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EFRAG research project on connectivity- Discussion Paper Draft content

PROPOSED DRAFT CHAPTER 4

ROADMAP FOR ENHANCING THE CONNECTIVITY AND DEFINITION OF BOUNDARIES OF DIFFERENT REPORTS

Overview- what information across different reports can or cannot be reasonably expected to be connected?

- 1 **Scope of Chapter 4:** The feedback from EFRAG’s outreach¹ to stakeholders, the aggregated observations on the 16 illustrations of connectivity in Chapter 3, and other thematic reviews of reporting practices; collectively convey that companies are progressing in their journey towards demonstrating different mechanisms of connectivity. Chapter 3 also highlights several points of attention (including suggested improvements) on the connection of reporting (as described in this Discussion Paper) under the current reporting requirements. Beyond these points of attention, the feedback from stakeholders has also brought to the fore that there could be situations where stakeholders may expect information to be connected across different reports (i.e. annual report sections) but this is not the case. This could be indicative of:
 - (a) an expectation gap among the stakeholders- with a corresponding need for education on why information cannot be connected;
 - (b) information that would be reasonably expected to be connected across reports but is not. Thus, there may be a need for standard setting activity.

- 2 Building on Chapter 3, the analysis in Chapter 4 aims to distinguish between paragraph 1a and paragraph 1b circumstances. It is noted that this Chapter’s objectives are different from the 2024 EFRAG connectivity project initial paper. Unlike the latter publication, whose objective was the broad education of stakeholders on connectivity and boundary concepts, similar to other EFRAG proactive research Discussion Papers, except for the suggested background information on materiality in the Appendix, this chapter places more emphasis on initially identifying areas where standard setting activity may be required and defining questions that can help gather stakeholder feedback during the consultation period. As done for other Discussion Papers, after the consultation period, EFRAG can issue a Recommendations and Feedback statement, which taken together with the Discussion Paper, can influence standard setters’ existing and potential related projects. Rather than trying to comprehensively accomplish all the objectives of the EFRAG research project on connectivity in a single document (this Discussion Paper), it is considered that the educational objectives have been met elsewhere including through the 2024 EFRAG

¹ Further to the meetings of the EFRAG CAP, and the EFRAG FR and SR pillar technical governance bodies, outreach has been done during meetings with EFRAG’s advisory working groups (EFRAG IAWG, EFRAG FIWG, EFRAG User Panel, and EFRAG CFSS), through a multi-stakeholder webinar held in April 2025, and by interviews with stakeholders (preparers, auditors, users). Stakeholders’ feedback was also obtained during EFRAG’s presentations (10 presentations) on the 2024 EFRAG Connectivity project’s initial paper. Finally, pertinent feedback to the IASB ED on Climate-related and other uncertainties in the financial statements has also been considered.

connectivity project initial paper and 2025 EFRAG roundtable webinar report. Moreover, Chapters 2 and 3 address the concepts and illustrations of connectivity and this content is also educational in nature.

- 3 **Audience of Chapter 4:** The content of this chapter is primarily targeted at standard setters to the extent it relates to paragraph 1b circumstances (e.g. it could inform the potential IASB-ISSB joint project on connectivity and the boundaries of financial statements). At this stage, based on the EFRAG FRB’s guidance at its June 2025 meeting, this chapter does not focus on recommendations to preparers except if there were to be a situation where standard setters may perhaps need to provide application guidance.
- 4 **Considerations that help distinguish information across different reports that can or cannot be reasonably expected to be connected:** Consideration of the boundaries of different reports (i.e. the dividing line/distinguishing factors that specify the information on transactions, activities, conditions, events, and impacts included within different reports) helps to understand whether information across reports can or cannot be connected. The following specific dimensions of the boundary of different annual report sections can be inferred from different literature² (standard setters’ and audit firms’ publications, and academic literature including Bayne³,2022):
- (a) nature of information/subject matter or topics boundary (e.g., non-monetary metrics would primarily be reported outside the financial statements, greater emphasis on narrative information in sustainability statement/disclosures relative to financial statements, governance disclosures would typically be disclosed outside the financial statements);
 - (b) boundaries arising from the different materiality perspectives related to financial statements and sustainability reporting;
 - (c) organisational reporting boundary (i.e. entities, operations, and assets reported on).

² The publications considered include: the 2024 EFRAG Connectivity Project’s initial paper, the [2021 PTF-NFRS report](#), the IAASB’s Proposed International Standard on Sustainability Assurance ISSA 5000 related definition, and academic literature (Girella, 2018; Bayne, 2022).

³ Bayne (2022) outlines 10 dimensions that define boundaries of different reports include: the **reporting entity** (extent of financial versus sustainability control/influence); **b) target users** (extent of investor versus wider stakeholder focus); **c) materiality** (extent of financial versus impact materiality); **d) extent of entity-wide versus topic boundary definition.** For instance, the GRI evolution of boundary rules from an entity-wide boundary concept (akin to financial reporting) to a topic-specific concept; **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.**

- (d) time horizon boundary (e.g. extent of orientation towards forward-looking or retrospective information in a report, and focus on current period financial statements versus future period financial statements);
- (e) boundary based on occurrence/existence and measurement uncertainty of transactions and events (i.e., a ‘past event’ and higher levels of certainty required for financial statements information);
- (f) boundaries arising from differences in presentation (Gross exposure in sustainability reporting versus net exposure in financial statements).

5 Relatedly, the 2024 EFRAG connectivity publication and feedback from stakeholders point to why certain material sustainability-related information may not be reported in the financial statements and therefore may not be connected:

- (a) *Certain information reported in the sustainability statement/disclosures does not meet the criteria for either recognition or disclosure in the financial statements. For instance;*
 - (ii) This could be due to the differing materiality thresholds applied for financial statements (where materiality is gauged relative to defined elements of financial statements) and sustainability reporting information (where materiality is gauged relative to an entity’s impacts, risks and opportunities-IROs).
 - (iii) Sustainability-related risks⁴ may fail to meet the criteria for recognition as provisions or disclosure as contingent liabilities,
 - (iv) Sustainability-related opportunities⁵ do not qualify to be recognised as assets or disclosed as potential revenue in the financial statements.

⁴ Taking into account 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 EFRAG PTF-NFRS connectivity publication concluded that the low likelihood of obligations from sustainability-related matters plays a hand in their failure to meet the IAS 37 present obligation criteria. There is also the challenge of establishing that an obligation of transfer of economic resources has occurred (i.e., probable outflow of economic resources) for many sustainability-related circumstances.

The 2021 EFRAG PTF-NFRS publication surmises there could be an increased reporting of sustainability-related risks as liabilities if more legal/regulatory measures were taken and created obligations (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).

⁵ Potential assets could be a) the economic value of potential reuse of materials (circular economy); and b) the potential future economic value from sustainability-related research and development activities that are not recognised as intangible assets.

- (b) *Differences in the presentation (level of aggregation) between financial statements and the sustainability statement/disclosures.* Sustainability disclosures are often far more detailed⁶, while financial statements aggregate information at a higher level based on accounting standards. For instance,
- (ii) Assets vulnerable to physical risk may be disclosed by location in the sustainability statement/disclosures but not be 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).
 - (iii) During outreach, a preparer from a banking financial institution indicated that investments in green finance are material for the sustainability report but not for the financial statements—particularly if there is a limited impact of such investments on the financial indicators related to the loan portfolio of the related entity (such as net interest income).
 - (iv) Training expenses may not be material for presentation as a separate line item in the financial statements but may be material for the sustainability statement.
 - (v) It has been observed that sustainability reporting typically depicts gross exposure before mitigation while the financial statements depict the net exposure and this may limit the connectivity of information.
- (c) Possible misinterpretations or gaps in IFRS Accounting requirements (e.g. the interpretation that IAS 36 impairment requirements limit the value in use calculation to cash flows within a five-year horizon).

6 Stakeholder feedback has also highlighted lingering questions around the following themes that if addressed could clarify why it may be difficult to connect financial statements and sustainability reporting information, and/or identify where there may be gaps in existing requirements:

⁶ As noted by the expert speakers during the April 2025 EFRAG webinar, sustainability reporting often requires more granular data by project, site or activity to reflect the specific ESG impacts, such as individual projects, facilities or specific activities. Disaggregation by country or asset may also be required, especially when the impacts, risks and opportunities (IROs) differ across the geographies.

- (a) **Differences in what is deemed financially material in different annual report sections:** What differentiates material information in the financial statements from that which is either financially material or double material in the sustainability statement or management report?
- (i) When should qualitative materiality assessment based on the IAS 1.31 (paragraph 20 of IFRS 18) requirements be applied to incorporate material sustainability-related information in the financial statements, and would this create unnecessary duplication?
 - (ii) When should forward-looking information be included in the financial statements? Transition plan investments, commitments and future-oriented expenses – are these disclosed in the financial statements to ensure the financial statements are sufficiently informative to users of financial statements?
 - (iii) When is a matter material in the context of the sustainability statement versus management report versus the financial statements, for example, due to the depiction of gross risk exposure in the sustainability statement versus net exposure in other risk reports and financial statements?
 - (iv) What is the interaction between anticipated financial effects disclosed in the sustainability and financial statements information in current and future reporting periods? In this regard, there is a need to distinguish between whether anticipated financial effects overlap with financial statements, whether these effects will crystallise in the future period financial statements, and what components of anticipated financial effects will never be reflected in the financial statements.
- (b) **Sustainability-related intangibles:**
- (i) What is the interaction between sustainability-related intangibles under the scope of CSRD and the information in the financial statements?
 - (ii) What aspects of human capital should be disclosed in the financial statements?
- (c) **Organisational reporting boundaries** (i.e. entities, operations, and assets reported on). Under sustainability reporting, these extend to the value chain, albeit different sustainability matters can have different organisational reporting boundaries. For instance, under ESRS, environmental disclosure encompasses information from the

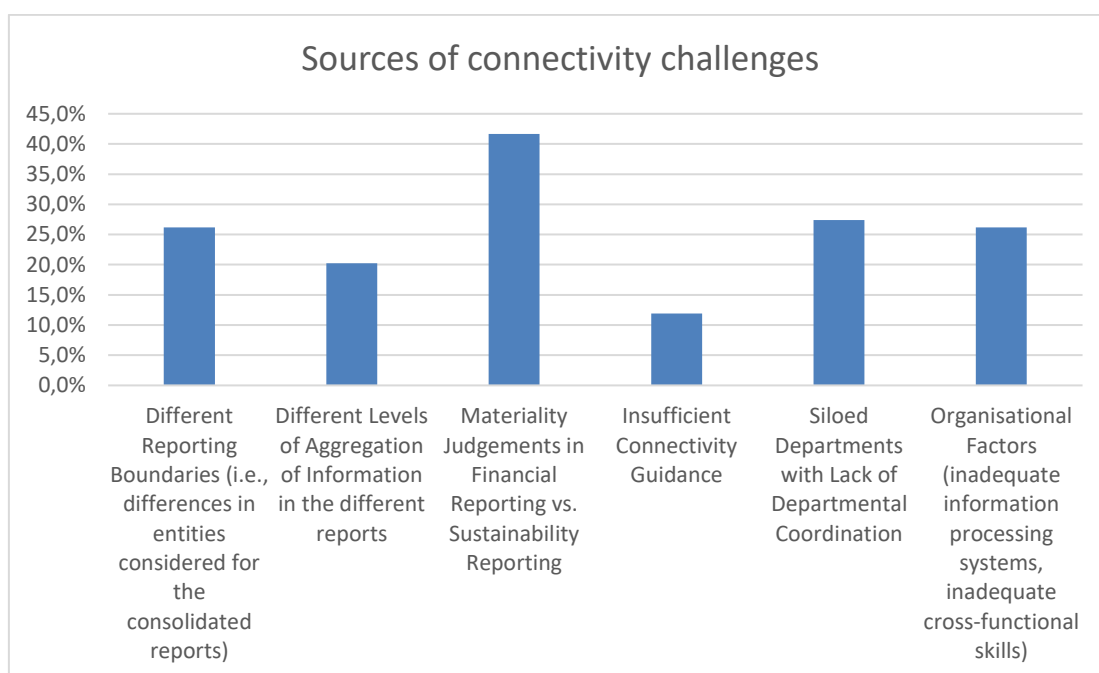
value chain, while governance disclosures are limited to information from the reporting entity's own operations. It is also worth noting that the notions of 'own operations' and 'operational control'⁷ applied in sustainability reporting do not exist in financial reporting requirements. The application questions/challenges noted during the outreach include:

- (i) How can the risk of misinterpretation of sustainability metrics due to the application of different organisational reporting boundaries for sustainability statement/disclosures and financial statements be lessened? For instance, for GHG and Energy consumption intensity metrics. That is, in cases where the numerator (GHG emissions or Energy consumption) is determined under a different scope of consolidation (e.g. consolidation based on operational control) from the denominator (revenue) determined based on the financial statements' scope of consolidation (i.e. based on control or 'financial control').
- (ii) Where do the most significant differences in organisational reporting boundaries arise? During EFRAG's outreach, some preparers have indicated that, for sustainability reporting, they include non-employees (suppliers/contractors) in their own workforce definition.

7 The expert speakers at the [April 2025 EFRAG webinar](#) and EFRAG outreach interviewees confirmed where connectivity questions may arise including **differences in materiality judgments in financial statements and sustainability reporting, differences in the level of aggregation, anticipated financial effects, and organisational reporting boundaries**. The bar graph below (Figure 4.1) with the results of audience responses to a polling question during the EFRAG webinar reflects these and other sources of connectivity challenges with materiality as the top concern.

Figure 4.1 EFRAG webinar feedback on connectivity challenges

⁷ In Appendix II, Table 2 (Definitions in the ESRs), operational control is defined as "a situation in which the (reporting) entity has the ability to direct the operating activities and relationships of the entity, site, operation or asset". For example, according to ESRs 1 AR 40 operational control exists when the entity (i.e. the parent company or a subsidiary) has the licence – or permission – to operate the assets of unconsolidated joint ventures, associates, non-significant subsidiaries and contractual arrangements.



Proposed Chapter 4 content

8 Based on the above, to enhance the connectivity of reported information and clarify the definition of boundaries, it is proposed that this chapter consists of an analysis of the following four issues:

(a) **Issue 1 (differences between items considered financially material in financial statements and sustainability reporting):** Below are a subset of issues that could be addressed

- (i) Qualitative materiality assessment: The general requirements under IAS 1.31 (paragraph 20 of IFRS 18) could be applied to include material sustainability matters that may not be required by the specific IFRS Accounting Standards. When should this general requirements paragraph be applied and does the interpretation of this paragraph need tightening?
- (ii) Forward-looking information- Transition plans including climate-related commitments: If/when should there be disclosures of climate-related commitments⁸ and other elements of transition plans in the financial statements?

⁸ For instance, the 2024 EFRAG connectivity publication highlighted the mixed views expressed by stakeholders on whether, for climate-related (net-zero) commitments that do not qualify to be recognised as a provision based on IAS 37 requirements, information (i.e., related to possible future outflows) for such commitments can be disclosed in the financial statements.

- (iii) Anticipated financial effects: Anticipated financial effects disclosed in the sustainability statement **are different in nature** (e.g. they can relate to events that have not occurred, the amounts are more uncertain) from the information in the financial statements. However, as noted earlier, anticipated financial effects could a) overlap with information in the current reporting period financial statement, b) crystallise in future period financial statements (i.e. intertemporal connectivity), or c) fail to crystallise in future period financial statements for a variety of reasons including when anticipated events do not occur or due to measurement uncertainty. An analysis of these different aspects is done including assessing the triggers/indicators of when financial effects arising from sustainability-related IROs and an entity's actions will migrate from the sustainability statement/disclosures to the financial statements.
 - (iv) It is acknowledged that the anticipated financial effects requirements are transitional requirements that will be phased in for wave 1 of ESRS reporting (i.e. pre-Omnibus ESRS) and ISSB Standards. The updated ESRS requirements under Omnibus are yet to be decided and will likely only be reflected in reports issued after 2027. Hence, even though Chapter 3 has illustrations of disclosures of anticipated financial effects, their reporting is not common.
- (b) **Issue 2- Level of aggregation**: There are differences in the level of aggregation (including the gross risk exposure depiction in sustainability reporting versus the net risk exposure presentation in the financial statements), and this is a reflection of the relevant reporting requirements for each of these reporting domains. It is noted that the IASB ED on Climate-related and other uncertainties in the financial statements had an example of the disaggregation of property, plant, and equipment (PPE) for transition investments (i.e. Example 8 of the IASB ED) that addresses this matter from the side of the financial statements taking account of the aggregation principles under IFRS 18 *Presentation and Disclosure in Financial Statements*. Are similar aggregation principles needed for sustainability reporting?
- (c) **Issue 3 (placement principles for grey areas- related to issue 1)** is related to what are referred to as grey areas (i.e. defined in this Discussion Paper as information that could be both material within and outside the financial statements). This has been a recurrent theme during EFRAG's conversations with its stakeholders. One of the grey areas that could be addressed is sustainability-related intangibles (human capital).

- (d) **Issue 4 (implications of differences in the organisational reporting boundaries of financial statements and sustainability reporting):** Are there any areas where the respective organisational reporting boundaries of sustainability reporting and financial statements could be better aligned? How can transparency in the differences of organisational reporting boundaries applied for different reporting sections be fostered?
- 9 **Other possible recommendations to enhance connectivity and clarify the definition of boundaries of different reports:** Chapter 4 could also emphasise:
- (a) The importance of connectivity in process (including governance within organisations) and connectivity in reporting requirements. During EFRAG’s outreach, stakeholders have underscored the importance of these aspects.
- (b) In its commentary to the IASB and ISSB, EFRAG has often called for a sustainability reporting conceptual framework. A conceptual framework could address the measurement methods including discounting principles for anticipated financial effects. It could also enhance the concepts applied such as the notion of operational control and own operations.
- (c) The importance and role of digitisation, including examining the intersection of digitally tagged reporting/AI in enhancing users’ access to reported information.

Questions for EFRAG FR TEG

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| 10 | Do EFRAG FR TEG members have any comments on the objective of the Chapter with a) a focus on issues that could be addressed by standard setters and b) the four proposed issues identified and other considerations to be addressed outlined in paragraphs 8 and 9? |
| 11 | Do EFRAG FR TEG members have any comments on the indicative drafting for the proposed issues for inclusion in Chapter 4 including the potential questions to constituents in paragraphs 40, 59, and 60? Please note this is indicative and incomplete drafting and suggested alternatives/solutions will be more fully formulated after agreement on the issues to be addressed in this chapter. |
| 12 | The content in the Appendix related to materiality under the EU framework and IFRS general purpose financial reports is educational in character. Do EFRAG FR TEG members agree with including this content in the Appendix to the Chapter? |

INDICATIVE DRAFTING FOR THE PROPOSED ISSUES TO BE ADDRESSED IN CHAPTER 4

- 13 The indicative drafting for the proposed issues to be addressed in Chapter 4 include:
- (a) Issue 1: Distinction between financial materiality in the context of sustainability reporting and financial statements information (IAS 1.31 application, disclosure of climate-related commitments, anticipated financial effects)
 - (b) **Issue 2: Level of aggregation- indicative drafting is yet to be developed**
 - (c) Issue 3: Placement principles for grey areas (sustainability-related intangibles)
 - (d) Issue 4: Organisational reporting boundaries
 - (e) Other considerations to enhance connectivity and clarify the definition of boundaries of different reports
 - (f) Appendix- Materiality perspective (EU versus IFRS general purpose financial reports)- *The content in the Appendix is educational in character to help stakeholders with identifying/conceptualising differences in the information in the financial statements, sustainability statement, and the rest of the management report. The usefulness of the Appendix content is to be discussed with EFRAG FR TEG.*

Issue 1: Distinction between financial materiality in the context of sustainability reporting and financial statements information

- 14 For background purposes, the Appendix to this Chapter recaps the materiality perspectives under the EU reporting framework and IFRS general purpose financial reports.
- 15 The analysis of issue 1 is broken into
- (a) Connectivity-related and boundaries-related issues (sub-issues IAS 1.31 application for forward-looking information, and anticipated financial effects)
 - (b) Proposed questions for constituents

Connectivity and boundary question- Issue 1- When should material sustainability information be reflected in the financial statements?

- 16 As conveyed by the 2024 IASB COUFS ED), [2019 IASB education article](#) and [\(updated in a 2023 IASB educational article- Effects of climate-related matters in the financial statements\)](#), IFRS Accounting Standards (i.e. both general requirements and specific standards) have implicit requirements for entities to either reflect material climate-related and other uncertainties or to explain why these uncertainties were not reflected in the financial statements when they were reasonably expected to be material by investors.

- 17 Nonetheless, 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](#)⁹ and [UKEB September 2023 report](#)).

Sub-issue 1 of Issue 1: Disclosure of material sustainability matters based on qualitative materiality assessment

- 18 Paragraph 31 of IAS 1 [Paragraph 20 of IFRS 18] requires an entity to consider whether to provide additional disclosures when compliance with the specific requirements in IFRS Accounting Standards is insufficient to enable users of financial statements to understand the effect of transactions and other events and conditions on the entity's financial position and financial performance. In applying paragraph 31 of IAS 1 [paragraph 20 of IFRS 18], the entity determines that additional disclosures to enable users of financial statements to understand the effect of the announced regulation on the entity's financial position and financial performance would provide material information. That is, omitting this information could reasonably be expected to influence decisions that primary users of the entity's financial statements make on the basis of those financial statements.
- 19 It is, however, noted that during the review of companies' reports, there were hardly any observable examples of this paragraph being applied. This could be seen as evidence of the earlier stated concerns about the limited application of the qualitative materiality assessment.
- 20 Nonetheless, in its comment letter response to the 2024 IASB ED Climate-related and other uncertainties in the Financial Statements, EFRAG acknowledged that paragraph 31 of IAS 1 is an essential requirement within IFRS accounting literature, as it can be applied to ensure the reporting of material information in the financial statements (including in the context of connectivity) that is not required by specific IFRS accounting requirements as was the

⁹ 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.

case with the IASB ED Example 1¹⁰ (statement of immaterial exposure) and Example 5¹¹ (additional information disclosed).

- 21 At the same time, during EFRAG’s outreach, it has been apparent that there are diverse interpretations¹² of when paragraph 31 of IAS 1 is applicable, and there is a concern from some stakeholders about its stretched application (i.e., a focus on what is missing at a line-item level instead of assessing materiality by viewing financial statements holistically).

¹⁰ Fact pattern- 2024 IASB COUFS ED Example 1: The entity is a manufacturer that operates in a capital-intensive industry and is exposed to climate-related transition risks. To manage these risks, the entity has developed a climate-related transition plan. The entity discloses information about the plan in a general purpose financial report outside the financial statements, including detailed information about how it plans to reduce greenhouse gas emissions over the next 10 years. The entity explains that it plans to reduce these emissions by making future investments in more energy-efficient technology and changing its raw materials and manufacturing methods. The entity discloses no other information about climate-related transition risks in its general purpose financial reports.

The entity concludes that its transition plan has no effect on the recognition or measurement of its assets and liabilities and related income and expenses because: (a) the affected manufacturing facilities are nearly fully depreciated; (b) the recoverable amounts of the affected cash-generating units significantly exceed their respective carrying amounts; and (c) the entity has no asset retirement obligations. There are no required disclosures under specific IFRS Standards (IAS 16, IAS 36 and IAS 37). As users would reasonably expect impact on the financial statements, applying IAS 1.31, the entity discloses its transition plan has no effect on its financial position and financial performance and explains why.

¹¹ Fact pattern- 2024 IASB COUFS ED Example 5: The entity operates in a jurisdiction whose government has announced regulation that would restrict the entity’s ability to operate and generate profits in that jurisdiction in the future. The announced regulation does not relate to taxation. However, the regulation could significantly affect the entity’s profitability and, therefore, its ability to recover the carrying amount of its deferred tax asset for the carryforward of unused tax losses. The regulation has not yet been enacted at the end of the reporting period. It is uncertain when the announced regulation would be effective. The government has stated that, because of other priorities, it will not discuss the regulation further in the next two years, a period that extends beyond the end of the entity’s next financial year. This information cannot be disclosed based on paragraph 125 of IAS 1 (paragraph 31A of IAS 8) as the entity determines that, in the next year, it is unlikely to change its assumption about changes in regulation.

Without this additional information, the decisions users of the entity’s financial statements make could reasonably be expected to be influenced by a lack of understanding that the announced regulation could have resulted in a material write-down of the deferred tax asset (and a related deferred tax expense) had the entity assumed the announced regulation would become effective earlier.

Therefore, applying paragraph 31 of IAS 1 [paragraph 20 of IFRS 18], the entity discloses information about: (a) the assumption that the announced regulation will become effective only after the entity has been able to utilise the unused tax losses; and (b) the effect of this assumption on the carrying amount of the entity’s deferred tax asset (for example, the entity discloses the amount of the deferred tax asset it recognised based on this assumption).

Case analysis: Should climate-related commitments and other forward-looking information be disclosed in the financial statements based on IAS 1.31?

- 22 This discussion of whether climate-related commitments should be disclosed in the financial statements arose in the context of the April 2024 IFRIC agenda decision¹³, which clarified that a public statement on net zero commitments would only be a constructive obligation if it created a valid public expectation. Thereafter, a provision would only be recognised if there is a past event and an expected outflow of economic resources. The agenda decision did not address disclosures.
- 23 In response to the consultation to the April 2024 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. Moreover, during the outreach done while developing the 2024 EFRAG connectivity publication, users indicated that the disclosure of a time series of likely costs would be useful even if such commitments do not qualify to be recognised as provisions or disclosed as contingent liabilities.
- 24 During EFRAG’s conversations with other stakeholders, it was considered whether IAS 1.31 could be applied to include disclosures of these climate-related commitments in the financial statements.
- 25 **View supporting disclosures of climate-related commitments in the financial statements based on IAS 1.31:** Stakeholders supporting disclosures argued that this should be done based on IAS 1.31 requirements. They noted that although IFRS S1, IFRS S2 and ESRS have requirements for the disclosure of anticipated financial effects, these requirements may not explicitly capture information investors and stakeholders expect to be reported and/or forward-looking information suited to be disclosed in the financial statements. Reference could be made to paragraph 3.6-b of the Conceptual Framework for Financial Reporting which requires consideration of whether information is useful for users.
- 26 **View against disclosures of climate-related commitments in the financial statements:** Other stakeholders¹⁴ noted that applying IAS 1.31 to include disclosures on net-zero commitments would be too liberal an interpretation of these general IFRS Accounting

¹³ Fact pattern addressed by the March 2024 IFRIC agenda decision: 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.

¹⁴ April 2024 IFASS meeting members’ discussions during breakout groups.

requirements. A view was expressed that IAS 1.31 ought to be only invoked in specific circumstances where an entity is misinterpreting the essence of the specific disclosure requirements, rather than it being seen as a substitute/alternative to specific disclosure requirements and a way of capturing broad topics. If IAS 1.31 can capture broad topics, what is the purpose of having specific standards for specific topics? It was also considered that this requirement should only relate to transactions, events and conditions affecting the current financial position and financial performance, and not to possible future financial position and financial performance items.

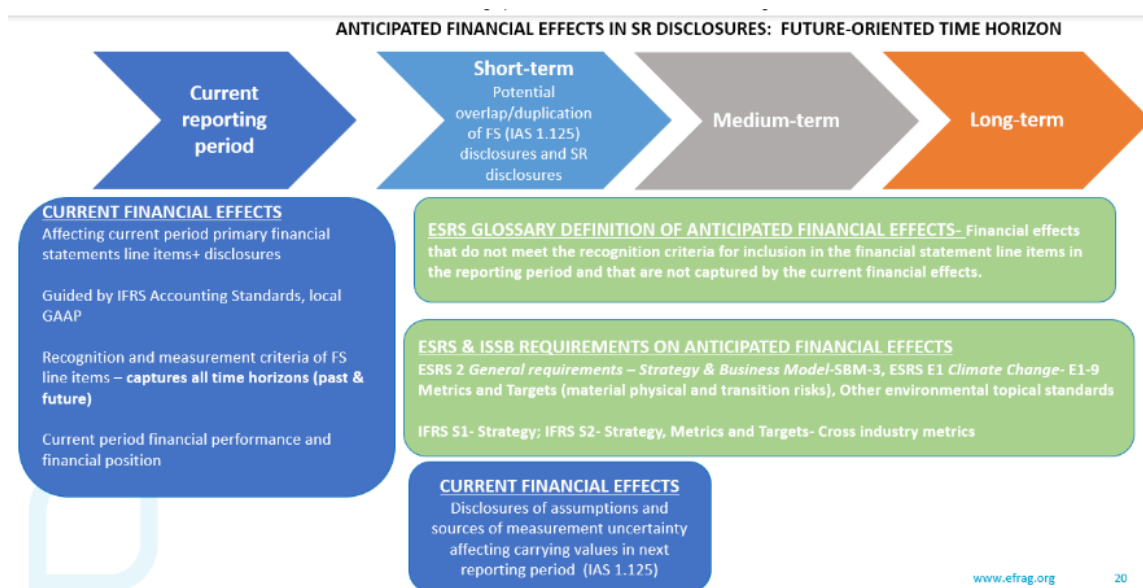
- 27 *Need to consider materiality holistically before applying IAS 1.31*: In response to the IASB ED Climate-related and other uncertainties in the financial statements, some stakeholders expressed concern about the stretched application of IAS 1.31. Correspondingly, while updating the IASB ED examples in response to the feedback, the IASB staff has suggested amendments to the wording of the qualitative materiality examples (Examples 1 and 2). These amendments make clear that IAS 1.31 is applied after stepping back and considering materiality in the context of the entire financial statements and not on a line-item basis.
- 28 *Avoiding unnecessary duplication*: The application of IAS 1.31 requirements may be constrained by consideration of possible disclosure overload. Moreover, some stakeholders have asked why entities should repeat in the financial statements information that should and will likely be disclosed in the sustainability statement/disclosures under ESRS E1 and IFRS S2 requirements. In their view, having such disclosure in the financial statements leads to redundancy and imposes a double reporting burden. Of note, as an example of connected information, IFRS S1.B40-c states that *‘if an entity committed to a particular sustainability-related target, but that commitment has not yet affected the entity’s financial position or financial performance because the applicable recognition criteria have not been met, connected information will depict that relationship.’*

Sub-issue 2 of Issue 1: Relationship between sustainability reporting-disclosed anticipated financial effects and financial statements information

Overview of anticipated financial effects

29 As depicted in the diagram below (Figure 4.2), ESRS and ISSB Standards have requirements for the disclosure of the current and anticipated financial effects of sustainability-related risks and opportunities over the short-, medium- and long-term.

Figure 4.2 Definitions of Current and Anticipated Financial Effects



- 30 As noted, the anticipated financial effects requirements are transitional requirements that will be phased in for wave 1 of ESRS reporting (i.e. pre-Omnibus ESRS) and ISSB Standards. The updated ESRS requirements under Omnibus are yet to be decided and will likely only be reflected in reports issued after 2027. Hence, even though Chapter 3 has illustrations of disclosures of anticipated financial effects, their reporting is not common.
- 31 As noted earlier, anticipated financial effects could a) overlap with information in the current period financial statements, b) crystallise in future period financial statements (i.e. intertemporal connectivity), and c) fail to crystallise in future period financial statements. Thus, as done below, it is useful to distinguish situations where disclosed anticipated financial effects are likely to crystallise in future financial statements from those where these anticipated financial effects reflect all possible outcomes (e.g. scenario analysis information) rather than probable outcomes.
- 32 **Disclosure of anticipated financial effects overlaps with current period financial statements:** Short-term anticipated financial effects could be sustainability-related risks and opportunities that 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, these anticipated financial effects disclosures may duplicate the financial statements’ disclosures made under IAS 1.125 requirements (i.e. disclosures of sources of estimation uncertainty).
- 33 Apart from the disclosures under paragraph 125 of IAS 1, the notes to the financial statements can include forward-looking information (e.g., commitments and Capex projections) and could be also reflected in the medium to long-term estimates of future

cash flows used to determine the carrying amount of assets and liabilities (e.g. in goodwill and asset impairment and fair value measurement of assets and liabilities). In this manner, duplicative reporting may arise if/when similar information is disclosed as anticipated financial effects in the sustainability statement/disclosures while being disclosed in the financial statement or embedded in the recognised amounts of assets and liabilities.

34 **Disclosed anticipated financial effects that crystallise in future period financial**

statements: Some of the disclosed anticipated financial effects arising from sustainability-related IROs may crystallise in an entity's future period financial statements. In effect, there can be a migration in reporting the financial effects of IROs from sustainability statement/disclosures and other sections of the management report into the financial statements over time across different reporting periods. This migration could occur due to the change in nature, quantifiability, magnitude/severity, probability of occurrence, or occurrence of a particular risk or opportunity (and its associated financial effects).

35 Hence, entities enabling the understanding and monitoring of the noted migration of information across reporting periods can be a key element of connectivity as it could explain and highlight the evolving nature of the financial effects of IROs.

36 Relatedly, for these financial effects, the question is, what are the triggers/indicators of migration of the financial effects from the sustainability statement/disclosures to the financial statements? For instance,

- (a) before a decommissioning provision is recognised, what information could enable users' anticipation of such recognition?
- (b) Sustainability-related research and development expenditures on carbon capture technologies that are not recognised as assets- what would be an indicator that this information will likely be recognised as an asset or disclosed in the financial statements in the future?
- (c) Is there any relationship between the write-down of stranded¹⁵/unrecognised assets reported in the management report or sustainability statement/disclosures and the impairment of assets in the financial statements?

¹⁵ Under ESRS, Stranded assets are understood as the active or firmly planned key assets of the undertaking with significant **locked-in GHG emissions** over their operating lifetime. Firmly planned key assets are those that the undertaking will most likely deploy within the next 5 years. The amount may be expressed as a range of asset values based on different climate and **policy scenarios**, including a scenario aligned with limiting climate change to 1.5°C.

- 37 **Disclosed anticipated financial effects that may never crystallise in future periods’ financial statements:** Some of the anticipated financial effects disclosed in sustainability reporting may never crystallise in an entity’s future financial statements. Inter alia, this could be due to a) outcome/occurrence uncertainty (e.g., climate physical risk may never crystallise); and b) estimation uncertainty due to the nascent methodologies for estimating sustainability matters (climate transition risk, biodiversity risk). Hence, the assumption of intertemporal connectivity (connectivity across reporting periods) falls apart in such instances and there will be no continuity across periods in the reporting of the item that was depicted as an anticipated financial effect.

Stakeholders preliminary feedback on anticipated financial effects

- 38 During EFRAG’s outreach, users and several other stakeholders have indicated that the disclosures of anticipated financial effects in the sustainability statement/disclosures are useful for the analysis of the companies’ prospects and risk profile. At the same time, users have noted that this information would be more useful if it were comparable. On the latter point, there has been an acknowledgement that ESRS and ISSB standards will be a step towards providing comparable information across companies. Moreover, users have noted that even if this type of disclosure is currently rare, if disclosed by a reporting entity, they can use it to engage with the management of the reporting entity’s competitors.
- 39 Though useful for investors, the following points of attention on anticipated financial effects have been raised by stakeholders:
- (a) *Definition of anticipated financial effects is too broad:* For instance, it is not clear whether these are future balance sheet items, expenses, cash items or non-cash items; or whether they refer to maximum exposure or expected value of the financial impact. As such, there is a varied interpretation of what the term means. Some stakeholders interpret it as a requirement for detailed cash flow forecasts, while others equate it to capital commitments. Others have indicated that a clearer distinction between the CapEx and OpEx components of forward-looking capital expenditures would be helpful. There is also uncertainty regarding the necessary granularity, both quantitative and qualitative, of the required disclosures.
 - (b) *Absence of standardised, comparable methodologies:* Not only can anticipated financial effects be difficult to quantify, but there are also inconsistencies in the measurement approaches for the measurement of anticipated financial effects. In this regard, some stakeholders have noted that if companies apply appropriate

methodologies to estimate these effects, the resulting information can be highly valuable to users.

- (c) *Confidentiality of forward-looking information*: Anticipated financial effects are construed by the same stakeholders as being related to commercially sensitive forward-looking information. To mitigate this concern, some stakeholders have suggested the approach for asset impairment (i.e. disclosing relevant information without revealing all sensitive data that companies usually safeguard) should be adopted for anticipated financial effects.
- (d) *Risk of misinterpretation*: This risk arises because
 - (i) As noted earlier, some of the disclosed anticipated financial effects may never crystallise in future period statements.
 - (ii) These disclosures could invite scrutiny over what ought to be reasonable discrepancies between forecasted and actual figures, potentially generating more questions than clarity.

Constituents' perspectives on issue 1- distinguishing materiality in financial statements and sustainability statement/disclosures

40 Based on the above analysis, the Discussion Paper could seek constituents' views on the following:

- (a) *Disclosure of material sustainability matters in the financial statements based on qualitative materiality assessment*. Some stakeholders have called for related application guidance. Is this needed or do the examples in the IASB ED on Climate-related and other uncertainties in the financial statements and the IASB materiality practice statement suffice?
- (b) *Overlaps (disclosed anticipated financial effects in sustainability statement/disclosures versus financial statements information)*: Is overlapping information a concern for constituents?
- (c) *Connection of sustainability reporting-anticipated financial effects to future financial statements*: What are constituents' views on the indicators/triggers of when anticipated financial effects disclosed may migrate to or be related to the financial statements information in future periods (e.g. indicators for the recognition of decommissioning provisions and/or recognition of expenditure on carbon capture technologies as assets, and the write-down of stranded, unrecognised assets that is indicative of impairment of assets in the financial statements)?

Issue 3: Placement principles for grey areas

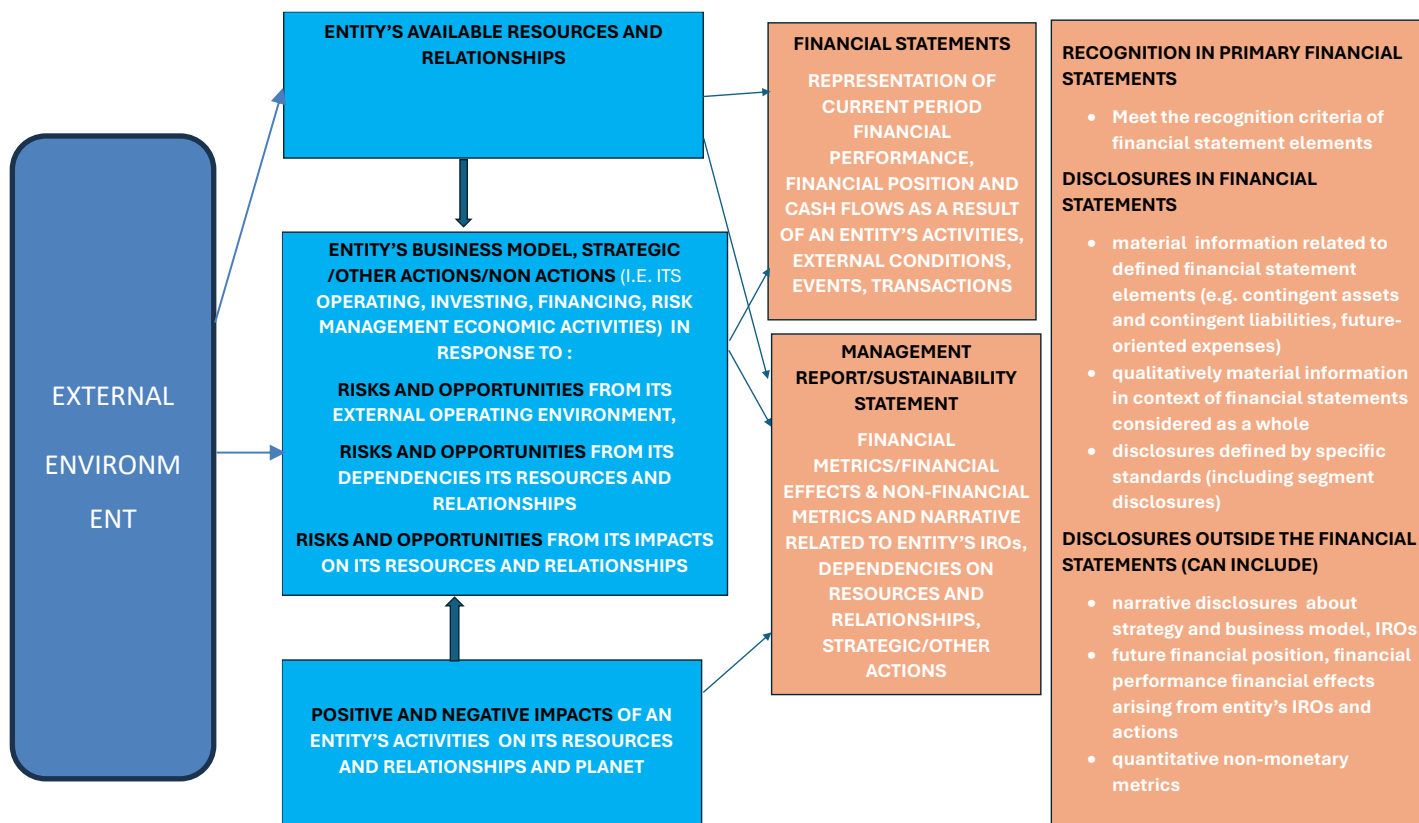
- 41 There are grey areas (i.e. items whose information could be material for disclosure both within and outside the financial statements) that result in questions about the appropriate placement of these items. The rest of this section is broken down into
- (a) Principles for determining whether information should be disclosed within or outside the financial statements
 - (b) Cases of grey areas (sustainability-related intangibles including some of the human capital disclosures)
 - (c) Questions for constituents

Principles for determining whether information should be disclosed within or outside the financial statements

Overarching framework- what triggers external reporting outcomes

- 42 To consider what should be reported within and outside the financial statements, as a starting point, the below diagram (Figure 4.4) delineates how an entity's reporting outcomes flow from the interplay between its strategy, business model and actions in response to a) its available resources and relationships, and b) the risks and opportunities that arise from its external environment, its dependencies on its available resources and relationships, and its impacts.

Figure 4.4 Interplay between entity’s events, conditions, actions and reporting outcomes









Source: EFRAG - Reporting outcomes (including financial effects reported within and outside the financial statements) are depicted in beige-coloured boxes.

43 Below is a definition of the terms applied in the above diagram

- (a) An **entity’s external environment** encompasses: (a) its direct environment—the industries and markets in which the entity interacts with its customers, suppliers, and competitors; and (b) the wider environment including the legal, regulatory and economic environment; the political, technological, social and cultural landscape; and the natural environment (Sourced from MCPS ED).
- (b) **Metric (financial and non-financial metrics)**- A measure used to monitor a quantitative or qualitative aspect of an entity’s financial or non-financial performance or position (Sourced from MCPS ED).
- (c) **Financial effects**: Financial effects are the financial metrics depicted as an entity’s assets (controlled economic resources) or potential assets, commitments/obligations, claims, current or potential income, and current or potential expenses. It also encompasses qualitative or quantitative descriptions of effects on an entity’s cost of capital and access to finance.

- (d) **Resources and relationships.** The diagram below (Figure 4.5) has examples of resources and relationships. These can span across an entity’s own operations (e.g. financial, intellectual property, manufacturing), upstream and downstream value chain (e.g. social), and external environment (e.g. natural).
- (e) **Dependencies-** How an entity directly or indirectly depends on resources and relationships to generate future cash flows.

Figure 4.5 Examples of resources and relationships

 Human	 Intellectual	 Financial	 Natural	 Manufactured	 Social
<ul style="list-style-type: none"> • Entity’s workforce • Workers in supply chains 	<ul style="list-style-type: none"> • Patents • Copyrights • Trademarks 	<ul style="list-style-type: none"> • Cash • Investments • Access to financial resources 	<ul style="list-style-type: none"> • Land • Water • Minerals • Raw materials 	<ul style="list-style-type: none"> • Machinery • Equipment • Buildings • Infrastructure 	<ul style="list-style-type: none"> • Stakeholder relationships • Customers • Indigenous communities

Source: 2024 ISSB educational material

Requirements for disclosures of information in the financial statements, management report, and sustainability reporting

- 44 **Financial statements:** The recognition of elements of primary financial statements (assets, liabilities, income, expenses, equity) is guided by the requirements of accounting standards (e.g. IFRS Accounting Standards). Unlike the management report and sustainability statement/disclosures which consider all resources and relationships available to the reporting entity, financial statements only depict resources (and claims on resources) owned by the reporting entity. Figure 4.6 outlines other key differences between the financial statements, the management report, and the sustainability statement under the EU reporting architecture.
- 45 For IFRS reporting entities (including EU-listed entities), the disclosures in the financial statements result from the IFRS Accounting general and specific requirements. In general, the following can be considered the guiding principles for the disclosures of information in the financial statements.
- (a) Disclosures should only relate to defined assets and liabilities (including contingent liabilities) and thus should be guided by specific IFRS Accounting Standards.
- (b) Disclosures are provided if deemed material for financial statements by users and done on the basis of general requirements under IAS 1.31 (paragraph 20 of IFRS 18)

- 46 The guidance for developing and drafting disclosure requirements (developed after the completion of the *Disclosure Initiative – Targeted Standards Level Review of Disclosures* project) indicated that disclosures can include information about unrecognised assets and liabilities including information about their nature and the risks arising from them.
- 47 Management report, sustainability statement/disclosures: For EU entities, the sustainability statement within the management report is prepared based on ESRS requirements and the management report is prepared based on the EU Accounting Directive and country-specific requirements.

Figure 4.6: Comparison of different AR sections (EU corporate reporting)

Financial statements (FS) (Source: Conceptual Framework)	Management report (Source: EU Accounting Directive)	Sustainability statement (Source: EU Accounting Directive and ESRS)
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 depends on financial control, separability of items, existence/occurrence and measurement uncertainty considered Reporting entity- entities in scope of consolidation depend on financial control	Reflects entity’s performance, position and development; it is traditionally a part of <u>general purpose</u> financial reporting with financial materiality perspective Under CSRD, management report can be deemed to be part of <u>general purpose</u> sustainability reporting Provides description of principal risks and uncertainties Primary audience is knowledgeable user Implicit that it has same reporting entity as FS	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 economy 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)		

Source: 2024 EFRAG Connectivity Considerations and Boundaries of Different Annual Report Sections

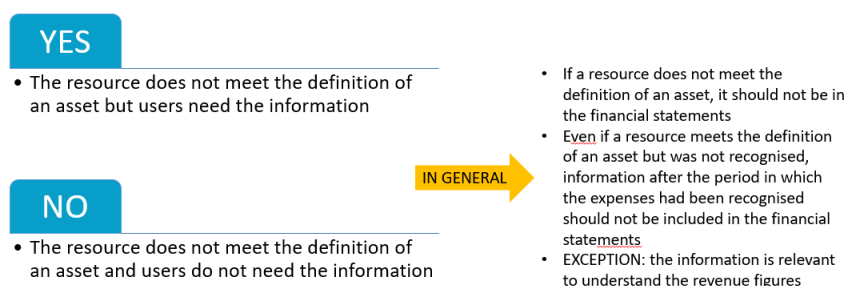
- 48 Determining the location of disclosures of grey areas: Notwithstanding the robust IFRS accounting requirements for disclosures in the financial statements reported under IFRS, and the recent requirements under ESRS and ISSB Standards, there are grey areas as noted (e.g. disclosures of climate-related commitments or unrecognised intangibles). These grey areas necessitate further conceptualisation on what ought to differentiate the placement of disclosures within and outside the financial statements.

Issue 3: connectivity and boundaries considerations- suggested placement principle for selected grey areas (unrecognised intangibles)- **section under development**

Case analysis- Aspects of sustainability-related intangibles (human capital disclosures) that should be reported in the financial statements

- 49 Discussions on the placement of information have been held at EFRAG in relation to climate-related commitments, unrecognised intangibles, and synergies realised as a result of business combinations. The discussion on unrecognised intangibles was in the context of the mixed feedback received on the 2021 EFRAG Discussion Paper¹⁶ *Better Information for Intangibles*. If a resource does not meet the definition of an asset, consistent with paragraph 3.6-b of the Conceptual Framework for Financial Reporting, whether it should be disclosed in the financial statements would depend on users’ needs. As a general rule, information on these resources should be placed outside the financial statements.
- 50 A corollary of the above is that, for resources that would meet the definition of an asset but had not been recognised, information after the period in which the expenses had been recognised, should, as a general rule, be placed outside the financial statements unless information about the asset was relevant for understanding the revenue figures of an entity. Information on items that could be said to have a value (although not meeting the definition of an asset) could (but not necessarily should) be provided in the financial statements.
- 51 The implication of EFRAG’s suggested approaches (see the diagram below- Figure 4.7) is that:
- (a) Some of the information not provided in the financial statements should be included in sustainability reporting (e.g., information on staff training).
 - (b) Information on ‘future-oriented expenses’ should be placed in the financial statements.

Figure 4.7 Should intangibles be disclosed in the financial statements?



¹⁶ EFRAG 2021, [Better information on intangibles - Which is the best way to go?](#)

Issue 4: Implications of differences in the organisational reporting boundaries of financial statements and sustainability reporting

Organisational reporting boundaries for financial statements and sustainability reporting

- 52 Under financial accounting (e.g. IFRS 10 *Consolidated Financial Statements*), consolidation of line items in the primary financial statements occurs when the investor controls¹⁷ the investee entity, while the equity method of accounting (e.g. under IAS 28 *Investments in Associates and Joint Ventures*) is applied when the investor has significant influence¹⁸ and the reporting entity's/investor's share of the net assets of its equity-accounted investees (joint venturers or associates) are deemed to be within the boundaries of the reporting entity. Under sustainability reporting, in many cases (e.g. for several topical ESRS standards including the social and governance standards), the scope of consolidation is the same as that of financial statements.
- 53 However, as shown in the [EFrag Implementation Guidance- Value Chain \(IG 2\)](#) and several audit firm publications¹⁹, there are several key differences between the sustainability reporting and financial statement reporting boundaries including:
- (a) The notion of operational control²⁰ of an investee (which does not exist under IFRS Accounting Standards) can be applied when reporting (i.e. consolidating GHG emissions) under the ESRS (E1 Climate Change) and ISSB Standards. The former allows and the latter requires the application of the GHG protocol²¹. An operational

¹⁷ Under IFRS 10, an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Power is defined as existing rights (voting rights or embedded in contractual arrangements) that give the current ability to direct the relevant activities.

¹⁸ According to IAS 28, the existence of significant influence by an entity is usually evidenced in one or more of the following ways: a) representation on the board of directors or equivalent governing body of the investee; b) participation in policy-making processes, including participation in decisions about dividends or other distributions; c) material transactions between the entity and its investee; d) interchange of managerial personnel; or e) provision of essential technical information. The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence.

¹⁹ PwC, 2024, Chapter 3- Boundaries of sustainability reporting

²⁰ In Appendix II, Table 2 (Definitions in the ESRSs), operational control is defined as "a situation in which the (reporting) entity has the ability to direct the operating activities and relationships of the entity, site, operation or asset".

²¹ The GHG protocol enables companies to measure and report their direct and indirect emissions (i.e. scope 1 and scope 2 emissions), as well as both their upstream and downstream scope 3 emissions. When being initially developed, the GHG Protocol aimed for consistency of its consolidation approaches with accounting requirements, For this reason, it is aligned with IFRS accounting requirements in the application of the notion of financial control

control approach can also be applied for the consolidation of metrics reported under ESRS E2 *Pollution* and ESRS E4 *Biodiversity and Ecosystems*. When applying the operational control approach, the organisational reporting boundary can extend beyond that applied for the consolidation of financial statements information to include own operations (a term used under ESRS but not ISSB Standards) and the entity's upstream and downstream value chain. ESRS 1.62 states that own operations include the following:

- (i) Parent entity or holding company;
 - (ii) Consolidated subsidiaries including subsidiaries that are less than wholly owned;
 - (iii) Leased assets;
 - (iv) Joint operations; and
 - (v) Entities, assets, operations, and sites under operational control, where required by topical ESRS. For example, according to ESRS 1.AR 40, operational control exists when the entity has the licence or permission to operate the assets of unconsolidated joint ventures, associates, non-significant subsidiaries, and contractual arrangements.
- (b) There is no equity method of accounting under sustainability reporting
- (c) Immaterial unconsolidated subsidiaries for the financial statements can be in the scope of consolidation of sustainability reporting if they have material sustainability-related IROs.

54 Figure 4.9 below highlights the differences between the consolidation of line items of investees in the financial statements and the consolidation of GHG emission metrics of

(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 including

a) 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). In contrast, the IFRS accounting requirements do not have the notion of operational control.

b) 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.

c) IFRS accounting requirements have the notion of significant influence over investees (i.e., for associates and joint venture) 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, there may be inconsistency between financial statements treatment and GHG protocol consolidation approaches on investee entities or assets that are not part of the consolidated group. Of note, the GHG protocol is currently being updated.

investees if an operational control approach is applied for consolidation in the sustainability statement/disclosures (i.e. under ESRS E1 *Climate Change*).

Figure 4.9: Similarities and differences in the reporting on investees

	Common characteristic(s)	Accounting treatment	Measuring impacts by metrics in ESRS E1 standard
Subsidiaries	Control (as defined in IFRS 10) – also referred to in this document as ‘financial control’	Include 100% of assets, liabilities, equity, income, expenses and cash flows	Fully included (scope of consolidation is the same as financial reporting)
Associates	Significant influence (as defined in IAS 28)	The investment is recognised as a single line item on the balance sheet (cost adjusted for post-acquisition changes in the investor’s share of net assets). The investor’s profit or loss and other comprehensive income include its share of the investee’s profit or loss and other comprehensive income	<ul style="list-style-type: none"> Operational control: GHG emissions to the extent of operational control (ESRS 1 paragraph 67). Associates that are actors in the value chain (purchases/sales with the investing undertaking): impacts connected to the undertaking’s products and services through transactions; <i>and/or</i> Associates with other business relationships (i.e., investees) as for investments below.
Joint ventures	Joint control (as defined in IFRS 11) with rights to the net assets of the arrangement	Same as associates	Same as associates
Joint operations	Joint control (as defined in IFRS 11) with rights to the assets and obligations for the liabilities relating to the arrangement	Recognise its assets, liabilities, revenue, expenses, including any share from items held jointly	The assets/liabilities of the joint arrangement recognised on balance sheet by the reporting undertaking from part of own operations. In addition, where the reporting undertaking has operational control over its joint operators’ assets, these

	Common characteristic(s)	Accounting treatment	Measuring impacts by metrics in ESRS E1 standard
			will be included under E1 paragraph 50(b)
Investments	All other investments (in the scope of IFRS 9)	Recognised at fair value; dividends in profit or loss; changes in fair value are recognised in profit or loss or other comprehensive income	No specific indications in ESRS E1 metrics on how to measure impacts connected with the undertaking through its investments (except for category 15 of GHG Protocol)

Sources: ESRS Value Chain IG

55 Figure 4.10 below highlights the differences between the consolidation of line items of investees in the financial statements and the consolidation of GHG emission metrics if an operational control approach is applied for consolidation in the sustainability statement/disclosures (i.e. under the GHG protocol which is applied under the ISSB Standards). It shows that, in essence, under the GHG operational control approach, the proportion of ownership does not matter.

Figure 4.10

Company E has investments in multiple non-wholly owned companies.

- The group prepares its financial statements under IFRS Accounting Standards.
- The group applies the GHG Protocol Corporate Standard and elects to use the operational control approach¹³. Under this approach, investments in other operations or companies are included within the organisational boundary, and therefore Scope 1 or 2, if E has operational control.

The following table illustrates the consolidation principles applied for a selection of E's investments.

Investment	Accounting policy under IFRS Accounting Standards	Operational control approach
O Ltd 80%-owned subsidiary; E has operational control	Full consolidation*	100% included
I Pty Ltd 50%-owned joint venture; E does not have operational control	Equity accounting**	0% included
L GmbH 50%-owned joint venture; E has operational control	Equity accounting**	100% included

Source: KPMG

Outreach feedback on organisational reporting boundaries

56 During EFRAG's outreach, stakeholders pointed to challenges that may arise from the different scopes of financial statements and sustainability statement/disclosures including.

- (a) *Risk of misinterpreting GHG and Energy intensity metrics based on revenue.* That is, in cases where the numerator (GHG emissions or Energy consumption) is determined under a different scope of consolidation (e.g. consolidation based on operational

control) from the denominator (revenue) determined based on the financial statements' scope of consolidation (i.e. based on control or 'financial control'). Other stakeholders have indicated that complexity arises when value chain information is presented in sustainability reports, often leading to misconceptions regarding its relevance to financial statements. Greenhouse gas (GHG) emissions were cited as an example, with stakeholders sometimes expecting a direct correlation with revenue figures.

- (b) *Definition of own operations:* Under the sector-agnostic sustainability reporting requirements, in some sectors (financial institutions), the notion of own operations was deemed to be difficult to interpret. It was noted that for industries with more complex structures—such as joint ventures or subsidiaries with shared ownership—determining whether an entity falls under "own operations" or "value chain" can be challenging. However, this difficulty is not in play in other sectors.
- (c) *Operational control:* A preparer from the pharmaceutical industry noted there can be a challenge in distinguishing between operational control and significant influence.

57 *Aligning the scopes of financial statements and the sustainability statement/disclosures:* Related to the above, there are ongoing efforts to update and further align the GHG protocol with the financial accounting requirements. In so doing, inter alia, there is a need to address what, if any, are the differences between an entity having significant influence and having operational control over another entity or asset. Some stakeholders have also noted that some of the subsidiaries may not be material in financial terms, yet may be significant from an impact standpoint, such as when a human rights incident occurs. The question arises as to whether such entities should be included in the scope of the parent company's operations for financial reporting purposes.

58 At the same time, a few stakeholders (including a preparer from the extractive industry) have also pointed to the challenges of having the same scope for the consolidation of financial statements and the sustainability statement/disclosures. They noted that this was more of an issue for non-environmental sustainability-matter indicators, particularly those measured using discrete/categorical data (i.e. in integers) rather than continuous data, for instance, the number of fatalities or the instances of corruption. In their view, an entity stating that it had 0.2 fatalities and 1.3 instances of corruption at a consolidated level did not make sense.

Potential questions for constituents

- 59 Do you agree or disagree with the identified challenges of having similar or different scopes of consolidation between the financial statements and the sustainability statement/disclosures?
- 60 Do the organisational reporting boundaries for climate reporting need to be further aligned to enhance the connectivity in the basis of preparation of financial statements and sustainability reporting information?

Other considerations to enhance connectivity and the definition of boundaries of different reports (to be further developed)

- 61 This section addresses the following:
- (a) The importance of connectivity in process (including governance within organisations) and connectivity in reporting requirements. During EFRAG’s outreach, stakeholders have underscored the importance of these aspects.
 - (b) The need for a sustainability reporting conceptual framework has been severally called for by EFRAG in its commentary to the IASB and ISSB. A conceptual framework could address the measurement methods including discounting principles for anticipated financial effects. It could also enhance the concepts applied such as the notion of operational control and own operations.
 - (c) The importance and role of digitisation, including examining the intersection of digitally tagged reporting/AI in enhancing users' access to reported information.

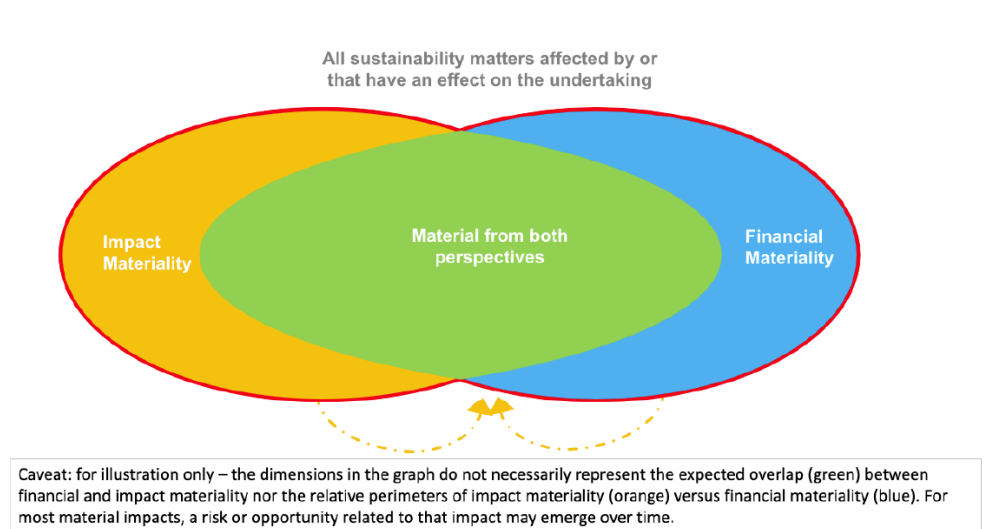
APPENDIX: CHAPTER 4- MATERIALITY PERSPECTIVES (EU & IFRS GENERAL PURPOSE FINANCIAL REPORTS)

- 1 The EU reporting framework and IFRS general purpose financial reports are in the scope²² of this Discussion Paper. Thus, a recap of the application of the materiality concept is done with respect to both these reporting frameworks including the similarities and differences in the objectives and materiality definitions of these different reports (as these are intertwined aspects).

Materiality definition of SR versus financial statements under the EU reporting framework

- 2 Due to the broad set of users of the sustainability statement (primary users of financial statements, affected stakeholders, and other users), as depicted in the below diagram and detailed in ESRS 1 and the [May 2024 EFRAG IG1: ESRS Materiality Assessment Implementation Guidance](#) (EFRAG MAIG), the sustainability statement is prepared from both a financial materiality and impact materiality perspective (i.e., double materiality).

Figure 4.11: Excerpt from the May 2024 EFRAG ESRS Materiality Assessment Implementation Guidance



- 3 *ESRS materiality definitions:* Under ESRS, a sustainability matter is ‘material’ when it is either impactfully material or financially material or both (ESRS 1. 28). A sustainability

²² In Chapter 1, it is noted that that financial statements under IFRS Accounting and local GAAP, the sustainability statement under ESRS within the management report/sustainability-related financial disclosures under ISSB Standards, and information in the rest of the management report (i.e. under the EU reporting framework)/management commentary under the IASB practice statement are in the scope of this Discussion Paper.

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). EFRAG ESRS MAIG Paragraph 37 notes that ‘For most material impacts, a material risk and/or opportunity may emerge over time²³...

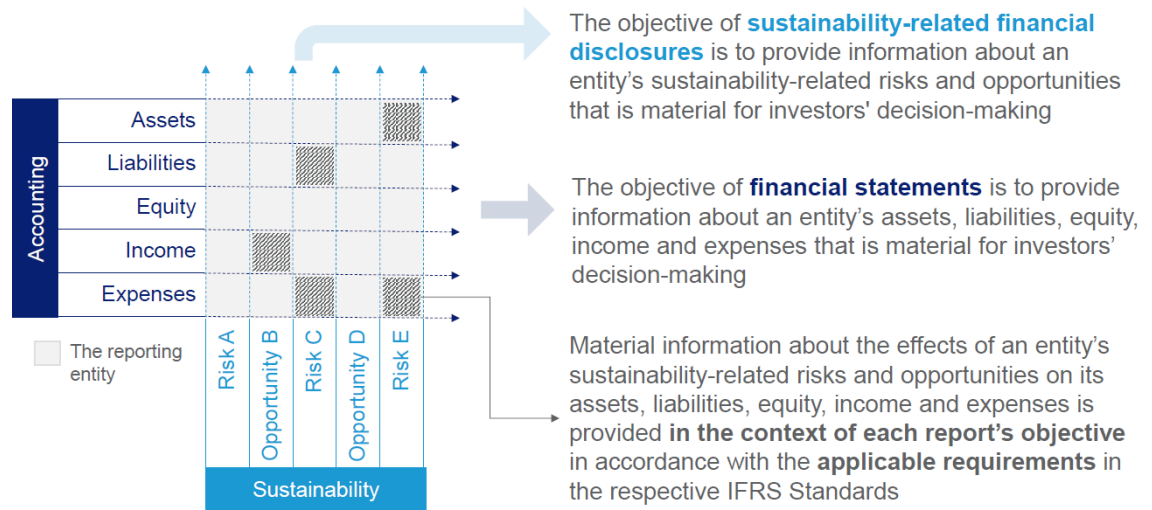
Objectives and materiality definitions of IFRS general purpose financial reports

- 4 Different pieces of guiding literature²⁴ from the IASB and ISSB (i.e. Conceptual Framework for Financial Reporting, Appendix A of IFRS S1 *General Requirements for Disclosures of Sustainability-related Financial Information*, IFRS 18 Presentation and Disclosure in the Financial Statements, and the 2021 Management Commentary Practice Statement ED and related staff papers for the finalisation of the MCPS by 1H 2025) provide definitions that convey the objectives, and materiality definitions of the different IFRS general purpose financial reports (i.e. IFRS general-purpose financial statements, sustainability-related financial disclosures, and management commentary). These different reports have a broad overlapping objective (i.e. to provide useful financial information about a reporting entity to primary users-investors related to providing resources to the entity). They also have distinctive objectives (e.g., general purpose financial statements provide information about financial statements’ elements, and sustainability-related financial disclosures provide information about sustainability-related risks and opportunities). Consequently, as shown

²³ 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.’

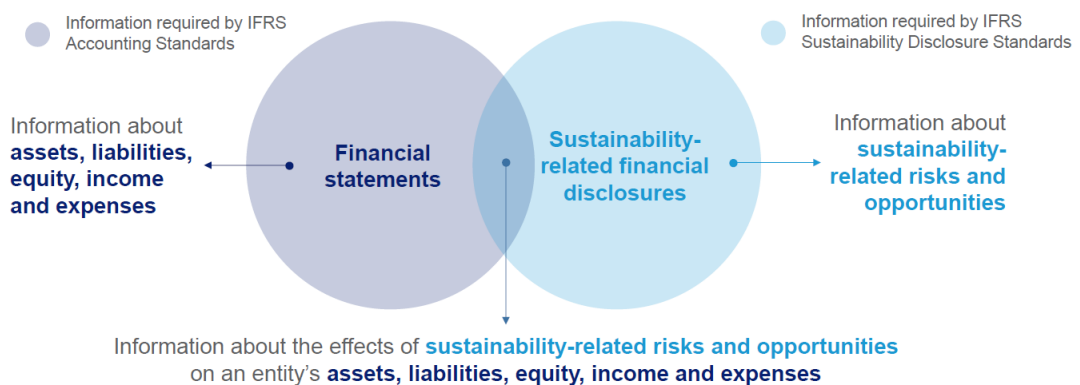
in Figure 4.12 below, the information that is material depends on the context of the respective objectives of each distinctive general purpose financial report.

Figure 4.12:



Source- IASB-ISSB slide presentation at the 2024 World Standard Setters Forum

- 5 The [November 2024 ISSB publication- Sustainability-related risks and opportunities and the disclosure of material information](#) (2024 ISSB materiality educational material) notes that the distinct scopes of the reported information—including differences in relevant time horizons and the types of information required to meet the respective objectives of sustainability-related financial disclosures and the related financial statements—mean that distinct materiality judgements are necessary for those disclosures and the related financial statements. It is also noted that, as depicted in the figure below, sustainability-related financial disclosures that provide information about sustainability-related risks and opportunities are not limited to information about whether those risks and opportunities have affected or relate to an entity's assets, liabilities, equity, income or expenses.



- 6 Moreover, Figure 4.4, which is excerpted from a November MCPS finalisation IASB staff [Agenda Paper 15B](#)- Appendix A indicates there has been an alignment in the definitions of

materiality for the different IFRS general purpose reports with the differentiating factor being the objective of the report (i.e. primary users use different IFRS general purpose financial reports to assess different aspects of the same purpose while making capital allocation decisions).

Conceptual Framework for financial reporting	IAS 1 Presentation of Financial Statements / IFRS 18 Presentation and Disclosure in Financial Statements	IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information	Staff recommendation for refinements to the proposal in the Exposure Draft in mark-up
Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity.	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. Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.	In the context of sustainability-related financial disclosures, information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.	In the context of management commentary, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that investors and creditors make on the basis of general purpose financial reports, which include the management commentary and of the related financial statements and which provide information about a specific reporting entity.

Source: IASB staff paper

7 From the above, a salient difference between financial statements and other general purpose financial reports seems to be that the materiality of financial statements' information is made solely on the basis of financial statements. On the other hand, the materiality of information within sustainability-related financial disclosures under ISSB Standards and management commentary developed based on the MCPS guidance is considered in conjunction with financial statements information.

ESRS versus IFRS general purpose financial reports- similarities and differences in the application of the materiality concept

8 As noted above, ESRS encompasses both financial materiality and impact materiality (i.e., double materiality), and its definition of financial materiality is the same as the definition of materiality for IFRS general purpose financial reports (i.e. financial statements, sustainability-related financial disclosures, and management commentary).

9 Impacts: Though ISSB Standards do not have the notion of impact materiality (and double materiality), they require the disclosure of information about how an entity's activities impact people and the environment when these impacts give rise to sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects, and the related information about those impacts is material to primary users. IFRS S1 explains that an entity's dependencies and impacts give rise to sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects.

- 10 Materiality determination: The materiality determination under ESRS involves two steps: a) determining which sustainability matters/topics are material and should be covered in a sustainability report; and b) determining which information within such matters/topical standards is material and should be disclosed. In contrast, for sustainability-related financial disclosures under ISSB Standards, entities are required to decide which of their sustainability-related risks and opportunities could be reasonably expected to affect the entity's prospects and thereafter to decide which information is material for investors.
- 11 Similarly, related to management commentary, the 2021 MCPS ED and subsequent IASB staff papers²⁵ have requirements for entities to ascertain key matters²⁶ before deciding on the material information. In other words, unlike ESRS, ISSB Standards and the IASB management commentary guidance being developed only refer to material information with no reference to material matters. **This is premised on the IFRS Foundation's view that materiality is a property of information.**
- 12 That said, there still seems to be an implicit two-step approach applied to determine material information for management commentary and sustainability-related financial disclosures under IFRS general purpose financial reports. Hence, the difference may be more of a matter of framing than essence.

²⁵ IASB staff papers on the IASB's tentative decisions whilst finalising the revision of the MCPS.

²⁶ Matters would be identified as 'key' if they are 'fundamental to the entity's ability to create value and generate cash flows'.