INITIAL PAPER

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 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.

EXECUTIVE SUMMARY

ES1 The enactment of mandatory sustainability reporting (SR) requirements within and outside the EU has been the hallmark of an ongoing evolving corporate reporting system as it augments companies' communication of their value creation story along with that of their planetary and societal impacts. Within the EU, the enhancement of SR requirements aims to ensure companies provide high-quality information on sustainability impacts as well as financial risks and opportunities. This information is expected to conform to the attributes of useful information, namely, relevance, faithful representation, verifiability, comparability and understandability.

ES2 The aforementioned SR enhancement is a core plank of the EU public policy objectives articulated within the March 2018 European Commission's Action Plan on Financing Sustainable Growth and European Green Deal, whose policy objectives are to stimulate sustainable investment and create both sustainable businesses and a sustainable economy. These policy objectives have underpinned the enactment of the Corporate Sustainability Reporting Directive (CSRD) and the European Sustainability Reporting Standards (ESRS) with effect from January 2024. An espoused objective of the 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.**

ES3 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.**

ES4 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-related impacts, risks and opportunities in SR.

ES5 SR information may not be reported in the financial statements due to the latter's recognition and measurement criteria. For instance, a high occurrence/existence and/or measurement uncertainty of transactions and events can preclude their recognition and measurement in the financial statements. Of note, related to recognition criteria, the March 2024 IFRS Interpretations Committee (IFRIC) final agenda decision addressed queries as to whether climate-related commitments should be recognised as provisions. The IFRIC agenda decision clarified the need for entities to have taken actions (i.e., in IFRS accounting lingo, there needs to be a "past event") and for there to be an outflow of economic resources before the recognition of climate commitments as liabilities in the financial statements occurs (and this is regardless of whether such commitments can be deemed to be constructive obligations).

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 embedded with financial statements line items 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 that is discussed in Section 2.4).

ES6 Besides the threshold for the inclusion of information in the financial statements, which is mainly pertinent for financial information, there is non-financial and detailed contextual information (e.g., non-monetary sustainability metrics and targets, operational metrics, the full profile of enterprise risks, and the description of an entity's strategy and business model) that is only appropriate to be located in the AR sections outside the financial statements.

ES7 Apart from the potentially missing information in financial statements alluded to in paragraph ES3, **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.**

ES8 It is against the backdrop of the above challenges that this paper (an initial deliverable of the EFRAG connectivity project) has been developed. Pointedly, crafting the way forward entails developing a shared understanding among stakeholders about the different aspects and benefits of connectivity as well as developing their understanding of the boundaries of different AR sections. With its focus on connectivity considerations and boundaries of different AR sections, this paper aims to contribute to the aforementioned shared understanding among stakeholders, and it has the below key messages:

a) **Connectivity has a pivotal role in ensuring the coherence and complementarity of AR sections. Moreover, connectivity helps to identify and lessen potential gaps (missing information) and overlaps of information across the AR sections.** We point out that due to their different evolution histories, objectives and audience needs; financial statements and the sustainability statement/disclosures have distinct reporting boundaries, and connectivity arises in the context of the distinct boundaries of different AR sections. Connectivity can play a key role in creating coherence between financial statements and the sustainability statement/disclosures as well as between these parts of the AR and other AR sections.

b) **Connectivity enhances the AR package's communication of the reporting effects of management's strategic choices (i.e., it is a part of strategic-oriented communication).** This is done via the integration of information across the AR sections to convey the effects of management's responses to impacts, risks and opportunities (IROs) on the entities' sustainability performance, financial performance, and financial position.

c) **The intertemporal dimension of connectivity (i.e., connectivity of information across different reporting periods) enhances the predictive value and complementarity of AR information.** For example, this is done through the disclosure of triggers of when items may migrate from the sustainability statement/disclosures to the financial statements and also through the disclosures in SR of anticipated financial effects (i.e., effects on future financial statements).

d) **ESRS' and ISSB Standards' connectivity/connection requirements from SR to financial statements could be considered for connectivity of financial statements information.**

e) **Differing placement of AR information across jurisdictions may have implications for where and what information can be connected.**

f) On reporting boundaries, even with the distinct objectives and audiences of different AR sections, **there are grey areas (i.e., where duplicated information exists or where there are diverse views among stakeholders on suitable location of information).** For instance, for disclosing unrecognised intangibles, information related to climate commitments, and synergies from M&A transactions.

g) **Multi-fold measures are necessary to enhance connectivity and lessen expectation gaps:** The paper proposes steps that could be taken to enhance connectivity and lessen the expectation gap around information reported in different AR sections. These include leveraging XBRL-tagging technology, enhancing management commentary guidance that better articulates when information should be in the management report versus financial statements, developing an SR conceptual framework that could among other things help to identify the triggers of SR information being recognised in the financial statements, and educating stakeholders on the boundaries of different AR sections.

ES9 In sum, with its role in fostering the AR package's communication about the reporting effects of management's strategic responses to IROs, connectivity is a cornerstone of the corporate reporting evolution. And further to connectivity being embedded into reporting requirements, there are steps including the suggested development of an SR conceptual framework and enhanced management commentary guidance that ought to be taken to resolve existing grey areas. These steps will help further embed connectivity into preparers' reporting practices and users/stakeholders' analysis of reporting information.

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INTRODUCTION

OVERVIEW

'Historically, corporate reporting has been centred on financial reporting, but this is just one limited perspective. Financial reports can be likened to an X-ray of a body: a lot can be inferred from an image of a skeleton, but it does not show the whole person. In future, I hope that sustainability reporting will be as helpful as an MRI scan in medicine, providing another image of the company.'
- Equity analyst who is a member of the EFRAG Connectivity Advisory Panel

'Sustainability reporting starts where financial reporting stops' - EFRAG SRB Chair

'A financial report and/or a sustainability report cannot tell the entire truth. Each of these reports can only be an excerpt of a company's reality' - IASB Chair at the April 2023 IFASS meeting

'There is no longer an assumed primacy of financial reporting over sustainability reporting, but rather these are two pillars of the same continuum which are there to tell a consistent story'
- Chair of ESMA at the November 2023 EFRAG Conference

1 As the above quotes portray, financial reporting[5] has traditionally been the bedrock of communicating an entity's value creation story but that is changing with the increased demand for and ongoing enhancement of sustainability reporting, which has distinctive information and is complementary to financial reporting. Sustainability reporting is expected to bridge the information gaps arising from the current boundaries[6] of the financial statements.

2 The rollout of mandatory sustainability reporting requirements is occurring within the EU (under the CSRD and ESRS) and outside the EU. The latter is the case for jurisdictions that have adopted or will adopt ISSB[7] Standards as well as those adopting jurisdictional-specific requirements including the US SEC Climate rule, New Zealand Climate Disclosures, Japan Sustainability Reporting Standards, and Korean Sustainability Reporting Standards. In tandem, not to be overlooked as a key component of the corporate reporting evolution, is the traditional ongoing development and amendment of IFRS Accounting Standards by the IASB. Pointedly, the IASB workplan (active and pipeline projects) consists of several connectivity-related and/or sustainability-linked projects (e.g., active projects on Climate-related and other uncertainties in the financial statements, Management commentary, Power purchase agreements, and Accounting for sustainability-linked bonds, and a potential project on Pollutant pricing mechanisms).

3 Besides the noted evolution, we underscore that, as depicted in Figure 1 and fleshed out in Section 2.2; the key sections of the Annual Report (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[8] for the different AR sections (i.e., the information included or excluded within these AR sections).

5 Financial reporting (e.g., reporting related to an entity's financial performance, financial position and cashflows) occurs across different AR sections albeit primarily being done in the financial statements. Similarly, sustainability reporting (e.g., disclosures on an entity's sustainability-related impacts, risks and opportunities) occurs across different AR sections albeit that in the EU it is designated to primarily occur in the sustainability statement.

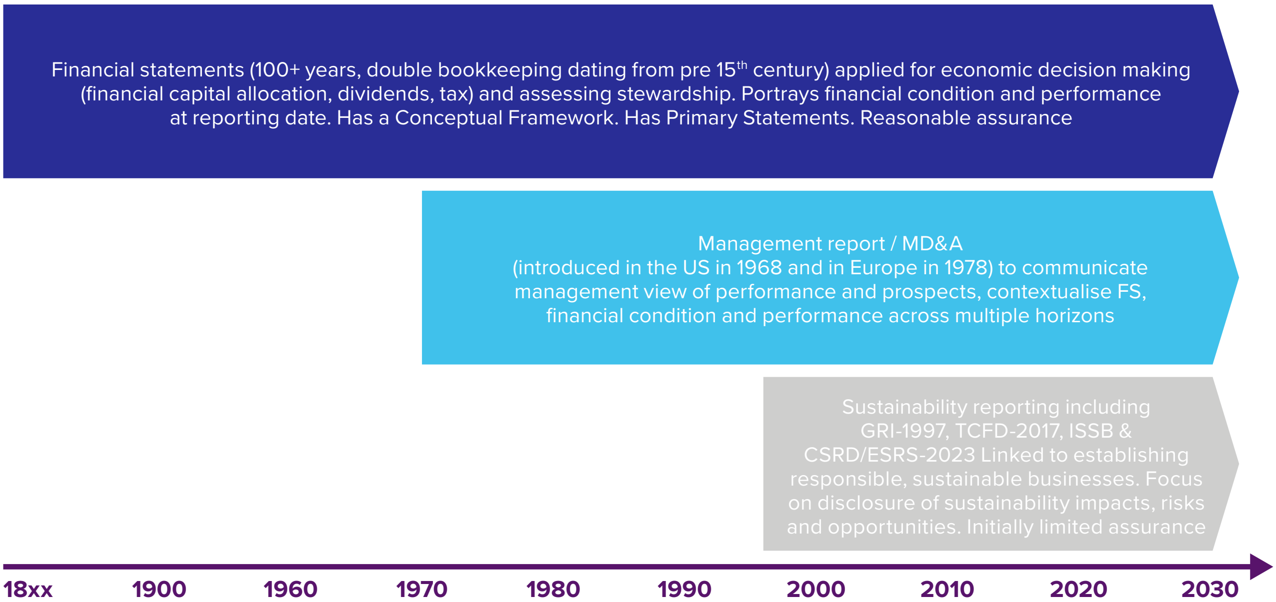
6 As detailed later in this paper, existing requirements for the recognition and measurement, presentation, or disclosure of information in the financial statements are underpinned by the objective of financial statements, which is oriented towards providing information that facilitates the decision making of financial capital providers and with a need to among other things, understand the entity's resources, claims against the entity and how these resources and claims change over time.

7 https://www.ifrs.org/news-and-events/news/2024/04/progress-towards-adoption-of-issb-standards-as-jurisdictions-consult/ This IFRS Foundation update indicates that Australia and Malaysia have consulted on ISSB Standards; Canada, Japan and Singapore are consulting on ISSB Standards; and Brazil, Costa Rica, Sri Lanka, Nigeria, and Turkey have announced decisions to adopt or otherwise use ISSB standards.

8 For example, existing requirements for the recognition and measurement, presentation, or disclosure of information in the financial statements (e.g., the need for a past event for the recognition of liabilities, consideration of existence and measurement uncertainty) are underpinned by the objective of financial statements and characteristics of useful information in Conceptual Framework for Financial Reporting.

4 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 the executive summary (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. This latter point was also highlighted in the 2021 publication of the EFRAG Project Taskforce on Non-Financial Reporting Standards-PTF-NFRS (see Appendix 3).

Figure 1: Varied evolution of different AR sections



Source: EFRAG

OBJECTIVE OF THIS PAPER

Analytical questions

5 The following key questions are addressed in this 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 are its benefits? What are the boundaries of AR sections (and the financial statements in particular)? How does connectivity relate to and how is it impacted by the boundaries of different AR 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?

6 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. Connectivity was also identified as an essential concept in the preparatory work that preceded these Standards (i.e., the 2021 PTF-NFRS publications and the 2021 IFRS Foundation Technical Readiness Working Group prototype document) (See Appendix 3 for more details). It is also embedded as one of the guiding principles in the 2013 and 2021 Integrated Reporting (IR) framework[9] 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).

7 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.

8 **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 strategic-oriented communication of value creation.

9 This paper also brings **to the fore connectivity in the context of both the EU corporate reporting framework and IFRS general purpose financial reporting.**

10 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[10] for the foreseeable future. And it becomes **useful to highlight the boundaries of different AR sections and why certain sustainability matters may not be reported in the financial statements . A particular focus on 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.** This analysis can **lessen the expectation gap and shed light on what information can or cannot be connected across the AR sections.**

9 In this paper, the reference to connectivity in the context of the IR framework **is limited to the external reporting aspects** (i.e., external reporting that aims to show a holistic picture of the combination, interrelatedness, and dependencies/relationships between different items of information). We are **not referring to integrated thinking**.

10 There is a process for enhancing accounting requirements. The IASB has a periodic agenda consultation (every five years) to identify areas for standard setting taking into account the pervasiveness of issues, importance for users, and gaps in existing in IFRS Accounting requirements. The IFRS Interpretation Committee interprets IFRS accounting requirements and advises the IASB where standard setting action is needed. Moreover, the IASB Conceptual Framework has a lengthy history of development and refinement. The latest revision occurred in 2018 and it was first introduced in the IASB predecessor body IASC in 1989 and FASB in 1978 (see related article on history of accounting standards).

SCOPE

11 The EFRAG connectivity project deliverables including this initial paper primarily focus on the connectivity of information[11] across different AR sections (during a reporting period and across reporting periods). Specifically, the connectivity of information between *financial statements*[12], *the sustainability statement/disclosures*[13] *in the management report, and the rest of the management report*. We assume that 'connectivity of information' is underpinned by the connectivity of the requirements/guidance for preparing information in different AR sections, and the connectivity of the process of preparing the AR or undertaking related standard-setting activities.

KEY MESSAGES/FINDINGS

12 Below is an elaboration of the key messages and findings related to the questions addressed in this paper highlighted in paragraph 5 above. Some of the messages are also included in the executive summary.

What does connectivity mean?

13 In broad terms, connectivity (i.e., connectivity of reported information) is 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.

14 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):

a) ***Strategic-oriented communication in AR-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 an integral 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**[14]. 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

11 As detailed in Section 1.1, a 2023 IFRS Foundation article highlighted that connectivity can be broadly categorised into connectivity in information/reports, connectivity in requirements (standard-setting products) and connectivity in process.

12 A complete set of financial statements comprises: '(a) a statement of financial position as at the end of the period; (b) a statement of profit or loss and other comprehensive income for the period; (c) a statement of changes in equity for the period; (d) a statement of cash flows for the period; (e) notes, comprising material accounting policy information and other explanatory information; (ea) comparative information in respect of the preceding period as specified in … ; and (f) a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements in accordance with …'

13 As detailed in Section 1.2, ESRS disclosures are located in a dedicated section of the management report (i.e., the sustainability statement) while IFRS sustainability-related financial disclosures have no specified location under IFRS general purpose financial reporting (i.e., are location agnostic).

14 Coherence is used in the 2021 IASB Management Commentary Practice Statement Exposure Draft (MCPS ED). It is, however, not included as one of the qualitative characteristics of useful information in the financial reporting conceptual framework.

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).

15 ***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.**

16 ***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

17 Stakeholders also expect[15] connectivity of financial statements' information to the information in the rest of the AR. However, unlike the ESRS' and ISSB Standards' connectivity/connection requirements, IFRS Accounting Standards do not have similar explicit requirements. In section 1.3, this 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).

18 However, there are also constraints in applying some of the ESRS' and ISSB 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

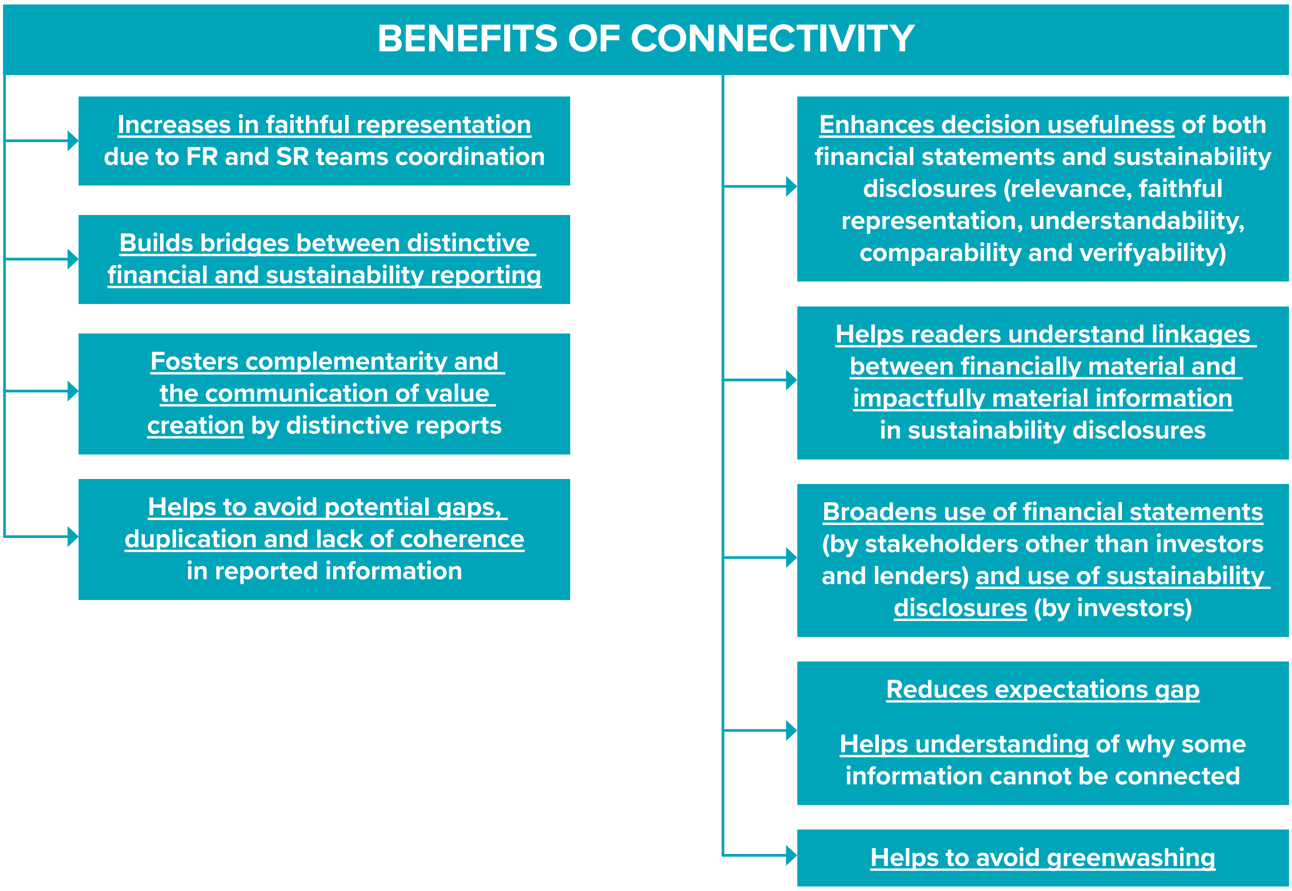
19 Differing placement of AR information across jurisdictions may have implications for where and what information can be connected: The context of corporate reporting (e.g., placement) varies across jurisdictions and this could have possible implications on where and what information can be connected. In this regard, in Section 1.2, we highlight 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

20 Figure 2 summarises why connectivity is important as detailed in Section 1.4

15 This was conveyed during EFRAG's outreach on the IASB project on climate-related and other uncertainties and by a raft of publications (see Appendix), financial statements information is also expected to be connected to the information in other AR sections.

Figure 2: Expected benefits of connectivity
(Diagram Developed by EFRAG based on engagement with stakeholders including EFRAG CAP)



Source: EFRAG

Boundaries of different AR sections

21 In the analysis of boundaries in Part 2 of this 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).

22 ***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.

23 ***Addressing expectation gaps:*** In the final section of this paper (i.e., Section 2.4), we analyse why certain sustainability matters may sometimes not be reflected 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[16] and facilitating the decision making of the primary audience of financial statements (i.e., financial capital providers). In general, there is a higher threshold[17] for entities to report 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.

24 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[18] 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).

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16 The Conceptual Framework for Financial Reporting (Paragraph 1.4) highlights that information is needed about: a) the economic resources of the entity, claims against the entity, and changes in those resources and claims; and b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.

17 For instance, before recognition of items as assets and liabilities, there is need to consider a) whether a past event has occurred; b) existence/occurrence uncertainty and measurement uncertainty; c) whether an entity has financial control (power to direct returns) of an asset.

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

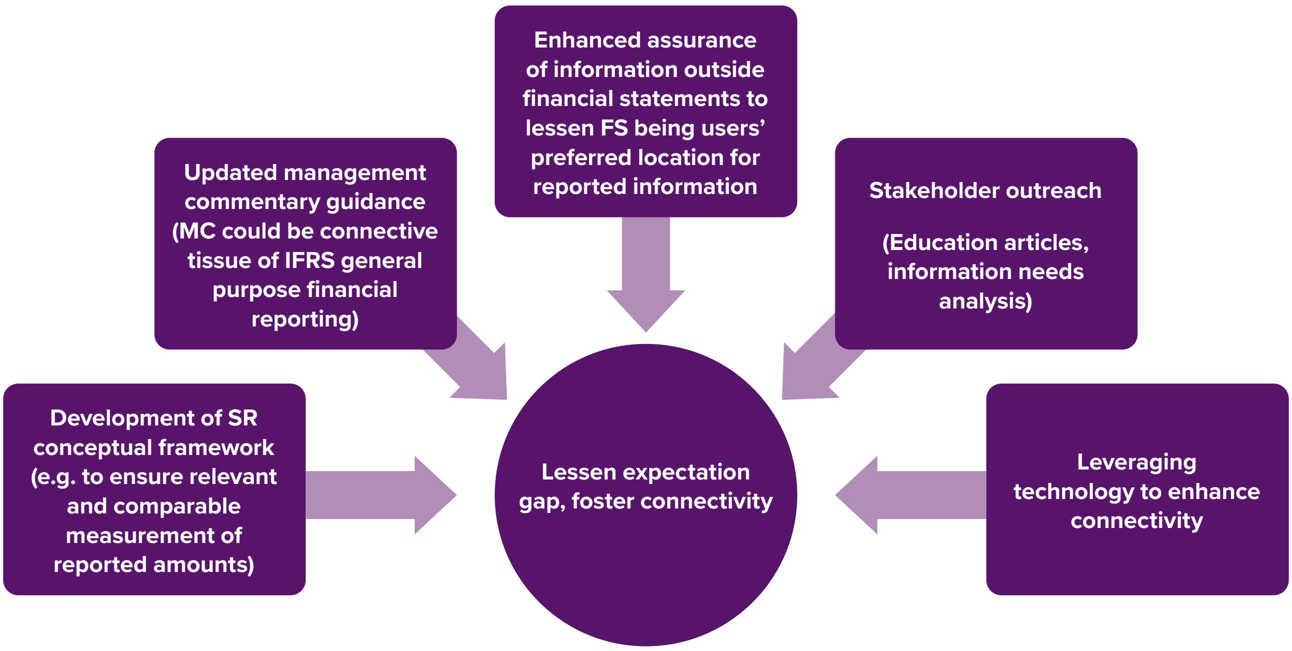
c) ***Enhancing assurance of AR information outside the financial statements:*** During discussions on whether certain information should be disclosed in the financial statements or management report (e.g., information on net zero commitments that is indicative of potential future liabilities), there 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.

25 The Appendix 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. The latter point has been underscored[19] by various experts. 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).

26 Figure 3 below summarises the steps that may lessen the expectation gap on the boundaries of different corporate reports and foster connectivity.

Figure 3: Takeaways- Steps to lessen expectation gaps and foster connectivity



Source: EFRAG

19 At the April 2024 IFASS meeting, XBRL CEO John Turner touched on the AI and digital tagging complementarity, he noted that AI will increase the demand for digital disclosures. A similar point was made at the September 2023 IFASS meeting.

PART 1. CONNECTIVITY CONSIDERATIONS

OVERVIEW OF CONNECTIVITY CONSIDERATIONS

27 Part 1 of this paper addresses some foundational questions related to connectivity with a focus on the following:

a) What is connectivity? Big picture (Section 1.1)

b) What is being connected (i.e., in the context of the EFRAG connectivity project) (Section 1.2)

c) What is connectivity? Dimensions of connectivity of reported information (Section 1.3)

d) Why connectivity is important (Section 1.4)

28 As mentioned in the introduction, addressing the above questions illuminates and contributes to a shared understanding on the purpose and dimensions of connectivity. In turn, such an understanding can help embed this notion into preparers' reporting practices and users' (and other stakeholders') analysis of information in the AR package.

SECTION 1.1:
WHAT IS CONNECTIVITY? THE BIG PICTURE

HIGHLIGHTS OF SECTION 1.1
Taking a big-picture perspective, this section discusses the below:

Broad aspects of connectivity, connectivity can relate to reporting/information, reporting requirements and processes related to preparing reporting information or developing Standards.

General observations on connectivity: A review of related literature and guidance shows that connectivity is both a new and familiar concept. And it is also a multidimensional concept.

Connectivity differs from integration in reporting: integration in reporting is a different and broader notion than connectivity.

Building on the big picture, Section 1.3 details the dimensions of the connectivity of reported information.

BROAD ASPECTS OF CONNECTIVITY

29 A 2023 IFRS Foundation article makes a helpful distinction between three broad categories of connectivity, namely: connectivity in reports (information), connectivity in standard-setting products (reporting requirements) and connectivity in process. These categories are expanded below.

30 **Connectivity in information (reports):** Relatedly, section 1.3 fleshes out the related ESRS' and ISSB Standards' connectivity/connection requirements for SR information. Pre-dating the aforementioned requirements, the 2021 IR framework also included connectivity of information as one of the seven guiding principles for the preparation of an integrated report. The IR framework points to the connectivity between:

a) the content elements: The integrated report connects the Content Elements[20] into a total picture that reflects the dynamic and systemic interactions of the organisation as a whole (e.g., linking organisation strategy and business model with changes in its external environment);

b) the past, present and future;

c) the capitals including the interdependencies and trade-offs between the capitals and how their availability, quality, and affordability affect the ability of the organisation to create value;

d) financial and other information (e.g., the impact of customer relationships and customer satisfaction on revenue and profit growth);

e) quantitative and qualitative information- both are necessary to represent an organisation's ability to create future value and to contextualise each other;

f) management information, board information and information reported externally; and

g) information in the integrated report, information in the organisation's other communications, and information from other sources.

20 The content elements referred to by the IR framework are: a) organizational overview and external environment; b) governance; c) business model; d) risks and opportunities; e) strategy and resource allocation; f) performance; g) outlook; and h) basis of preparation.

31 **Connectivity in reporting requirements (standard-setting products):** This refers to consistency in required standards and the basis of preparation of reported information within the financial statements and sustainability reports. And the imperative of ensuring connectivity in standard-setting products falls upon standard-setting bodies (e.g. IASB, ISSB, EFRAG SR Pillar/EC and other National Standard Setters).

32 Related to this type of connectivity, both the ESRS and IFRS Sustainability Disclosure Standards require the same reporting entity and reporting period as the financial statements. These requirements also have similar approaches for the treatment of events after the reporting date, changes in estimates, and changes in preparation and presentation practices as the financial statements. Both IFRS S1 and ESRS requirements were influenced by IAS 1 *Presentation of Financial Statements*, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requirements, and IAS 10 *Events After the Reporting Period* requirements. Furthermore, the qualitative characteristics of information of IFRS Accounting Standards, IFRS Sustainability Disclosure Standards and ESRS are based on the Conceptual Framework for Financial Reporting.

33 **Connectivity in process:** The term connectivity is also applied in the context of processes of providing guidance and preparing reporting information. Hence, it captures institutional connectivity within and across the organisations responsible for financial reporting and sustainability reporting standard setting (e.g., IFRS Foundation[21] and other jurisdictional standard setters). It also captures the idea of different functional teams working together within organisations. It is beyond the scope of the EFRAG connectivity project to assess or illustrate connectivity in process. Nonetheless, the development of the EFRAG research project deliverables with input from a multi-stakeholder advisory panel and with collaboration between the EFRAG FR and SR pillars is itself an embodiment and recognition of the value of connectivity in process.

GENERAL OBSERVATIONS ON CONNECTIVITY

34 **Connectivity is both a new and familiar concept:** Connectivity is a nascent concept within authoritative requirements (has been included in ESRS in the EU and ISSB Standards) but it is not explicitly included in the IFRS Accounting requirements, Conceptual Framework for Financial Reporting, and any other legal requirements that were applicable before the 2024 reporting year. At the same time, connectivity is a familiar concept as it is one of the seven guiding principles of the 2013 and updated 2021 International Integrated Reporting Council ('IIRC')- integrated reporting (IR) framework. That said, the specific application of the IR framework in external reporting and via integrated thinking is not in the scope of the EFRAG connectivity project.

35 **Connectivity-related concepts included in other guidance:** Other notions associated with connectivity, such as the consistency of information across AR sections were already baked into other authoritative requirements, including the Transparency Directive and auditor guidance (EU Accounting Directive Article 34 par.1 (a) (i) and ISA 720). Consistency has also been the focus of different regulators (AMF-France, ESMA, Finanstilsynet-Norway, and UK FRC) and stakeholder publications (e.g., Carbon Tracker) in their thematic reviews of trends in the reporting of climate-related risks in the financial statements (including in assessing whether there is a disconnect with versus the information outside the financial statements). Moreover, as explained in the introduction and Section 1.3, coherence, which is another notion associated with connectivity, was included as one of the characteristics of useful information in the 2021 MCPS ED.

36 **Connectivity is a multi-dimensional concept:** As noted in the introduction, multiple notions are associated with connectivity including complementarity, coherence, consistency, and integration in reporting. Some of these terms (e.g., coherence, consistency) are sometimes used as synonyms for connectivity. Other times, these terms (coherence, complementarity, consistency) are applied as being elements of connectivity. And still, at other times, some of the terms (coherence, integration in reporting) are described as distinct notions from connectivity. In this paper, as detailed in Section 1.3, coherence/complementarity and consistency are considered as overarching aspects of connectivity and, as detailed below, connectivity and integration in reporting are two different concepts.

21 The importance of connectivity in the work of the IASB and ISSB is further highlighted in the ISSB Agenda Consultation feedback summary on connectivity (paragraph 9 page 3). In paragraph 11 of page 4, stakeholders' calls for 'interconnected standards' instead of simply 'compatibility and avoiding potential conflicts'. Other relevant suggestions are being made in paragraphs 22-24 (pages 8-9) of the same document. https://www.ifrs.org/content/dam/ifrs/meetings/2024/january/iasb-issb-joint/ap2b-feedback-summary-connectivity.pdf

CONNECTIVITY VERSUS INTEGRATION IN REPORTING

37 The May 2023 ISSB Request For Information (RFI) *Consultation on Agenda Priorities* framed 'connectivity or connection in reporting' as being a distinct and narrower notion than 'integration of reporting'. The RFI states that *'Integration in reporting takes the concept of connectivity a step further. Integration in reporting not only encompasses where, what and how information on value creation can be connected through conceptual and operational linkages (for example, in terms of compatibility of language and assumptions), but also includes the collective consideration of the interdependencies, synergies and trade-offs between:*

a) the various resources and relationships reported on in general purpose financial reports; and

b) how the value that an entity creates for itself and for its investors is inextricably linked to the value the entity creates for other stakeholders, society, and the natural environment.'

38 EFRAG's August 2023 comment letter response to the ISSB agenda consultation noted the need to further clarify the definition of integration in reporting (see above paragraph) and that the immediate priority for the ISSB and IASB should be connectivity rather than integration in reporting. Of note, three-quarters of the respondents to the consultation either considered integration a lower priority than other projects or did not rank its relative priority.

39 EFRAG's comment letter also called for the development of a sustainability reporting conceptual framework (SR conceptual framework) akin to the one in place for financial reporting before a project on integration in reporting is undertaken. EFRAG conveyed that an effective 'integration in reporting' project would need to be underpinned by a robust SR conceptual framework so as to avoid overlaps/duplications or gaps across the two distinct and intended complementary pillars of the corporate reporting system.

40 We note various concepts are idiosyncratic to sustainability reporting (e.g., applying the notion of operational control or considering the value chain whilst developing environmental or social disclosures; the absence of constraints in incorporating forward-looking information; the absence of primary statements; etc.) and these could benefit from further development of underpinning conceptual principles. To that effect, the preparatory work done for ESRS reflected in the PTF-NFRS publications, the conceptualisation done during the initial ESRS development by the project taskforce for ESRS (PTF-ESRS[22]) (see attached January 2022 PTF-ESRS working paper on double materiality conceptual guidelines for standard setting), the pre-ISSB work done by the IFRS Foundation TRWG, and the various voluntary guidance and standards for non-financial reporting (also summarised in the 2021 PTF-NFRS Appendix 4.3 *Conceptual Framework for Non-Financial Information Standard-Setting*) collectively have content that could be used as the basis for developing an SR conceptual framework.

41 At the same time, we acknowledge that ESRS 1, IFRS S1, the 2021 PTF-NFRS publications, various IFRS Accounting Standards (IAS 1, IAS 8 and IAS 10) and the FR Conceptual Framework collectively provided a sufficient albeit non-structured conceptual underpinning for the development of the initial authoritative sustainability standard setting deliverables (i.e., ESRS sector-agnostic standards and IFRS S1 and S2). Moreover, given the workplan and competing priorities faced by the ISSB and EFRAG SR pillar, and taking account of the feedback to the ISSB agenda consultation, the development of a comprehensive SR conceptual framework may not be considered an immediate goal.

22 The PTF-ESRS (a 35-person task force) that drafted the ESRS issued for public consultation in April 2022. The PTF-ESRS, which was operational from June 2021 to April 2022 inherited the mantle of the PTF-NFRS that did preparatory work from September 2020 to March 2021.

SECTION 1.2:
WHAT INFORMATION IS BEING CONNECTED?

HIGHLIGHTS OF SECTION 1.2

This section shows that the connectivity of information can go beyond connecting information across the AR to also include connecting AR information to that outside the AR. That said, consistent with EFRAG's mandate, the focus of the EFRAG connectivity project is on connections across the AR sections as these have an established stature (i.e., are subject to assurance, are enforceable, and have robust underpinning guidance) and complementary objectives. Hence, as noted earlier, the focus is on the connection of information across the financial statements, the sustainability statement/disclosures in the management report, and the rest of the management report.

This section also outlines the connections to be respectively made across these AR sections under the EU corporate reporting and IFRS general purpose financial reporting requirements. In so doing, we also point to the salient differences between these two sets of reporting requirements. Specifically, the extent to which the objective, audience, and materiality perspective of SR differs from that of the financial statements, and clarity on the location of sustainability reporting information in the EU versus the location-agnostic placement of SR information under ISSB Standards. These aspects are further detailed in Part 2 of this paper (Boundaries of different AR sections).

42 As described in Section 1.1, the IR framework states that the scope of applying connectivity includes connectivity between the integrated report, information in the organisation's other communications and information from other sources. Nonetheless, consistent with EFRAG's mandate related to authoritative requirements (i.e., influencing IFRS Accounting Standards and developing ESRS in its role as the technical adviser to the EC), the focus of the EFRAG connectivity project is on connections between sections of the annual report that have complementary objectives and a well-identified nature, purpose, and established stature (i.e., are subject to assurance, are enforceable, and have robust underpinning guidance). Specifically, the focus is on connections across the financial statements, the sustainability statement/disclosures in the management report, and the rest of the management report.

43 Such a focus neither negates the expected need for consistency in management's communication of the company's story across all channels including outside the annual report (press releases, management presentations) nor does it preclude that there may be connections made (e.g., to financial statements) in the non-authoritative information communicated by management and in other mandated reports (country-by-country reports, regulatory reports etc.).

EU CONTEXT

44 *Location considerations*: As shown in Figure 5 below, in an EU context the EFRAG connectivity project focuses on the connection of information across the financial statements of EEA companies prepared under IFRS Accounting requirements, sustainability statement (including Taxonomy-Article 8 disclosures) in the management report under ESRS and the rest of information in the management report guided by the Accounting Directive.

45 The EFRAG connectivity project also considers connectivity based on the nature rather than placement of information. Hence, relevant information within other sections of the annual report (e.g., remuneration report, corporate governance report) is in scope to the extent that such information has been incorporated in the sustainability statement by referencing as allowed[23] by ESRS 1.

46 *Connectivity is considered from a GAAP-agnostic prism*: Though the focus is on connections to (and from) financial statements prepared under IFRS Accounting requirements (as that affects EU-listed companies and EFRAG's influencing working on financial reporting is related to IFRS), there are similarities in underlying concepts and elements of IFRS and local GAAP. Thus, it is unlikely that there would be significant differences in the connectivity considerations related to financial statements prepared under local GAAP versus those prepared under IFRS. For instance, the similarities between IFRS and EU Accounting Directive principles can be seen in the 2017 publications from ANC (France) (Elements for a European Conceptual Framework and European criteria for the endorsement of IFRS standards and their compatibility with the Conceptual Framework). The reference to the aforementioned publications is only[24] to show that stakeholders consider EU jurisdictional/local GAAP principles and requirements to be significantly aligned with those within IFRS Accounting requirements.

47 *Audience and materiality*: As detailed in Part 2 of this paper, the reporting under ESRS is done from a double materiality perspective (both financial and impact materiality perspectives) and is targeted at a broad set of users (including investors).

Figure 5: EFRAG connectivity project– what is being connected under the EU corporate reporting framework

Source: EFRAG

23 ESRS 1.119-122 state the requirements for incorporation by reference. Paragraph 119 conveys that information including a datapoint prescribed by a Disclosure Requirement of an ESRS, may be incorporated in the sustainability statement by reference to: (a) another section of the management report; (b) the financial statements; (c) the corporate governance statement (if not part of the management report); (d) the remuneration report; (e) the universal registration document; and (f) public disclosures under Regulation (EU) of the European Parliament and of the Council (Pillar 3 disclosures). If the undertaking incorporates by reference information from Pillar 3 disclosures, it shall ensure that the information matches the scope of consolidation used for the sustainability statement by complementing the incorporated information with additional elements as necessary.

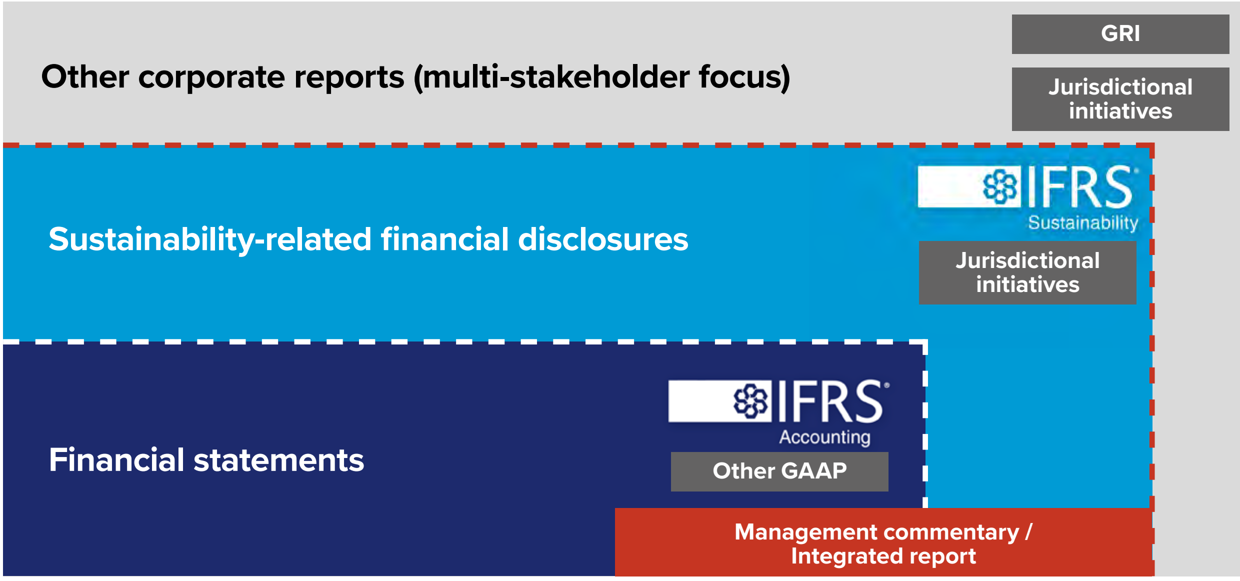
Paragraph 120 states the conditions for disclosures being incorporated by reference. Specifically that they (a) should constitute a separate element of information and are clearly identified in the document concerned as addressing the relevant Disclosure Requirement or its prescribed relevant specific datapoint; (b) are published before or at the same time as the management report; (c) are in the same language as the sustainability statement; (d) are subject to at least the same level of assurance as the sustainability statement; and (e) meet the same technical digitalisation requirements as the sustainability statement. Paragraph 122 requires that, when incorporation by reference is done, the undertaking shall consider the overall cohesiveness of the reported information and ensure that the incorporation by reference does not impair the readability of the sustainability statement.

24 The mandate of EFRAG's FR pillar and therein EFRAG research projects is influencing IFRS Accounting Standards and the reference to the ANC publication is not an expression of EFRAG's position on European financial reporting.

IFRS GENERAL PURPOSE FINANCIAL REPORTING

48 The connection of information across IFRS general purpose financial reports for companies outside the EU is also in the scope of the EFRAG connectivity project. IFRS general purpose financial reports as defined by the IFRS Foundation consist of IFRS financial statements, the management commentary and the IFRS sustainability-related financial disclosures (depicted in dark blue, light blue and red in **Figure 6 below**).

Figure 6: EFRAG Connectivity project– what is being connected under IFRS general purpose financial reporting



Source: IFRS Foundation slides

49 _Location-agnostic sustainability-related financial disclosures_: Similar to ESRS, IFRS Sustainability Disclosure Standards allow[25] including information by cross-reference. However, unlike the CSRD/ ESRS' clear placement requirements for the sustainability statement within the management report, the IFRS Sustainability Disclosure Standards' sustainability-related financial disclosures are location-agnostic. As we understand, this means that a sustainability-related disclosure under IFRS Sustainability Disclosure Standards could be located in the notes within the financial statements. That said, jurisdictional authorities within non-EU jurisdictions that adopt IFRS Sustainability Disclosure Standards may also have placement requirements for the information reported outside the financial statements in a manner that may or may not be comparable to EU placement requirements.

50 _Objectives of SR under an IFRS approach (i.e., sustainability-related financial disclosures)_: The objectives of sustainability-related financial disclosures are closely interlinked with the objectives of the financial statements and the management commentary (see Section 2 for more details). In contrast, ESRS could be seen as part of jurisdictional initiatives depicted in the grey section of **Figure 6**. ESRS and other jurisdictional initiatives on sustainability reporting may be considered as general purpose sustainability reporting. The latter (i.e., the sustainability statement under ESRS) has objectives that are distinct from that of financial statements and it includes both the information that would be under sustainability-related financial disclosures (light blue) and that which would be in the light grey section (other corporate reports with a multi-stakeholder focus).

25 IFRS S1.B45 states that 'Information required by an IFRS Sustainability Disclosure Standard might be available in another report published by the entity. For example, the required information could be disclosed in the related financial statements. Material information can be included in an entity's sustainability-related financial disclosures by cross-reference, provided that: a) the cross-referenced information is available on the same terms and at the same time as the sustainability-related financial disclosures; and b) the complete set of sustainability-related financial disclosures is not made less understandable by including information by cross-reference.'

IFRS S1.B47 states that 'If information required by an IFRS Sustainability Disclosure Standard is included by cross-reference: a) the sustainability-related financial disclosures shall clearly identify the report within which that information is located and explain how to access that report; and b) the cross-reference shall be to a precisely specified part of that report.'

51 *Audience and materiality of SR*: IFRS general purpose financial reports (including sustainability-related financial disclosures) have investors as their primary audience and are prepared under the same materiality definition/perspective as financial statements and management commentary. There is an assumption that investors are focused on general purpose financial reports. This contrasts with the sustainability statement under ESRS requirements, whose audience is broader stakeholders (including investors) and is based on a double materiality perspective (as noted earlier).

CONCLUSION INCLUDING INTEROPERABILITY CONSIDERATIONS

52 As noted above, for illustrating connectivity through examples, EFRAG's connectivity project will primarily focus on EEA companies that report under ESRS and IFRS Accounting requirements. The project's focus on IFRS Accounting requirements is for practical reasons (e.g., ease of access to an English version of the AR), it is consistent with EFRAG's FR mandate, and also because there ought to be no difference relative to a local GAAP focus. The project will also consider reporting under IFRS S1 and IFRS S2 to the extent that early adopters with good practice can be identified. Relatedly, some stakeholders have asked about the implications of the May 2024 ESRS-ISSB Standards Interoperability Guidance for the scope of the EFRAG connectivity project. On this question, as noted in Appendix 1 (Glossary of a selection of key terms), interoperability is a different notion to connectivity and it relates to the compatibility of requirements within the SR domain. Hence, assessing the reporting implications of the aforementioned interoperability guidance is not within the scope of the EFRAG connectivity project. That said, the review of illustrations of connectivity from any reports prepared under the premise of interoperability (i.e., early adopters[26] of ESRS and IFRS Sustainability Disclosure Standards) and their inclusion in the forthcoming EFRAG connectivity project Discussion Paper when suitable, is not precluded.

53 In addition to the above-articulated EU reporting and IFRS general purpose financial reporting requirements, Appendix 2 highlights how digital tagging and the role of technology would support connectivity regardless of the placement of information.

26 Due to the timeline of the EFRAG connectivity project, the illustrations of connectivity will be examples from reporting year end of 2023 and before.

SECTION 1.3: WHAT IS CONNECTIVITY? DIMENSIONS OF CONNECTIVITY OF REPORTED INFORMATION

HIGHLIGHTS OF SECTION 1.3

This section builds on the big picture perspective on connectivity in Section 1.1. It describes the dimensions (i.e., categories and related concepts) of connectivity of reported information categories and related concepts that are encompassed within authoritative requirements and other guidance (e.g., ESRS, ISSB Standards, and regulatory publications). Specifically, the following is done in this section:

Overarching concepts related to the connectivity of reported information such as connectivity in the basis of preparation, avoiding unnecessary duplication, and the balance between connections across versus connections within AR sections are laid out.

Connectivity requirements within ESRS and ISSB Standards: This section unpacks the connectivity/connection requirements of ESRS and ISSB Standards with a distinction between overarching aspects (integration of information and consistency) versus techniques of linking/connecting information (direct and indirect connectivity). A distinction is also made between static (at reporting date) connectivity and intertemporal (across reporting periods) connectivity.

Connectivity-related concepts in other publications including the notion of coherence of reported information are discussed.

The connection of financial statements information to other AR sections whereby the limitations of applying ESRS' and ISSB Standards' connectivity/connection requirements towards financial statements are highlighted.

Reporting outcomes from applying connectivity concepts: A delineation of the effects of applying connectivity concepts on the qualitative characteristics of useful information is provided.

OVERARCHING CONCEPTS RELATED TO CONNECTIVITY OF REPORTED INFORMATION

54 **Connectivity in standards (consistent basis of preparation) and process contributes to the connectivity of information:** Both the ESRS and IFRS Sustainability Disclosures require reporting of information with qualitative characteristics consistent with those of the IFRS Conceptual Framework for Financial Reporting and the CSRD. These standards also require the same reporting entity and reporting period as the financial statements. And they also have similar approaches for the treatment of events after the reporting date, changes in estimates, and changes in preparation and presentation practices as the financial statements. They were influenced by IAS 1, IAS 8, and IAS 10.

55 The consistent basis of preparation contributes to the connectivity of information at a point in time and over time. That said, while the above contributes to connectivity, as detailed in Section 2.3, there are also multiple differences between the requirements for financial statements and sustainability reporting (e.g., the recognition and measurement criteria for financial statements) that result in distinct information across the two reporting domains and underpin the need for connectivity requirements to ensure complementary reporting sections.

56 **Clear and concise** disclosures as required by both IFRS S1 and ESRS contribute to the connectivity of information (i.e., understandability). The ESMA report[27] also considered 'simple and clear' and 'organised and well formatted' as principles for selecting examples. **Avoiding unnecessary duplication**, including through the use of cross-referencing, is part of clear and concise communication.

27 ESMA, October 2023, The Heat is on: Disclosures of Climate-related matters in the financial statements

57 **Self-sufficiency of each corporate report per its stated purpose:** As noted earlier and in Section 2.1, these different corporate reports have distinctive[28] albeit complementary objectives (i.e., the reports capture different versions of an entity's reality, and a user needs different reports to build the mosaic of the company's value creation story). In tandem, as alluded to by the October 2023 ESMA report, these reports are expected to be self-sufficient in providing information related to their distinctive objectives. And this may either necessitate repetition (albeit this should be done with tailoring/ giving a flavour suited for the objective of the report) or some cross-references may be included to avoid duplication. On the latter, it must be underscored that, in the financial statements, cross-references to other AR sections can be used to avoid duplication or to link/connect to information outside the financial but barring a few exceptions they cannot be used for compliance with IFRS requirements (see further discussion in paragraph 68 below).

58 **Connections across versus within AR sections:** Some stakeholders consider that connectivity ought to be primarily related to information across (rather than within) reports. Such a view would be especially apt for jurisdictions where SR information is distinctive and has objectives that are clearly demarcated from the financial statements objectives. This is largely the case under the EU corporate reporting framework with its double materiality perspective for SR information. For such jurisdictions, the foremost purpose of connectivity is to create a complementary reporting package and connections of information across the AR sections.

59 However, there are other descriptions of connectivity/connection of information that emphasise both connections within and across reports. This is the case within the 2021 MCPS ED's guidance on coherence and the IFRS S1 connection requirements. IFRS S1. 21 conveys that connected information entails an entity providing information that allows users to understand the following connections:

a) connections between the items to which the information relates, such as connections between various sustainability-related risks and opportunities that could be reasonably expected to affect the entity's prospects; and

b) the connections between disclosures provided by the entity:

(i) within its sustainability-related financial disclosures, such as connections within its disclosures of governance, strategy, risk management, and metrics and targets; and

(ii) across its sustainability-related financial disclosures and other general purpose financial statements published by the entity such as its financial statements.

60 From the preceding paragraph, it could be inferred that, for SR information, along with connections across AR sections, connections within an AR section are also important for regimes with a location-agnostic approach towards SR information, whereby SR information is considered to be part of general purpose financial reporting. For instance, under the IFRS general purpose financial reporting, sustainability-related financial disclosures can be located in the notes to the financial statements. In such situations, the connection between the sustainability disclosures and the information in the financial statements is important. It would be an example of a desirable connection of information within a particular AR section (i.e., the connection of items within the financial statements).

CONNECTIVITY CATEGORIES WITHIN ESRS AND IFRS SUSTAINABILITY STANDARDS REQUIREMENTS

61 **Strategic-oriented communication- integration of information linking an entity's strategic choices and the resulting reporting effects:** This overarching aspect of connectivity (which we describe as 'integration of information') entails an entity communicating and explaining how its strategy, business model, impacts, risks and opportunities (IROs) are linked to its sustainability and financial performance, financial position, cash flows, and other metrics and targets in the short-, medium- and long-term (i.e., as required by ESRS 1.123). In effect, it shows the interaction between an entity's strategic responses to IROs and the resulting financial statements and SR effects.

28 For example, if company Y does a tax transparency report for NGOs particularly interested in tax transparency and establishing whether companies pay their fair share of tax. This report is an independent report and whilst it may pull numbers and narrative from other reports, is stands on its own for these users.

62 ESRS 1.123 notes that to allow users to assess connections in information, the undertaking might need in particular to explain the effect or likely effect of its strategy on its financial statements or financial plans, or on metrics and targets used to measure progress against performance. ***Furthermore, the undertaking might need to explain how its use of resources and changes within its supply chain could amplify, change or reduce its material impacts, risks and opportunities. It may need to link this information to the potential or actual effects on its production costs, to its strategic response to mitigate such impacts or risks, and to its related investment in new assets. This information may also need to be linked to information in the financial statements and to specific metrics and targets.*** IFRS S1. B43 provides the same example with slightly different wording.

63 Moreover, related to the above, IFRS S1.B44 indicates that connections can include:

a) an explanation of the combined effects of the entity's sustainability-related risks and opportunities and its strategy on its financial position, financial performance and cash flows over the short-, medium- and long-term. ***For example, an entity might face decreasing demand for its products because of consumer preferences for lower-carbon alternatives. The entity might need to explain how its strategic response, such as closing a major factory, could affect its workforce and local communities, and the effect of such a closure on the useful lives of its assets and on impairment assessments; and***

b) a description of the alternatives that an entity evaluated in setting its strategy in response to its sustainability-related risks and opportunities, including a description of the trade-offs between those risks and opportunities that the entity considered. ***For example, an entity might need to explain the potential effects of its decision to restructure its operations in response to a sustainability-related risk on the future size and composition of the entity's workforce.***

64 **Techniques for depicting the interrelatedness of quantitative and narrative information across reports:** The ESRS connection requirements (ESRS 1.124-125) also specify **direct and indirect connectivity** that could be construed as the linkage/connection of quantitative datapoints. These two forms of connectivity are attained through cross-referencing (direct connectivity) and the reconciliation of related datapoints (indirect connectivity). Examples of direct and indirect connectivity include:

a) revenue amount in the GHG intensity metric can be directly linked to IFRS 15 revenue through cross-reference in the sustainability statement; and

b) reconciliation of revenue amount in GHG intensity metric to IFRS 15 revenue amount when it cannot be directly linked. This reconciliation will be in the sustainability statement.

65 Qualitative disclosures can also link/connect interrelated information within and across different corporate reports. For instance, describing the financial statement line items that are affected by a sustainability-related risk or opportunity if an entity is unable to provide quantitative disclosures of current and anticipated financial effects (IFRS S1.40).

66 Consistency is another aspect of connectivity. This includes the **consistency of data, assumptions, units of measurement (e.g., presentation currency) and narrative information** (as reflected in ESRS 1.127-128 and IFRS S1.23). It also includes relating forecasts to information of past and present and disclosing information about **significant differences between data and assumptions used**. We note that audit guidance requires an assessment of consistency (i.e., ISA states there should not be an inconsistency and there is a need to explain any significant differences). Similarly, the enforcers' thematic reviews often monitor the consistency of reporting.

67 **Intertemporal dimension of connectivity (also discussed in Section 2.3: materiality considerations):** Connectivity has a static/point-in-time dimension (i.e., connectivity of information located within and across different AR sections at a particular reporting date). It also has an intertemporal (over time) dimension where the risks and opportunities are linked to financial performance, financial position, and cash flows over multiple periods (i.e., short-, medium- and long- term) and, for instance, are reflected in the required disclosures of anticipated financial effects. Connectivity over time means there can be a change in the location of reporting impacts, risks or opportunities across different reporting periods (i.e., migration of items across different sections of the Annual Report over time). For instance, this could be due to the change

in nature, quantifiability, magnitude/severity, or probability of occurrence of a particular risk or opportunity. It can also be due to impacts disclosed in one period translating into financial obligation at a future period (i.e., dynamic materiality).

68 Related to the preceding paragraph, 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 related information. It could also highlight the potential evolution of an item from the management report or sustainability statement/disclosures to the financial statements as the risks and opportunities In effect, the **intertemporal dimension of connectivity can enhance the predictive value and complementarity of AR information across reporting periods.**

69 **Linking forecast information to past/present reported information:** Under ESRS requirements, another aspect of linkage across periods is captured by forecast information being related to past/present reported information.

70 **Limitations of anticipated financial effects:** Notwithstanding their predictive value, there are instances where anticipated financial effects (including short- term anticipated financial effects) disclosed in SR may not necessarily crystallise as anticipated in an entity's future financial statements (and in such cases, there will be no continuity across periods in the reporting of the item that was depicted as an anticipated financial effect). This can be due to a) outcome/occurrence uncertainty (e.g., climate physical risk/threat may never crystallise); and b) estimation uncertainty. For instance, due to the extant, early-stage methodologies for estimating sustainability matters (climate transition risk, biodiversity risk); and c) anticipated financial effects disclosed in the sustainability statement/disclosures may relate to risks and opportunities in the value chain rather than own operations and therefore may only indirectly translate into financial effects.

CONNECTIVITY-RELATED CONCEPTS HIGHLIGHTED IN OTHER PUBLICATIONS

71 **Coherence of reported information:** Similar to connectivity, coherence has no commonly accepted definition nor is it one of the Conceptual Framework's qualitative characteristics of useful information. Though this term has been used in different publications[29] sometimes synonymously and at other times as a distinct desirable information attribute related to connectivity, there are only a few instances where there is an elaboration of its meaning (e.g. we are only aware of this being done by the 2021 MCPS ED and by a November 2023 New Zealand XRB[30] publication). The 2021 MCPS ED indicated the term is related to the completeness, clarity and comparability of reported information. The ED conveys different elements of the term as follows:

a) the disclosure of information to assess the implications of interrelated matters. ***For instance, if a trend in the external environment has implications for an entity's business model, strategy, resources and relationships, risk exposure and financial performance or financial position; there should be information explaining these implications;***

b) the presentation of information in a particular corporate report in a way that explains the context and relationships **with information in the same or other reports to allow connections between the two sets of information**[31] (this aspect of coherence was also described in the NZ XRB publication). ***For instance, if an entity discloses its strategy is to grow a particular customer base, and in another part of the management report (e.g., commentary on relationships) it provides more details of the customer base; the latter should also be reflected in the disclosure on strategy.***

c) presentation of information in a way that allows users to relate it to information in the financial statements. ***For instance, the disclosure of an entity's operations in the management report/commentary should be relatable to the segment information disclosed in the financial statements;*** and

d) explanation of inconsistency between information across different AR sections (e.g., management commentary/report and information in the financial statements).

29 The ESMA and Norwegian Finanstilsynet publications refer to coherence but without defining the term. This term was also one of the attributes of useful information in the 2021 EFRAG PTF-RNFRO report where it is stated that the term connotes clear links between reports.

30 NZ XRB staff guidance, November 2023, Climate-related matters in Financial Statements

31 This is similar to the IFRS S1.21 requirement that requirements showing connections within sustainability-related financial disclosures and across general purpose financial reports.

72 Based on the above, in this paper, coherence is deemed to be an aspect of connectivity and it is related to the disclosure and presentation of information in a manner that allows users to get a more complete picture and understand the interrelatedness of different pieces of information). In that sense, coherence can be seen as a feature of effectively depicting the interaction/link between an entity's strategic choices, value-creation factors (i.e., impacts, risks, opportunities and available resources and relationships), and financial effects. It amounts to providing **complementary and/or supplemental** information to the information in a corporate report in a manner that users can readily identify the connections/ interrelatedness of the overall reported information in the context of value creation.

73 **Correlation and 'cause and effect' links:** Another non-mandatory technique for linking reported information could be disclosing the correlations and 'cause and effect' links of information across different AR sections. For instance, this was the case when *SAP outlined the correlated links between financial and non-financial information in its 2021 Integrated report*. ***The interactive chart showed the effect of changes in employee engagement on profitability.***

74 **Explaining why certain information has not been or cannot be connected:** Although not mandated, stakeholders (including EFRAG CAP members) have indicated that in cases where there would be a reasonable expectation of information to be connected and that is not the case, an entity explaining why there is no connection (e.g., due to differing level of aggregation) would be useful and is in itself an aspect of connectivity. As such, this could be a good voluntary practice.

SYNTHESIS OF CONNECTIVITY CONCEPTS

75 Figure 7 below is a diagrammatic synthesis of the connectivity-related concepts.

Figure 7: diagrammatic synthesis of the connectivity-related concepts.

Overarching aspect- integration of information to convey value creation

- Communication/depicting the effects of strategic responses to (impacts, risks and opportunities) on sustainability performance, financial performance and financial position
- Entity's explaining how their strategy and business model, risks and opportunities are linked to financial position, financial performance, cash flows, other metrics and targets in short, medium and long term **(ESRS 1.123 and IFRS S1.35 and IFRS S1.B44)**
- Linking disclosures of risks entities face from reliance on resources/ dependencies to entities actions/ strategy to mitigate these risks and disclosed related current and anticipated financial effects **(ESRS 1.123 and IFRS S1.B43)**
- Explaining trade-offs between risks and opportunities faced when setting strategy **(IFRS S1.B44)**

Connecting interrelated quantitative and narrative information

- Linking quantitative via cross-referencing **(direct connectivity as per ESRS)** **(ESRS 1.124-125)**
- Linking quantitative information via reconciliation **(indirect connectivity as per ESRS)** **(ESRS 1.124-125)**
- Qualitative disclosures stating financial statements line items affected by disclosed risks and opportunities if unable to disclose quantitative current and anticipated financial effects **(IFRS S1.B40)**
- **NON-MANDATORY ELEMENTS BELOW**
- Not required, stakeholders have also suggested explaining why information cannot be connected (e.g., due to differing level of aggregation) could be useful
- Correlation and cause and effect links (voluntary practice, e.g., SAP past reports)

Other overarching aspects of connectivity

- **Consistency:** Consistent data, narrative/qualitative disclosures, assumptions and units of measurement (presentation currency) across SR and the financial statements **(ESRS 1.127-128 and IFRS S1.23)**
- **Coherence:** Presentation and disclosure of information within and across different corporate reports in a manner that gives a more complete picture of an entity's value creation while depicting the interrelatedness of the overall reported information **(Derived from IASB 2021 MCPS ED)** (same notion as complementary)
- Disclosure and explanation of lack of consistency is an element of coherence

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

vs

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

CONNECTION OF FINANCIAL STATEMENTS' INFORMATION TO OTHER AR SECTIONS

76 Reciprocal/two-way connectivity (i.e., connection of information in sustainability reporting to the financial statements and the rest of the management report versus connection of financial statements information to other AR sections) is expected by stakeholders. However, unlike ESRS and IFRS Sustainability Standards for SR information, there are currently no explicit IFRS Accounting connection requirements related to information in the financial statements. Therefore, in the EFRAG connectivity project, there has been discussion of if/how the SR connection requirements (e.g., including information by cross reference, the concepts of direct and indirect connectivity, and consistency of assumptions, data, and narrative) can be extended and applied towards financial statements' information while assessing or developing illustrations (i.e., in the forthcoming EFRAG Discussion Paper) of the connectivity of financial statements' information to other AR sections.

77 In that regard, there are **aspects of the ESRS' and ISSB Standards' connectivity/connection requirements (e.g., depicting the connections between strategic responses to IROs and reporting effects, and the consistency requirements) that can be readily applied for financial statements.** At the same time, relative to the information in the management report or the sustainability statement/disclosures, **there are restrictions in incorporating information into the financial statements by reference.** The following related points have to be considered:

a) ***Including material information by cross-referencing is only explicitly allowed under IFRS Accounting requirements in rare cases:*** As noted earlier (in Section 1.2), subject to certain conditions, ESRS 1 and ISSB Standards generally allow the incorporation into the sustainability statement/disclosures of sustainability-related information in other reports by cross-reference. In contrast, IFRS Accounting Standards only explicitly allow the incorporation of required financial statements' information by reference in very specific cases (i.e., IFRS 7.21B for hedge accounting disclosures and IFRS 7.35C for credit risk disclosures). That said, as we understand, there are no explicit prohibitions[32] to either signposting supplemental information (i.e., not material for financial statements) (e.g., from management commentary) or incorporating material information by cross reference. Of note, in March 2024 IASB discussions held on its project on climate-related and other uncertainties in the financial statements, a suggestion was made that, for a presented line item in the financial statements, a disclosure along the lines of *'this information includes the total amount of assets disclosed as more vulnerable to transition risk as disclosed in accordance with IFRS S2'* could be added. Moreover, the March 2024 IASB staff paper (see link) on the development of examples related to the IASB project on climate-related and other uncertainties in the financial statements indicates that the IASB staff will consider presenting at a future IASB meeting whether and how to illustrate in draft examples the use of cross-references for financial statements information.

b) ***Legal risk on forward-looking information:*** The discussions within EFRAG have highlighted there could be legal risk associated with the incorporation of forward-looking information into the financial statements by cross-referencing.

c) ***Impaired understandability and fragmentation may arise:*** Including material information outside the financial statement by cross reference can help avoid disclosure overload and lessen the reporting burden. At the same time, excessive cross-referencing can lead to fragmentation and difficulties in users accessing or readily having a full picture. This argument was also made in paragraph BC 120 of the 2021 IASB MCPS ED.

32 We note that in BC paragraphs 50-53 of the Conceptual Framework, the Board discussed and promised to address this as part of phase E of the Conceptual Framework on disclosure principles, but it never did so.

d) ***Constraints to cross-referencing arising from the level of assurance:*** A condition for including information by cross-referencing in the financial statements is that the information has the same level of assurance as other information in the financial statements (i.e., reasonable assurance). As highlighted in a November 2023 Mazars – Shift publication (*Understanding Assurance in the ESRS*) based on the analysis of EU Directive 2022/2464, a goal of the CSRD is that financial statements and the sustainability statement should have the same level of assurance (i.e., reasonable assurance expressed in a positively-framed opinion that the subject matter has been prepared in accordance with defined criteria). That said, the CSRD allows limited assurance (which is expressed in an 'opinion' that nothing has come to the assurance provider's attention that would lead them to conclude that the subject matter is materially misstated) from 2025 and with an expectation of reasonable assurance by 2028 (i.e., a gradual approach). It is recognised that there is currently no commonly agreed standard for the assurance of sustainability reporting, especially in relation to 'forward-looking and qualitative disclosures.' Some stakeholders have questioned whether the absence of reasonable assurance for sustainability reporting will affect the connectivity of information (via cross-referencing) in the immediate term.

78 Within the EFRAG CAP, a view has been expressed that **indirect connectivity (e.g., through the use of reconciliations) may be more applicable for linking sustainability reporting information to financial statements than the other way around**. The disclosure of a reconciliation between a monetary amount in the financial statements to an amount in the sustainability statement/disclosures in the notes within the financial statements could be seen as obscuring[33] other material information in the financial statements.

79 Notwithstanding the observations made in the above paragraphs, ultimately, it is the IASB's responsibility to consider how to enhance the connectivity of IFRS financial statements' information could be attained. **This could be done by possibly developing connection requirements and developing illustrative examples. Both these steps could be taken as part of the IASB actions in its project on climate-related and other uncertainties in the financial statements.**

REPORTING OUTCOMES FROM APPLYING CONNECTIVITY CONCEPTS (I.E., INFORMATION ADHERENT TO QUALITATIVE CHARACTERISTICS OF DECISION-USEFUL INFORMATION)

80 The application of the highlighted connectivity concepts (including those encompassed within ESRS' and ISSB Standards' connectivity/connection requirements) to SR information and, where suitable, to financial statements' information can contribute to **information adherent to the qualitative characteristics of the conceptual framework** (i.e., relevance, faithful representation, verifiability, understandability, and comparability). This expectation is fleshed out below.

a) ***Relevance:*** Connectivity via an explanation of linkage between strategy and business aims to tell a more complete story of the entity's value creation and in so doing provides relevant information.

b) ***Faithful representation:*** Consistent assumptions across different reports, linkage of narrative information to current financial effects, and reconciliation of interrelated amounts as well as completeness of information in relation to the depicted matter could ensure faithful representation and lessen greenwashing.

c) ***Verifiability:*** Connecting information contributes to enhanced verifiability through the linkage of objective data to the disclosures of information in both the sustainability statement and financial statements and thereby through the creation of an appropriate 'audit trail', which is the basis of any assurance approach.

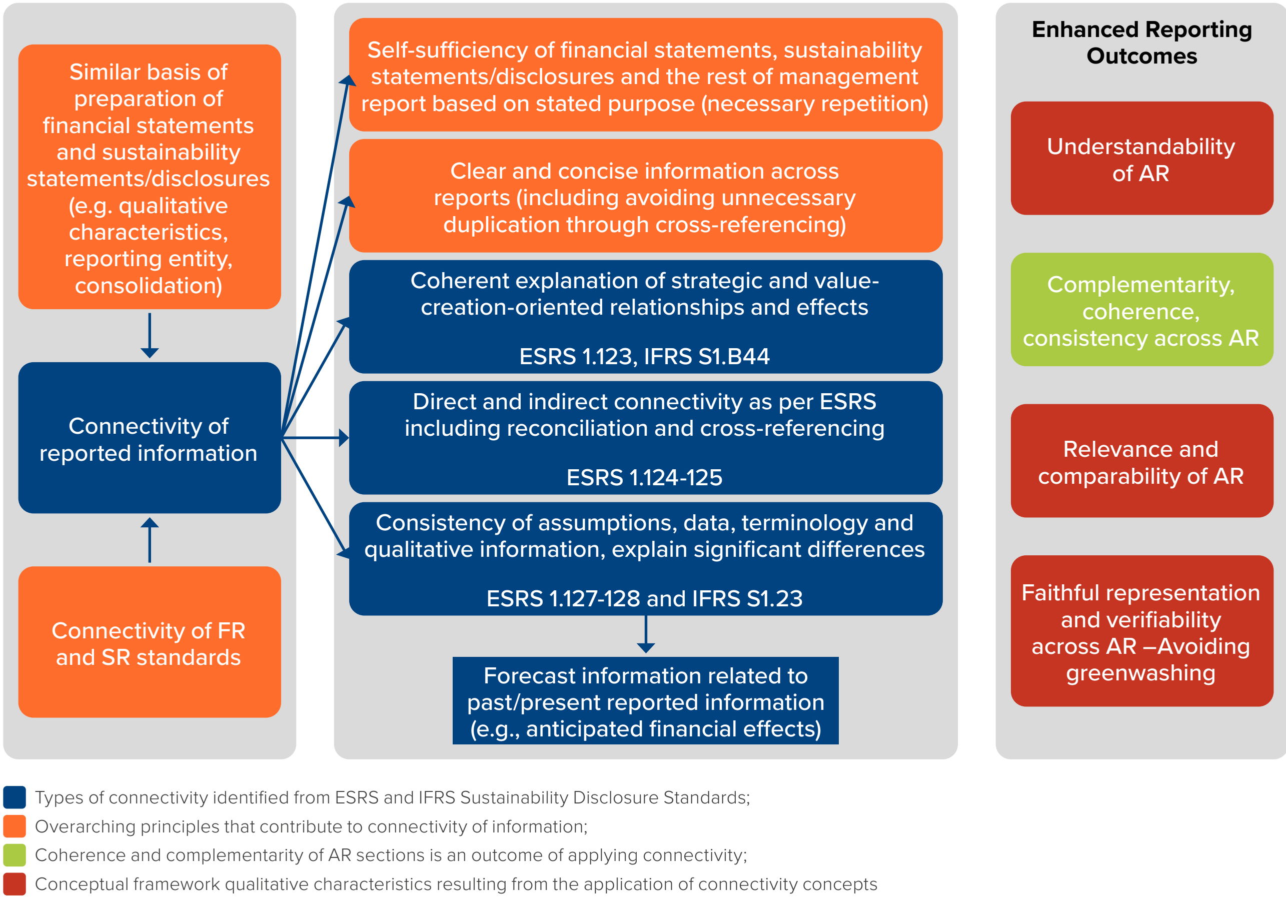
d) ***Understandability:*** Connectivity by applying consistent assumptions contributes to understandability because any inconsistency between the two reports would confuse the reader. Cross-referencing between the various sections of the annual report helps ensure the ease of navigation through the information provided in the annual report. And avoiding unnecessary duplication avoids the obscuring of material information.

e) ***Comparability:*** Comparability can be enhanced to the extent entities share common assumptions (benchmark references, carbon prices, timelines related to sustainability matters) and there is a consistency of assumptions underpinning the related sustainability disclosures and the measurement of assets and liabilities.

33 Some stakeholders have expressed the view that only immaterial information can lead to disclosure overload.

81 In addition to the above, connectivity contributes to the **complementarity and coherence of the different sections of the annual report (AR).** Figure 8 below visually depicts the categories of connectivity and connectivity-related concepts and how these contribute to reporting that is adherent to the required qualitative characteristics of the information.

Figure 8: Connectivity concepts and outcomes



Source: EFRAG

SECTION 1.4: WHY CONNECTIVITY IS IMPORTANT

This section sums up the multiple benefits of applying connectivity-related concepts for reporting information including building bridges, fostering complementarity, increasing interdepartmental collaboration, enhancing the attributes of useful information, and enabling strategic-oriented communication via the AR package.

CONNECTIVITY BUILDS BRIDGES AND FOSTERS COMPLEMENTARY AND FAITHFULLY REPRESENTATIVE REPORTING

82 ***Complementary reporting and building bridges:*** As highlighted in the introduction and detailed in Section 2.2, the financial statements and the sustainability statement/disclosures have distinctive objectives. Though these reports are distinctive and ought to be self-sufficient based on their stated objective (as asserted in Section 1.3), they are also meant to collectively inform about the entity's performance and value creation. As such, these different reports can be seen as complementary parts of a single Annual Report package that communicates a reporting entity's value-creation story. In turn, connectivity between these different reports fosters their overall complementarity. This view was reflected in the 2022 Basis for Conclusions for Draft ESRS 1 (BC 42), which stated, *'Connected information establishes clear links between the management report, sustainability statements and financial statements and provides a holistic view between all the factors that affect value creation.'*

83 As highlighted in the introduction, the absence of a formal connection across AR sections could lead to potential gaps, overlaps (i.e. duplication), and a lack of coherence and impaired relevance of the overall reported information. As discussed in Sections 1.2 and 1.3, due to the respective distinctive objectives of the financial statements and the sustainability statement under the EU reporting framework, connectivity can help to build bridges between these two reporting domains while respecting their boundaries and underpinning concepts. In this sense, connectivity lessens the concerns about gaps and overlaps across the FR and SR domains. Similarly, under a location-agnostic approach whereby SR information is part of general purpose financial reporting and can be potentially be located in the financial statements, connectivity across and within AR sections is important.

84 ***How far should bridges be built and boundaries revised?*** Some stakeholders expect a radical revision of the boundaries of the financial statements. For instance, there are several initiatives[34] aiming to monetise impacts/externalities (e.g., environmental impacts) and incorporate such impacts into the financial statements. This would necessitate a change in the existing recognition and measurement criteria and potentially broaden the current boundaries of financial statements. **This paper is developed on the premise that a radical revision of the Conceptual Framework for Financial Reporting and/or boundaries of the financial statements is yet to be justified[35] especially in light of the available complementary SR information.** Hence, the consideration of the aforementioned initiatives is not within the scope of the EFRAG connectivity project (and this paper) nor are these initiatives encapsulated within the definitions of connectivity provided in this paper.

34 Cohen, R and Serafeim, G. 2020, How to Measure a Company's Real Impact, Harvard Business Review https://hbr.org/2020/09/how-to-measure-a-companys-real-impact. Stakeholders have shared examples of initiatives in certain jurisdictions on how to monetise and incorporate CO2 into financial reporting standards (e.g., expenses and carbon liabilities).

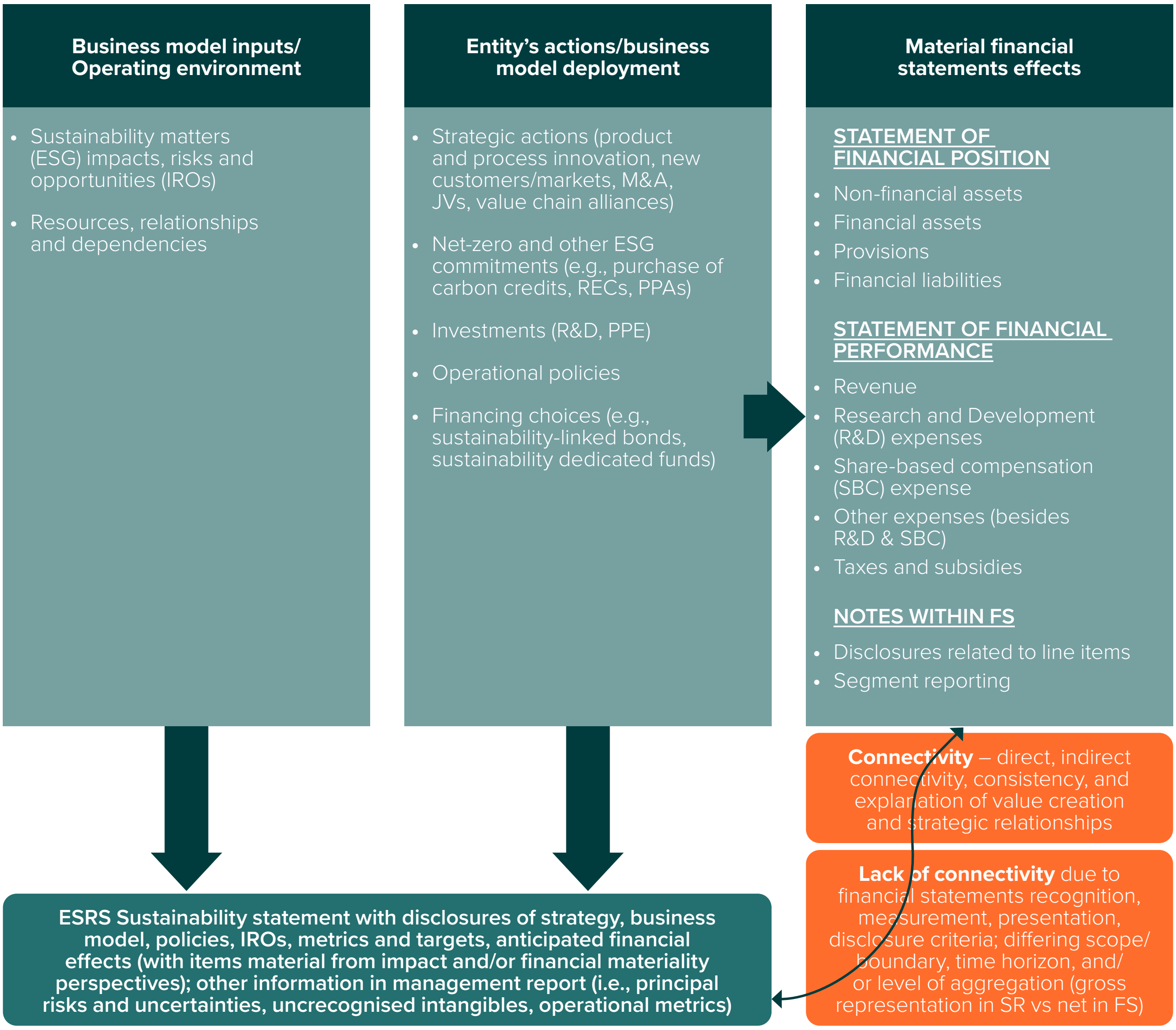
35 As noted in footnote 10 in the introduction, IFRS Accounting requirements are not static. They are underpinned by the Conceptual Framework for Financial Reporting principles that was developed over decades and updated in 2018. Moreover, accounting requirements have an ongoing and robust due process of being updated after taking account of identified practical challenges/including diversity in practice, usefulness of reported information for investors, economic consequences, and any identified conceptual gaps.

85 ***Nudge effects on interdepartmental collaboration and faithful representation of sustainability matters:*** Applying the connectivity concepts (including the ESRS connectivity requirements and IFRS S1 connection requirements) will likely result in increased interaction between financial and sustainability reports teams within companies (i.e., nudge effects). This can increase the financial reporting team's awareness of sustainability risks and opportunities and contribute to a more faithful representation of sustainability matters in the financial statements. Conversely, the sustainability team will be better positioned to develop disclosures on financial effects that do not (yet) meet the criteria for recognition in the financial statements.

CONNECTIVITY ENHANCES THE AR- STRATEGIC-ORIENTED COMMUNICATION

86 As noted in earlier parts of this paper (introduction and Section 1.3), **connectivity enhances the AR's communication of the reporting effects of management's strategic responses to an entity's IROs.** Figure 9 below depicts how this is the case. It also shows the types of connectivity or reasons for lack of connectivity between the different AR sections that can arise and it provides a segue to the discussion about the boundaries of different AR sections in Part 2 of this paper.

Figure 9: Role of connectivity in communicating entity's value creation

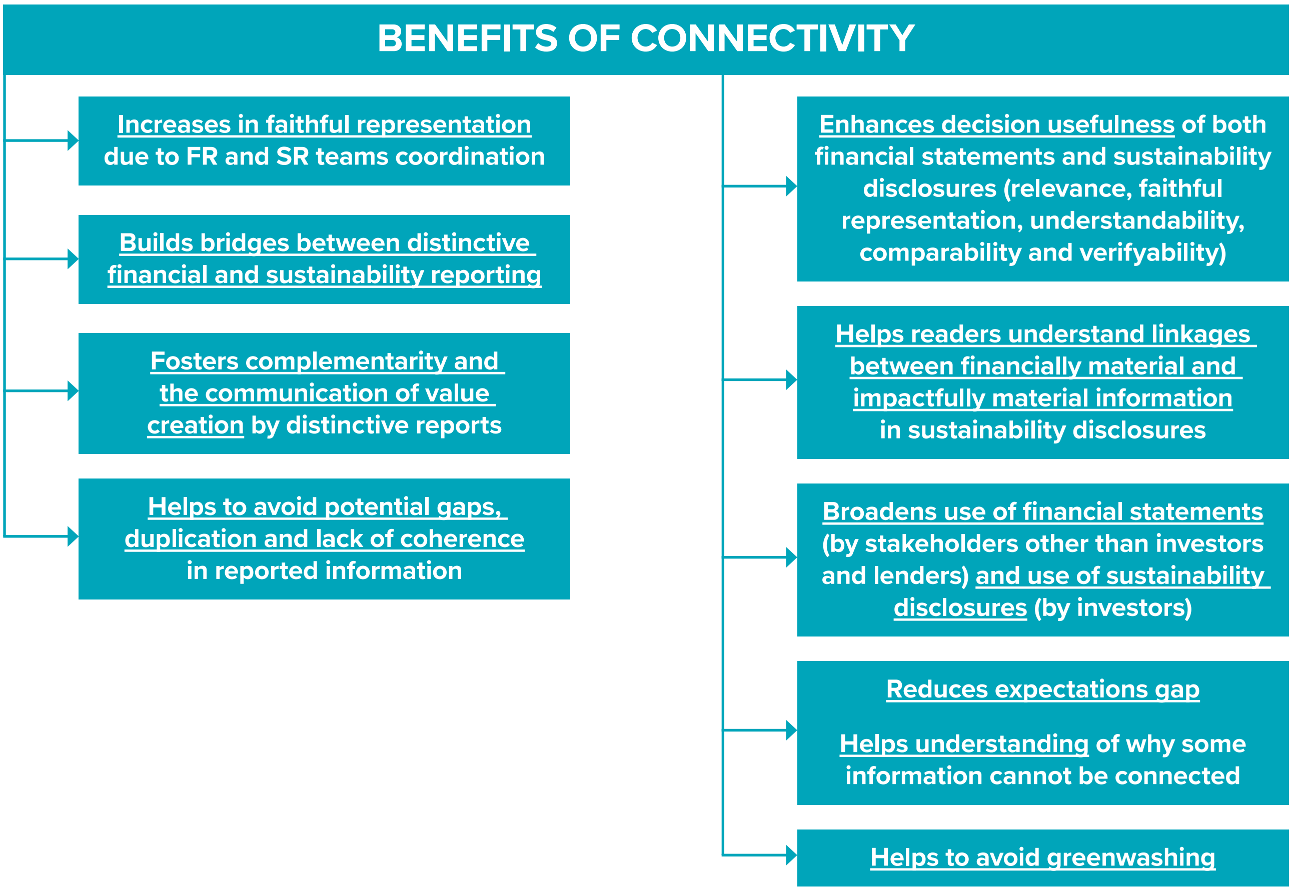


Source: EFRAG

SUMMARY OF EXPECTED BENEFITS OF CONNECTIVITY

87 Figure 10 below summarises the benefits expressed above, those outlined in the introduction (pivotal role of connectivity) and in Section 1.3 (outcomes of applying connectivity requirements) and other expected benefits of connectivity expressed by stakeholders, including EFRAG CAP and EFRAG's technical governance bodies members.

Figure 10: Expected benefits of connectivity
(Diagram Developed by EFRAG based on engagement with stakeholders, including EFRAG CAP)



Source: EFRAG

PART 2. BOUNDARIES OF DIFFERENT AR SECTIONS

SECTION 2.1: REPORTING BOUNDARY – OVERARCHING PERSPECTIVE

88 Similar to how the boundary of a geographical territory connotes what is part of that territory, in broad terms the reporting **boundary connotes the dividing line between information (i.e., information on transactions, activities, conditions and impacts) included and excluded within different corporate reports (i.e., financial statements, management report, the sustainability statement/disclosures, and other reporting sections in the Annual Report).** As noted earlier, in the EU the sustainability statement is a separate, dedicated section of the management report whereas the IFRS sustainability-related financial disclosures are location-agnostic. The boundary notion applies to sustainability information regardless of whether such information has a specific location (i.e., applies to both the ESRS sustainability statement and the IFRS sustainability-related financial disclosures). In other words, this notion pertains to information of a particular reporting domain/section rather than to the location of information.

89 As noted in the introduction, due to the differing objectives and levels of evolution of the aforementioned different corporate reports, they have (or would be expected to have) distinct boundaries, and the connectivity between these reports is pivotal to a coherent annual reporting package with complementary sections. Moreover, an understanding of the boundaries of different corporate reports is essential to identifying the connections that either can or cannot be made between sustainability reporting, the rest of the management report and the financial statements. Such an understanding can also help to reduce the expectation gap on the information that ought to be contained within different corporate reports.

90 ***How can a boundary be defined?*** This paper's articulation of the dimensions of the boundaries of different corporate reports considered the related analysis done in the PTF-NFRS connectivity publication (*Appendix A4 Interconnection between Financial and Non-Financial Information*). This publication noted the financial reporting criteria of financial control or significant influence (under IFRS and EU Accounting Directive) for an entity's investees to be part of the consolidated financial statements (i.e., within the consolidated amounts or as a separate line item). It also laid out the boundaries for financial statements' information imposed by the recognition and measurement criteria for different line items, and it also pointed to the potentially broader definition of the reporting boundary in the non-financial reporting domain (e.g., when applying the GHG Protocol guidance). Concurrently, the PTF-NFRS main publication underscored the need to develop conceptual guidelines for the levels and boundaries of reporting (i.e., this was one of the publication's six identified areas for SR conceptual guidelines). The publication stated that SR goes beyond the level (often referred to as 'scope') of operations under the control of the reporting entity (which is the traditional boundary of financial reporting). It recommended that the value chain should also be covered since major impacts of the activities carried out by a reporting entity may occur in the value chain or through products and services.

91 We also reviewed the boundaries-related conceptualisation done by the PTF-ESRS while developing the initial draft of ESRS as a follow-up to the PTF-NFRS work (see the non-authoritative January 2022 PTF-ESRS working paper on double materiality conceptual guidelines). The PTF-ESRS working paper addressed materiality assessment, and the conceptualisation at the time has been updated by the May 2024 EFRAG IG1: ESRS Materiality Assessment Implementation Guidance (EFRAG ESRS MAIG), which we also reviewed and incorporated into the analysis in Section 2.2. The aforementioned PTF-ESRS working paper also analysed the implications of the different aspects of the financial statements' recognition criteria (separability of items, consideration of control and likelihood of occurrence) and a focus on the past events on information quality. It expressed reservations about changing the objectives and criteria for recognising information in the financial statements.

92 To reflect the breadth of dimensions related to the reporting boundary, we also take account of related academic literature and the IAASB Proposed International Standard on Sustainability Assurance ISSA 5000 related definition[36]. Notably, Bayne[37] (2022) outlines 10 dimensions that have underpinned the description of the reporting boundary. This was based on a review of the prevailing guidance at the time for non-financial or sustainability reporting (2021 EU NFRD Proposal, 2020 GRI-ED, 2021 IR Framework, 2020 SASB-CF ED, 2017 TCFD recommendations, and 2018 UK Strategic Report Guidance) and for IFRS general purpose financial reporting, including financial statements (2018 IFRS Conceptual Framework, 2020/2021 IFRS Foundation Consultation Paper and ED, and the 2021 IFRS MCPS-ED). These dimensions include:

a) the **reporting entity** (extent of financial versus sustainability control/influence). Relatedly, Girella[38] (2018) describes the evolution of what is circumscribed within the reporting entity, including the scope for consolidation of the financial statements. This author further notes the uptake (transplanting) of a similar concept of reporting entity by the multitude of the then-prevailing voluntary sustainability reporting frameworks;

b) **target users** (extent of investor versus wider stakeholder focus);

c) **materiality** (extent of financial versus impact materiality). In the assessment of materiality, we took account of the EFRAG ESRS Materiality Assessment Implementation Guidance, the IASB materiality practice statement, and several NSS publications on materiality;

d) **boundary description** (extent of entity-wide versus topic boundary definition). For this aspect, Bayne (2022) draws attention to 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**.

36 Paragraph 17-oo: *Reporting boundary – Activities, operations, relationships or resources to be included in the entity's sustainability information in accordance with the applicable criteria.*

Paragraph A30 states, *'Although the entity's sustainability information and financial statements may relate to the same reporting entity, the reporting boundary for sustainability information may differ from the boundary for purposes of preparing financial statements. For example, the reporting boundary may include activities, operations, relationships or resources up and down the entity's value chain. An entity's supply chain is part of the value chain.'*

Paragraph A31 states, *'The reporting boundary is determined by the applicable criteria. In some cases, framework criteria may specify the reporting boundary. In other circumstances, the reporting boundary may be determined by the entity, in which case the reporting boundary will be part of the entity-developed criteria. The reporting boundary may vary for different topics and aspects of topics (e.g., some key performance indicators may have different boundaries from other key performance indicators because of the nature of the sustainability matters).'*

37 Bayne, L. (2022), 'Understanding reporting boundaries in annual reports: a conceptual framework', Accounting, Auditing & Accountability Journal, Vol. 35 No. 5, pp. 1316-1348. https://doi.org/10.1108/AAAJ-01-2020-4387

38 Girella, L. (2018). The Boundaries in Financial and Non-Financial Reporting- A Comparative Analysis of their Constitutive Role. Routledge- Taylor and Francis Group

93 As noted, the aforementioned boundary dimensions are based on the guidance that was in place before the ESRS and IFRS Sustainability Disclosure Standards were developed. Nonetheless, along with the factors considered in the PTF-NFRS connectivity publication, these dimensions are pertinent and encapsulated within this paper's analysis of boundaries below with a focus on the following:

a) **objectives and audiences of different AR sections (Section 2.2).** In this section, in addition to the distinct objectives of different AR sections, we highlight the similarities in the basis of preparation including the reporting entity across the ESRS, IFRS Sustainability Disclosure Standards and IFRS Accounting requirements. Hence, unlike for the reports prepared under some of the voluntary non-financial/sustainability reporting guidance, the reporting entity under ESRS and IFRS Sustainability Disclosure Standards is not a differentiating FR versus SR dimension;

b) **materiality-related considerations (Section 2.3),** including the intertemporal dimensions of connectivity, due to the shift of items from being financially material outside the financial statements at a reporting date to being financially material for the financial statements at a future date. Also addressed are grey areas (e.g., where there is diversity in views on the appropriate location of financially material information and/or areas where duplicated reporting in the financial statements and the sustainability statement/disclosures may arise); and

c) **considerations on why certain sustainability matters may not be reflected (i.e., recognised, measured, disclosed or presented) in the financial statements (Section 2.4).** This section illustrates the boundaries of the financial statements and touches on other dimensions of the reporting boundary besides materiality.

SECTION 2.2: OBJECTIVES AND AUDIENCES OF DIFFERENT AR SECTIONS

HIGHLIGHTS OF SECTION 2.2

This section details the respective objectives/purpose and audiences of the financial statements, management report/management commentary and the sustainability statement/disclosures. And included within these descriptions are the other dimensions of the boundary suggested by Bayne (2022) (value, impact on company, outward impact and reporting entity).

This section shows the similarities between the information in SR under ESRS and ISSB Standards, management report and the financial statements. For instance, the reported information is based on the same reporting entity, is underpinned by the same characteristics of useful information, and it aims to inform on an entity's financial position and financial performance). These AR sections also have a shared audience (financial capital providers).

This section also shows differences across the AR sections. Specifically, there are more constraints in reporting information in the financial statements relative to other AR sections. For instance, the information in financial statements focuses on reflecting an entity's present rights to future economic benefits (assets) and present obligations to transfer economic resources (liabilities) predicated on the occurrence of a past event and with the entity having control over the assets (i.e., power to direct). Financial statements reflect the financial position and financial performance at the reporting date. This differs from the SR under ESRS and ISSB Standards that include anticipated financial effects over the short-, medium- and long-term (i.e., related to the entity's potential/ future financial position and financial performance). Other differences highlighted are that, unlike the financial statements, SR allows the application of the notion of operational control whilst calculating metrics.

Moreover, based on the underpinning double-materiality perspective and the broader set of users (i.e., not only financial capital providers) under ESRS, the sustainability statement prepared also includes information that is material from an impact materiality perspective. Such information facilitates the assessment of an entity's impacts on people and the planet prior to the assessment of the resulting financial effects. Materiality is further addressed in Section 2.2.

94 Figure 11 below summarises the key similarities and differences across AR sections that are further elaborated in this section and Sections 2.3 and 2.4.

Figure 11: Comparative analysis of different AR sections (EU corporate reporting)

Financial statements (FS)
(Source: Conceptual Framework)

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

Primary audience of financial capital providers

Includes information material to FS users

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

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

Management report
(Source: EU Accounting Directive)

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

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

Provides description of principal risks and uncertainties

Primary audience is knowledgeable user

Implicit that it has same reporting entity as FS

Sustainability statement
(Source: EU Accounting Directive and ESRS)

It is a section of the management report

Discloses entities' sustainability impacts, risks and opportunities

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

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

OBJECTIVE AND AUDIENCE OF FINANCIAL STATEMENTS REPORTED UNDER IFRS ACCOUNTING STANDARDS

95 The financial statements of listed EU entities reporting under IFRS Accounting requirements are also within the scope of the minimum requirements of the EU Accounting Directive[39]. According to the IASB's Conceptual Framework for Financial Reporting (the 'Conceptual Framework'):

'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions involve decisions about:

a) buying, selling or holding equity and debt instruments;

b) providing or settling loans and other forms of credit; or

39 The EU Accounting Directive (included in the Appendix) outlines high-level principles.

c) *exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.'*

(Conceptual Framework paragraph 1.2)

96 The Conceptual Framework describes that these decisions depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases (Conceptual Framework paragraph 1.3). To help them form these expectations, information is needed about:

a) the economic resources of the entity, claims against the entity and changes in those resources and claims; and

b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.

(Conceptual Framework paragraph 1.4)

Elements of primary financial statements

97 The elements of financial statements that are linked to the economic resources, claims and changes in economic resources and claims are (Conceptual Framework paragraphs 4.1 and 4.2):

a) assets, liabilities and equity, which relate to a reporting entity's financial position; and

b) income and expenses, which relate to a reporting entity's financial performance.

98 These elements are defined as follows.

a) An asset is a present economic resource controlled by the entity as a result of past events (Conceptual Framework paragraph 4.3).

b) A liability is a present obligation of the entity to transfer an economic resource as a result of past events (Conceptual Framework paragraph 4.26).

c) Equity is the residual interest in the assets of the entity after deducting all its liabilities (Conceptual Framework paragraph 4.63).

d) Income is increases in assets, or decreases in liabilities, that result in increases in equity other than those relating to contributions from holders of equity claims (Conceptual Framework paragraph 4.68).

e) Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims (Conceptual Framework paragraph 4.69).

99 For an item to be included in the financial statements[40], this item should meet the definition of an asset or a liability (or be a residual of or change in these). In addition, the item should meet recognition criteria that are set on a standards level and are different for various types of assets and liabilities.

100 The definitions, for example, mean that an economic resource that is not controlled by an entity cannot be recognised as an asset and future obligations cannot be recognised as liabilities. Having a present obligation requires that the entity has already obtained economic benefits or taken an action and as a consequence will or may have to transfer an economic resource that it would not otherwise have had to transfer[41] (Conceptual Framework paragraph 4.43).

40 The Conceptual Framework is not a Standard and overrides any Standard. Requirements in IFRS Accounting Standards may thus also depart from aspects of the Conceptual Framework. IFRS Accounting Standards do currently not require or allow items, the IASB does not consider meet the definitions of assets and liabilities to be recognised in the financial statements [Insert note about IAS 37 project to reflect the status of this project when the DP will be issued].

41 [Reference to the IASB project on Provisions – targeted improvements to be included to reflect the status of the project when the DP is issued]

101 The recognition criteria can result in, for example, an asset not being recognised if its measurement (i.e., the value the asset will be presented at in the financial statements) is too uncertain and certain liabilities not being recognised if it is not probable that they will result in an outflow of economic resources.

Notes to the accounts

102 In addition to presenting items on the primary financial statements, information is provided in notes to the financial statements. IAS 1 *Presentation of Financial Statements* (to be amended depending on IFRS 18) states that:

Notes contain information in addition to that presented in the statement of financial position, statement(s) of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements. (IAS 1 paragraph 7)

103 Paragraph 11 of the IASB guidance[42] for developing and drafting disclosure requirements in IFRS Accounting Standards (which was developed as part of the IASB project Disclosure Initiative– Targeted Standards-Level Review of Disclosures) states the purpose of the disclosure requirements in an Accounting Standard can be stated as to require an entity to disclose the following types of information in the notes, if such information is useful to users of financial statements:

a) information that supplements the information presented in the primary financial statements, including:

(i) disaggregation of information presented in the primary financial statements;

(ii) information about the nature of, and the risks arising from, recognised assets and liabilities;

b) **information about unrecognised assets and liabilities, including information about their nature and about the risks** arising from them;

c) the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements;

d) information about transactions and other events that have occurred after the end of the reporting period; and

e) forward-looking information relating to the entity's assets or liabilities – including unrecognised assets or liabilities – or equity that existed during or at the end of the reporting period, or to income or expenses for the reporting period.

OBJECTIVE AND AUDIENCE OF THE MANAGEMENT COMMENTARY/ MANAGEMENT REPORT

104 To contextualise the information in the financial statements, some jurisdictions also require (or allow) entities to provide a management commentary which, depending on jurisdiction, is also referred to as the management report, MD&A (management discussion and analysis), strategic report, etc. The legislative requirements for management commentary vary across jurisdictions, including across EU member states[43]. Furthermore, even though the IASB Management Commentary Practice Statement is voluntary and not endorsed in the EU, nor is it applied across several large economies[44], its guidance can inspire the prevailing diverse regimes of management reporting requirements.

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42 https://www.ifrs.org/content/dam/ifrs/groups/iasb/guidance-for-developing-and-drafting-disclosure-requirements-in-ifrs-accounting-standards.pdf

43 Rowbottom, N & Schroeder, M 2014, 'The rise and fall of the UK Operating and Financial Review', Accounting, Auditing and Accountability Journal, vol. 27, no. 4, pp. 655-685 notes that *"In June 2003, the EU Accounts Modernisation Directive 2003/51/EC required member states to introduce legislation to ensure that all large and medium sized companies disclose management commentary within their annual reports in a revised Business Review in the Directors' Report (effective by January 2005). Listed companies were expected to make additional non-financial disclosures, to the extent necessary for an understanding of the business, relating to employee and environmental matters in an 'enhanced' Business Review...*

The EU Transparency Directive 2004/109/EC, adopted in December 2004, also required listed companies to produce a 'management report' in their interim and annual reports.'

44 Australian Accounting Standards Board staff paper, May 2021, *Comparison of Narrative Reporting Requirements applicable to Not-For-Profit Entities*. The paper reviewed the narrative reporting requirements of nine jurisdictions (Australia, Canada, Germany, Hong Kong, New Zealand, Singapore, South Africa, United Kingdom and United States) and none of these jurisdictions apply the Practice Statement, and there is diversity across these countries in the extent of the alignment of their requirements to the proposed revised MCPS guidance (included in the 2021 Exposure Draft).

EU management report

105 The preamble to the EU Accounting Directive states: *'The management report and the consolidated management report are important elements of financial reporting'* (paragraph 26).

106 Paragraph 1 of Article 19 of the EU Accounting Directive states, *'The management report shall include a fair review of the development and performance of the undertaking's business and of its position, together with a description of the principal risks and uncertainties that it faces.*

The review shall be a balanced and comprehensive analysis of the development and performance of the undertaking's business and of its position, consistent with the size and complexity of the business.

To the extent necessary for an understanding of the undertaking's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. In providing the analysis, the management report shall, where appropriate, include references to, and additional explanations of, amounts reported in the annual financial statements.'

107 As noted, mandatory requirements differ across jurisdictions. Illustratively, Appendix 3 has a summary of the objectives of the management report requirements in France and Germany. Of note, the EU Directive sets minimum requirements, and the jurisdictions develop further specific requirements (e.g., GAS 20 in Germany).

Management commentary as part of IFRS general purpose financial reporting

108 The preface to IFRS Accounting Standards states that the Standards are *'designed to apply to the general purpose financial statements and other financial reporting of profit-oriented entities'* (paragraph 5): *'Other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improvise users' ability to make efficient economic decisions'*.

109 In a similar vein, the IASB's Conceptual Framework for Financial Reporting states that *'The qualitative characteristics of useful financial information apply to financial information provided in financial statements, as well as to financial information provided in other ways' (paragraph 2.3).*

110 The IASB's existing Practice Statement 1 Management Commentary – A framework for presentation (2010) states that *'[t]he Practice Statement is prepared on the basis that management commentary lies within the boundaries of financial reporting because it meets the definition of other financial reporting in paragraph 7 of the Preface to International Financial Reporting Standards. Therefore management commentary is within the scope of the Conceptual Framework for Financial Reporting.'* (paragraph IN 4)

111 The existing Practice Statement describes the following objective of management commentary:

a) Provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances but also why it has happened and what the implications are for the entity's future.

b) Complements and supplements the financial statements by communicating integrated information about the entity's resources, the claims against the entity and its resources, and the transactions and other events that change them.

c) Explain the main trends and factors that are likely to affect the entity's future performance, position and progress. Consequently, management commentary looks not only at the present but also at the past and the future.

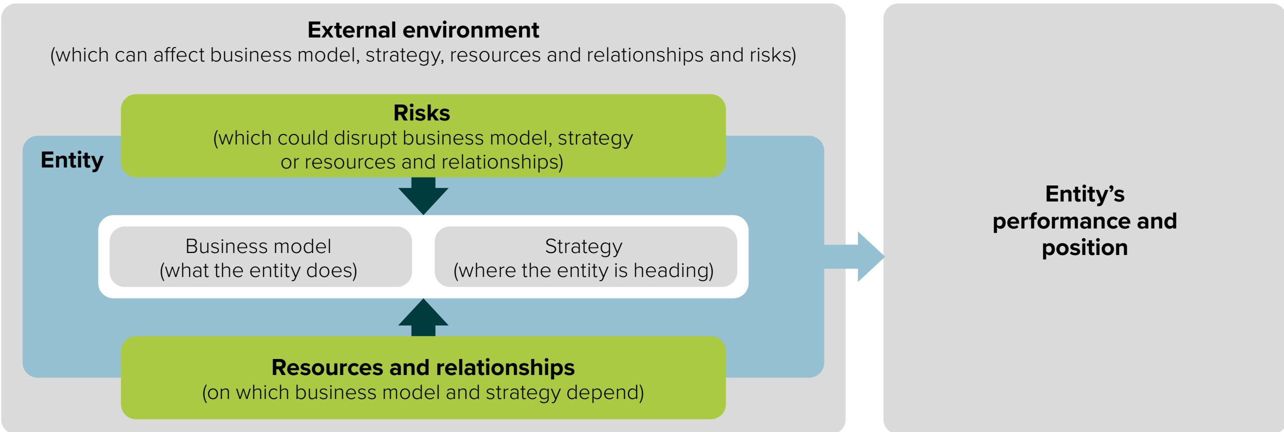
112 The existing Practice Statement is under review, and in 2021 the IASB published an Exposure Draft *Management Commentary* (ED). Following the feedback to the ED, the IASB is in the process of considering how to proceed with the MCPS project including if and to the extent collaboration with the ISSB will occur in finalising the project. As such, the content of the ED may be revised based on the feedback to the ED and in light of the sustainability reporting developments that have occurred since the ED was published. Nonetheless, we note that, in addition to the objectives of the existing practice statement in the above paragraph, Paragraph 3.1 of the 2021 IASB Exposure Draft *Management Commentary* (ED) proposes that an entity's management commentary provide information that:

a) enhances investors' and creditors' understanding of the entity's financial performance and financial position reported in its financial statements; and

b) provides insight into factors that could affect the entity's ability to create value and generate cash flows across all time horizons, including in the long term.

113 Figure 11 shows the relationships between disclosure objectives for areas of content within the MCPS ED.

Figure 11: Relationships between disclosure objectives for areas of content within the MCPS ED



Source: EFRAG

114 An entity's financial position and financial performance was a content area under the MCPS ED (i.e., it was one of the six proposed content areas). Hence, a question could arise on the distinction between information on the financial position and financial performance in the management commentary and the notes in the financial statements. In this regard, paragraph 10.3 of the ED states that information in management commentary about an entity's financial performance and financial position complements information provided in the related financial statements. Accordingly, management commentary provides more discussion, analysis, forward-looking information and non-financial information than is included in the entity's financial statements to explain the entity's financial performance and financial position reported in those financial statements.

115 Furthermore, paragraph 10.6 of the ED states that the information about the entity's financial performance and financial position shall enable investors and creditors to understand:

a) what factors have affected the entity's financial performance and financial position in the reporting period or could affect them in the future, including in the long term;

b) how management has allocated financial resources in the reporting period; and

c) how the entity's financial performance and financial position compare with forecasts or targets previously published by the entity, if any.

OBJECTIVE AND AUDIENCE OF SUSTAINABILITY REPORTING – IFRS SUSTAINABILITY DISCLOSURE STANDARDS AND ESRS

IFRS Sustainability Disclosure Standards

116 IFRS S1.1 states that the objective of IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information is to require an entity to disclose information about its sustainability-related risks and opportunities that is useful to primary users of general purpose financial reports in making decisions relating to providing resources to the entity.

ESRS

117 In the EU legislation, sustainability reporting standards were considered necessary to:

a) reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth (Directive EU 2022/2464, preamble (paragraph 2));

b) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues (Directive EU 2022/2464, preamble (paragraph 2)); and

c) Foster transparency and long-termism in financial and economic activity (Directive EU 2022/2464, preamble (paragraph 2)).

118 The legislation explains that (Directive EU 2022/2464, preamble (paragraph 9)):

'If undertakings carried out better sustainability reporting, the ultimate beneficiaries would be individual citizens and savers, including trade unions and workers' representatives who would be adequately informed and therefore able to better engage in social dialogue. Savers who want to invest sustainably will have the opportunity to do so, while all citizens would benefit from a stable, sustainable and inclusive economic system. To realise such benefits, the sustainability information disclosed in the annual reports of undertakings first has to reach two primary groups of users. ***The first group of users consists of investors, including asset managers,*** *who <u>want to better understand the risks and opportunities that sustainability issues pose for their investments and the impacts of those investments on people and the environment</u>. The second group of users consists of* ***civil society actors, including non-governmental organisations and social partners,*** *which wish to <u>better hold undertakings to account for their impacts on people and the environment</u>. Other stakeholders might also make use of sustainability information disclosed in annual reports, in particular, to foster comparability across and within market sectors.*

The business partners of undertakings, including customers, *might rely on sustainability information to understand and, where necessary, report on their sustainability risks and impacts throughout their own value chains.* ***Policymakers and environmental agencies*** *can use such information, in particular on an aggregate basis, to monitor environmental and social trends, to contribute to environmental accounts, and to inform public policy. Few individual citizens and consumers directly consult undertakings' annual reports, but they might use sustainability information indirectly, for example, when considering the advice or opinions of financial advisers or non-governmental organisations.'*

119 The information disclosed in accordance with ESRS enables users of the sustainability statement to understand the undertaking's material impacts on people and environment and the material effects of sustainability matters on the undertaking's development, performance and position (ESRS 1 paragraph 2).

120 Aligned with these objectives, and in line with the concept of double materiality, ESRS 1 *General Requirements* identify two main groups of stakeholders for sustainability information (ESRS 1 paragraph 22):

a) affected stakeholders: individuals or groups whose interests are affected or could be affected – positively or negatively – by the undertaking's activities and its direct and indirect business relationships across its value chain; and

b) users of the sustainability statement: primary users of general-purpose financial reporting (existing and potential investors, lenders, and other creditors, including asset managers, credit institutions, and insurance undertakings), and other users of the sustainability statement, including the undertaking's business partners, trade unions and social partners, civil society and non-governmental organisations, governments, analysts and academics.

OTHER SIMILARITIES BETWEEN FINANCIAL STATEMENTS AND SUSTAINABILITY REPORTING REQUIREMENTS

121 *Similar qualitative characteristics:* The qualitative characteristics of the ESRS and IFRS Sustainability Disclosures Standards (IFRS Sustainability Disclosure Standards) are largely in common with those of the Conceptual Framework for Financial Reporting[45].

122 *Similar basis for preparation (reporting entity and reporting period):* Both ESRS and IFRS Sustainability Disclosure Standards also require the same reporting entity and reporting period as the financial statements.

123 *Similar basis for preparation (other aspects):* Both ESRS and IFRS Sustainability Disclosure Standards also have similar approaches for the treatment of events after the reporting date, changes in estimates, and changes in preparation and presentation practices as the financial statements. And they were influenced by IAS 1, IAS 8, and IAS 10 requirements.

OTHER DIFFERENTIATING FACTORS

124 Besides materiality, which is addressed in the next section (Section 2.2), there are other factors addressed in Section 2.3 affecting the boundaries of the financial statements (e.g., constraints imposed by the recognition, measurement, presentation and disclosure criteria for financial statements). Moreover, as detailed in Section 2.3, there can be a lack of connectivity between financial statements and sustainability reporting due to:

a) differing level of aggregation between these corporate reports;

b) the lengthier time horizon typically applied towards sustainability reporting;

c) the extent to which forward-looking information is incorporated;

d) the extent of reporting non-monetary/narrative information/ metrics (i.e., much greater in SR), along with the difficulties of translating non-monetary metrics into monetary values;

e) the incorporation of value chain information in sustainability reporting;

f) the absence of primary statements; and

g) the application of operational control whilst calculating metrics in sustainability reporting.

45 Under ESRS, specific adjustments have been introduced to reflect impact materiality.

SECTION 2.3: MATERIALITY-RELATED CONSIDERATIONS

HIGHLIGHTS OF SECTION 2.3

Materiality (an element of relevance, i.e., a fundamental qualitative characteristic of useful information) is an overarching concept in corporate reporting, and it is applied as a filter for determining the nature, magnitude and level of aggregation of information in different AR sections. As noted earlier[46], materiality is one of the dimensions of defining boundaries and it impacts connectivity across different AR sections in both a static and dynamic sense. Thus, this section addresses:

- **the application of materiality across different AR sections;**
- **the intertemporal/dynamic dimension of connectivity (i.e., migration across reports over time), which can result from either dynamic materiality (impact material items becoming financially material) or the shift of items from being financially material outside the financial statements at a reporting date to being financially material for the financial statements at a future date; and**
- **grey areas of financially material items (i.e., where there may be double reporting, missing information across different reports; and/or where there are diverse views and no explicit requirements where particular information should be reported). We sum up the takeaways from grey areas and the steps that could be taken to both enhance connectivity and lessen the expectation gap on the boundaries of the financial statements.**

In Section 2.3, we also outline other factors related to the boundaries of the financial statements and the sustainability statement/disclosures.

APPLICATION OF MATERIALITY ACROSS DIFFERENT REPORTS

125 An explanation offered for the often-observed disconnect between the reporting of sustainability (e.g., climate-related) risks and opportunities in the financial statements relative to the management report and sustainability disclosures has been that these risks and opportunities may have been considered immaterial for financial statements albeit being deemed material for the sustainability disclosures.

126 Hence, it has to be underscored that the **application of materiality within each report is in the context of its objective**. By extension, the respective boundaries of financial statements, the sustainability statement and the rest of the management report (i.e., what information is included in each of these reports) are influenced by the application of materiality in the context of the objectives of these different AR sections.

Definition of materiality for IFRS general purpose financial reporting

127 The Conceptual Framework for financial reporting, IAS 1.7 and IAS 8.5 provide the following definition of materiality:

'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… The understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.'

46 In the preface, we note that Baynes (2022) identified 10 dimensions needed to define boundaries including materiality.

128 The IFRS Practice Statement 2 *Making Materiality Judgements* (materiality practice statement) notes that an entity makes materiality judgments when making decisions about recognition, measurement, presentation, and disclosure. The materiality practice statement contains three key elements, namely: a) an overview of general characteristics of materiality, b) four steps of the materiality judgments process, and c) materiality judgments in specific circumstances (such as prior-period information, errors, covenants and interim reporting). The four-step process consists of the following:

a) *Identify* information that can be considered material within the requirements of IFRS Accounting Standards while taking into consideration the needs of primary users of the financial statements;

b) *Assess* whether the identified information is, in fact, material by considering both quantitative and qualitative factors related to the entity and its external environment;

c) *Organise* the information within the draft financial statements; and

d) *Review* the draft financial statements whether all material information has been considered.

129 The materiality practice statement also states that requirements in IFRS Standards only need to be applied if their effect is material to the complete set of financial statements[47], and an entity need not provide a disclosure specified by an IFRS Standard if the information resulting from that disclosure is not material. This is the case even if the Standard contains a list of specific disclosure requirements or describes them as 'minimum requirements'. Conversely, the entity must consider whether to provide information not specified by IFRS Standards if that information is necessary for users to understand the effect of particular transactions, other events and conditions on the entity's financial position, financial performance and cash flows.

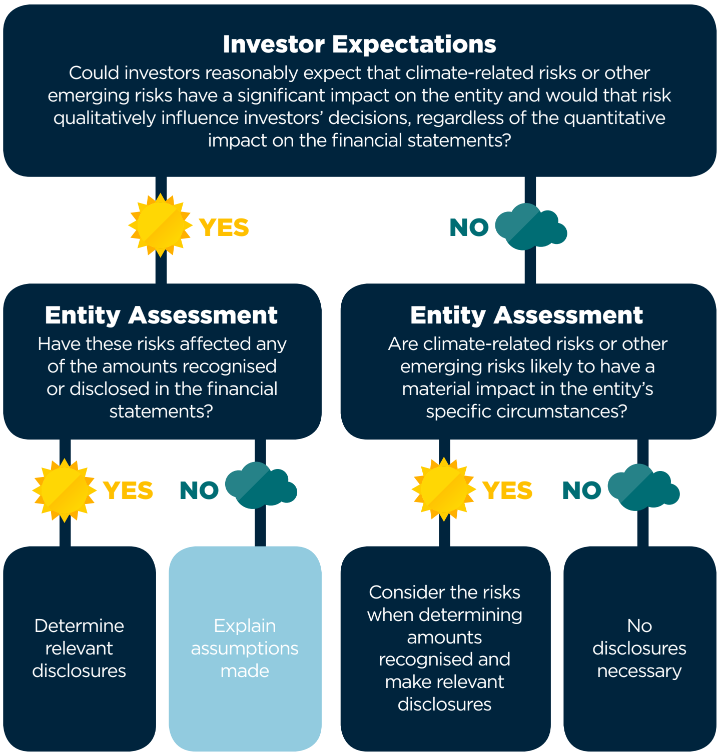
130 In 2018, consequential amendments to IAS 1 and IAS 8 emphasised the application of materiality depends on the nature or magnitude of information. In other words, an entity is required to assess whether the information, either separately or in aggregate with other information, is material in the context of the financial statements. The IAS 1.7 definition of materiality is also applied across IFRS general financial reporting that encompasses the financial statements, sustainability-related financial disclosures, and management commentary.

131 Pointedly, Figure 12 below from a 2019 AASB publication[48] summarises key considerations related to assessing the materiality of climate risks and other emerging risks in financial statements.

47 In other words, information needs to be material to the primary financial statements and notes taken together.

48 AASB, 2019, Climate-related and other emerging risks disclosures- assessing financial statement materiality using AASB/IASB materiality Practice Statement 2.

Figure 12: Key considerations in assessing materiality



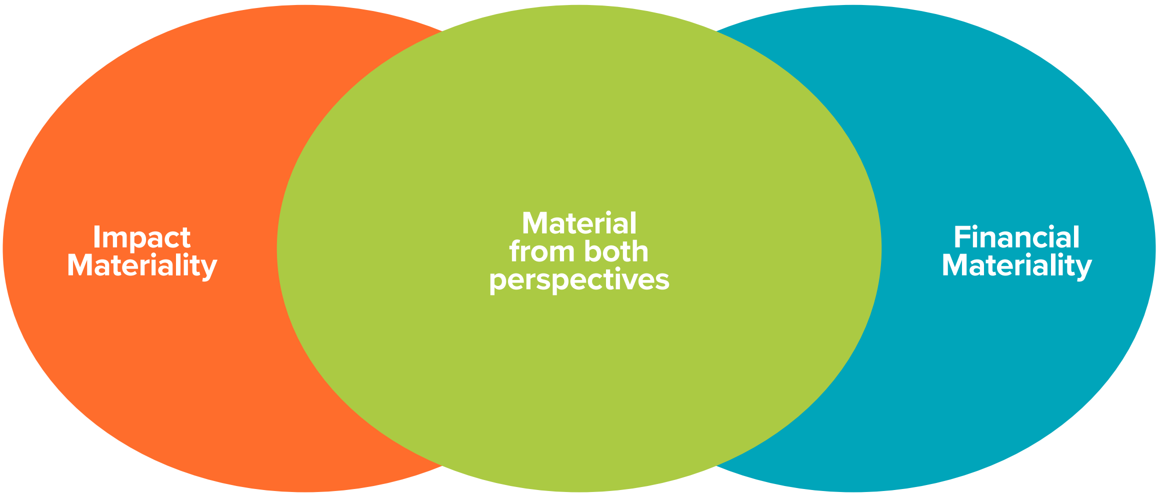
Source: Modified from 2019 AASB publication- Climate-related and other emerging risks disclosures.

Materiality under ESRS, ISSB Standards and MCPS ED

132 The reporting/preparation of the sustainability statement by EU entities under ESRS requirements aims to report on the impacts, risks and opportunities arising from sustainability matters and, as a result of its broad set of users as depicted in Figure 13, this is done under the double materiality perspective.

Figure 13: Excerpt from the May 2024 EFRAG ESRS Materiality Assessment Implementation Guidance

All sustainability matters affected by or that have an effect on the undertaking



Caveat: for illustration only – the dimensions in the graph do not necessarily represent the expected overlap (green) between financial and impact materiality nor the relative perimeters of impact materiality (orange) versus financial materiality (blue). For most material impacts, a risk opportunity related to that impact may emerge over time.

Source: Adapted from May 2024 ESRS Materiality Assessment Implementation Guidance

133 ***Materiality assessment under ESRS versus ISSB versus IASB MCPS ED:*** Materiality assessment under ESRS involves two steps. The first step is determining which sustainability matters/topical standards are material and should be covered in the sustainability statement/disclosures. The second step is determining which information within such matters/topical standards is material and should be disclosed. In other words, reporters have to identify material matters/topics and then material information.

134 In contrast, ISSB Standards (IFRS S1 and IFRS S2) only refer to material information and there is no reference to material matters. For these 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. Similarly, related to management commentary, the 2021 MCPS ED also proposed the need for entities to ascertain key matters before deciding on the material information. For this purpose, matters would be identified as 'key' if they are 'fundamental to the entity's ability to create value and generate cash flows'.

135 ***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 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).*

136 The May 2024 EFRAG IG1: ESRS Materiality Assessment Implementation Guidance (EFRAG ESRS MAIG) includes frequently asked questions (FAQs) related to both impact materiality and financial materiality. FAQs 3, 4 and 5 (and responses) of the guidance address financial materiality and convey that, **whilst the concept of financial materiality does not differ between ESRS and financial reporting standards, the information that is likely to be material under the two sets of standards would differ.**

137 In other words, there are differences between information that is likely to be financially material for financial statements and information that is likely to be financially material for the sustainability statement. For instance, financially material information for the sustainability statement would, inter alia, include anticipated financial effects (i.e., financial effects that would not be recognised in the financial statements at a reporting date) and information about material risks and opportunities arising from its business relationships, i.e., in the upstream/downstream value chain. This highlighted analysis of the EFRAG ESRS MAIG affirms that what is adjudged to be material information depends on the context and type of report.

INTERTEMPORAL DIMENSION OF CONNECTIVITY: MIGRATION OF ITEMS ACROSS DIFFERENT AR SECTIONS

138 As noted in Section 1.3, connectivity has a static/point-in-time dimension (i.e., connectivity of information located in different AR sections at a particular reporting date) and an intertemporal/dynamic dimension where there is a change in the reporting location of impacts, risks, or opportunities across different reporting periods (i.e., migration of items across different AR sections over time). The latter could be due to a change in the nature, quantifiability, magnitude/severity or probability of occurrence of a particular risk or opportunity. Enabling the understanding and monitoring of the noted migration of information across reporting periods is a key element of connectivity as it explains and highlights the evolving nature of the related information. Under ESRS requirements, intertemporal connectivity is captured by forecast information being related to past/present and in the disclosures of anticipated financial effects.

139 As noted in Section 1.3., there are instances where anticipated financial effects (including short- term anticipated financial effects) disclosed in SR may not necessarily crystallise as anticipated in an entity's future financial statements (and in such cases, there will be no continuity across periods in the reporting of the item that was depicted as an anticipated financial effect). This can be due to a) occurrence uncertainty (e.g., climate physical risk/threat may never crystallise); and b) estimation uncertainty. For instance, due to the extant, early-stage methodologies for estimating sustainability matters (climate transition risk, biodiversity risk); and c) anticipated financial effects disclosed in the sustainability statement/ disclosures may relate to risks and opportunities in the value chain rather than own operations.

140 Migrations of items across different AR sections can be due to the below.

141 ***Dynamic materiality***[49]: For instance, a sustainability matter that is material (from an impact-materiality perspective) may shift from being a disclosure in the sustainability statement at a particular reporting to becoming a financially material and recognised, presented, or disclosed item in the financial statements at a future reporting date. For example, adverse impacts reflected in an entity's sustainability statement at a reporting date may translate to legal risk and fines that are reported in the financial statements at a future reporting date. Relatedly, a Harvard Business School article[50] conceptualises how ESG risks become financially material.

142 Under ESRS, with the consideration of the long-term horizon, most of the matters that are material for impacts are also material financially (in particular, virtually all the impacts translate into reputational risks though the timing in which they ultimately get reflected in the statements may vary). Said differently, it is hard to find items that would exclusively be in the orange part of the Venn diagram in Figure 13 above (i.e., only material for impacts).

143 ***Financially material information reported outside the financial statements at a particular reporting date may either get recognised, presented, or disclosed in the financial statements at a future reporting date:*** For instance, risks and opportunities disclosed in the sustainability statement/disclosures or risk report at a reporting date may at a future reporting date, be recognised as assets, liabilities (including provisions), revenue, impairment charges, research and development expenses, other expenses in the primary financial statements, or be disclosed in the notes within the financial statements.

Conceptualisation of where the intertemporal dimension of connectivity may arise

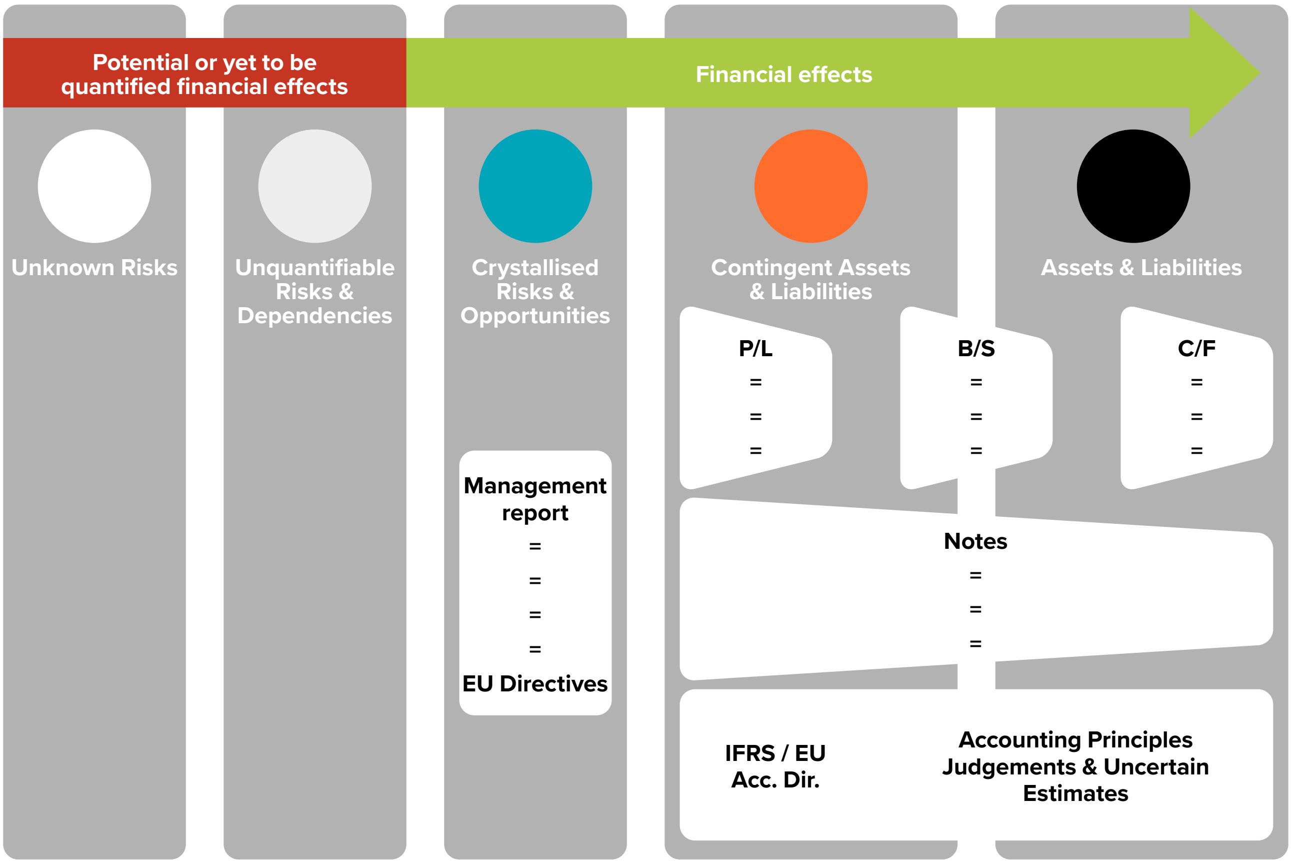
144 Figure 14 below, which is modified from the PTF-NFRS connectivity publication, is a high-level depiction of items that can be connected to and reported in the financial statements at a future date versus those that cannot and therefore pertain exclusively to sustainability reporting. Connectivity to the financial statements arises for items that are financially material and earmarked as the blue zone category (i.e., crystallised risks and opportunities disclosed in the management report). There could be static connectivity for the blue zone items in the management report (i.e., they can be linked to financial statements at a reporting date). There could also be an intertemporal dimension of connectivity (i.e., the items could be linked to the statement of financial performance and statement of financial position of a future reporting date).

145 In contrast, the items earmarked as white zone (unknown risks) and grey zone items will be difficult to connect to the financial statements. Items in the grey zone consist of both externalities and risks that companies face that are difficult to quantify. Human rights in certain jurisdictions could be perceived as an example of a grey zone item as it is an actual or could be a potential, adverse impact of the company that is not deemed to be a risk to the company by the management.

49 Dynamic materiality recognises that whilst a company may have many positive and negative impacts on people, planet and social prosperity, a subset of those impacts can, in turn, positively or negatively affect the company's business model and therefore create or erode its enterprise value and financial returns to providers of capital.

50 How ESG Issues Become Financially Material to Corporations and Their Investors

Figure 14: Continuum of financial effects (adapted from 2021 PTF-NFRS Publication)



Source: EFRAG

146 Further analysis of materiality dynamics can be found in the EFRAG ESRS MAIG and the earlier mentioned Harvard Business School article.

Illustration of dynamic materiality

147 Illustratively, the EFRAG ESRS MAIG Paragraph 37 notes that *'For most material impacts, a material risk and/or opportunity may emerge over time. 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.'*

GREY AREAS IN THE LOCATION OF INFORMATION

148 As noted above, consideration of whether the information is material for financial statements ought to be intertwined with consideration of the respective objectives of financial statements, the sustainability statement/disclosures, and the rest of the management report. The fact patterns below and the associated questions posed by stakeholders exemplify grey areas *(i.e. where there is duplication or missing information across the package of reports, where there could be diverse perspectives on the best location of information)*. Duplication may be an inconvenience/reporting burden, but missing information would be deemed a serious concern and reporting shortcoming.

149 ***Fact pattern 1:*** *In investor X's investment portfolio, there is an auto company that is ramping down its production of internal combustion engine vehicles, whose sales are set to be banned in the EU from 2035. It is of interest to investors to know how much of the company's plant and workforce used to manufacture internal combustion engines could be used to manufacture electric vehicles and how much would have to be sold as scrap.*

The financial statements did not include any material impairments. Hence, the investment team could not estimate the effects of the ban as the company did not provide disaggregated information on its fixed assets by engine type. For an auto parts supplier with most of their business manufacturing petrol parts, is the information of interest to investors material information for financial statements (per IAS 1)?

a) View 1 – Yes, it is material information for the financial statements as it is useful for valuation purposes.

b) View 2: No - the time horizon (2035) is after the remaining useful life of all assets and the going concern test. There are no line items on the balance sheet which are impacted by the certain discontinuation of the business from 2035.

150 ***Fact pattern 2 (location of net-zero commitments disclosures):*** *Even if net-zero commitments do not qualify to be recognised as a provision based on IAS 37 requirements, should information (i.e., related to possible future outflows) for such commitments be disclosed in the financial statements?*

151 *We note that in response to the November 2023 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.*

152 *Moreover, during the outreach done by EFRAG so far, users have indicated a disclosure of a time series of likely costs would be useful even if provisions are not recognised. It has also been expressed that it should be clear when items migrate from the sustainability statement/disclosures to the financial statements (i.e., what are the triggers for the recognition of provisions or contingent liabilities). Another suggestion has been that, if material for the purposes of the financial statements, information disclosed in the sustainability statement/disclosures could be included in the financial statements by cross- reference. Below are arguments underpinning the views in support and against disclosing the aforesaid information in the financial statements.*

a) View 1 (supportive view): Yes, information (i.e., related to possible future outflows) should be disclosed if material for financial statements based on user expectations.

(i) As noted in Section 1.3, financial statements should be self-sufficient and complete with material information for investors in the context of their objectives. In this regard, a January 2023 Corporate Reporting Users Forum (CRUF) article- *Getting visibility on the financial statement effects of climate change* outlines the expected respective roles of sustainability disclosures and financial statements by users. This article opines that, instead of substituting financial statements' information, sustainability reporting information could create awareness of information missing in the financial statements (also described as the expected nudge effects of forthcoming sustainability disclosures).

(ii) Some stakeholders expect IAS 1.31 requirements to be applied to reflect disclosures beyond the disclosure requirements of specific Standards. That said, we note diverse views exist on the applicability of this paragraph. For instance, other stakeholders[51] have noted that applying this paragraph to include net-zero commitments would be too-liberal an interpretation of the requirements as they observe that the application of IAS 1.31 is rare in practice. Yet other stakeholders do not rule out the applicability of the paragraph in cases where there is a disconnect between the management report and financial statements in the portrayal of how climate-related risks affect the entity's overall prospects. Thus, the IASB project on climate-related and other uncertainties (of which an Exposure Draft-ED is expected later in 2024) may help to address the expectation gaps. The ED will propose illustrative examples including those related to the application of IAS 1.31 requirements.

(iii) Related to IAS 1, as noted in Section 2.3, 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**[52] and **UKEB September 2023 report**).

(iv) Though IFRS S1, S2 and ESRS have requirements for the disclosure of anticipated financial effects, these SR requirements may not explicitly capture information stakeholders expect to be reported and which they could consider to be suited to be disclosed in the financial statements.

(v) The information could be in both the sustainability disclosures and financial statements. The information disclosed on the financial implications of transition plans in the short-, medium- and long-term disclosed in sustainability could be included by cross-reference into the financial statements. As noted in section 1.3, there is no explicit prohibition of either incorporating material into the financial statements by cross-reference or signposting in the financial statements, supplemental information (that may not be material for the financial statements) that is disclosed in the management report (including sustainability disclosures).

(vi) Related to the preceding paragraph, required information on future outflows (including by cross-reference from SR) can be seen as akin to risk disclosures under IFRS 7, which allows incorporation of credit risk and hedge-accounting-related disclosures by cross-reference, albeit that, as noted in Section 1.3, this is a rare case of required information being incorporated by cross-reference.

b) View 2a (Against): disclosure in the financial statements should only relate to defined elements of financial statements (including contingent liabilities).

(i) As clarified in the March 2024 IFRIC discussion, unless there is a past event, even if commitments meet the IAS 37 definition of a constructive obligation, they do not meet the definition of either provisions or contingent liabilities and therefore, the specific IAS 37 disclosure requirements do not apply.

(ii) Why should constructive obligations arising from climate-related commitments be treated differently from other constructive obligations?

(iii) It could be assumed that users are agnostic on the location of where material information is disclosed and that they view disclosure of material information in the context of the annual reporting package rather than expecting material information to always be in the financial statements (i.e., financial statements are not self-sufficient and have to be read with other sections of the Annual Report). And during EFRAG's engagement with stakeholders thus far, including with EFRAG CAP members, some users have expressed that they are agnostic on the location of material information.

51 April 2024 IFASS member discussions during breakout groups.

52 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.

(iv) Other users in EFRAG CAP have indicated that, though they are not location-agnostic and expect material information necessary to understand the financial position and financial performance to be in the financial statements (e.g., due to the level of assurance of the financial statements), they distinguish between an entity's mere intentions (which, though important to understanding the entity's prospects ought to be in the management report) and actual obligations for outflows which should be reported in the financial statements. These users have indicated that they do not expect a forewarning of potential liabilities disclosed in the financial statements and they are satisfied with the recognition thresholds within IAS 37.

(v) IAS 1.125 (disclosures of estimation uncertainty on carrying values) requirements need to be considered in the context of existing/defined assets and liabilities.

(vi) The application of IAS 1.31 requirements may be constrained by consideration of possible disclosure overload. Moreover, this requirement[53] could be interpreted as relating only to transactions, events and conditions affecting the current financial position and financial performance, and not to possible future financial position and financial performance items.

(vii) Why repeat information that should and will likely be disclosed in the sustainability statement/disclosures under ESRS E1 and IFRS S2 requirements when this can lead to redundancy and may impose a double reporting burden? Of note, IFRS S1.B40-c states that as an example of connected information, *'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.'*

(viii) Though there is no explicit prohibition to including information by cross-reference in the financial statements, the information needs to be subject to the same level of assurance, and there can be concerns about legal risk from incorporating information of a forward-looking nature. Moreover, excessive cross-referencing can impair the understandability of information in the financial statements.

c) View 2b (Against in a most restrictive way): disclosures in the financial statements should only relate to recognised financial statement line items.

(i) Such a view assumes the commitment has to qualify to be a recognised provision before any disclosure. On one hand, this view could be dismissed as it is inconsistent with existing IFRS requirements. For instance, there are disclosure requirements for unrecognised assets and liabilities (e.g., contingent liabilities disclosure requirements under IAS 37.86). And, as mentioned in Section 2.1, the guidance for developing and drafting disclosure requirements (developed after the completion of the *Disclosure Initiative – Targeted Standards Level Review of Disclosures* project) indicated disclosures can include information about unrecognised assets and liabilities including information about their nature and the risks arising from them.

(ii) However, some stakeholders have expressed that they expect disclosures should only relate to recognised line items in the financial statements. This was the case, for instance, in the feedback to EFRAG's Discussion Paper *Better Information on Intangibles* as reflected in the Recommendations and Feedback statement (see link and responses to Question 9 on the placement of information). That said, other views on the matter were also expressed in the feedback.

53 IAS 1.31 states that '… *an entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.*'

153 ***Fact pattern 3 (Anticipated financial effects – possible duplication):*** *ESRS and IFRS S1 and S2 have requirements for the disclosure of the anticipated financial effects of sustainability-related risks and opportunities over the short-, medium- and long-term. In turn, short-term anticipated financial effects may relate to how sustainability-related risks and opportunities 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, it may duplicate the financial statements' disclosure requirements under IAS 1.125 requirements*[54]*. This duplication could be avoided by including the information by cross-reference.*

154 *The notes to the financial statements can include forward-looking information (e.g., maturity tables, commitments and Capex projections), and duplicative reporting may arise if/when similar information is disclosed as anticipated financial effects in the sustainability statement/disclosures.*

155 ***Fact pattern 4 (location of missing disclosures related to environmental liabilities):*** *Whilst exploring possible incremental disclosure requirements on anticipated financial effects for the forthcoming Oil and Gas, and Mining sector Standards; the EFRAG SR pillar's Secretariat reviewed relevant academic literature and conducted a desktop review of the reporting of environmental and decommissioning liabilities*[55] *by a sample of companies. Their analysis reflected in an October 2023 agenda paper for the joint EFRAG FR and SR TEG meeting (see link) points to the limitations in the related IFRS Accounting requirements (IAS 37 and IFRIC 21) along with the inadequacies in the observed companies' disclosures (diversity in practice and missing useful information). For instance, the reviewed companies did not disclose the triggering event of the decommissioning provisions, the disclosure of the estimated retirement date was missing and it was difficult to identify the asset for which an asset retirement obligation or decommissioning provision is recognised. Concurrently, the enacted sector-agnostic ESRS do not require this information. Should these disclosures be in the financial statements and considered as part of IAS 37 amendments?*

156 The above fact patterns are indicative rather than being an exhaustive description of the so-called grey areas (i.e., where there is duplication or missing information across the package of reports, where there could be diverse perspectives on the best location of information). For instance, debates among stakeholders on the suitable location of disclosed information have also occurred with respect to a) disclosures related to synergies arising during business combinations and b) disclosure of unrecognised intangibles (as evident in the feedback on the EFRAG research project *Better Information on Intangibles* related to the placement of unrecognised intangibles).

TAKEAWAYS FROM ANALYSIS OF GREY AREAS

157 To address the above-noted areas, several steps could be taken. Foremost, as mentioned earlier in this paper (section 1.2), it would be **useful to develop an SR conceptual framework akin to the one in place for financial reporting.** An SR conceptual framework could enhance the information attributes in the sustainability statement/disclosures (e.g., developing measurement principles could contribute to the relevance and comparability of disclosed data points). It could also help to avoid overlaps/duplications or gaps across the two distinct pillars of the corporate reporting system as underscored in Section 1.3.

158 Second, as there are other value-creation factors (besides sustainability matters) disclosed in the management report, and as there are instances where there is no consensus on whether information should be in the management report or financial statements (see Paragraph 145), **it would also be useful for the respective responsible authorities to enhance their guidance on management commentary/management report, and for the IASB to update**[56] **its management commentary guidance and more clearly define what information is in the scope of management commentary.** This would be congruent with management commentary being expected to enhance the connectivity of information across IFRS general purpose financial reports (i.e., serving as the connective tissue).

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54 IAS 1.125 requires an entity to provide '… *information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year.*'

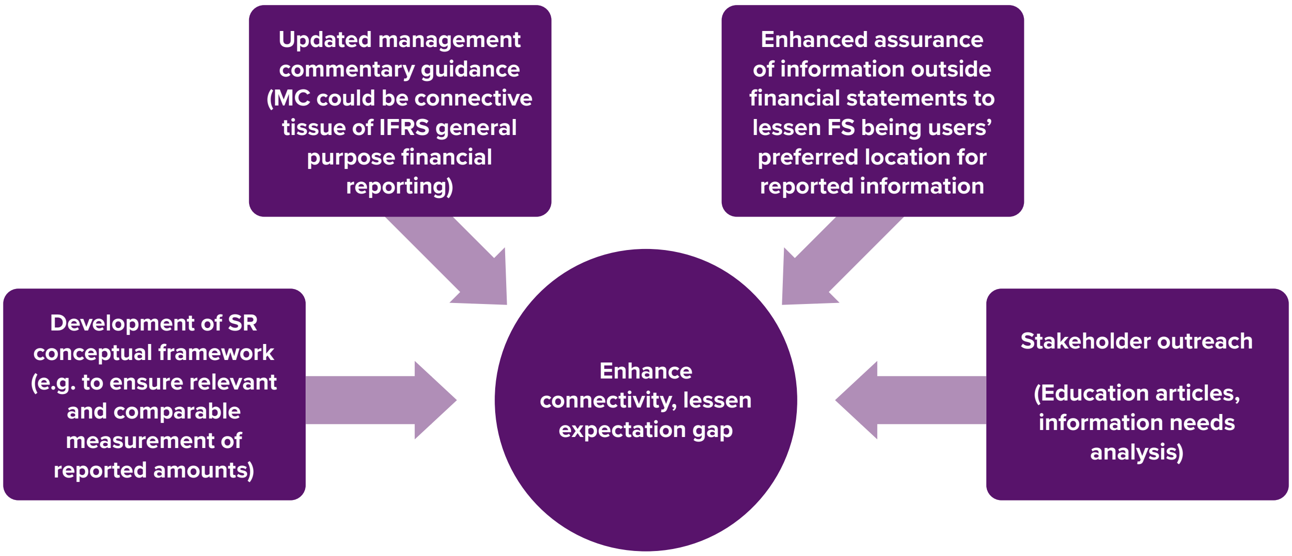
55 The financial statements of six Oil and Gas companies (BP, Equinor, Eni, Repsol, Shell and TotalEnergies) were reviewed by the SR pillar's EFRAG Secretariat.

56 The need for the IASB to finalise the management commentary project was also made in the 2021 EFRAG comment letter response to the MCPS ED and the 2023 comment letter response to the ISSB RFI on agenda priorities.

159 Third, the disparity in the level of assurance across different corporate reports contributes to users' expectations of information to be reported in the financial statements. This has been evident during several discussions on whether certain information should be disclosed in the financial statements or management report (e.g., information on net zero commitments that is indicative of potential liabilities). On one hand, there are indications that some users are location-agnostic. At the same time, a reason posed by other users for preference for 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 (i.e., going beyond limited assurance) could contribute to some users becoming more location-agnostic than they currently are,** and this could potentially lessen the expectation gap. Moreover, it could enhance connectivity. As noted in Section 1.3, the disparity in assurance levels is an impediment to information being included in the financial statements by cross-reference.

160 Finally, it has been clear from discussions where EFRAG has been involved so far including during a session on connectivity at the April 2024 IFASS meeting[57] **that further outreach to educate stakeholders on the boundaries of different corporate reports and to identify information needs in the context of each of these reports could lessen the expectation gap.**

Figure 15: Synthesis of takeaways to lessen expectation gap



Source: EFRAG

57 April 2024 IFASS meeting, Item 16, Connectivity and boundaries of different parts of the Annual Report (case study- net-zero commitments disclosures)

SECTION 2.4: WHY CERTAIN SUSTAINABILITY INFORMATION MAY SOMETIMES NOT BE REPORTED/IDENTIFIABLE IN THE FINANCIAL STATEMENTS

HIGHLIGHTS OF SECTION 2.4

Building on the delineation of the objectives of the different AR sections in Section 2.1, this section expounds on why certain sustainability information may not reported or readily identifiable in the financial statements. Such information may fail to meet the financial statements' recognition, measurement, disclosure or presentation criteria. The objectives of financial statements to inform and facilitate the decision making of the primary audience of financial statements (i.e., financial capital providers) have shaped the criteria of reported information.

Explaining why certain sustainability information may not be reported or readily identifiable in the financial statements also sheds light on why it may be difficult to connect the information in the financial statements and the sustainability statement/disclosures. As noted in the introduction, the particular focus on the boundaries of financial statements is warranted because, compared to other AR sections, there is a higher threshold of including information in the financial statements and the expectation gap is therefore mainly in relation to the information content of the financial statements.

That being said, this section does not aim to convey that sustainability matters cannot or should not be reflected in the financial statements. To that effect, the preamble to this section has a recap of the reasons why climate-related and other uncertainties can be reflected in the financial statements (as conveyed by the 2020 and 2023 IASB educational articles). Rather, this section only aims to help lessen the expectation gap on what information can be reported in the financial statements. As noted, this is not in contradiction with the objectives of the IASB education articles.

CLIMATE-RELATED AND OTHER UNCERTAINTIES CAN BE REPORTED IN THE FINANCIAL STATEMENTS

161 As noted in a 2019 IASB education article and (updated in a 2023 IASB educational article- *Effects of climate-related matters in the financial statements*), IFRS Accounting Standards have implicit requirements for entities to either reflect material climate risk and any other risk or to explain why a matter expected to be material by investors was not reflected in the financial statements. Climate-related matters may be material for significant judgments and estimates management has made while preparing the financial statements. In addition, qualitative external factors, such as the industry an entity operates in, may lead to the need for disclosures in the financial statements regardless of the quantitative impact of such factors. Furthermore, companies should consider whether investors could reasonably expect that climate-related and other matters affect the financial statements.

162 These considerations can be reflected in various IFRS Standards. Below is a non-exhaustive list of requirements related to climate-related matters:

a) *IAS 1:* This Standard includes overarching disclosure requirements for information not presented elsewhere in the financial statements but is relevant for their understanding. Entities will therefore need to consider whether to provide additional disclosures to enable investors to understand the impact of climate-related matters on the company. In addition, climate-related matters may give rise to estimation uncertainty and other significant judgements made.

b) *IAS 2:* The selling price of inventories or their completion cost.

c) *IAS 12:* Estimates of future taxable profits and the recognition of deferred tax assets.

d) *IAS 16/38:* Climate-related matters may prompt expenditure to adapt operations (including R&D). They may affect the recognition of costs as assets and estimations pertinent to residual values and useful lives of assets.

e) *IAS 36:* Estimates of recoverable amounts, impairment assessment for assets and goodwill, impairment indicators, and disclosures of key assumptions leading to the recognition of impairment.

f) *IAS 37:* The recognition, measurement and disclosure of liabilities, the nature of provisions or contingent liabilities; and any uncertainties on the timing or amount of outflows of economic benefits.

g) *IFRS 7:* The nature and extent of risks and the concentration of market risk for types of financial instruments.

h) *IFRS 9:* Climate-related contractual terms may affect the classification and measurement of financial instruments and the measurement of expected credit losses (ECL).

i) *IFRS 13:* Fair value measurement of assets and liabilities and related disclosures.

j) *IFRS 17:* Assumptions used to measure insurance contract liabilities and disclosures about significant judgements and risk exposure.

163 Nonetheless, various thematic reviews of financial statements have highlighted a disconnect between the reporting of climate risk across different reports as well as the often inadequate, high-level and largely qualitative reporting of climate risks in the financial statements. Hence, stakeholders have expressed concerns that material climate-risk information is not being reported in the financial statements.

164 This concern was also conveyed during the 2021 IASB agenda consultation, and it motivated the IASB's commencement of a project on 'Climate-related and other uncertainties in the financial statements.' Thereafter, the findings of a root-cause-analysis-oriented outreach (reflected in the September 2023 IASB staff paper and a September 2023 EFRAG Secretariat Briefing: Climate-related Risks in Financial Statements) pointed to an expectation gap on what should be reported in the financial statements. This gap contributes to the aforementioned concern. Hence, an analysis of why material sustainability-related information may not be recognised, disclosed or presented in the financial statements can shed light on the connectivity of information and possibly lessen the expectation gap.

WHY CERTAIN MATERIAL SUSTAINABILITY-RELATED INFORMATION MAY NOT BE REPORTED OR READILY IDENTIFIABLE IN THE FINANCIAL STATEMENTS

165 Below is a summary of why certain material sustainability-related information may not be reported or readily identifiable (i.e., recognised, measured, presented or disclosed) in the financial statements:

a) The nature of sustainability-related and other non-financial information may be only appropriate to be disclosed outside the financial statements.

b) Sustainability-related information may be embedded (and therefore not separately presented) in financial statements' line items.

c) There could be differences in the level of aggregation in financial statements versus the sustainability statement.

d) Certain sustainability-related information cannot be recognised or disclosed in the financial statements.

e) Possible gaps in IFRS Accounting requirements.

f) IFRS Accounting requirements may not be sufficiently clear.

g) Other factors.

166 The above factors underscore the need for clarifying boundaries further, the complementary nature of sustainability reporting and financial statements information and the importance of ensuring connectivity between these two reporting domains.

Nature of sustainability-related information may be inappropriate for financial statements

167 There is non-financial and detailed contextual information that is only appropriate to be located in other AR sections outside the financial statements (e.g., in the sustainability statement/disclosures or the rest of the management report). For instance, non-monetary metrics and targets that are related to sustainability performance (but not necessarily meant to inform on the entity's financial performance and financial position) are best disclosed in the sustainability statement/disclosures. Similarly, a delineation of the full profile of enterprise risks (besides sustainability-related risks) could be best placed in the risk report within the management report. And a detailed description of the strategy and business model is best suited for the management report.

Sustainability-related information may be embedded in financial statements' line items

168 Sustainability-related matters are only a subset of the multiple factors that may affect an entity's financial performance, finance position and future cash flows as reflected in the financial statements. For instance, climate risk could be one amongst multiple macroeconomic and business risk factors affecting a bank's loan portfolio default risk and its recognised expected credit loss (ECL) under IFRS 9 *Financial Instruments*. As a result, it may be difficult for such a bank to separately identify and disclose the climate risk effects in the notes within the financial statements in a manner that such information can be connected to related sustainability disclosures. In effect, in some situations, while disclosing a sensitivity analysis related to changes in measurement it can be difficult to attribute the effects of climate risk separately from other measurement inputs.

169 Another example would be whenever climate-related risk is part of the risk adjustment under IFRS 17 *Insurance Contracts*. The best estimate in accordance with IFRS 17 requirements should include all risks and opportunities. As required under IFRS 13, this risk should also be part of either the observable market prices or the internal fair value estimate of assets held by entities subject to climate-related risks.

Differences in the level of aggregation in the presentation or disclosure of information in financial statements versus aggregation in the sustainability statement

170 There could be differences in unit of account and level of aggregation/disaggregation of information disclosed/presented in financial statements versus information disclosed in the sustainability statement/disclosures. For instance, physical risk (assets vulnerable to physical risk) may be disclosed by location in the sustainability statement but not 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).

Certain sustainability-related information cannot be recognised, disclosed or presented in the financial statements

171 Below is a non-exhaustive list of why certain disclosed sustainability-related information may not be recognised, disclosed or presented in the financial statements.

172 **Differing materiality thresholds applied for sustainability disclosures versus financial statements:** As noted in Part 2.2 of this paper, the application of materiality is in the context of the objective of the report, there may be information items disclosed under an impact materiality lens that would not be financially material for the financial statements. However, such items may become financially material for the financial statement during future reporting periods (i.e., the concept of dynamic materiality is at play in practice).

173 Some sustainability reporting stakeholders have expressed an expectation that, at least in the long run, financial statements ought to reflect climate-related 'inside-out' impacts (e.g., an adjustment of the statements of financial position and financial performance for a company's negative impacts including its GHG emissions). These stakeholders have pointed to the nascent initiatives[58] conceptualising the monetisation and internalisation of these impacts/externalities into financial reporting. However, many stakeholders support retaining the current distinctive purposes of financial statements and sustainability reporting.

174 **Sustainability-related risks may not meet the criteria for recognition of provisions and liabilities:** After assessing 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 PTF-NFRS connectivity publication concluded that there is a clear demarcation for recognising provisions in relation to sustainability-related matters. The publication notes 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 publication surmises there could be an increased reflection of sustainability-related matters 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).

175 Appendix 2 of the 2021 PTF-NFRS publication also highlights several positive and negative externalities (i.e., impactfully material) and information that may be financially material within sustainability disclosures and the rest of the management report but do not necessarily meet the definition of assets and liabilities within the financial statements. These items include:

a) adverse nature/environmental impacts caused by the company's products (e.g., impacts of microplastic in groundwater, seawater; oil spills) without the company having restoration obligations;

b) potential liabilities for potential health problems caused by the company's products (e.g., alcohol, tobacco, medicine, hormonal damages), waste, and emissions (e.g., Nitrogen dioxide and Sulphur dioxide from plants and vehicles);

c) value of potential reuse of materials (circular economy); and

d) the potential future value from sustainability-related research and development activities that are not recognised as intangible assets.

176 Similarly, at the April 2023 IFASS meeting, the AcSB representative noted that, in comparing IAS 37 guidance with related sustainability disclosure guidance in IFRS S1 and S2, two key connectivity concerns arise when a) determining when the information disclosed under IFRS S1 and S2 triggered disclosure or recognition in the financial statements; b) the different approaches to the disclosure of commercially sensitive information.

177 It was noted that both IFRS S1 and IAS 37 contain exemptions from disclosing commercially sensitive information where disclosure could be expected to seriously prejudice the entity's position. However, the exemption in IFRS S1 was asymmetric (i.e., only applies to opportunities and not risks), whereas the exemption in IAS 37 was symmetric (i.e., applies to contingent assets as well as provisions and contingent liabilities). Hence, even if an entity was exempt from disclosing commercially sensitive information on sustainability-related risks in its financial statements, it would still be required to provide such information in its sustainability disclosures. When users see such information, they could question why there was no corresponding financial statement disclosure.

58 Cohen,R and Serafeim,G. 2020, How to Measure a Company's Real Impact, Harvard Business Review https://hbr.org/2020/09/how-to-measure-a-companys-real-impact. Stakeholders have shared examples of initiatives in certain jurisdictions on how to monetise and incorporate CO_2 into financial reporting standards (e.g., expenses and carbon liabilities). The PTF-NFRS publication Chapter lists several other experimental initiatives

178 In November 2023, IFRIC discussed a submission received related to a net zero commitment with the questions posed including 'Does the public statement of a net zero transition commitment create a constructive obligation as defined in IAS 37?' and *'Does a constructive obligation created by a net zero transition commitment meet the criteria in IAS 37 for recognising a provision?'* The Committee agreed with the IASB staff conclusions (illustrated through a manufacturer publishing a commitment to reduce its emission targets by 60% in the next nine years and to thereafter purchase and retire carbon credits for remaining emissions and emissions made after nine years).

179 The IASB staff concluded that a constructive obligation does not necessarily exist at the time of publication of a net zero commitment and a constructive obligation would not result in the recognition of a provision when there is no present obligation as a result of a past event (i.e., if the commitment is not independent of the entity's future actions. For instance, if the commitment is to revamp manufacturing processes to attain the target). The staff concluded that in nine years there may be circumstances under which a provision would be recognised due to: a) the entity having emitted (and there being a past event) and b) its commitment to purchase the carbon credits would result in a net outflow of resources (see Appendix 2 for further details). Following a public consultation, in March 2024, IFRIC confirmed its November 2023 agenda decision. It also agreed with staff analysis in response to a second submission on whether entities should apply the disclosure requirements for a contingent liability[59] to constructive obligations that have not been recognised as provisions, and where the IASB staff assessed that this should not be the case under the fact patterns that were presented, as no past event had occurred. In April 2024, the IASB approved the IFRIC agenda decision.

180 **Anticipated financial effects in SR may not crystallise in financial statements:** As noted in Sections 1.3 and 2.3, due to both occurrence and estimation/measurement uncertainty and challenges as well as due to being related to the value chain, there are instances where anticipated financial effects (including short-term anticipated financial effects) disclosed in SR <u>may not necessarily crystallise as anticipated in an entity's future financial statements (and in such cases, there will be no continuity across periods in the reporting of the item that was depicted as an anticipated financial effect)</u>.

181 **Constraints related to measurement basis:** Besides recognition criteria, sometimes information (e.g., climate-related loss of value) cannot be connected due to the measurement basis of recognised assets and liabilities (e.g., historical cost versus fair value).

182 **Constraints in reporting sustainability-related economic opportunities:** Stakeholders have noted that many firms are adapting their business models to capitalise on the profit-generating activities arising from the transition to a low-carbon economy (i.e., opportunities). However, under current IFRS Accounting Standards' recognition and measurement requirements, these opportunities (that could be deemed potential assets) cannot be recognised[60] as line items in the primary financial statements. However, opportunities are sometimes incorporated into sensitivity analysis disclosures.

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59 IAS 37.10 states that: 'A contingent liability is:

a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.'

60 Paragraph 5.7 of the Conceptual Framework for Financial Reporting conveys that an asset or liability is recognised only if such recognition provides users of financial statements with information that is useful (**relevant** and a **faithful representation**). Paragraph 5.12 conveys that recognition of relevant information may not provide relevant information if, for example: a) it is **uncertain whether an asset or liability exists; b) an asset or liability exists, but the probability of an inflow of economic benefits is low.** Paragraph 5.18 conveys that whether a faithful representation can be provided may be affected by the level of **measurement uncertainty** associated with the asset or liability or by **other factors** (e.g., to avoid a misleading depiction of income, expenses and changes in equity, and whether related assets and liabilities are recognised).

183 **Coverage of value chain information:** Sustainability reporting explicitly encompasses impacts, risks and opportunities across the value chain (see the May 2024 EFRAG IG 2 Value Chain Implementation Guidance). For example, sustainability disclosures may include investments in opportunities across the value chain related to the transition to net-zero emission targets. Such investments may not be reconcilable to the investments reported in the financial statements. That said, value chain information is implicitly incorporated in the financial statements (e.g., estimating the expected credit loss requires an analysis of customer risk profiles).

184 **Differences and effects of the time horizons typically[61] applicable to sustainability disclosures and financial statements information:** The time horizon for climate risk can be much longer than that typically[62] applied in the recognition, measurement and disclosure of financial statements information. As such, climate and other sustainability-related risks may be included in sustainability disclosures earlier than can be recognised or disclosed in the financial statements. This could be due to some stakeholders interpreting the applicable time horizon for disclosure of estimation uncertainty under IAS 1.125 to be 12 months, and this is an aspect where the IASB is exploring whether to undertake Standard Setting activity (i.e., as per the March 2024 IASB staff papers on project direction). We also note that in March 2024, IASB staff developed draft illustrative examples (see example 4 related to IAS 1.125 in related IASB staff paper and the IASB staff indicated they interpret that the time horizon referred to in IAS 1.125 could be longer than 12 months[63]. EFRAG's outreach on the draft illustrative examples showed that stakeholders interpret IAS 1.125 literally as referring to the next year/12 months. In addition, some stakeholders have pointed to a lack of clarity on the time horizon for impairment testing under IAS 36, and we note that this was identified as a cause for concern by the IASB and EFRAG during the May to September 2023 outreach (See the discussion further below on the limitations of IFRS Accounting Standards).

185 Furthermore, due to the typical long-term nature of climate and other sustainability-related risks, the effect of discounting these risks is that their impact on the currently reported carrying values in the financial statements is often not material. In addition, low-probability long-term risks may not be reflected as liabilities or provisions due to failing to meet the IAS 37 recognition criteria (i.e., a probable outflow of economic resources, and can be reliably measured).

186 **Extent to which forward-looking information is incorporated:** Both financial statements and SR have forward-looking estimates. However, financial statements information is primarily focused on the future consequences of past actions on existing assets and liabilities whereas sustainability-related information also encompasses future consequences of future actions. That said, financial statements' information can also reflect future consequences of future actions (e.g., goodwill impairment tests that necessitate estimates of the terminal value of groups of cash-generating units. Another example would be the incorporation of future, committed restructurings in the value-in-use calculation).

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61 Financial reporting information ought to be able to reflect all time horizons. In practice, one of the reasons provided for climate-related risks not being reflected is the long-time horizon associated with these risks.

62 There are no limits to the time horizon applicable for FR information

63 IAS 1.125 states *'An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.'*

187 **Financial control versus operational control:** Financial control is the criterion for the recognition of assets and consolidation of subsidiaries in the financial statements. It is also applied as the primary criterion for the consolidation of sustainability-related metrics (e.g., GHG emissions). However, the notion of operational control (i.e., when the reporting undertaking has the power to direct operational policies of an entity or assets), which is in some cases applied for the calculation of sustainability-related metrics (e.g., GHG[64] emissions), does not exist under IFRS Accounting requirements. There could be challenges in connectivity related to some items outside of the reporting entity in the financial statements (i.e., value chain items outside the entity's financial control). The May 2024 EFRAG IG 2 Value Chain Implementation Guidance further details the FR versus SR differences.

188 **Extent of use of non-monetary units of measurement and aggregated measures:** Sustainability reporting information predominantly comprises non-monetary metrics, which in turn affects the level of aggregation that is possible, whereas financial statements information is primarily comprised of monetary metrics and easier to derive aggregated measures such as profit.

189 **Application of accrual principle and preparation of summary/aggregated primary statements:** As outlined in an academic paper (*Wagenhofer*[65], 2023), unlike for financial statements, in mandatory sustainability reporting there is no 'stocks and flows' representation, and the accruals principle for the intertemporal allocation of amounts is not applied. There are also no mandated summary statements with aggregated line items (akin to the primary financial statements).

Possible gaps in IFRS Accounting Requirements highlighted during EFRAG and IASB Outreach

190 Both the IASB and EFRAG outreach on the climate-related and other uncertainties in the Financial Statements project shows that stakeholders consider that IFRS Accounting Standards are mostly sufficient albeit that they do not explicitly address climate-related and other sustainability-related risks. However, there are perceived limitations of some IFRS Accounting Standards (e.g., IAS 1 and IAS 36 impairment testing requirements), as enumerated below.

191 **Perceived limitations of IAS 1 requirements:** As noted in paragraph 144, several stakeholders interpret IAS 1.125 as not requiring an entity to disclose the sources of estimation uncertainty that could have a material impact on the financial statements in more than 12 months. Hence, IAS 1 may be perceived to prohibit disclosures that affect carrying amounts of assets and liabilities for periods beyond the next 12 months. That said, as noted in paragraph 144, the IASB may explore standard-setting activity on IAS 1.125. Moreover, in March 2024 IASB staff developed draft illustrative examples (see Example 4 related to IAS 1.125). These examples may be included in an Exposure Draft and potentially included in the IASB illustrative examples thereafter.

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64 The GHG Protocol, which when developed aimed for consistency of its consolidation approaches with accounting requirements, is aligned with IFRS requirements in the application of the notion of financial control (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. For instance:

- the 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) but IFRS requirements do not have the notion of operational control;
- 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; and
- IFRS requirements have the notion of significant influence over investees (e.g., for associates) 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, it is not always clear whether there will always be consistency between financial statements' treatment and GHG consolidation approaches on investee entities or assets that are not part of a legal entity.

65 Alfred Wagenhofer (2023), Sustainability Reporting: A Financial Reporting Perspective, Accounting in Europe.

192 **Perceived limitations of IAS 36 requirements:** Following the feedback gotten from outreach on challenges associated with the IAS 36 impairment testing requirements and the decision made by the IASB thereafter to explore the raised matters with IFRIC, the IASB staff paper[66] for the November 2023 IFRIC meeting notes that entities may not be adequately factoring climate-related risks over extended time horizons into impairment calculations. The IASB staff paper notes challenges arising from IAS 36.35, which states that, when estimating the recoverable amount of an asset, an entity can use cash flow projections for a period longer than five years if management is *'confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period'.* A few stakeholders indicated they interpret this requirement as prohibiting entities from forecasting cash flows for a longer period when calculating value in use. And, consequently, this perceived prohibition can result in some entities calculating a terminal value based on cash flows expected in year five, even when those cash flows are not indicative of profitability in the long term. That said, some other stakeholders have disagreed with this interpretation of IAS 36 requirements (i.e., perceived prohibition of considering cash flows after five years). Moreover, it has been noted that the recoverable amount considered while conducting the impairment test of an asset is the higher of its fair value and value in use. Hence, even if there were limitations with the value in use calculation, entities still have to consider the fair value of the non-financial asset held.

193 In addition, the EFRAG outreach (reflected in the September 2023 EFRAG Secretariat Briefing) indicated there are difficulties in determining the treatment of incremental/improvement capex versus maintenance capex under current IAS 36. The Green Deal and transition to a green economy necessitate significant incremental capex (future investments to reduce emissions, including upgrades to existing facilities, replacing energy sources, changing production processes, and new product lines); yet, it is often unclear whether or not this incremental capex has to be/or has been reflected in the impairment testing. That said, we note that Paragraph 33-b of the March 2024 ED *Business Combinations-Disclosures, Goodwill and Impairment*- proposes[67] removing the prohibition from including cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance whilst performing the IAS 36 value-in-use calculation.

Some IFRS Accounting Requirements may be insufficiently clear

194 The September 2023 IASB staff paper conveying the findings of outreach related to the climate-related and other uncertainties in the financial statements project identified several areas where IFRS Accounting requirements may be insufficiently clear. During meetings with EFRAG stakeholders, scepticism was expressed about this characterisation with the view that the absence of explicit mention of climate risk in a Standard does not make it unclear. EFRAG has not done any outreach to interrogate why some stakeholders considered the standards mentioned in the IASB paper to be insufficiently unclear.

195 In respect of IAS 36 impairment testing, the IASB staff paper for the November 2023 IFRIC meeting notes that when measuring the value-in-use of an asset using the traditional approach, entities may not properly consider that cash flows (or discount rates) used should represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset rather than a single most likely, minimum or maximum possible amount (IAS 36.38).

196 Relatedly, EFRAG's outreach showed that the diversity of practice arises due to the interpretation of 'management's best estimate of the range of conditions that will exist over the remaining useful life of the asset' under IAS 36.33. Specifically, whether such an estimate is management's judgment, a market-based estimate or an estimate derived under an assumption of alignment with policy goals (e.g., an estimate based on the entity's conformance to Paris-aligned goals). For instance, a study that reviewed the reporting of 88 Dutch entities noted the limited reference made to whether or not assumptions are Paris-Agreement aligned.

66 ap03-climate-related-uncertainties-ias-36.pdf (ifrs.org)

67 (BC205) notes the IASB's view that this change would reduce complexity because: stakeholders said that can be challenging for management to distinguish maintenance capital expenditure from expansionary capital expenditure and identify which cash flows need to be excluded because they relate to expansionary capital expenditure.

Other factors

197 **Possible narrow definition of materiality not taking account of qualitative materiality:** As seen in two ESMA enforcement actions, material information on climate-related risks is sometimes excluded by reporting entities. Furthermore, a September 2023 UKEB publication highlighted that feedback from stakeholder groups indicated that preparers and auditors interpreted the IAS 1 requirements as a reason for excluding information to avoid unnecessary disclosures. Accordingly, some stakeholders suggested the development of application guidance for IAS 1 materiality requirements (i.e., IAS 1.29-31).

198 Relatedly, EFRAG outreach indicated users face difficulties in understanding entities' assessment of the materiality of long-term risks, and these users have suggested the IASB consider requiring an entity to disclose how it has performed the materiality assessment. Similarly, outreach by UKEB highlighted in the September 2023 publication showed investors were of the view that the definition of materiality was not being consistently applied to climate-related risks and pointed to challenges in assessing how material risks were reflected. Some users conveyed expectations of a statement of immateriality.

199 In effect, there is a situation of inadequate guidance and possible misaligned expectations between preparers and users on the application of qualitative materiality. Incidentally, EFRAG's outreach in response to the IASB exploring developing examples to facilitate the application of materiality showed that there is either limited awareness or limited application of the IASB Materiality Practice Statement, which includes two examples (i.e., Example C –materiality judgements that lead to the disclosure of information in addition to specific disclosure requirements, and Example K –influence of external qualitative factors on materiality judgment). Similarly, the October 2023 AASB research on materiality, showed that a large proportion of auditors are unaware of and cannot explain the content of the IASB Materiality Practice Statement.

200 **Difficulties and constraints in assessing and measuring climate-related risks:** These difficulties arise for the following reasons.

a) Complex calculations and estimations are associated with climate-related risk. Illustratively, the study by Van der Tas, Aggarwal and Maksimovic (2022) noted the challenges in applying IFRS 13 guidance by entities with exposure to climate risk. When these entities assess fair value less cost of disposal for assets, a market participant perspective needs to be taken. In assessing the fair value, the market data of the potential effect of climate on energy demand and prices as well as emission rights and other regulations can differ significantly from one source to the other.

b) There is limited data availability for entities to assess and report on climate-related risks, particularly data for physical risks.

c) Some entities with limited resources may have inadequate risk management systems and inadequate skills to identify and manage climate-related risks.

d) The prevalence of siloed organisations limits the interdepartmental collaboration (e.g., between finance, sustainability, environment and strategy departments) required for the effective identification, assessment and reporting of climate-related risks.

201 Of note, the ESRB April 2024 publication *Climate-risks and accounting* points out that it may be operationally difficult for banks and insurers to incorporate climate-related risks in their models. The publication notes that for banks expected credit loss models typically forecast three years ahead, which may be too short a horizon to cater for most climate-related risks.

APPENDICES

APPENDIX 1:
GLOSSARY OF A SELECTION OF TERMS

Anticipated and current financial effects of sustainability-related risks and opportunities

ESRS glossary defines anticipated financial effects as the ‘Financial effects that do not meet the recognition criteria for inclusion in the financial statement line items in the reporting period and that are not captured by the current financial effects.’

Anticipated financial effects – ‘The anticipated effects of sustainability-related risks and opportunities on the entity’s financial position, financial performance and cash flows over the short, medium and long term, taking into consideration how sustainability-related risks and opportunities are included in the entity’s financial planning.’ (ESRS 2.48, IFRS S1.34b)

Current financial effects – ‘The effects of sustainability-related risks and opportunities on the entity’s financial position, financial performance and cash flows for the reporting period.’ (ESRS 2.48, IFRS S1.34a)

Boundary (i.e., reporting boundary)

In broad terms, the reporting boundary connotes the dividing line between information (i.e., information on an entity’s transactions, activities, conditions and impacts) included and excluded within different corporate reports (i.e., financial statements, management report, the sustainability statement/disclosures, and other reporting sections in the AR).

Connectivity

Connectivity is a nascent and multi-dimensional concept introduced to enhance the usefulness of reported information (e.g., it is an ESRS and IFRS S1 requirement and a guiding principle of the IR framework, and implicit in the TCFD recommendations). At the same time, the term so far has no commonly accepted definition nor is it included as one of the qualitative characteristics of useful information in the Conceptual Framework for Financial Reporting.

Connectivity of reported information is the attribute of high-quality information that supports the provision of a holistic and coherent set of information within and across different AR sections (or different corporate reports). Different dimensions of connectivity of reported information including overarching aspects such as consistency, coherence, and integration of information across AR sections in strategic oriented communication are detailed in Section 1.3.

Connectivity of reported information can also be categorised into point-in-time connectivity (i.e. 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); and also providing disclosures that enable users to understand the migration of items from one corporate report to another across different time 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*).

Multiple terms are associated with or sometimes used synonymously in relation to connectivity. These include complementarity, coherence, and consistency. In this paper, we treat these terms as elements of the notion of connectivity. We also consider integration in reporting to be broader than connectivity (see below and in Section 1.1).

Connectivity-related term – Coherence of reported information

In this paper, coherence (a term included in the 2021 MCPS ED but not in the Conceptual Framework for Financial Reporting) is deemed to be an aspect of (rather than a synonym) to connectivity. It entails the **presentation and disclosure of information** by a reporting entity in a manner that gives a **more complete picture** of value creation and shows the **interrelatedness of its overall reported information**), and this includes **explaining inconsistencies across different AR sections.** It amounts to providing **complementary and/or supplemental** information to the information in a corporate report in a manner that users **can readily identify** the interrelatedness of the overall reported information (e.g. *if a change in business model disclosed in SR can be readily linked to the identified operating segments disclosed in the financial statements. Other high-level examples in Section 1.3*).

Complementary versus supplemental reported information

Based on the dictionary definition of the words complementary and supplementary, in a reporting context we infer that complementary information to a particular information is information that is likely to be of a different nature relative to the particular information, and when taken together with the particular information helps to depict a more complete and holistic aggregate picture of the reporting entity's prospects, financial condition and impacts. Supplementary information is additive/enhancing to the particular information but not necessarily part of the portrayal of a holistic picture of the reporting entity.

Disclosure versus information

Information is a broader notion than disclosures. Disclosures are a subset of reported information.

Dependencies

A business' reliance on or use of resources and relationships.

Forward-looking information (as defined by securities regulators)

Disclosure regarding possible events, conditions or financial performance that is based on assumptions about future economic conditions and courses of action and includes future-oriented financial information with respect to prospective financial performance, financial position or cash flows that is presented either as a forecast or a projection

integration of information versus Integration in reporting versus Integrated reporting

Integration of information – as we describe above it is an aspect of connectivity (i.e., linking an entity's strategic responses/other actions in response to IROs and reporting effects).

Integration in Reporting – As per the 2023 ISSB Agenda Consultation, integration in reporting is a broader notion than connectivity. It not only encompasses where, what and how information on value creation can be connected through conceptual and operational linkages (for example, in terms of compatibility of language and assumptions), but also includes the collective consideration of the interdependencies, synergies and trade-offs between:

> the various resources and relationships reported on in general purpose financial reports; and
>
> how the value that an entity creates for itself and for its investors is inextricably linked to the value the entity creates for other stakeholders, society, and the natural environment.

Integrated Reporting – A form of reporting propounded by the IR framework, whose purpose (according to the 2021 IR framework) is to establish Guiding Principles and Content Elements that govern the overall content of an integrated report and to explain the fundamental concepts that underpin them. The IR framework defines an integrated report as a concise communication about how an organization's strategy, governance and performance and prospects, in the context of its external environment, lead to the creation, preservation or erosion of value over the short-, medium- and long-term.

Interoperability of reporting requirements

We are not aware of any definition of interoperability of reporting requirements. In this paper, we consider it to be a design principle applied by the standard-setting bodies of a particular reporting domain (e.g., SR) to ensure the compatibility of their respective requirements in order to help reduce the reporting burden faced by entities eligible to apply these requirements.

Interoperability is not a synonym for connectivity. As noted earlier, the latter relates to the connection of information and requirements across different reporting domains (FR and SR) while the former is related to the compatibility of requirements within a reporting domain (e.g., SR).

APPENDIX 2: ROLE OF TECHNOLOGY IN FOSTERING CONNECTIVITY

A2.1 Technology has a role in fostering connectivity albeit it needs to be used as a tool of reflecting the underlying principles of connectivity. The 2021 EFRAG European Lab publication on Good Practices in Business Model, Risks and Opportunities Reporting in the EU (hereafter referred to as the 2021 PTF-RNFRO publication[68]) included findings from a survey to preparers, which show they consider technology as having a role in creating links within and between different AR sections beyond the primary objective of providing digital access to information included in each corporate report. The PTF-RNFRO publication also highlights:

a) the use of interactive technology (visualisation and hyperlinks) to facilitate the connection of information. The publication provides an illustrative company example;

b) the use of natural language processing to identify the co-occurrence of information;

c) the use of XBRL to tag financial and non-financial information as a way of attaining connectivity; and

d) similarly, at the 2023 EFRAG Conference, the Head of ESMA underscored the use of digital tools as a mechanism of connectivity.

A2.2 As noted above, XBRL technology and tagging of both financial statements and the sustainability statement/disclosures present an opportunity to attain connectivity at a grassroots level. Specifically, the machine-readable format of the sustainability reporting is a required deliverable under the CSRD and the availability of the three taxonomies (IFRS Accounting Taxonomy for the financial statements and ESRS and Article 8 (Taxonomy legislation) XRBL Taxonomies for the sustainability reporting information), which are embedded into the ESEF Regulation will create an ecosystem of accessible public data through the European Single Access Point (ESAP). In this context, technology plays an important role in supporting the connectivity of corporate reporting information. Some potential aspects to be focused on are:

a) the creation of individual elements or even their specific data type classification (i.e. monetary elements such as 'assets at physical risk') within the sustainability taxonomy will facilitate the access and usability of data connected to the financial statements;

b) potential creation of interoperability between the aforementioned financial reporting and sustainability reporting related taxonomies (e.g., through the reuse of elements from the accounting taxonomy, e.g. Revenue/Turnover and Assets);

c) the presentation of anticipated financial effects of sustainability matters (ESRS), by combining financial statement line items with an ESRS dimension; and

d) the reconciliation between financial statement items and operating segments with ESRS Sectors and related data points (e.g., Revenue in ESRS SBM-1).

A2.3 Moreover, at the May 2023 EFRAG-hosted EAA symposium (see report- Multi-stakeholder perspectives on Connectivity), it was noted that in the context of the IFRS Foundation's work on connectivity, the digital taxonomy of the Sustainability Disclosure Standards would be informed by the taxonomy used for the Accounting Standards to help achieve connectivity in the Standards.

A2.4 XBRL could provide connection points as the need to tag information requires the use of shared terminology, such as on the definitions of revenue, provisions, segments and entity, and it enables the use of consistent terminology.

68 Towards Sustainable Business: Good Practices in Business Model, Sustainability Risks and Opportunities Reporting in the EU. Examples are in the Supplementary Document: Good Reporting Practices.

A2.5 From an analysis of information standpoint, XBRL and tagging in tandem with the use of AI to retrieve and consume information could help users to process both financial and sustainability information. However, it was noted that, though useful, AI can sometimes lead to the loss of the context surrounding the information. Therefore, humans will still be needed to perform the tasks to ensure all material information is captured.

APPENDIX 3: CONNECTIVITY IN OTHER PUBLICATIONS AND EVENTS

EFRAG publications and events

A3.1 In the preparatory work that preceded the sector-agnostic ESRS development, the EFRAG PTF-NFRS publication (*Proposals for a Relevant and Dynamic EU Sustainability Reporting Standard Setting*) considered establishing connectivity requirements to be one of the six prerequisite concepts for robust standard setting in the EU. Of note, another of the six concepts (raised by the PTF-NFRS main publication) where conceptual guidelines are needed is *'the levels (or scope) and boundaries of reporting',* which is the other key aspect addressed in this paper.

A3.2 The PTF-NFRS publication noted the absence of a formal interconnection between different sections of the annual report could lead to potential gaps, overlaps (i.e., duplication) and a lack of coherence in reported information. It recommended connectivity from a two-way perspective (i.e., sustainability statement/disclosures to financial statements and vice versa). Specifically, it suggested that:

a) sustainability reporting standards should define anchor points to create connectivity to financial reporting together with the necessary reconciliations or cross-references. Anchor points may be direct when a monetary sustainability disclosure is derived[69] from accounting data, and they may be indirect when sustainability disclosures simply need to be coherent with financial disclosures; and

b) conversely, financial reporting standards should consider anchor points from sustainability reporting, for instance, when financial accounting standards require forward-looking estimates or risk disclosures.

A3.3 In addition to the PTF-NFRS main report's call for connectivity, its supplemental report *Appendix A4 Interconnection between Financial and Non-Financial Information* detailed key connectivity considerations (e.g., potential connectivity approaches such as direct and indirect connectivity, location considerations, and boundaries of IFRS Standards).

A3.4 Connectivity was also one of the seven recommendations of the October 2021 EFRAG European Lab project report (*Towards Sustainable Business: Good Practices in Business Model, Sustainability Risks and Opportunities Reporting in the EU*) following the review of a selection of EU companies' reporting practices. This report highlighted many companies' failure (i.e., at the time) to disclose/quantify the financial effects of sustainability risks and opportunities.

A3.5 Moreover, following EFRAG's outreach related to the IASB project on climate-related and other uncertainties in the financial statements, the September 2023 EFRAG Secretariat Briefing: Climate-related Risks in Financial Statements conveyed the lack (and importance) of connectivity between information within and outside the financial statements.

A3.6 ***EFRAG events:*** During the May 2023 EFRAG-hosted European Accounting Association- EAA symposium on connectivity (see report- *Multi-stakeholder perspectives on Connectivity*), concerns about overlaps/duplicative information also came to the fore. These include the burden of double reporting by preparers and the risk of double counting during the valuation of companies by users. In a similar vein, at the November 2023 EFRAG *European Corporate Reporting – Two Pillars for Success* Conference connectivity panel session (see summary report), the preparer panellist emphasised connectivity as being about getting a complete picture, and the user panellist conveyed that it is about understanding the financial effects of sustainability-related matters.

69 An example of information derived from accounting data would be European Taxonomy KPIs.

Other EU regulator and stakeholder publications

A3.7 From an EU perspective, the findings in ESMA's October 2023 report on Disclosures of Climate-related matters in the Financial Statements and other regulatory and stakeholder publications[70] (AMF, Norway Finanstilsynet, Mazars, Dutch MAB) based on thematic reviews of the reporting of climate risk in the financial statements by European companies underpin the need for two-way connectivity (of information in both financial statements and sustainability reporting). A European Systemic Risk Board (ESRB) April 2024 publication *Climate-risks and accounting* notes that failing to ensure connectivity between accounting and sustainability standards can have a negative effect on the quality of information disclosed to capital markets, with potentially system-wide consequences. Section 1.4 expands on other benefits of connectivity.

International publications and events

A3.8 Apart from the IR framework, a similar emphasis on connectivity has occurred internationally with the establishment of the ISSB as part of the IFRS Foundation pre-ISSB preparatory work. It was included as a conceptual element of the 2021 Technical Readiness Working Group (TRWG) Disclosure of Sustainability-related Financial Information Prototype, and the connectivity between the IASB and ISSB was proposed as an operational principle in the 2021 TRWG Programme of Work. As a result, IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* includes requirements for the connection of information.

A3.9 In April 2024, though the ISSB decided not to pursue a project on integration in reporting following the feedback to its 2023 Agenda Consultation, both the IASB and ISSB pledged to continue supporting the use of the IR framework (of which connectivity is a key principle) as a resource that drives high-quality corporate reporting and contributes to a cohesive information package for investors.

A3.10 Connectivity has also been a recurrent discussion theme at recent International Forum of Accounting Standard Setters (IFASS) meetings (see January, April and September 2023 IFASS reports with presentations on connectivity by the AASB, AcSB, EFRAG, FRC-UK, IASB, ISSB and UKEB; AASB and EFRAG also presented on connectivity and boundaries at the April 2024 IFASS meeting). Some of the non-EU NSS (AASB, FRC-UK, UKEB, New Zealand-XRB) have issued publications[71] and/or hosted events (e.g., AASB webinar[72]) related to climate-related reporting in the financial statements and connectivity.

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70 a) ESMA, March 2023, Report- *2022 Corporate reporting enforcement and regulatory activities*.

b) Finanstilsynet, March 2023, *Report on Information on climate-related matters in annual financial reports*.

c) Autorité des Marchés Financiers – AMF, 2022, *Overview of the information provided in the 2021 financial statements on the effects of climate change and the commitments made by companies*.

d) Leo van der Tas, Yukti Aggarwal, and Danijela Maksimovic, September 2022, *Effects of climate change on financial statements of entities listed in the Netherlands*, MAB – Maandblad voor Accountancy en Bedrijfseconomie.

e) Mazars, January 2024, Financial reporting of European companies on climate issues- Findings from 2022 financial statements.

71 FRC UK, July 2023, CRR Thematic review of climate-related metrics and targets

UKEB, September 2023, A Study in Connectivity: Analysis of UK Company 2022 Annual Reports;

NZ XRB staff guidance, November 2023, Climate-related matters in Financial Statements

72 March 2024 AASB webinar on Connectivity and Boundaries of the Annual Report

APPENDIX 4: NOVEMBER 2023 IFRIC CONSIDERATION OF NET ZERO COMMITMENT

IASB Staff analysis and recommendations to IFRIC

A4.1 **Fact pattern analysed:** 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. Below is an analysis of two of the three questions posed.

A4.2 **Question 1** – Does the public statement of a net zero transition commitment create a constructive obligation as defined in IAS 37?

A4.3 Based on the requirements in IAS 37.10 and 20[73], for the fact pattern analysed the IASB staff concluded that, though other parties are involved as the entity's obligation is to the affected public at large, a net zero commitment does not necessarily create a constructive obligation. The staff notes entity's management would need to judge whether such a commitment has created a valid expectation before concluding there is a constructive obligation.

A4.4 **Question 2** – Does a constructive obligation created by a net zero transition commitment meet the three criteria in IAS 37.14 for recognising a provision? Specifically,

a) **the present obligation criterion** – the entity has a present obligation as a result of a past event, which has to exist independently of the entity's future actions (IAS 37.18-19);

b) **the probable outflow criterion** – it is probable that an outflow of resources will be required to settle the obligation; and

c) **the reliable measurement recognition criterion** – a reliable estimate can be made of the amount of the obligation.

A4.5 The IASB staff concluded that for the fact pattern analysed, even if there is a constructive obligation, such a constructive obligation does not meet the present obligation criterion and therefore a provision is not recognised at the time the commitment is published. There is no present obligation at the date the entity publishes the commitment because the costs of meeting this commitment (i.e., modifying manufacturing methods and purchasing carbon credits) are costs that will/need to be incurred to operate in the future. Financial statements deal with the financial position at the reporting date and not its possible position in the future, and the obligations do not exist independently of the entity's future actions as required by IAS 37.18-19. However, the IASB staff notes that, at some point, the entity will incur a present obligation to pay for resources it purchases for modifying its manufacturing methods (e.g., new plant or equipment) but only when it receives those resources. It will also have a present obligation to purchase carbon credits only if and when it emits greenhouse gases in nine years and thereafter.

A4.6 On the 'probable outflows' criterion, the IASB staff concluded that the entity's commitment to reduce emissions in nine years does not satisfy this criterion because it will receive resources (e.g., a new plant) in exchange for the costs of modifying its manufacturing methods. Conversely, the commitment to offset remaining emissions in nine years satisfies this criterion as the entity will not receive any resources in exchange for its purchase of carbon credits.

73 **IAS 37.10** defines a constructive obligation as: 'An obligation that derives from an entity's actions where:

a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.'

IAS 37.20 states that: ' ...Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.'

A4.7 Taken together, the staff concluded that the entity could not recognise a provision for the commitment to invest in modifying its manufacturing methods. However, in nine years a provision could be recognised for the commitment to purchase the carbon credits. IFRIC agreed with the IASB staff's conclusions. In March 2024, IFRIC agreed to finalise the agenda decision.

A4.8 In addition, in March 2024 a second submission was made that if management concludes that a provision is not to be recognised for a 2030 commitment, the entity should **disclose the information required for contingent liabilities** under IAS 37.86 unless the possibility of any outflow in settlement is remote.

A4.9 The IASB staff analysis considered that the definition of a contingent liability in IAS 37.10 requires that:

a) it is at least possible (even if not certain) that the entity has a present obligation as a result of past events; and

b) a 'possible obligation' exists when there is uncertainty or dispute about the facts or how a law or statement applies to those facts.

A4.10 The IASB staff noted that, in the fact patterns described in the agenda decision and second submission, there is no uncertainty or dispute about whether events that create a present obligation have occurred– these events have not yet occurred. The event that gives rise to a present obligation is not the statement of a net zero transition commitment; it is the action to which the commitment applies (for example, the emission of greenhouse gases that the entity has committed to offset). Until that action has occurred, there is not even the possibility that the entity has a present obligation, so the definition of a contingent liability is not met. Accordingly, the disclosure requirements for contingent liabilities in IAS 37.86 do not apply. IFRS IC agreed with the IASB staff's analysis.

APPENDIX 5: ANNUAL REPORT DEFINITIONS

A5.1 As noted in the main body of this interim deliverable paper, we are addressing boundaries within the Annual Report which, depending on jurisdiction, is also referred to as the Integrated Annual Report, Universal Registration Document, etc. Paragraph 2 of Article 4 of the Transparency Directive (Directive 2004/109/EC) indicates that the Annual Financial Report comprises the audited financial statements, the management report; and statements[74] related to the information made by the responsible issuing persons.

A5.2 Similarly, paragraph 12 of International Standards of Auditing (ISA) 720 *(Revised) The Auditor's Responsibilities Related to Other Information and Related Conforming Arrangements* defines an Annual Report as *'a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements. An annual report contains or accompanies the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters.'*

A5.3 Paragraph A3 of ISA 720 notes that depending on the law, regulation or custom in a particular jurisdiction, one or more of the following documents may form part of the Annual Report: management report or similar reports by those charged with governance (e.g., a directors' report); chairman's statement; corporate governance statement; and internal control and risk assessment reports. Paragraph A5 gives examples of reports that when issued as standalone documents, are not typically part of the combination of documents that comprise an annual report (subject to law, regulation or custom). These include separate industry or regulatory reports (e.g., capital adequacy reports), diversity and equal opportunity reports; product responsibility reports; labour practices and working conditions reports; human rights reports; and corporate social responsibility reports.

74 Statements to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole and that the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face and, where appropriate, that it is prepared in accordance with sustainability reporting standards.

APPENDIX 6: EU ACCOUNTING DIRECTIVE DETAILS

EU Accounting Directive Accounting Principles

A6.1 Paragraph 3 of Article 4, *'The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.'*

A6.2 Paragraph 1 of Article 6, *'Items presented in the annual and consolidated financial statements shall be recognised and measured in accordance with the following general principles:*

the undertaking shall be presumed to be carrying on its business as a going concern;

a) *accounting policies and measurement bases shall be applied consistently from one financial year to the next;*

b) *recognition and measurement shall be on a prudent basis, and in particular:*

(i) *only profits made at the balance sheet date may be recognised,*

(ii) *all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and*

(iii) *all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss;*

c) *amounts recognised in the balance sheet and profit and loss account shall be computed on the accrual basis;*

d) *the opening balance sheet for each financial year shall correspond to the closing balance sheet for the preceding financial year;*

e) *the components of asset and liability items shall be valued separately;*

f) *any set-off between asset and liability items, or between income and expenditure items, shall be prohibited;*

g) *items in the profit and loss account and balance sheet shall be accounted for and presented having regard to the substance of the transaction or arrangement concerned;*

h) *items recognised in the financial statements shall be measured in accordance with the principle of purchase price or production cost; and*

i) *the requirements set out in this Directive regarding recognition, measurement, presentation, disclosure and consolidation need not be complied with when the effect of complying with them is immaterial.'*

MANAGEMENT REPORT OBJECTIVES ACROSS A SELECTION OF EU JURISDICTIONS

France

A6.3 The French commercial code issued by the Ministry of Finance incorporates the transposed requirements of the EU Accounting Directive[75] Paragraph 2[76] of Article L232-1 of the French commercial code[77]: 'The management report describes the company's situation during the past financial year, its foreseeable development, significant events occurring between the end of the financial year and the date on which the report is drawn up, and its research and development activities. Existing branches are mentioned'.

Germany

A6.4 Both the German commercial code[78] and GAS 20[79] refer to:

a) Course of business and position: Article 289, 'The management report is to present accurately the business development, including the business performance of the share capital company and its position, in keeping with its actual circumstances …';

b) Future development: Article 289, 'Furthermore, the management report is to assess the company's likely future development …'; and

c) Risks and opportunities: Article 289, 'material opportunities and risks it faces and is to provide an explanation thereof'.

A6.5 GAS 20 separately refers to:

a) The use of resources by management: *'The objective of group management reporting under this Standard is to report on the use of the group's resources by management';*

b) User needs: *'[the objective of the group management report is] to provide information that enables a knowledgeable user to obtain a suitable understanding …';* and

c) Takeovers: *'The objective of the takeover-related disclosures is to enable a potential offeror to obtain a comprehensive picture of the potential offeree entity and its structure, as well as any barriers to takeovers, before making a takeover bid'.*

75 https://www.legifrance.gouv.fr/loda/id/JORFTEXT000030920982

76 As translated by this paper's authors.

77 https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000037313425

78 https://www.gesetze-im-internet.de/englisch_hgb/englisch_hgb.html#p1236

79 https://www.drsc.de/en/pronouncements/gas-20/

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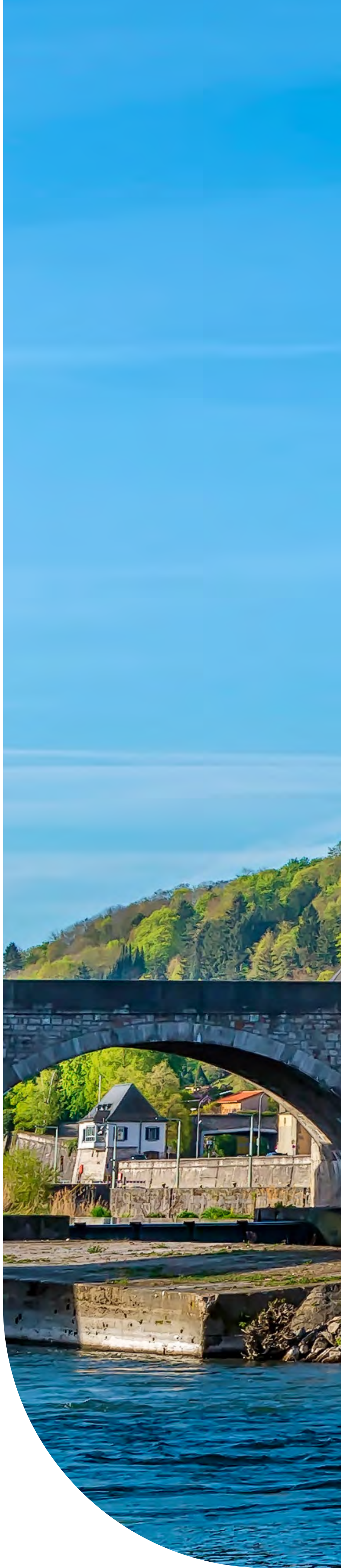

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