Cover note and issue Paper
Connectivity between financial and sustainability reporting

Objective

1. The objective of this session is to have an initial discussion on the key contents of a possible structured technical assessment of how to develop, from the perspective of financial reporting, an approach to connected information between financial and sustainability reporting. This is in preparation for a possible EFRAG proactive research project and in order to be able to assess the scope and size of such a project.

Ongoing developments in sustainability reporting

2. Directive 2014/95/EU also called the Non-Financial Reporting Directive (NFRD) – lays down the rules on disclosure of non-financial and diversity information by certain large companies. This directive currently applies to large public-interest companies with more than 500 employees, including listed companies, banks, insurance companies, and other companies designated by national authorities as public-interest entities.
3. On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD. The proposal extends the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises), requires the audit (assurance) of reported information, introduces more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards, requires companies to digitally ‘tag’ the reported information, so it is machine-readable and feeds into the European single access point envisaged in the capital markets union action plan.
4. The proposal clarifies the principle of double materiality, removing any ambiguity about the fact that companies should report information necessary to understand how sustainability matters affect them, and information necessary to understand the impact they have on people and the environment. It specifies that companies should report qualitative and quantitative information, forward-looking and retrospective information, and information that covers short, medium and long-term time horizons as appropriate. It removes the possibility for Member States to allow companies to report the required information in a separate report that is not part of the management report. It requires that undertakings also disclose information on intangibles, including information on intellectual, human, social and relationship capital.
5. The final timetable for the implementation of the new reporting directive will depend on how the Parliament and Council progress in their negotiations, as well as on the outcome of them. In the April 2021 April proposal by the EC it is foreseen that, if they reach an agreement in the first half of 2022, the EC should be able to adopt the first set of reporting standards (prepared by EFRAG in draft) by the end of 2022. That would mean that companies would apply the standards for the first time to reports published in 2024, covering the financial year 2023. These deadlines are currently subject to the ongoing negotiations.
6. EFRAG has put in consultation the first set of exposure drafts of European Sustainability Reporting Standards (ESRS) on 29 April 2022, with a deadline of the consultation on 8 August 2022.
7. At the same time the International Sustainability Standards Board (ISSB), established at COP26 to develop a comprehensive global baseline of sustainability disclosures for the capital markets, launched at the end of March 2022 a consultation on its first two proposed standards: ESRS S1 sets out general sustainability-related disclosure requirements and ESRS S2

specifies climate-related disclosure requirements. When the ISSB issues the final requirements, they will form a comprehensive global baseline of sustainability disclosures designed to meet the information needs of investors in assessing enterprise value.

8. Internationally, another significant initiative is the ongoing consultation by the US SEC[1] which would require registrants to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics **in a note to their audited financial statements**. The required information about climate-related risks also would include disclosure of a registrant's greenhouse gas emissions, which have become a commonly used metric to assess a registrant's exposure to such risks. Specifically, with reference to the note in their audited financial statements, the proposal is to include the following:

    a. the positive and negative financial impacts of severe weather events and other natural conditions and transition activities (which includes efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks on each financial statement line item, unless the aggregate impact on an absolute value basis is less than 1% of the total for the line item;

    b. the aggregate amount of climate-related costs incurred that are both expensed and capitalized, unless the aggregate is less than 1% of expenditures or capitalized costs incurred;

    c. whether and how climate-related events and transition activities impacted the estimates and assumptions they used in preparing the financial statements.

Implications for financial reporting

9. In the coming years, sustainability reporting including sustainability statements are expected to develop significantly, both in terms of content and in terms of quality. These developments will create challenges in terms of the location of information (which information to be provided where) and in terms of connectivity (enabling an understanding of how sustainability information relates to financial statements and the other way around).

10. Relatedly, the IASB, other National Standard Setters, other initiatives (e.g., Climate Disclosure Standards Board) and audit firms have all commented[2] on how climate risk should impact financial statements information. As noted in session 11 (Agenda papers 11-02 and 11-03) on the decisions on the IASB agenda, climate-related risks was one of the highest priority topics for respondents to the IASB's Third Agenda Consultation Request For Information. The respondents affirmed that there are deficiencies in reporting about climate-related risks relating to inconsistent application of the IFRS Standards and insufficient disclosures. However, the IASB is unclear about the underlying causes of these deficiencies and the best way to address them, without further investigation. Therefore, <u>the IASB decided to add a 'maintenance and consistent application' project on climate-related risks that aim to investigate the underlying causes of such deficiencies and consider whether any narrow-scope action might be needed</u>.

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[1] https://www.sec.gov/rules/proposed/2022/33-11042.pdf

[2] In 2020, the IASB published educational material related to effects of climate risk on financial statements. https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf

In 2021, an educational paper by FASB addressed the intersection of ESG matters and accounting standards

https://www.fasb.org/page/ShowPdf?path=FASB_Staff_ESG_Educational_Paper_FINAL.pdf&title=FASB%20Staff%20Educational%20Paper-Intersection%20of%20Environmental,...

11. Furthermore, in assessing the feedback to the Third agenda consultation, the IASB acknowledged that the connectivity between the IASB and the ISSB will be an overarching theme for the IASB in the coming years. The IASB considered that connectivity may affect a) new Accounting Standards and major amendments to Accounting Standards, b) digital financial reporting, c) understandability and accessibility of Accounting Standards and d) stakeholder engagement. Nonetheless, they recognised that capacity implications of connectivity are uncertain and are likely to evolve and some flexibility in terms of resources should be retained.

EFRAG recent positions

12. In its comment letter on the ED IFRS Practice Statement Management Commentary, EFRAG suggested *the IASB reconsider the finalisation of the management commentary project in the context of the work that the ISSB is about to start.* ***The role of the Practice Statement in fostering connectivity of financial reporting and sustainability information*** *could be enhanced if the IASB and ISSB manage the project jointly.*

13. In its comment letter to the IASB in response to the Third Agenda Consultation, *EFRAG suggested the IASB identify a separate area of its activity to address the connectivity between financial reporting and sustainability reporting. Financial and sustainability reporting are currently not formally connected. EFRAG considers that the ongoing developments in financial reporting standards may facilitate the creation of connectivity between financial and sustainability information. EFRAG considers that cooperation between financial reporting standard setters and sustainability reporting standard setters to ensure the continuity and coherence of corporate reporting is essential.*

14. In its joint consultation document on the IASB agenda and EFRAG research agenda, *EFRAG noted that the issue of connecting financial reporting and sustainability reporting will require greater attention in providing a full picture of companies' reporting.* ***Synergies between financial and sustainability reporting could be explored and may pave the way toward a more holistic and integrated reporting system.*** *In its March 2021 report, the EFRAG European Lab Project Task Force on preparatory work for the elaboration of possible EU non-financial reporting standards (PTF-NFRS), called for financial reporting standard setters, including the IASB, to consider 'anchor points' between financial and sustainability reporting. An 'anchor point' is defined as a data and/or information (quantitative or qualitative) that offers a connection opportunity (e.g., area of overlap) between financial reporting and sustainability reporting, hence the absence of identified anchor points indicates the absence of potential connectivity. The perspective of such a technical discussion would still be within the scope of the financial reporting. For example, there is growing momentum in sustainable or responsible investments and the question is to what extent IFRSs accommodate the needs of this growing category of primary users (providers of financial capital). In addition, the project could investigate how financial reporting requirements and in particular disclosure could evolve to facilitate the contextualization or reconciliation with selected key performance indicators generally used to report the outcome of an entity's policies on ESG matters. Climate-related financial implications are to be considered as a starting point. However, the aim should be to address environmental, social, and governance (ESG) matters comprehensively. In terms of detailed contents for this project, EFRAG suggests a more ambitious project on climate-related financial implications than the proposals in the RFI. This project would address more holistically the connectivity between IFRS Standards and sustainability reporting. A more holistic approach is supported by the following:*

   a. In the EC consultation on the renewed sustainable finance strategy,[3] one question asked whether stakeholders 'see any further areas in existing financial accounting rules (based on the IFRS framework) which may hamper the adequate and timely

[3] Summary Report of the Stakeholder Consultation on the Renewed Sustainable Finance Strategy.

recognition and consistent measurement of climate and environmental risks'. The following, in particular, could be considered:

   i. *Disclosure on the alignment of the assumptions used for impairment and amortisation of fixed assets with the implications of the Paris Agreement;*

   ii. *Disclosures about how companies factor climate-related risks into the best estimate of provisioning amounts;*

   iii. *Assessment of IFRS Standards on provisioning for future risks, considering the broader implications of climate transition risk, significant climate-related contingent liabilities and the impact of biodiversity.*

b. *A report recently issued by a group of Investors[4] called for company accounts to be 'aligned with the objectives of the Paris Agreement on climate change'. The report notes that 'there is growing evidence that company accounts are leaving out material impacts linked to accelerating climate change and the associated regulatory response – namely, efforts to decarbonise our economies by 2050 in line with the Paris Agreement on climate change.* ***This means there are risks that both capital and profits associated with activities that are harmful to the climate are overstated, driving excessive investment into damaging activities.'***

15. *The project could investigate the reasons for the omissions and whether further standard setting could provide a solution. The project could be combined with the IASB's envisaged project on Pollutant Pricing Mechanisms (currently in the IASB's pipeline of inactive projects) which aims at providing accounting guidance for such mechanisms aiming at encouraging a reduction in the production of greenhouse gases.*

Necessary reading to prepare for this session

16. IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*, selected paragraphs are accessible through the following link:

    https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financial-information.pdf

    a. General Feature- Connected information (paragraphs 42 to 44)

17. EFRAG Exposure Draft ESRS 1, selected paragraphs are accessible through the following link with connectivity being primarily addressed in **Chapter 5- Providing linkage with other parts of corporate reporting**:

    https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FED_ESRS_1.pdf

    b. Chapter 2: Applying CSRD Principles

       i. Characteristics of information quality (Paragraphs 25/41)

       ii. Double materiality as the basis for sustainability disclosures (Paragraphs 42/56)

       iii. Boundaries and value chain (Paragraphs 63/77)

       iv. Time horizon (Paragraphs 78/84)

    c. Chapter 4: Basis for preparing and presenting sustainability information (Paragraphs 107/124)

[4] The Institutional Investor Group on Climate Change (IIGCC) - Letter issued in November 2020.

d. **Chapter 5: Providing linkage with other parts of corporate reporting (Paragraphs 131/143)**

e. Chapter 6: Structure of the sustainability statements (Paragraphs 144/152)

f. Appendix E

18. The publication "Approach to financial materiality, a contribution by members of EFRAG PTF ESRS" was developed as part of the preparatory work for the cross-cutting ESRS standard-ESRS 1 *General Requirements* (**Agenda Paper 07.02**)

Background reading

19. Appendix 4.4 to the final Report of EFRAG PTF NFRS (March 2021) *Interconnection between financial and non-financial information.*

    https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520PTF-NFRS_A4_FINAL.pdf

Questions to EFRAG FR TEG Members

20. Paragraphs 12 and 13 above provide the initial directions of a possible EFRAG proactive research on connectivity. How should the scope of such a project be defined?

21. Do EFRAG FR TEG members have specific suggestions and observations on the scope of such a project?