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Climate-related and Other Uncertainties in the Financial Statements

Cover Note

Introduction and Objective

1 The objective of the session is for:

(a) EFRAG FR and SR TEG to discuss a draft comment letter on the IASB's Exposure Draft *Climate-related and Other Uncertainties in the Financial Statements* - Proposed illustrative examples, issued by the IASB on 31 July 2024 (the 'ED'); and

(b) EFRAG FR TEG to recommend the draft comment letter to be approved by the EFRAG FRB.

2 Questions to be asked to EFRAG FR and SR TEG can be found in agenda paper 01-02.

Background of the IASB project and introduction to the ED

3 In March 2023, the International Accounting Standards Board (IASB) added to its work plan a project to explore targeted actions to improve the reporting of the effects of climate-related risks in the financial statements.

4 The IASB decided to work on this project because of strong demand from respondents to its Third Agenda Consultation. These respondents were concerned that information about the effects of climate-related risks in the financial statements was insufficient or appeared to be inconsistent with information entities provide outside the financial statements, particularly information reported in other general purpose financial reports.

5 In September 2023, after outreach to stakeholders on the nature and causes of concern related to the reporting on climate-related risks in the financial statements, the IASB decided to respond to stakeholders' concerns by, inter alia, exploring possible illustrative examples. Based on further outreaches[1] conducted in September 2023 - March 2024, in April 2024 the IASB tentatively decided:

[1] The IASB's outreaches included the following meetings: Capital Markets Advisory Committee in October 2023, Global Preparers Forum in November 2023, IFRS Interpretations Committee in November 2023, Accounting Standards Advisory Forum in December 2023 and March 2024.

(a) to provide examples to illustrate how an entity applies IFRS Accounting Standards to report the effects of climate-related and other uncertainties in its financial statements;

(b) to include the examples as illustrative examples that would accompany IFRS Accounting Standards; and

(c) to publish an Exposure Draft (the ED) to obtain feedback from stakeholders about the examples with a 120-day comment period. The ED has been issued on 31 July 2024 with a comment period ending on 28 November 2024.

EFRAG discussions on the IASB project

6 The findings of outreach conducted[2] by EFRAG in Q2-Q3 2023 were aligned with those of the IASB outreach.

7 Furthermore, EFRAG discussed the examples and the vehicle for the examples with various stakeholders and a summary of the feedback is provided in the Appendix to this paper. This feedback has been used as a basis for preparing the draft comment letter.

Next steps

8 Following the recommendation of the EFRAG FR TEG, the EFRAG FRB will be asked to approve the draft comment letter in a joint meeting with the EFRAG SRB on 18 September 2024.

Agenda Papers

9 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 01-02 – Climate-related and Other Uncertainties in the Financial Statements (COUFS) – Draft comment letter; and

(b) Agenda paper 01-03 – IASB Exposure draft - *Climate-related and Other Uncertainties in the Financial Statements* - Proposed illustrative examples.

[2] After the IASB initiated the project in March 2023 and started its outreach, EFRAG concurrently conducted similar outreach on the nature and causes of concerns and possible solutions for the perceived inadequate reporting. EFRAG's outreach and analysis of multiple thematic reviews of EU companies' reporting practices led to the publication of an EFRAG Secretariat Briefing on climate-related risks in the financial statements.

Appendix – Feedback from previous EFRAG discussions

10 The following paragraphs summarise the preliminary feedback received and analysis by the EFRAG Secretariat on the illustrative examples when these were discussed by the IASB in March 2024 and at the March 2024 ASAF meeting. In particular, they reflect the input received at the April 2024 EFRAG FR TEG meeting along with the written input received from EFRAG FR TEG-CFSS and EFRAG Secretariat's analysis on the March 2024 ASAF papers. The EFRAG Secretariat also had discussions on this topic at the 23 October joint EFRAG SR TEG and FR TEG meeting and February 2024 joint EFRAG SRB and FRB meeting.

General comments on the ED and vehicle for the illustrative examples

11 *Overall feedback on the illustrative examples*: The preliminary feedback received by the EFRAG Secretariat is agreement with the IASB's decision to develop the eight illustrative examples to enhance the reporting of climate-related uncertainties. However, it has also been considered useful to add examples related to recognition and measurement requirements (for instance, on how to incorporate climate risk into the expected credit loss measurement). In addition, the feedback has recommended adding examples of:

(a) Materiality assessment with a fact pattern where investors reasonably expect a matter (e.g., climate risk) to be material, but the entity judges it to be immaterial (and the reason/s why this is the case) [alternative fact pattern applicable to examples 1 and 2];

(b) How climate-related uncertainties may affect the determination of fair value under IFRS 13. An EFRAG FIWG member sought clarifications on a suggestion made from feedback from stakeholders, to have an additional example illustrating how climate-related and other uncertainties affect the determination of fair value under IFRS 13. This member considered that such an example would be useful if it addressed issues around the methodology and assumptions used to assess fair value, but it would be too difficult if it sought to illustrate how the fair value of specific assets is determined and, in any case, IFRS 13 already incorporated requirements on uncertainty.

(c) Disaggregation of revenue for business models affected by climate risk (i.e., examples should also cover income statement and not only statement of financial position disclosures) [alternative fact pattern applicable to example 8];

(d) A case where *it is probable that the regulations will be effective* within e.g. 3 years and the regulations will apply *before* the entity has been able to utilise *all deductible temporary differences* [alternative fact pattern applicable to example 5]*;* and

(e) Additional examples on contingent liabilities and provisions under IAS 37. The EFRAG Secretariat notes that this will be addressed by the IASB's project *Provisions—Targeted Improvements*, for which an ED is expected in November 2024.

12 Further, it has been noted that the examples should include how materiality assessment is (ought to be) done by entities applying the four-step process of the Materiality Practice Statement (i.e., identify, assess, organise and review) including having a qualitative materiality assessment that takes the expectations/needs of users into account.

13 Moreover, feedback received indicated that the IASB should further clarify what is encompassed within uncertainties and whether/when these uncertainties fall within the boundaries of the financial statements (as opposed to the management report). It was also noted that the more fundamental question is connectivity-related (i.e., what should be in

the sustainability disclosures versus financial statements, while some of the examples are more of interim guidance).

14 A comment was made that a heavy focus is being placed on IAS 1 to address the reporting challenges (Examples 1,2,4 and 5).

15 Some constituents considered that the issues analysed in each of the examples are very broad and can be applied to any type of risk and not just climate-related risks (e.g., COVID, Brexit, AI, Ukraine).

16 A call was made for the IASB to facilitate access to a central repository of illustrative examples.

17 One EFRAG FR TEG member indicated that consulting on these examples could inform the IASB about whether the practice has developed differently from intended and/or whether amendments to the Standards are needed.

18 The EFRAG FIWG Chair also highlighted the risk of a two-sided misinterpretation of illustrative examples. This misinterpretation pertains to when examples are applied to cases where they are not intended to be applied, and, conversely, when entities fail to map a specific case to the example. In addition, a suggestion was made that as practice develops and there is greater maturity in reporting of ISSB disclosures, the IASB may be better placed to identify and focus on more specific areas where challenges in reporting in the financial statements exist. Members highlighted the need to be alert to the risk of double reporting and to consider connectivity of the examples to multiple sustainability reporting requirements including ESRS.

19 At the September EFRAG FIWG meeting, it was noted that rather than being intended to be an exhaustive or multiple representation of the application of different requirements, each of the examples only focuses on a selection of requirements. Thus, it was suggested that the IASB should add a disclaimer that the purpose of the ED is to only illustrate some of the most relevant disclosure requirements in IFRS Accounting Standards that are applicable to the illustrated fact patterns and an entity would still need to consider other relevant disclosure requirements in order to assess what additional material information needs to be disclosed. Relatedly, in response to a concern voiced by one member that auditors would apply the examples as a checklist, another member noted that auditors consider the entirety of the Standards' requirements to determine the appropriate reporting.

20 One EFRAG FIWG member indicated that an entity needed to provide information that is material instead of, for example, making a recurring disclosure that there is no significant impact.

21 *Vehicle for the illustrative examples*: Although the feedback received by EFRAG Secretariat so far indicates a preference for the incorporation of examples into the impacted IFRS Accounting Standards to ensure their enforceability and endorsement, so far, no disagreement has been expressed about their inclusion in the Illustrative Examples accompanying the Standards.

Main comments received on the other examples

Examples 1 and 2 - Materiality judgements

22 In addition to the suggestion included in paragraph 12 above, preliminary feedback received indicated general support for these examples as they help clarify the concept of materiality (including from both a qualitative and quantitative perspective). They can also lessen the expectation gap on what is deemed material information.

23 It was questioned why paragraph 17(c)[3] of IAS 1 was not referred to.

24 Moreover, it was noted that paragraph 31 of IAS 1 has been applied in the past in some exceptional situations, such as COVID-19, but does not apply to every situation. Doubts were expressed regarding how consistency is ensured between disclosing information on plans to achieve a targeted reduction in greenhouse gas emissions and disclosing information on other plans such as, for example, internationalisation or restructuring plans. When an entity concludes that an event has no effect on its financial position and performance, it is expected that information about this event will not be disclosed. Furthermore, it was also highlighted that the disclosure (or not) of information depending on expectations for the sector the entity operates in introduces a significant subjectivity on the reporting process.

25 As the entity has provided information on its transition plan and GHG emission targets outside the financial statements and has concluded that expectations are created (based on materiality) for additional disclosures to be made in the financial statements, information should be included in the financial statements without the need for cross-referencing.

Example 3 – Specific disclosure requirements IAS 36

26 In order to increase the usefulness of the information provided in accordance with IAS 36.134(f), the example should also illustrate how to determine the extent of a "reasonably possible change" in the key assumptions to be presented in the sensitivity analysis. Furthermore, some stakeholders noted that the example does not illustrate how such a fact pattern might have an impact also on discount rates used for the impairment test; this lack of information might confuse current practice.

27 Another comment received indicated that paragraph 3.6 of the ED (paragraph 3.5 in the March 2024 IASB paper 14B on the IASB staff draft examples) requires firms to disclosure the key assumptions used to compute the value in use, including emission allowance cost assumptions such as the future price of greenhouse gas emission allowances and the potential future increase in scope and stringency of emission regulations. However, IAS 36 requires firms to disclose the key assumptions and not the values assigned to those assumptions (as the future price of greenhouse gas emission allowances).

[3] This paragraph states:

In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity: .. (c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

28 In addition, references are not made to all applicable paragraphs in each example. However, it was noted that, in this case, it should be made clear that the disclosures required by IAS 36.134(d) (iii)-(v)[4] must also be provided (only the disclosures required by IAS 36.134(d) (i) and (ii) are referred to in paragraph 3.5 of the ED).

Example 4 - General disclosure requirements about assumptions in IAS 1

29 Although EFRAG FR TEG members generally agreed with the IASB staff's interpretation of the time horizon of IAS 1.125 - i.e., it refers also to assumptions about uncertainties that will not be resolved within the next financial year, but that have a significant risk of resulting in a material adjustment to the carrying amount of those assets if the entity were to revise those assumptions in the next financial year - they considered that this interpretation may vary among stakeholders. Therefore, they reiterated that examples should not substitute standard setting nor provide clarification.

30 There was a more general comment that "encouragements" to make voluntary disclosures should be deleted from IFRS Accounting Standards (e.g. IAS 36.132, IAS 7.50, IAS 16.79). In this respect, it was highlighted that if the information is material, it must be disclosed. If it is not, then it should not be disclosed, even voluntarily.

Example 5 – Specific disclosure requirements IAS 1/IFRS 18

31 There has been agreement with the IASB staff's intention to illustrate disclosures about sources of information other than those about climate-related risk. However, concerns were expressed about the scenario presented for the following reasons:

(a) Risk of misinterpretation of the disclosure requirements about "not yet enacted/substantively enacted" new laws/regulations as mentioned in IAS 12;

(b) Disclosure of assumptions about a highly uncertain future event:

(i) Does it mean remote probability to occur? Would this example be consistent with IAS 37 requirements?

(c) Other ESG risks besides climate risk could be illustrated.

32 Consistently with paragraph 24 of this paper related to Example 1, it was noted that if an entity concludes that it should recognise a deferred tax asset and the requirements for its

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[4] Paragraph 134 of IAS 36 states:

An entity shall disclose the information required by (a)–(f) for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

…

if the unit's (group of units') recoverable amount is based on value in use:

…

(iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.

(iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/ forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

(v) the discount rate(s) applied to the cash flow projections.

recognition are met, it would not be necessary to disclose the additional information, as is being proposed.

33 An alternative fact pattern on Example 5 was proposed – refer to paragraph 11(d) of this paper.

Example 6 — Disclosure about credit risk (IFRS 7)

34 In addition to the disclosure requirements mentioned in the proposed example (paragraphs 35A-38 of IFRS 7), an EFRAG FR TEG member noted that other requirements in IFRS 7 might also provide useful information in relation to the illustrated fact pattern. For example, the proposed example makes a reference to paragraphs 35A-38 of IFRS 7 and it was suggested to also make a reference to the requirements in IFRS 7.33[5] and 34[6], which refer respectively to the general qualitative and quantitative disclosures about each type of risk arising from financial instruments.

35 EFRAG FIWG expressed overall support for the content of Example 6 of the ED. It was suggested that the example could also encompass the assessment of qualitative materiality under the IAS 1.31 (IFRS 18.20). In this regard, the EFRAG Secretariat notes that the ED focuses on standalone illustrative examples accompanying Standards rather than walkthrough examples. Unlike for the latter, it would be difficult and potentially confusing for stakeholders if standalone examples cover multiple Standards. For instance, this has become apparent in the feedback to example 5, which is meant to address IAS 1/IFRS 18 but touches on IAS 12 and IAS 37.

36 Another broad concern raised on Example 6 was the seeming disconnect between the contextual fact pattern and the description of the application of the IFRS requirements.

Example 7 – Specific disclosure requirements IAS 37

37 The usefulness of the example was questioned, i.e., the fact pattern was considered rare in practice (i.e., the carrying amount of the provision is immaterial because of the discount effect being costs incurred so far into the future). Indeed, in such a fact pattern, a sensitivity analysis - with the long-term time horizon being one of the most relevant assumptions - would provide more useful information.

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[5] Paragraph 33 of IFRS 7 states:

For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

[6] Paragraph 34 of IFRS 7 states:

For each type of risk arising from financial instruments, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IAS 24 Related Party Disclosures), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 35A–42, to the extent not provided in accordance with (a).

(c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

38 In addition, suggestions were made to make more explicit why the proposed information is provided even though it is not quantitatively material and to explore whether disclosure about the undiscounted amounts of future costs.

39 A comment was made that the additional disclosures would not provide useful information, given that the probability of occurrence is already implicit in the judgment about whether it is a provision or a contingent liability.

40 Some asked for the IASB to reconsider the example because of how acceptable it was to assert that because the entity would be in place in perpetuity, there would not be an obligation accrued on the balance sheet.

41 It was also highlighted that it would be more helpful to illustrate how an entity satisfies the requirements in IAS 37.85 about the resulting expected cash outflows.

Example 8 – Specific disclosure requirements IFRS 18

42 One comment was received that the example related primarily to IAS 16/PPE rather than IFRS 18.