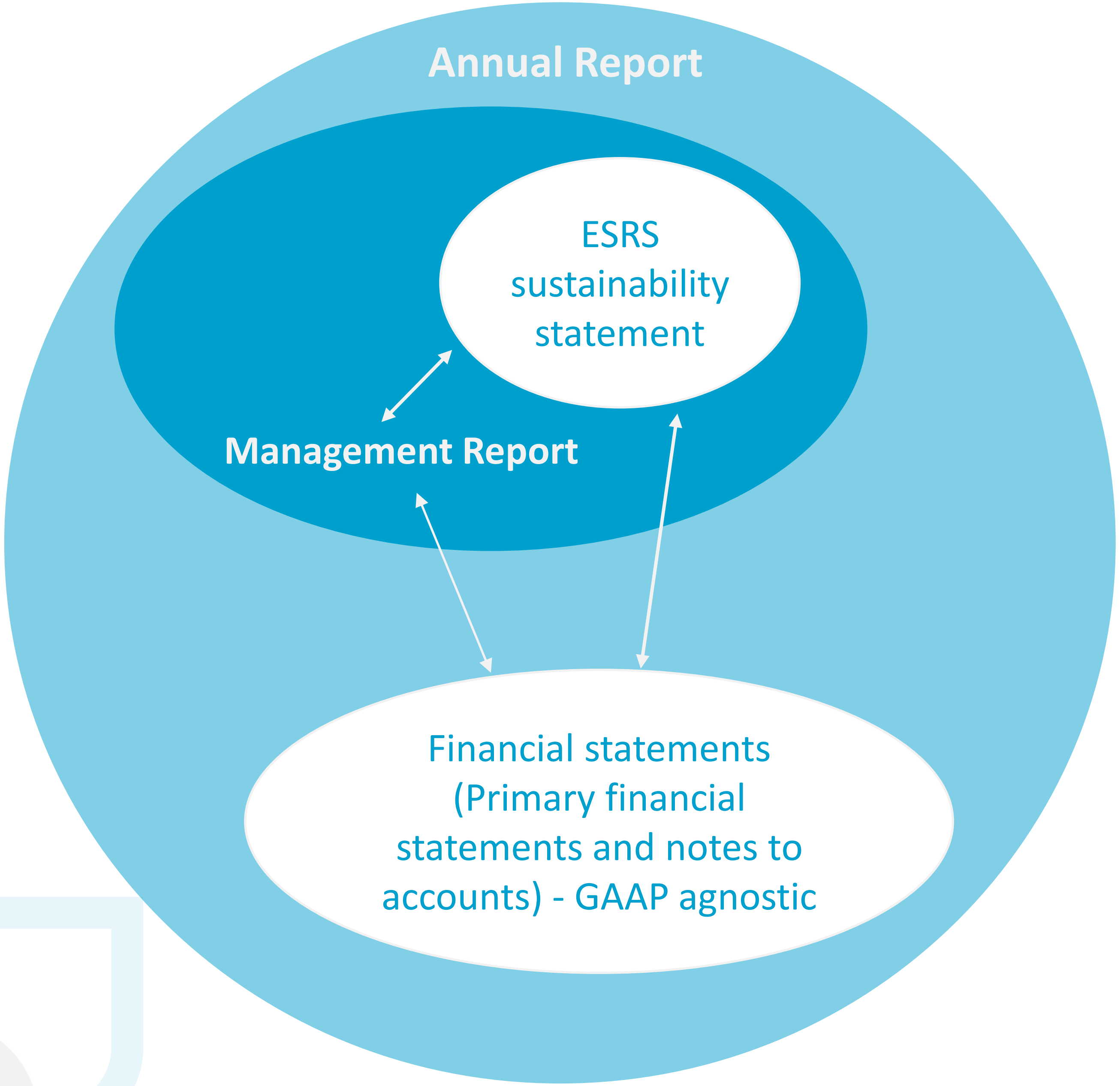


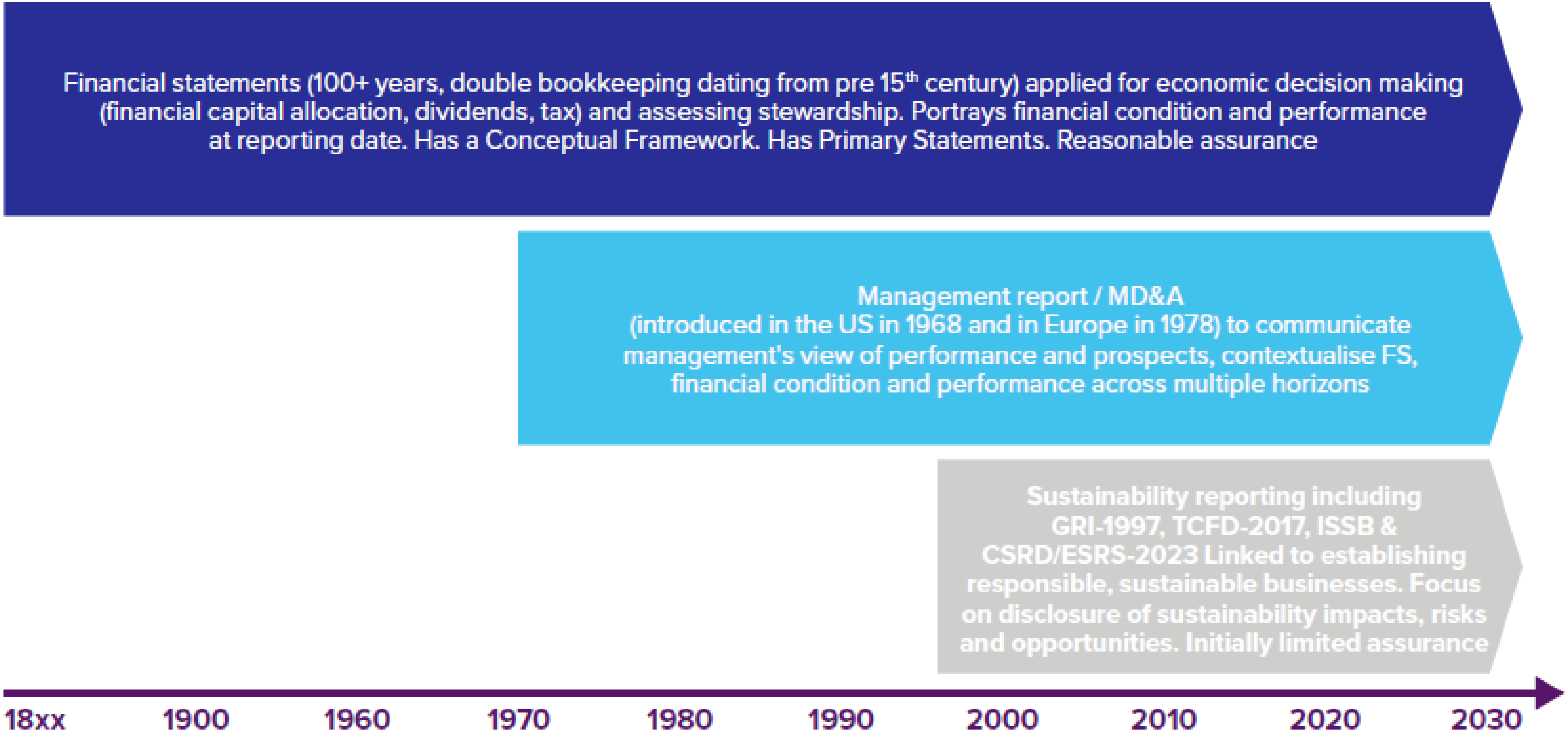
ESRS sustainability statement- SR (objectives, location and scope)

- Clear demarcation of SR versus financial statements objectives
- Clear placement within management report
- Entities in scope (large undertakings: IFRS and local GAAP applicants)

SR audience and materiality

- Broad set of users (including investors), investors deemed to consider financial and impact material information
- Double materiality perspective
- Same definition of financial materiality as financial statements

BOUNDARIES: VARIED MATURITY OF DIFFERENT AR SECTIONS



KEY DIFFERENCES ACROSS DIFFERENT AR SECTIONS

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Financial statements (FS)
(Source: Conceptual Framework)

Reflects financial position, financial performance at reporting date (present assets and liabilities)

Primary audience of financial capital providers

Includes information material to FS users

Recognition of assets/liabilities depends on separability of items, existence/occurence and measurement uncertainty considered

Financial control-considered for reporting entity (determining entities in scope of consolidation) and recognition of assets

Management report
(Source: EU Accounting Directive)

Reflects entity's performance, position and development; it is traditionally a part of general purpose financial reporting with financial materiality perspective

Under CSRD, management report can be deemed to be part of general purpose sustainability reporting

Provides description of principal risks and uncertainties

Primary audience is knowledgeable user

Implicit that it has same reporting entity as FS

Sustainability statement
(Source: EU Accounting Directive and ESRS)

It is a section of the management report

Discloses entities' sustainability impacts, risks and opportunities

Discloses financial effects of IROs in short, medium and long term

Audience of stakeholders including investors and other users with interest in entity's impacts on planet and society

Financially and/or impactfully material information included

Same reporting entity as FS, consideration operational control in calculation of environmental metrics

Observations

- Materiality is interrelated with objectives and audience; similarity in the definition of financial materiality and difference of information in different AR sections stems from differences in their objectives
- Similarities: overlaps in information related to current financial performance and financial position; same reporting entity, informs financial capital allocation decisions and users' assessment of management's stewardship of entity's own resources
- Differences: FS does not focus on representing information related to future financial performance and financial position. Application of operational control in only SR extends the related reporting boundary beyond that of FS; sustainability statement informs on externalities, CSR (stewardship of planetary and societal resources)

DIFFERENTIATING DIMENSIONS

Objectives & Audiences

Materiality (whether impact materiality considered)

FS recognition and measurement criteria

Typical time horizon considered

Focus on current vs future financial position, financial performance

REPORTING BOUNDARY

Consideration of operational control in calculation of SR metrics

Extent of explicit incorporation of value-chain impacts, risks and opportunities

DIMENSIONS OF CONNECTIVITY OF REPORTED INFORMATION

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Overarching aspect- integration of information to convey value creation

- Communication/depicting the effects of strategic responses to (impacts, risks and opportunities) on sustainability performance, financial performance and financial position
- Entity's explaining how their strategy and business model, 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.B43)**
- Explaining trade-offs between risks and opportunities faced when setting strategy **(IFRS S1.B44)**

Connecting interrelated quantitative and narrative information

- Linking quantitative via cross-referencing **(direct connectivity as per ESRS)** **(ESRS 1.124-125)**
- Linking quantitative information via reconciliation **(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.B40)**
- **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)

Other overarching aspects of connectivity

- **Consistency:** Consistent data, narrative/qualitative disclosures, assumptions and units of measurement (presentation currency) across SR and the financial statements **(ESRS 1.127-128 and IFRS S1.23)**
- **Coherence:** 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 **(Derived from IASB 2021 MCPS ED)** (same notion as complementarity)
- Disclosure and explanation of lack of consistency is an element of coherence

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

vs

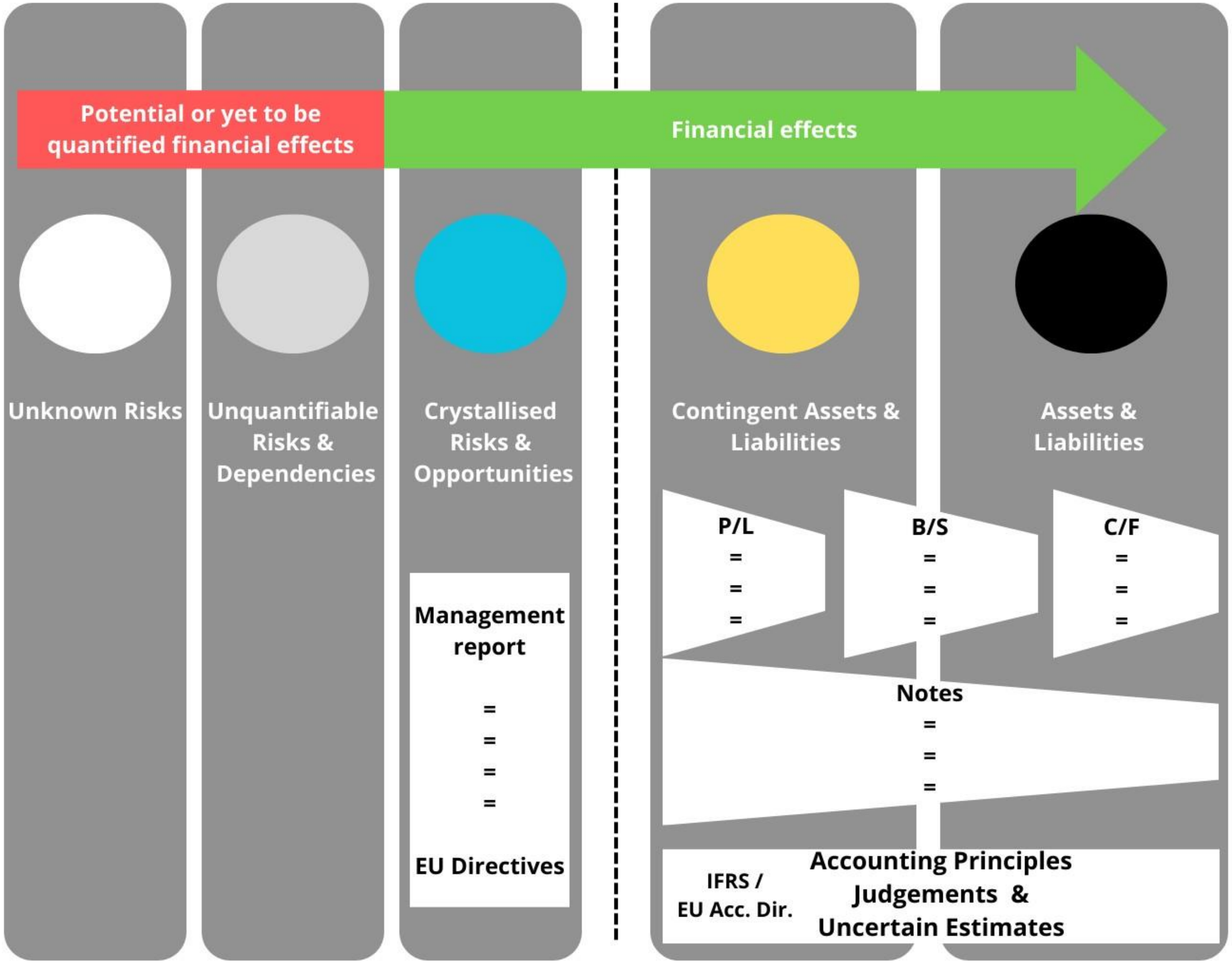
Intertemporal connectivity (over time)
(including anticipated financial effects (ESRS 2.48, IFRS S1.34-35) and disclosures that enable users to understand migration of items across reports over time- IFRS S1.B40-c)

Connectivity within a reporting period/across AR sections (**current financial effects**)

Connectivity across different reporting periods (**anticipated financial effects**)

INTERTEMPORAL/DYNAMIC DIMENSION OF CONNECTIVITY

MIGRATION OF ITEMS (financial effects) ACROSS REPORTS/REPORTING PERIODS



Entity impacts; risks and opportunities; strategy& business model deployed (operational choices, risk mitigation and adaptation measures) have financial effects

Financial effects are reported across AR sections

Higher threshold of reporting financial effects in financial statements (e.g., a past event is needed)

CURRENT vs ANTICIPATED FINANCIAL EFFECTS

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ANTICIPATED FINANCIAL EFFECTS IN SR DISCLOSURES: FUTURE-ORIENTED TIME HORIZON

Current reporting period

Short-term
Potential overlap/duplication of FS (IAS 1.125) disclosures and SR disclosures

Medium-term

Long-term

CURRENT FINANCIAL EFFECTS

Affecting current period primary financial statements line items+ disclosures

Guided by IFRS Accounting Standards, local GAAP

Recognition and measurement criteria of FS line items – **captures all time horizons (past & future)**

Current period financial performance and financial position

ESRS GLOSSARY DEFINITION OF ANTICIPATED FINANCIAL EFFECTS- Financial effects **that do not meet the recognition criteria for inclusion in the financial statement line items in the reporting period and that are not captured by the current financial effects.**

ESRS & ISSB REQUIREMENTS ON ANTICIPATED FINANCIAL EFFECTS

ESRS 2 *General requirements – Strategy & Business Model*-SBM-3, ESRS E1 *Climate Change*- E1-9 Metrics and Targets (material physical and transition risks), Other environmental topical standards

IFRS S1- Strategy; IFRS S2- Strategy, Metrics and Targets- Cross industry metrics

CURRENT FINANCIAL EFFECTS

Disclosures of assumptions and sources of measurement uncertainty affecting carrying values in next reporting period (IAS 1.125)

ANTICIPATED FINANCIAL EFFECTS - POINTS OF NOTE

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Overlap/possible duplication, challenges- current vs anticipated financial effects

- Interaction with IAS 1.125 (i.e., requirements of disclosure on assumptions and sources of measurement uncertainty affecting carrying values within next reporting period)
- Possible challenge of distinguishing between anticipated vs current financial effects
- Uncertainty of amounts (i.e., due to existence/occurrence uncertainty and measurement uncertainty)

Possible reasons for non-disclosure of quantitative anticipated financial effects in SR

- Lack of separability from other risk factors
- Measurement uncertainty
- Systems, methodology and data availability constraints
- Immaterial long-term financial effects due to entity’s mitigation/adaptation actions

WAY FORWARD - GREY AREAS THAT NEED TO BE RESOLVED

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Examples of location grey areas, i.e., disclosures could be within and/or outside the financial statements

- Unrecognised intangibles
- Synergies in business combinations
- Disclosures related to net-zero commitments
- Anticipated versus current financial effects in sustainability reports
- Risk disclosures
- Power purchase agreement disclosures
- Carbon credit disclosures

RECOMMENDED LONG - TERM STEPS

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