INITIAL PAPER-SHORT VERSION

EFRAG CONNECTIVITY PROJECT

CONNECTIVITY CONSIDERATIONS AND BOUNDARIES OF DIFFERENT ANNUAL REPORT SECTIONS

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EFRAG

Europe's voice in corporate reporting

This Initial Paper – short version is issued by EFRAG.

DISCLAIMER

This is an initial paper of EFRAG's project on connectivity between financial reporting and sustainability reporting (EFRAG connectivity project), which is part of EFRAG's proactive research workplan. The purpose of the initial paper is to raise awareness of the articulation and conceptual foundations of the notion of connectivity as primarily reflected in the ESRS' and ISSB Standards' connectivity/connection requirements and of the boundaries of different Annual Report sections. Another objective is to highlight the pivotal role of connectivity in ensuring the coherence and complementarity of the information across the Annual Report. The content of this paper will be incorporated into a Discussion Paper being developed, which will also have practical illustrations of connectivity. Once finalised, the Discussion Paper will be issued for public consultation.

The content of the EFRAG connectivity project initial paper is the result of the technical discussions held by the EFRAG Connectivity Advisory Panel (EFRAG CAP[1]), EFRAG's FR TEG and SR TEG and EFRAG's FRB and SRB (hereafter collectively referred to as 'EFRAG Technical governance bodies') along with a review of the literature including the ESRS 1 *General Requirements* and IFRS Sustainability Disclosure Standards (IFRS S1 *General Requirements* for Disclosure of Sustainability-related Financial Information), other reporting guidance, various publications by EFRAG and NSS, various regulatory thematic reviews and insights from the discussions held on connectivity by EFRAG-organised panels and at the International Forum of Accounting Standard Setters (IFASS) meetings held in 2023/4.

The EFRAG connectivity project's initial paper is non-authoritative. Moreover, the deliverables of EFRAG's research project (i.e., this initial paper and the forthcoming Discussion Paper) are <u>not part of EFRAG's European sustainability reporting standard-setting activity nor should they be read as ESRS implementation guidance</u>. As noted, EFRAG is only issuing this initial paper and will also issue a Discussion Paper as part of its proactive research activities, whereby the objective is to stimulate public debate and influence corporate reporting developments.

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

EFRAG RESEARCH ACTIVITIES IN EUROPE

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European and international constituents and providing timely and effective input to the early phases of the IASB's work. Four strategic aims underpin proactive work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards'), including through engaging with international constituents;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on EFRAG's website.

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OVERVIEW

1 An espoused objective of the Corporate Sustainability Reporting Directive (CSRD) is to have mandatory, robust, comparable, and assured **SR information that has the same footing as financial statements' information prepared under either IFRS Accounting requirements or local GAAP**.

2 In tandem, stakeholders have pointed to the disconnect between financial statements' information and SR information. Notably, the sustainability statement/disclosures of reporting entities convey the impacts, risks and opportunities faced by these entities along with the actions taken including the commitments to meet sustainability policy targets and the allocation of financial resources to meet those targets. Yet, **the corresponding information is either difficult to identify or missing in the financial statements.** Illustratively, entities sometimes omit material sustainability information in the financial statements due to a failure to consider qualitative materiality[2] while assessing whether to report such information in the financial statements. As a result, it can be difficult to connect SR to the financial statements. In effect, **across the Annual Report (AR), there can be a disjointed portrayal of a reporting entity's risk profile and prospects while in reality, the continuity between or complementarity of different AR sections is highly desirable.**

3 There are **different reasons why certain sustainability information may not be reported in the financial statements.** Foremost, are the primarily conceptual differences in the respective nature of financial statements and SR information. Inter alia, these differences arise due to the mainly retrospective orientation of financial statements information versus the forward-looking[3] orientation of SR information; the consideration of legally binding obligations[4] at the year-end in financial statements versus contingent risks and opportunities in SR; and the incorporation of the control approach (for determining the reporting entity and assets recognition) in financial statements versus the inclusion of the value chain impacts, risks and opportunities in SR.

4 Apart from the potentially missing information in financial statements alluded to in paragraph 2, a converse potential problem is that of duplicated reporting across the AR sections in a manner that could impose a double reporting burden for preparers and create the risk of confusion when users analyse corporate reporting information.

5 Moreover, as depicted in Figure 1; the key AR sections, namely, the financial statements, the management report, and the sustainability statement/disclosures have differing historical profiles, objectives, audience types and needs, and levels of maturity. For instance, there are differences in their level of assurance, enforcement, application by capital market participants, and the extent of development of an underpinning robust conceptual framework. Hence, it is not surprising that there are distinct reporting boundaries for the different AR sections (i.e. the information included or excluded within these AR sections).

6 The pivotal role of connectivity arises against the backdrop of the above-noted distinct boundaries as well as the challenges associated with reporting information across the different AR sections highlighted in paragraphs 2 and 4 (i.e., disjointed reporting, perception of missing information, and possible double reporting). Specifically, connectivity can ensure the coherence and complementarity of information across the AR. It also lessens the potential overlaps/duplicated information and gaps/missing information across the AR.

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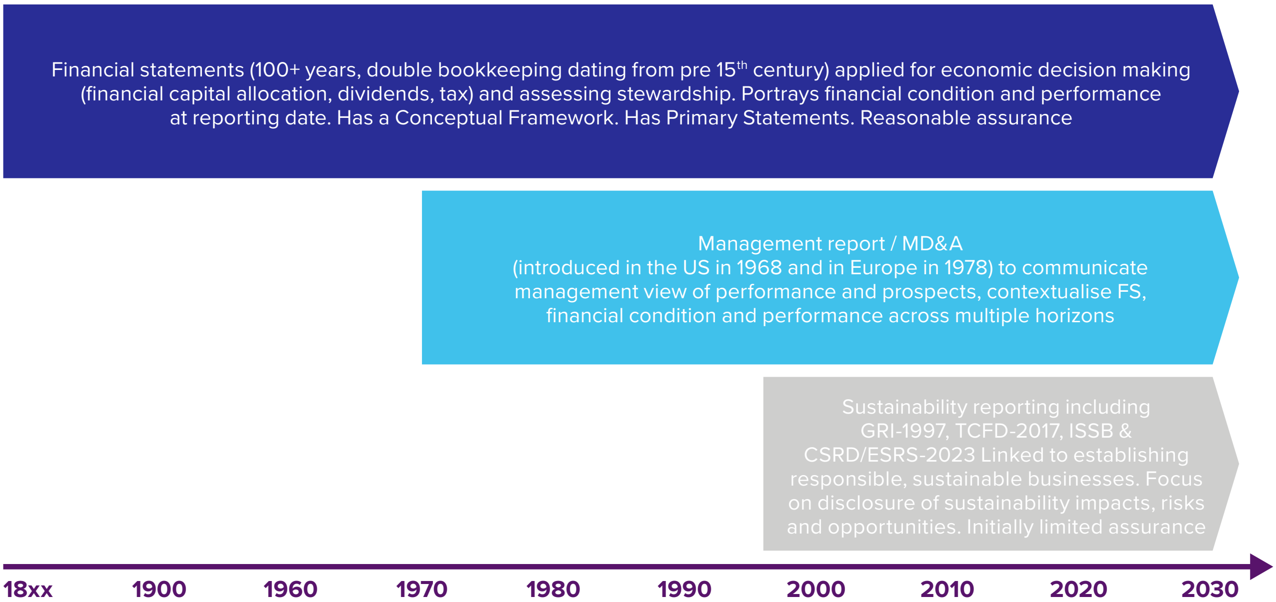
2 For example, the effects of a sustainability matter on financial statement line items may not be quantitatively material yet investors (and other stakeholders) would have reasonably excepted otherwise based on the information reported in other AR sections. In such a case, an explanation of why there are no financial statement effects could be deemed qualitative material information.

3 There are also forward-looking aspects in financial statements line items information and disclosures.

4 Legally binding obligations include contractual and those arising from regulations. IFRS accounting requirements also consider constructive obligations (as highlighted in March 2024 IFRIC agenda decision on climate-related commitments discussed in Section 2.4 of the EFRAG connectivity project initial paper-full version).

Figure 1: Varied evolution of different AR sections



Source: EFRAG

OBJECTIVE OF THE PAPER

Analytical questions

7 The following key questions are addressed in the EFRAG connectivity project initial paper:

a) *What role does connectivity play in an evolving and multi-layered corporate reporting system?*

b) *Linked to the above, are sub-questions including what does 'connectivity' mean? what information can be connected under EU versus IFRS general purpose financial reporting? what are the benefits of connectivity? How does connectivity relate to and how is it impacted by the boundaries of different Annual Report sections? Are there gaps or duplicated information arising from existing boundaries of different corporate reports? What could be the possible solutions to avoid gaps or duplicated information and to determine the best location of certain information?*

Why are we addressing these questions?

8 Apart from guiding the EFRAG connectivity project on the aspects of connectivity to illustrate in the forthcoming Discussion Paper, addressing these questions is **intended to contribute to a shared stakeholder understanding of this relatively nascent and multidimensional concept including how it enhances the usefulness of information.** Of note, connectivity has no commonly accepted definition and it is not included as one of the qualitative characteristics of useful information in the Conceptual Framework for Financial Reporting. That said, there are explicit connectivity/connection requirements in both ESRS and IFRS Sustainability Disclosure Standards. Moreover, connectivity was identified as an essential concept in the preparatory work that preceded these Standards (i.e., the 2021 EFRAG Project Taskforce for Non-financial Reporting Standards (PTF-NFRS) publications and the 2021 IFRS Foundation Technical Readiness Working Group prototype document). It is also embedded as one of the guiding principles in the 2013 and 2021 Integrated Reporting (IR) framework and was implicitly included in the 2017 Taskforce for Climate-related Financial Disclosures (TCFD) recommendations, i.e., via the call for entities to disclose the financial impact of climate-related risks and opportunities on the organisation. Moreover, a related concept (i.e., coherence) was included in the 2021 IASB Management Commentary Practice Statement Exposure Draft (2021 MCPS ED).

9 In the course of the EFRAG connectivity project including during the discussions with the EFRAG Connectivity Advisory Panel (EFRAG CAP) and EFRAG technical governance bodies, it has been clear that there is a varied understanding of what the term connectivity means. Multiple terms are associated with connectivity including complementarity, coherence, consistency, integrated reporting, and integration in reporting. Some of these terms (e.g., coherence, consistency) are sometimes used as synonyms for connectivity. Other times, these terms (e.g. complementarity, coherence, consistency) are applied as only being elements of connectivity. And still, at other times, some of the terms (coherence, integration in reporting) are described as being distinct notions from connectivity. Admittedly, it can be all quite confusing. Moreover, some stakeholders understand connectivity as confined to the connection of information across reports while for other articulations of connectivity (e.g. IFRS S1.21), connections are expected to be made in respect of information within and across different AR sections.

10 **Addressing what connectivity means is not just a case of quibbling over semantics in a manner that is bereft of practical implications.** Apart from potentially lessening the garbled use of the term connectivity, a better and consistent understanding of its different dimensions including its primary purpose, its overarching aspects such as coherence and consistency, the techniques to connect information (e.g., cross-referencing), and the limits of applying these techniques can contribute to the intended enhanced reporting. In this regard, **we give prominence to the integration of information across reports as an aspect of connectivity that is at the heart of enhancing the communication of value creation.**

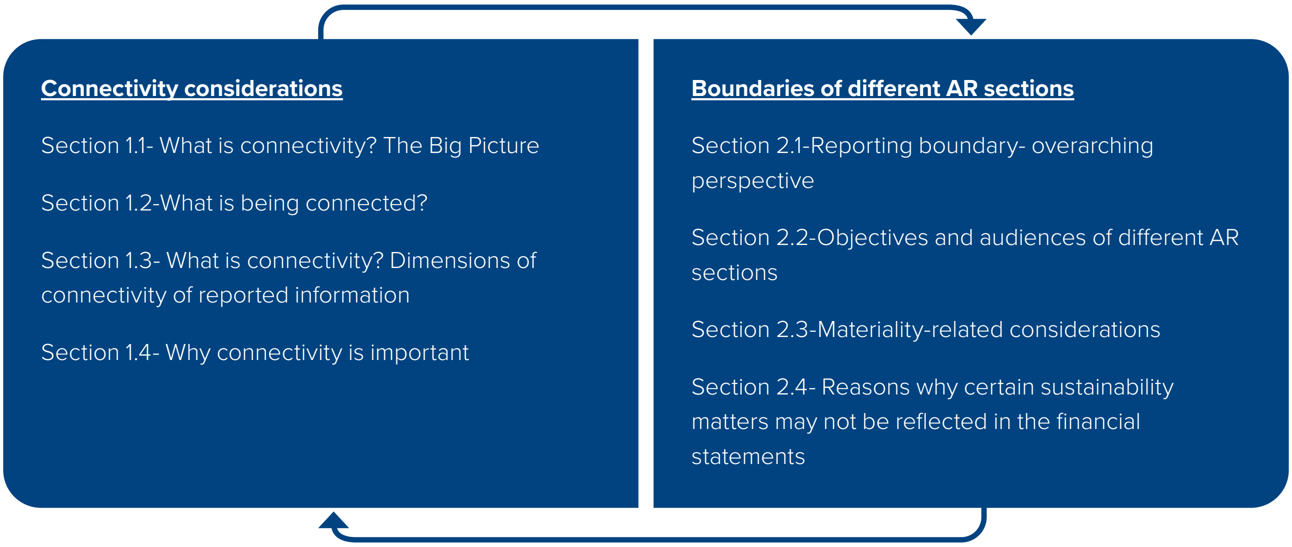
11 This paper also brings **to the fore connectivity in the context of both the EU corporate reporting framework and IFRS general purpose financial reporting.** This is vital to understanding what information can be connected under different reporting regimes.

12 Finally, amidst the backdrop of the ongoing evolution of the corporate reporting system, **there often seems to be an expectation gap regarding which information ought to be reported in the financial statements.** For instance, a few stakeholders have expressed they expect an entity's impacts on the planet and society (i.e., negative and positive externalities) to be reported in the financial statements and there are some ongoing experimental initiatives in this regard. However, the EFRAG connectivity project is undertaken on the premise that the existing distinct boundaries of different AR sections (e.g., for the financial statements) will be retained for the foreseeable future. And it becomes **useful to highlight reporting boundaries and why certain sustainability matters may not be reported in the financial statements.** A particular focus on addressing the boundaries of financial statements is appropriate because, **relative to other AR sections, there is a higher threshold for including information in the financial statements.**

STRUCTURE - CONNECTIVITY CONSIDERATIONS AND BOUNDARIES OF DIFFERENT AR SECTIONS

13 The EFRAG connectivity project's initial paper has the structure indicated in Figure 2.

Figure 2: EFRAG Connectivity project Initial Paper structure



SUMMARY OF KEY MESSAGES/FINDINGS

14 This summary conveys the key messages and findings related to the questions highlighted in paragraph 7 above.

What does connectivity mean?

15 In broad terms, connectivity can be described as the attribute of high-quality information that supports the provision of a holistic and coherent set of information within and across the different AR sections.

16 To translate the above into practical application, we pinpoint the following aspects that are encapsulated within the ESRS and IFRS S1 requirements and other related guidance (see Section 1.3 of the full-version paper):

a) ***Strategic-oriented communication-integration of information to convey entity's value creation and impacts:*** An overarching aspect of connectivity (which we describe as 'integration of information') is communication that links an entity's strategic choices in response to its impacts, risks, and opportunities (IROs) to the resulting reporting effects. As required by ESRS, this entails an entity explaining how its strategy, business model, and IROs are linked to its overall financial performance, sustainability performance, financial position, cash flows and other metrics and targets in the short-, medium- and long-term. For example, this may entail an entity providing disclosures linking the risks faced from its reliance on natural resources to the actions/strategy undertaken to mitigate these risks as well as to the disclosed, and related current and anticipated financial effects (e.g., if a semiconductor manufacturer has operations in a water-stressed location, it may explain how this risk has affected the entity's investment choices and production costs). In this respect, **connectivity through the integration of information is a key part of management's strategic-oriented communication via the AR package.**

b) ***How connections can be made (i.e., techniques):*** Depicting the interrelatedness of reported information by linking both narrative and quantitative information within and across different corporate reports can be done in various ways. It can be through the disclosure of current and anticipated financial effects or by qualitative disclosures, such as stating the financial statement line items affected by disclosed risks and opportunities. It can also be done through linking/connecting quantitative information across different corporate reports (through techniques such as cross-referencing and disclosing reconciliations), and this is referred to as either **direct or indirect connectivity** under ESRS.

c) ***Other overarching aspects of connectivity of information:*** Other overarching aspects of connectivity are the **consistency** of information across AR sections (i.e., assumptions, data, units of measurement (e.g., presentation currency) and narrative) and **coherence**. The latter involves the presentation and disclosure of information in a manner that enables users to have a more complete and consistent view of an entity's value creation story and to understand the interrelatedness of overall reported information. Coherence also includes explaining inconsistencies across AR sections (i.e., avoiding contradictory or conflicting information across AR sections is part of coherence).

17 ***Point-in-time connectivity versus intertemporal connectivity:*** Connectivity of information can also be categorised into **point-in-time connectivity** (i.e., the connection of information across different corporate reports at the reporting date) and **intertemporal/over time** connectivity. The latter includes linking or explaining the effects of risks and opportunities on the entity's financial position, financial performance and cash flows over multiple time horizons (short-, medium- and long-term), including through the disclosure of anticipated financial effects. It also entails providing disclosures that enable users to understand the migration of items from one corporate report to another across different reporting periods (e.g., what may trigger a risk disclosed in the management report/sustainability statement at a particular date to become a recognised provision in the financial statements at a future date). In effect, the **intertemporal dimension of connectivity enhances the predictive value and complementarity of AR information across reporting periods.**

18 ***Limits of disclosed anticipated financial effects in the sustainability statement/disclosures:*** Anticipated financial effects are indicative of items that may migrate from the sustainability statement/disclosures in a particular reporting period to the financial statements of future reporting periods (i.e. intertemporal connectivity). However, due to occurrence and estimation uncertainty, certain items that are disclosed as anticipated financial effects may not crystallise in the financial statements of future periods. As a result, there may be a lack of continuity in the reporting across periods of some items labelled as anticipated financial effects in the sustainability statement/disclosures.

Connectivity of financial statements' information

19 Stakeholders also expect connectivity of financial statements' information to the information in the rest of the AR. However, unlike the ESRS and IFRS Sustainability Disclosure Standards connectivity/connection requirements, IFRS Accounting Standards do not have similar explicit requirements. Section 1.3 of the full-version paper **posits that some of the SR connectivity/connection requirements can apply to financial statements' information** (e.g., how strategic choices and other entity actions in response to risks and opportunities have current period financial effects, and the consistency of assumptions and narrative in FS relative to information in the sustainability statement/disclosures).

20 However, **there are also constraints in applying some of the ESRS and IFRS Sustainability Disclosure Standards connectivity/connection requirements towards information in financial statements** (e.g., the option to incorporate information from another report by reference, and the reconciliation of quantitative amounts). Specific challenges include the legal risk that could arise from incorporating forward-looking information by reference, impediments to incorporating SR information by cross-reference due to the limited assurance of such information, disclosure overload and impaired understandability that may arise from excessive cross-referencing, and it not being applicable to reconcile starting from an amount in the financial statements to an amount outside the financial statements.

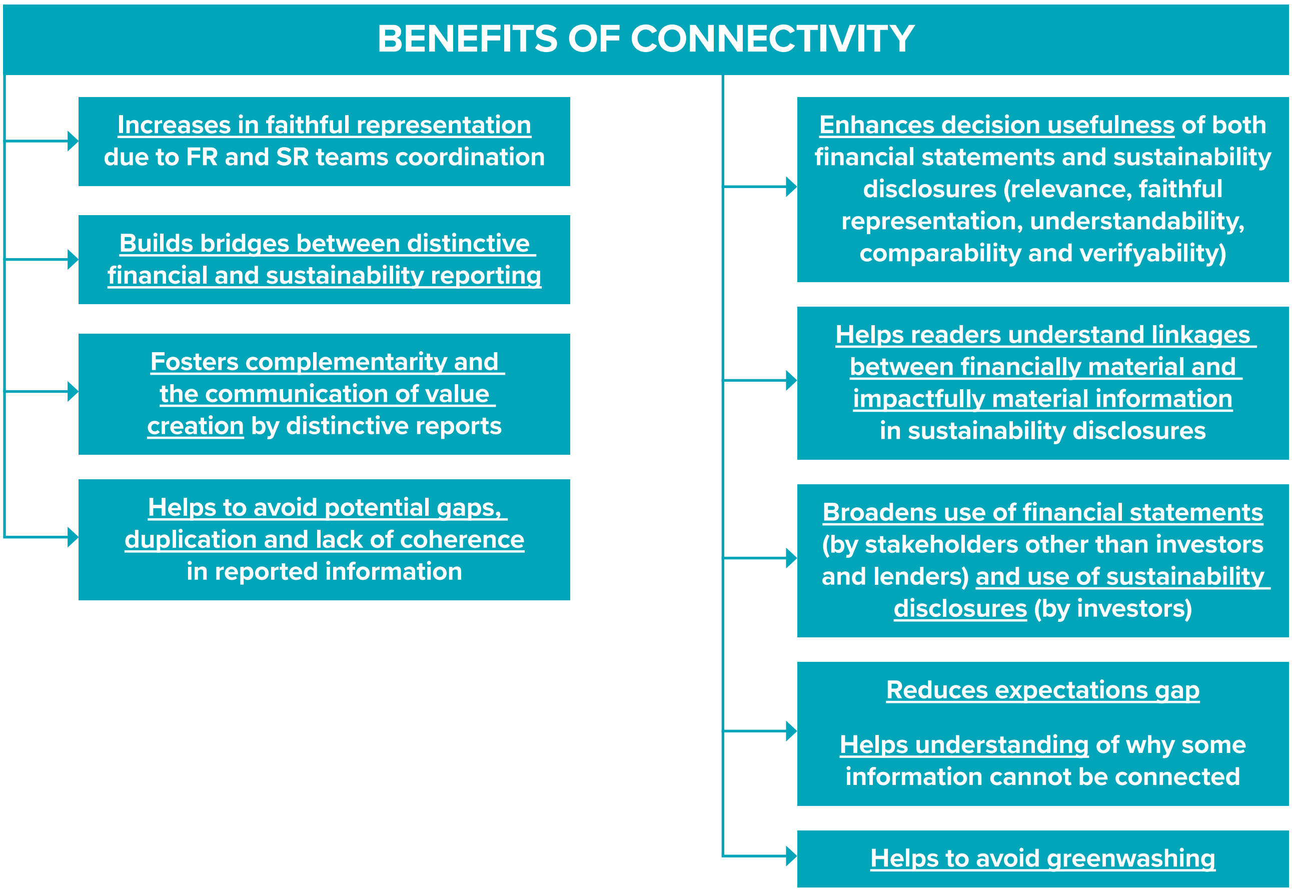
Where and what information is being connected

21 ***Differing placement of AR information across jurisdictions may have implications for where and what information can be connected:*** The context of corporate reporting (e.g. placement) varies across jurisdictions and this could have possible implications on where and what information can be connected. In this regard, Section 1.2 of the full-version paper highlights the similarities and salient differences between a) the EU corporate reporting framework consisting of IFRS or local GAAP financial statements, the sustainability statement in the management report, and the rest of the management report; and b) IFRS general purpose financial reporting (i.e. IFRS financial statements, sustainability-related financial disclosures, and management commentary).

Why connectivity is important

22 Figure 3 summarises why connectivity is important as detailed in Section 1.4.

Figure 3: Expected benefits of connectivity
(Diagram Developed by EFRAG based on engagement with stakeholders including EFRAG CAP)



Source: EFRAG

Boundaries of different AR sections

23 In the analysis of boundaries in Part 2 of the full-version paper, from the standpoint of EU corporate reporting, we highlight the similarities and differences between the objectives, audiences, materiality and other key features of financial statements, the sustainability statement in the management report, and the rest of the management report. The following key points are made:

a) **Materiality is interrelated with objectives and audience:** There is a similar definition of financial materiality across different AR sections but there is a difference in the information reported across AR sections due to differences in the objectives of these different reporting sections.

b) **Changes in material items over time:** a sustainability matter that is material (from an impact-materiality perspective) and disclosed in the sustainability statement may become financially material and qualify for inclusion in the financial statements at a future reporting date. For example, adverse impacts may translate to legal risk and fines reported in future period financial statements. Under ESRS, with the consideration of the long-term horizon, most of the matters that are material for impacts are also or will become material financially. Notably, virtually all the impacts translate into reputational risks though the timing in which they ultimately get reflected in the statements may vary.

c) **Similarities across AR sections:** The financial statements, management report, and the sustainability statement/disclosures are based on the same reporting entity and provide information related to current financial performance and financial position. These AR sections all facilitate financial capital allocation decisions and users' assessment of management's stewardship of an entity's own resources.

d) **Differences across AR sections:** Financial statements do not focus on representing information related to future financial performance and financial position. The application of operational control in only sustainability reporting extends the related reporting boundary beyond that of financial statements, and the sustainability statement (but not financial statements) informs on externalities and an entity's stewardship of planetary and societal resources (i.e. corporate environmental and social responsibility).

24 ***Grey areas on suitable location:*** We also highlight that there are some grey areas on the location of material information (i.e., where there may be duplicated or missing information across the reports and/or where there are diverse stakeholder views on the best location of certain information). For example, whether disclosures of net-zero commitments that are likely to result in the recognition of provisions at a future date and/or have future cash flow consequences should be disclosed in the financial statements in addition to the sustainability statement/disclosures. And when disclosed in the sustainability statement, how should they be measured? Also noted are other topics (e.g., unrecognised intangibles, synergies that arise during business combinations) where there is a diversity of views on whether these should be disclosed in the financial statements or management report.

25 ***Addressing expectation gaps:*** Section 2.4 of the full-version paper assesses why certain sustainability matters may sometimes not be reported/identifiable in the financial statements (even when expected by some users). The reasons include not meeting the financial statements recognition, measurement, disclosure or presentation criteria. These criteria have been formulated with the objective of informing and facilitating the decision making of the primary audience of financial statements (i.e., financial capital providers). As noted earlier, there is a higher threshold for entities to reflect items in the financial statements relative to doing so in other AR sections, and the expectation gap is therefore mainly in relation to the financial statements. In this regard, sustainability matters (e.g., an entity's planetary and societal impacts) that do not meet the criteria to be reflected in the financial statements could be considered to be particular sustainability information that only ought to be disclosed in the sustainability statement/disclosures.

26 To help address the grey areas and expectation gaps, this paper proposes the following:

a) ***SR conceptual framework development:*** The development of an SR conceptual framework akin to the one in place for financial reporting could help resolve several challenges that stem from the differing nature and objectives of sustainability and financial reporting information. For instance, an SR conceptual framework could address the placement and presentation of information and identify the triggers for the expected migration of items from the sustainability statement/disclosures to the financial statements. It could also address how to measure financial effects in the sustainability statement/disclosures. In this manner, an SR framework could bolster the complementarity, coherence and ability to connect SR and financial statements' information.

b) ***Enhancing management report/commentary guidance:*** There are other non-sustainability-related value-creation factors (e.g., certain intangibles and non-sustainability-related risks and opportunities) disclosed in the management report. In tandem, there are instances where there is no consensus on whether certain items within such information should be in the management report or financial statements (e.g., disclosure of synergies during business combinations, and disclosure of unrecognised intangibles). Hence, to foster connectivity and lessen expectation gaps on location, it would also be useful for the respective responsible authorities to enhance their guidance on management commentary/the management report. In a similar vein, the IASB ought[5] to update its management commentary guidance. This could include more clearly defining what information ought to be in the scope and further specifying the role management commentary (MC) fulfils in enhancing the connectivity of information across IFRS general purpose financial reports (i.e., clarify how MC can serve as the connective tissue of IFRS general purpose financial reporting).

5 Of note, on 19 June 2024, the IASB decided to finalise the project to revise the MCPS.

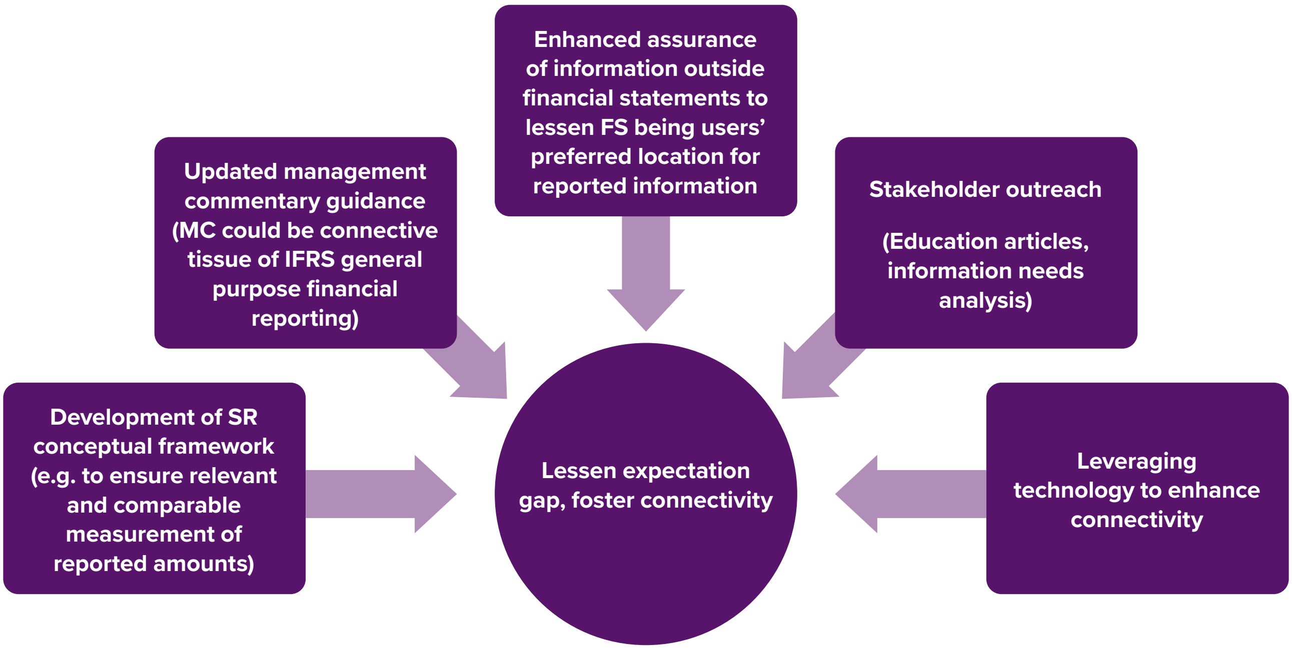
c) ***Enhancing assurance of AR information outside the financial statements:*** During discussions on whether certain information should be disclosed in the financial statements or management report (e.g., information on net zero commitments that is indicative of potential future liabilities), there have been indications that some users are location agnostic. At the same time, a reason posed by other users for their preference of disclosure in the financial statement is the associated current higher level of assurance. Thus, an enhancement in the level of assurance for information outside the financial statements could contribute to some users becoming more location-agnostic than they currently are, and this could potentially lessen the expectation gap (e.g., on what information should be in the financial statements).

d) ***Identify user needs and undertake stakeholder education:*** It is also clear from the discussions so far at EFRAG that further outreach to educate stakeholders on the boundaries of different corporate reports and to identify information needs in the context of different corporate reports could lessen the expectation gap.

27 Appendix 2 of the full-version paper also highlights the **role of technology in fostering connectivity** including through the use of interactive technology, XBRL tagging of information, and the possible combined use of AI and XBRL-tagged structured data. We also note that three taxonomies under development (IFRS Accounting, ESRS and EU taxonomy on sustainable activities) present an opportunity to enhance the connectivity of information (e.g., the reconciliation of financial statement line items and operating segments with ESRS sectors and related data points).

28 Figure 4 below summarises the steps that may lessen the expectation gap on the boundaries of different corporate reports and foster connectivity.

Figure 4: Takeaways- Steps to lessen expectation gaps and foster connectivity



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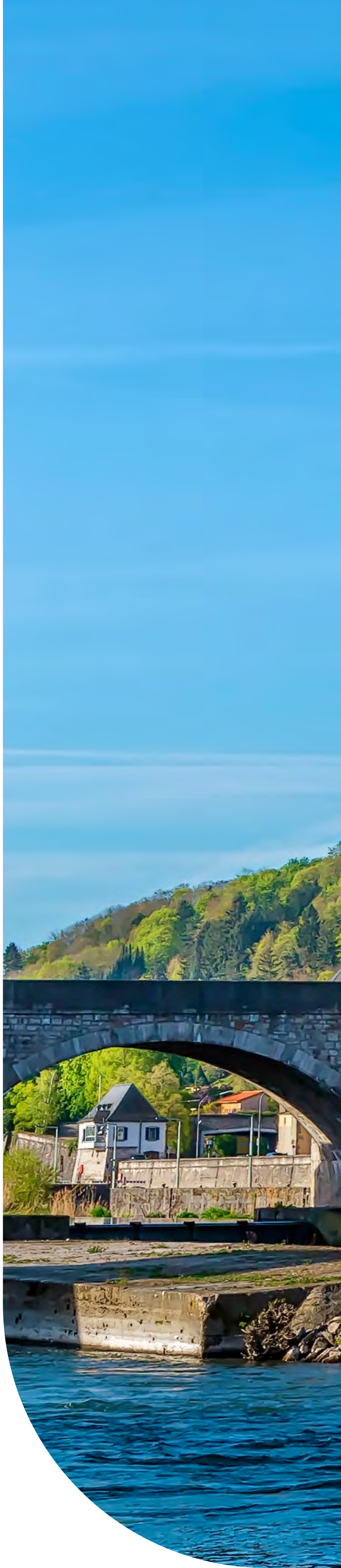

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