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Background paper only- agenda paper used during the EFRAG FR TEG and FRB approval of the scope and approach of the connectivity project

Connectivity between Financial and Sustainability Reporting Information

Suggested scope and approach of EFRAG Research project

Objective

- 1 The objective of the session is for the EFRAG FR TEG and EFRAG FRB to discuss:
 - (a) the proposed approach to EFRAG's research project on Connectivity between Financial Reporting (FR) and Sustainability Reporting Information (SR), including its articulation in two phases;
 - (b) the proposed scope and timing for the first phase.
- 2 EFRAG FR TEG has discussed but not approved the scope and approach of the project. The purpose of this session is to allow for a joint EFRAG FR TEG and FRB discussion on the thinking done so far and any further considerations needed. The EFRAG research project direction will then depend on the approval of the scope and approach by the EFRAG FRB.
- 3 The proposed scope and approach articulated in this paper reflect suggestions made during:
 - (a) the discussion held by the EFRAG FRB during its approval of the project in June 2022 informed by the discussion and recommendation of the EFRAG FR TEG in May 2022; and
 - (b) discussions that were subsequently held at the July 2022 EFRAG FR TEG, November 2022 EFRAG Academic Panel, and January 2023 Joint EFRAG FR and SR TEG meetings.
- 4 The project falls under the FR pillar and will be under the governance of EFRAG FR TEG and FRB. Nonetheless, it is expected that to draw on the SR pillar's domain expertise, the EFRAG SR TEG and SRB will be periodically updated and their input sought, including during joint FR and SR meetings. Furthermore, in order to ensure effective coordination between the work of the FR and SR pillars factored into this project, it is important that the results of the research are compatible with the SR developments and conceptualisations.

- 5 The rest of the paper is structured as follows:
- (a) Background
 - (b) Research objectives and definition of connectivity
 - (c) Scope considerations
 - (d) Proposed two-phase approach
 - (e) Advisory panel
 - (f) Proposed timeline
 - (g) Appendix 1- Other related initiatives (IASB, ISSB and IFASS)
 - (h) Appendix 2- Illustrative metrics (ESRS E1 *Climate Change*, ESRS E4 *Biodiversity*, ESRS S1 *Own Workforce*)
 - (i) Appendix 3- Links to relevant publications

Background

- 6 In June 2022, the EFRAG FRB approved the addition of a project on the connectivity between FR and SR information to the EFRAG proactive research agenda. The project was identified as a high priority in the feedback to the May 2021 EFRAG agenda consultation (it was the most¹ supported new EFRAG proactive agenda project).
- 7 Furthermore, in Q4 2022, while providing input for the 2023 workplan, several EFRAG FRB members underscored the importance of and need to prioritise this project. IFASS members² also identified this topic as a priority and at the January 2023 IFASS meeting, UK Endorsement Board (UKEB) staff presented a paper with preliminary views on thematic areas where connectivity should be considered (see Appendix 1). Similarly, a review of reporting practices and recommendations made by the European Lab project task forces (PTF-CRR and PTF-RNFRO) emphasised the need for an enhancement of connectivity in reporting.
- 8 As noted above, the articulated research objectives and the scope and approach proposed below have incorporated the feedback from EFRAG FR TEG, EFRAG SR TEG and EFRAG Academic Panel.

Research objectives and suggested definition of connectivity

- 9 *Research objective:* EFRAG's financial reporting stakeholders are facing the challenges of a fast-evolving corporate reporting environment, with SR gaining increased public attention and internal scrutiny. This results in the need to understand how FR will be impacted, from a conceptual and operational standpoint. Also, work on connectivity is critical towards enhancing the consistency and coherence between the information in the front and back ends of the annual report during the communication of the story of entities' value creation. The connectivity project, which will have both a practical and conceptual orientation, can contribute to the mutually complementary enhancement of FR and SR requirements and reporting practices.
- (a) For instance, SR requirements and information (e.g., on stranded assets/locked-in emissions and other disclosed sustainability risks and

¹ This project was supported by 14 of 19 outreach respondents, 5 of 6 survey respondents and 7 of 10 comment letter respondents.

² A polling question at the September IFASS meeting showed that 89% of the meeting respondents supported the possible role of IFASS in developing the connectivity topic.

- opportunities) can be an input for determining current and future financial statements information.
- (b) Conversely, current financial effects (sustainability matters reflected in financial statements) are an important SR disclosure (under both ESRS and IFRS S1 and S2 requirements).
- 10 The deliverables of the research project are intended to fulfil multiple objectives including:
- (a) to influence the ongoing³ SR and FR standard setting including on the expected standard setting by the IASB and ISSB, notably on Management Commentary and Integrated Reporting. The research findings could be considered when addressing conceptual issues related to SR and serve as input to the forthcoming IASB narrow-scope project on climate-related risk in financial statements.
- (b) to contribute to research/thought leadership on the topic of connectivity, which is a nascent and high-priority area for stakeholders.
- (c) to support practice through identified good reporting practices. Examples that will be identified during the research can enable companies to benchmark themselves and improve their reporting practices.
- (d) to serve as an educational resource for a diverse range of stakeholders concurrent to ongoing significant developments in SR and its connection with FR.
- 11 *Definition:* Connectivity is a term with diverse possible definitions. Furthermore, due to its multiple dimensions (e.g., conceptual connectivity of FR and SR requirements, connectivity of information in the Annual Report, institutional connectivity via coordination of standard-setting bodies, etc), there can be myriad interpretations by stakeholders on the scope of the EFRAG project on connectivity. Hence, an upfront definition of what it means in the context of the EFRAG project is necessary to manage expectations and avoid confusion on the objectives of the research. In addition, developing an operable definition can be a distinct contribution of this research. It will contribute to the thought leadership and educational components of the research objective.
- 12 In addition to the general requirements in ESRS 1 *General Principles* and IFRS S1, possible starting points for the development of a definition to be applied in this project- which will encompass the connectivity of FR and SR requirements and reported information- are the elements of the definitions stated in the [January 2021 Integrated Reporting \(IR\) framework](#) and the [March 2021 EFRAG PTF-NFRS report- Appendix 4.4 Interconnection between financial and non-financial information](#). These definitions are as follows:
- (a) 2021 IR framework definition: *“Connectivity is intended to address the connection between financial, non-financial information in order to provide a holistic view of the combination, interrelatedness and dependencies between all the factors that affect value creation.”*
- (b) EFRAG PTF-NFRS definition: The EFRAG PTF-NFRS report, which asserts that linking SR and FR ought to be based on anchor points (i.e., items that fall within the boundaries of both sustainability reporting and financial reporting),

³ At the January 2023 IFASS, 61% of respondents had the view that work on connectivity should precede (or be considered) in the development of new SR Standards.

also distinguishes between 'direct connectivity' and 'indirect connectivity' as elaborated below.

- (i) *“The direct connectivity concept aims at directly reconciling sustainability information with information in the financial statements or the general ledger.”* An example of direct connectivity can be the disclosure of 'training costs' as part of sustainability reporting that can be reconciled to a financial statements line item or the disclosure of GHG or energy intensity metrics based on net revenue, where revenues are reconcilable to IFRS revenue.
- (ii) *“The indirect connectivity concept aims at identifying links to financial reporting information, for disclosure that cannot be directly reconciled to the financial statements or accounting estimates in the current period.”* An example of indirect connectivity is the consistency of internal carbon prices applied for carbon pricing schemes and that applied for asset impairment in financial statements.

Scope considerations

- 13 *SR requirements to be linked to financial reporting information:* To respond to the needs of European stakeholders, the project will cover the mandatory ESRS and ISSB requirements. Considering the timing of the expected appearance of the first reports prepared according to ESRS and ISSB requirements, when reviewing reporting practices, the project will also cover reporting practices under voluntary guidance (GRI, TCFD recommendations etc).
- 14 *What information should be the focus of the connectivity research?* The project could focus on the connection of:
 - (a) SR under ESRS and ISSB requirements (sustainability statements, disclosures of sustainability-related risks and opportunities) to financial statements;
 - (b) SR under ESRS and ISSB requirements (sustainability statements, disclosures of sustainability-related risks and opportunities) to general purpose financial reporting (i.e., financial statements, management commentary);
 - (c) SR under ESRS and ISSB requirements (sustainability statements, disclosures of sustainability-related risks and opportunities) to the reporting package (i.e., general purpose financial reporting and other regulated information and reports).

It is proposed that the EFRAG project should cover (b) above. It is noted that ISSB has requirements for the connection of SR to general purpose financial reporting. Furthermore, the mandatory location (as set in the CSRD) of the sustainability statements is in a separate section of the management report, and ESRS 1 requirements allow reporting companies' sustainability statements to incorporate, by cross-reference, the information that is presented in other sections of the management report. Hence, scope (b) above seems a logical starting point to build a connected system of information.

Operationalising the linkages between FR and SR, starting from their respective conceptual borders as defined in the current regulation and standards

- 15 The project will need to take into account the conceptual borders and differences between FR and SR. Below is a non-exhaustive list of reasons for the differences between FR and SR
 - (a) *Reporting across the value chain;* There is consistency in the definition of reporting undertaking/entity applied as the basis for preparing FR and SR.

That said, FR information is limited to the reporting entity but SR considers impacts, risks, and opportunities across the value chain⁴.

- (b) *Differing time horizons* (e.g., climate horizon can be much longer than that applied in the measurement of financial statement line items) as expressed in the articulation of the notion of 'Tragedy of Horizons' by Mark Carney
 - (c) *Extent to which forward-looking information is incorporated*. Both FR and SR have forward-looking estimates. However, an important difference is that FR is focused on future consequences of past actions whereas SR also encompasses future consequences of future actions.
 - (d) *Data reliability and estimation uncertainty*: Relative to SR, FR information is typically based on the recording of transactions under a more robust control environment (underpinned by a double-entry recording system) and this has a bearing on the respective reliability and measurement uncertainty of FR and SR information.
 - (e) *Materiality*: FR information is required to be reported only when financially material. SR information is reported under the double materiality perspective (impact materiality and financial materiality) under the ESRS requirements and impact materiality perspective under the GRI Standards.
- 16 The project will also take account of different audience needs. FR and SR information serve different purposes, have differing features as explained in the preceding paragraph and cater to different sets of users. Therefore, not all FR and SR information ought to be connected. In this regard, the EFRAG research project will aim to understand the expectations that users of FR and SR information have on connectivity.

Proposed two-phase approach

- 17 Based on the EFRAG FR TEG recommendation, it is proposed that the EFRAG research project should be conducted in two phases.

Reasons for a two-phase approach

- 18 In May and July 2022, EFRAG FR TEG recommended the phasing of the project (i.e., a two-phase approach) after observing that neither the ESRS nor ISSB standards were applicable yet and it would be necessary to observe sustainability statements/ disclosures by entities under the mandatory requirements before being able to fully consider all the practical and conceptual challenges of connectivity.
- 19 At the January 2023 joint EFRAG FR and SR TEG meeting, some SR TEG members (a minority view) suggested the conceptualisation and rethink of current FR and SR boundaries should be the priority of the EFRAG project. However, for practical reasons, the proposed phasing, starting with a primary focus on operational techniques of linkage of FR and SR, is necessary because
- (a) the aim of the project, at least in the first phase, should not be to challenge the current boundaries of FR and SR information as defined within the current legislative and regulatory framework. Rather, the aim of Phase 1 is to support the development of connectivity practices, which involve possible changes to FR as well as SR practices during the early stages of preparers' and other stakeholders' acclimatising to and implementing the mandatory SR requirements. The practical insights and learnings gleaned from Phase 1 as well as from the work done on the topic by other NSS (e.g., IFASS members)

⁴ Gathering information along the value chain is needed to estimate Scope 3 CO₂ emissions and to assess the risks of modern slavery.

can inform future extended work by EFRAG including addressing the more conceptual aspects.

- (b) to be able to meaningfully influence international developments (which is the ultimate goal of EFRAG FR proactive research), there is a need to monitor the developments of the work done by the ISSB and IASB related to connectivity including their envisioned work on the IR framework and management commentary. As needed, Phase 2 may explore the challenges and opportunities offered by a possible revision of the current FR and SR boundaries, including through the conceptualisation and application of integrated reporting.

- 20 Hence, the proposed two phases are a) Phase 1- *definition of connectivity and how to operationalise it given the current conceptual borders*; and b) Phase 2- *possible connectivity developments if the conceptual boundaries of FR and SR were to be changed and integrated reporting applied*. The scope and content of phase 2 cannot be defined with reasonable certainty until we will know more about the ISSB developments.

Phase 1 – Definition of connectivity and how to operationalise it given the current conceptual FR and SR borders

Phase 1 Approach

- 21 Focus on operational techniques to foster linkage: As noted above, it is proposed that the initial focus will primarily (but not only) be on practical, operational techniques including digitisation⁵ tools (where applicable) that foster cohesiveness between financial and sustainability information. As noted above, Phase 1 will not aim to challenge the current boundaries of FR and SR. Furthermore, the objective of this phase is not to address ESG-linked FR requirements (e.g., the objective is not to come up with proposals for the accounting treatment of ESG-linked financial instruments, recognition and measurement of pollutant pricing mechanisms)
- 22 Identify anchor points: The project will identify anchor points (i.e., items that fall within the boundaries of both sustainability reporting and financial reporting) by conducting a detailed examination of the metrics and other disclosure requirements within the ESRS and ISSB Standards that have current financial statements effects or may result in future period financial effects. We describe this further below in Paragraphs 26 and 27.
- 23 Include conceptual elements to set the scene for Phase 1: To set the scene on what information should be connected, Phase 1 will also have a clear illustration of the conceptual elements of the CSRD and ESRS such as double materiality (i.e., both impact materiality⁶ and financial materiality⁷ of sustainability matters as defined in

⁵ As ESRS and IFRS digital taxonomy is under development, it is likely premature to consider digitisation and connectivity.

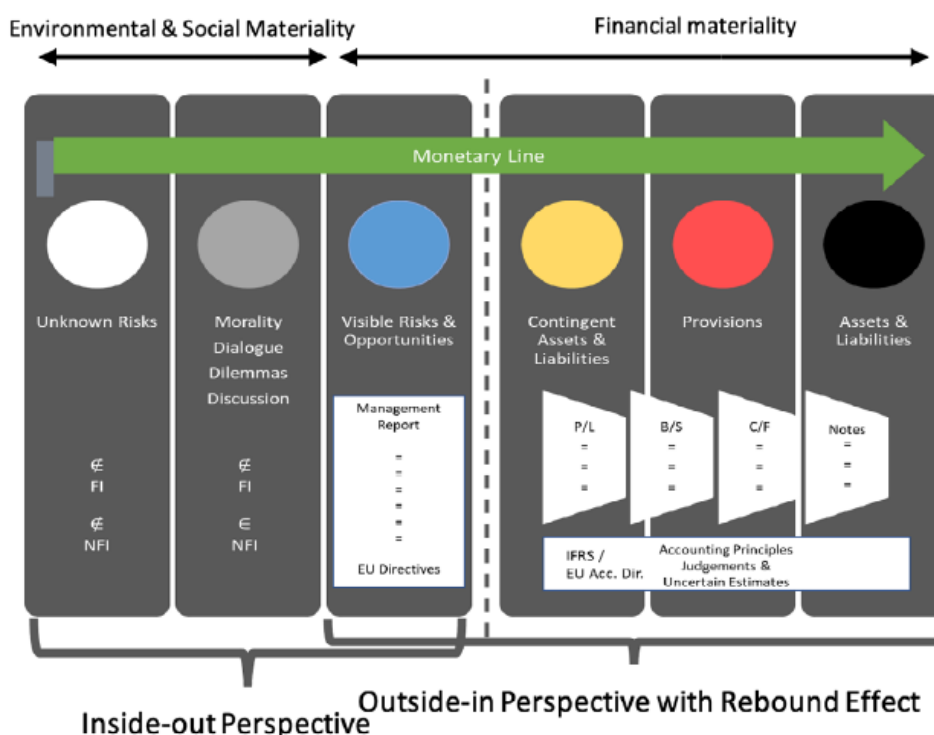
⁶ ESRS 1.46 states that a sustainability matter is material from an impact perspective when it pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- and long-term time horizons. Impacts include those caused or contributed to by the undertaking and those which are directly linked to the undertaking's own operations, products, or services through its business relationships. Business relationships include the undertaking's upstream and downstream value chain and are not limited to direct contractual relationships.

⁷ ESRS 1.52 states that a sustainability matter is material from a financial perspective if it triggers or may trigger significant financial effects on the undertaking's development, performance, and position in the short-, medium- or long-term. This is the case, in particular, when it generates or may generate significant risks or opportunities that influence or are likely to influence the future cash flows. Future cash flows with other critical factors such as business model, strategy, access to finance and cost of capital, in turn are likely to influence the financial position and financial performance of the undertaking in the short-, medium- or long-term, including affecting the enterprise value. Risks and opportunities may derive from past events or future events and may have effects in relation to:

- (a) assets and liabilities already recognised in financial reporting or that may be recognised as a result of future events;
or

ESRS 1). For instance, the research could analyse if/how and the extent to which SR information that is either financially material (both monetary and non-monetary metrics) or impactfully material (e.g., non-monetary metrics) ultimately translates to financial statements effects. Illustratively, Figure 1 (Monetary Line) below, excerpted from the PTF-NFRS Appendix 4A report, depicts a continuum of the translatability of different sustainability matters to monetary and financial statements effects.

Figure 1: Monetary Line



Source: PTF-NFRS Report- Appendix 4- Page 13- Figure 4

- 24 Identify items that should not or cannot be connected: As part of the conceptualisation that sets the scene, Phase 1 will also highlight which types of FR and SR information cannot be connected. The inappropriateness or inability to connect can be due to
- differing nature of SR versus FR information (time horizon, differing reporting boundary, measurement uncertainty, reliability) as enumerated in Paragraph 15 above
 - the limits of the IFRS requirements of recognition of assets and liabilities in the financial statements (e.g., due to high threshold for recognition). The PTF-NFRS Appendix 4A report and other papers (e.g., UKEB staff paper for January 2023 IFASS meeting) include an initial analysis of the limits of IFRS requirements. The EFRAG research project will use these publications as input.
 - limits of SR or FR information (e.g., lack of separability of sustainability risks and opportunities from other reported risks such as macroeconomic risks).

(b) factors of enterprise value creation that do not meet the financial accounting definition of assets and liabilities and/or the related recognition criteria but contribute to the generation of cash flows and creation/maintenance of enterprise value. The latter factors are generally referred to as 'capitals' in frameworks promoting a multi-capital approach.

For the above, the related conceptual elements in the Accounting Directive, IFRS Accounting Standards, IFRS Conceptual Framework for Financial Reporting, and the ISSB Standards will be considered.

- 25 Apply an iterative approach The project will apply an iterative approach between the two phases whereby findings from the second phase may help to reconsider matters addressed in the first phase and vice versa (i.e., feedback and feedforward loops).

Identifying anchor points-Linking ESRS and ISSB requirements to IFRS financial reporting requirements

- 26 As noted, Phase 1 will identify anchor points (i.e., data points within the boundaries of both FR and SR). A starting point will be to assess the content of the 12 draft ESRS (2 cross-cutting; 5 environmental, 4 Social, 1 Governance) and ISSB IFRS S1 and S2 requirements and their linkage to financial statements requirements.
- 27 Both ESRS and IFRS S1 and S2 Standards have requirements for disclosure of current and potential/anticipated financial effects (i.e., reflected in current or future financial statements). In addition, other non-monetary metrics may be pre-financial information (i.e., may affect financial statements in future periods). For instance, the level of GHG emissions can be indicative of potential future liabilities. Illustratively, Appendix 2 of this paper has ESRS monetary and non-monetary metrics related to ESRS E1 Climate Change, ESRS E4 Biodiversity and ESRS S1 Own Workforce. In some cases, these metrics could be either directly or indirectly connected to financial statements information.

Operational techniques for linkage in FR and SR information

- 28 In relation to the operational techniques for the linkage of FR and SR information, draft ESRS 1.119-130 has a connectivity principle with requirements for undertakings/entities to establish the connection between SR information and financial statements. These requirements that encompass direct and indirect connectivity (as described in Paragraph 12-b above) include:
- (a) *Description of relationships between different pieces of information:* The undertaking shall describe the relationships between different pieces of information. Doing so could require connecting narrative information on governance, strategy, and risk management to related metrics and targets. For example,
- (i) to allow users to assess connections in information, the undertaking might need to explain the effect or likely effect of its sustainability strategy on its financial statements or financial plans, or on metrics and targets used to measure progress against performance.
 - (ii) the undertaking might need to explain how its use of natural resources and changes within its supply chain could amplify, change or reduce its material impacts, risks and opportunities.
 - (iii) It may need to link this information to the potential or actual effect(s) on its production costs, its strategic response to mitigate such impacts or risks and 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.
- (b) *Cross-referencing:* ESRS 1.120-3 require the incorporation by cross-referencing. ESRS1.125 states that when the sustainability statements include monetary amounts or other quantitative data points that are above a threshold for material information and are directly presented in financial statements, the undertaking shall include a reference to the relevant paragraph of its financial statements where the corresponding information can be found. The EFRAG project will consider where it is appropriate to use

cross-referencing. And will draw on insights from constituents' feedback to the respective 2022 public consultations on ESRS and IFRS S1, S2 Exposure Drafts, and the 2021 IASB's exposure draft *Management Commentary*, and the redeliberations made thereafter.

- (c) *Reconciliation to financial statements information:* In some cases, sustainability statements may include monetary amounts or other quantitative data points above a threshold for material information that is either an aggregation of, or a part of, monetary amounts or quantitative data presented in the undertaking's financial statements. If this is the case, the undertaking shall explain how these relate to the most relevant amount(s) presented in the financial statements. This disclosure shall include a reference to the line item and/or to the relevant paragraph(s) of its financial statements where the corresponding information can be found. For material amounts, a reconciliation shall be provided, and it may be presented in a tabular form.
- (d) *State consistency of underpinning assumptions, data and qualitative information:* When there is no direct or indirect link, the undertaking shall state (based on a threshold for material information) the consistency of data, assumptions used, and qualitative information included in its sustainability statements with the corresponding data, assumptions and qualitative information included in the financial statements.
- 29 Similar to ESRS, IFRS S1 has requirements⁸ for the connection between the disclosures of sustainability-related risks and opportunities and general-purpose financial reporting information.

Considerations during the analysis of the connection between SR and financial statements

- 30 *Limits of potential financial effects:* The project will consider the limits of connectivity of potential financial effects as some of these effects may never be reflected in the financial statements. For instance, these potential effects will be based on a multitude of assumptions and cover a lengthy time horizon⁹beyond that considered in the financial statements and be highly uncertain information (e.g., can be related to time horizons of longer than 50 years for climate risk) and, therefore, be outside the scope of inclusion in financial statements. Furthermore, potential financial effects from sustainability risk that are derivable from current financial statements (e.g., assets at material physical risk) may never crystallise and translate to actual financial effects during future periods.
- 31 *Difficulties in establishing connectivity of non-monetary metrics:* There are difficulties in establishing the connection between SR non-monetary metrics and current or future financial statements (e.g., due to the difficulties in the valuation/translation of monetary impacts of social impacts) and these will be taken into account by the project.

⁸ IFRS S1.42. states that an entity shall provide information that enables users of general-purpose financial reporting to assess the connections between various sustainability-related risks and opportunities, and to assess how information about these risks and opportunities is linked to information in the general purpose financial statements.

IFRS S1. 43 states that an entity shall describe the relationships between different pieces of information. Doing so could require connecting narrative information on governance, strategy and risk management to related metrics and targets. For example, to allow users of general purpose financial reporting to assess connections in information, an entity might need 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 entity might need to explain how its use of natural resources and changes within its supply chain could amplify, change or reduce its significant sustainability-related risks and opportunities. The entity may need to link this information to the potential or actual effect on its production costs, its strategic response to mitigate such risks and 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. Information that describes connections shall be clear and concise.

⁹ Mark Carney's Tragedy of Horizons

Phase 1 Other steps and deliverables

32 Other steps

- (a) *Outreach to users*: There will be an outreach to users of FR and SR information to ascertain the forms of connectivity that will address their information needs.
- (b) *Gathering examples*: The project will identify and document examples of reporting practices and proforma examples on the application of the connectivity principle. climate-related reporting could be initially prioritised and taking account of work done by the EFRAG European Lab and other thematic studies (e.g., Carbon tracker- Flying Blind report);
- (c) *References to other initiatives*: The project will consider ESMA's guidelines on Alternative Performance Measures as a possible source of inspiration for requirements on aggregation and reconciliations of ESRS/ISSB metrics. In addition, the following reference sources will be considered:
 - (i) The TCFD project on connectivity (e.g., an ongoing project on TCFD disclosures and asset valuations);
 - (ii) The ISA 720 requirements related to 'the auditor' involvement with other information¹⁰. The ISA 720 requirements could inform the assessment of the consistency between the front part and back end of the annual report (financial statements).

33 **Deliverables**: A Discussion Paper containing a systematic illustration of the possible connections between FR and SR requirements, and illustrative good reporting practices could be expected in early to mid-2024. When it will not be possible to identify real cases of reporting practices, the Discussion Paper will develop proforma examples.

Phase 2 – possible connectivity developments if the conceptual boundaries of FR and SR were to be changed and integrated reporting

- 34 *Overall objective*: The definition of the scope and content of this phase will only be possible once the ISSB developments in particular for integrated reporting will be clear. We present below some preliminary indications of an approach to Phase 2, that will be subject to discussion in the next months.
- 35 Phase 2 could conceptualise how to enhance the integration between FR and SR information. Specifically, it could:
- (a) Conceptualise and possibly rethink the boundaries of FR and SR information after considering
 - (i) information where there are overlaps in FR and SR information (i.e., anchor points),
 - (ii) where there are inherent differences in FR and SR information (i.e., information that cannot be connected), and
 - (iii) where there should be closer alignment between FR and SR information.
 - (b) Explore the advantages and disadvantages of integrated reporting (i.e., holistically explaining how the enterprise is creating value) and the role of management commentary.

¹⁰ Defined as financial and non-financial information, other than the audited financial statements, that is included in entities' annual reports.

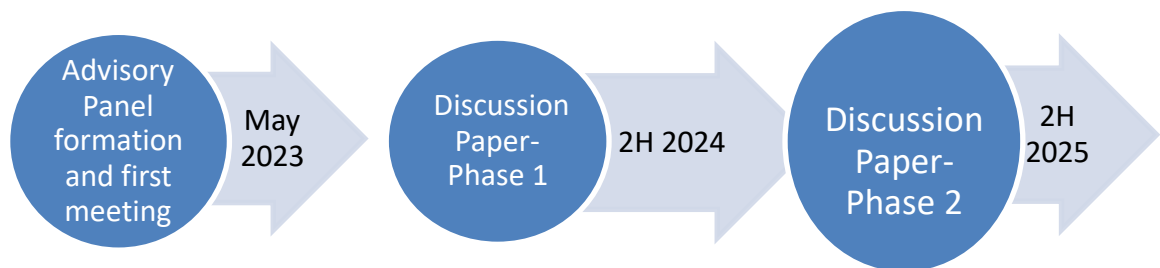
- 36 *The output of Phase 1 will refine the objectives and scope of Phase 2:* As noted above, to set the scene, Phase 1 will include the conceptualisation and identification of areas where FR and SR should not or cannot be connected. There will also be a gathering of examples that illustrate the operational techniques of linkage. The output and learnings from Phase 1 could further inform the conceptualisation of the boundaries between FR and SR under Phase 2.
- 37 *Influence the IASB-ISSB work on connectivity:* EFRAG FR proactive research aims to influence the activity of the IASB. In this case, Phase 2 (objective in paragraph 32-b) can influence the IASB-ISSB project on the connectivity between management commentary and integrated reporting.
- 38 *Identify and develop areas of enhancing conceptual alignment in preparing FR and SR information:* In Phase 2, the research will identify and develop areas of conceptual alignment between the basis of preparing FR and SR information. For example, as highlighted in a paper presented by UKEB staff at the January IFASS meeting (see Appendix 1), this could be related to the development of a conceptual framework for SR, assessing the criteria for the recognition of assets and liabilities, aligning the principles of disclosures of SR to those that are applied for FR (i.e. objectives-based disclosures), and any other area where alignment in underlying principles may be needed.
- 39 An example of where there may be a need for greater conceptual alignment in FR and SR is in the respective consolidation requirements applied for financial statements and sustainability reporting information and the application of the notion of control. In this regard, Phase 2 could explore and provide proposals for the greater alignment of GHG Protocol carbon accounting consolidation requirements to IFRS requirements for accounting for investee entities.
- 40 Of note, 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,
- (a) 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.
 - (b) the GHG Protocol also allows an equity market share approach (*de facto* proportionate consolidation) whereas IFRS requirements no longer allow proportional consolidation for joint arrangements.
 - (c) IFRS 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.
- 41 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. Of note, the GHG protocol was last updated several years ago. Hence, Phase 2 could also address this type of issue where greater alignment may be desirable.
- 42 *Timeframe for Phase 2:* Consistent with the expectation that an ISSB/IASB project on connectivity and integrated reporting (arising from the upcoming ISSB agenda consultation) could be conducted over the next two years (2024-2025), EFRAG could consider a similar timeframe for Phase 2.

Advisory panel

- 43 To obtain the benefits of practical experience and insights, it is proposed to form an advisory panel consisting of a broad set of users (not only FR primary users), preparers, experts with in-depth knowledge of sustainability matters, and individuals with detailed knowledge of both SR and FR Standards (including valuers) and other stakeholders to act as a sounding board to help identify connectivity issues and suggest how to address them. This panel could play a similar role to the one played by EFRAG's Advisory Panel on Intangibles.

Proposed timeline

- 44 Below is a summary of the below preliminary proposed timelines for the project.



Appendix 1: Other related initiatives

IASB and ISSB activities

IASB activities

- 1 The IASB has no active project on connectivity between Financial and Sustainability Reporting. Following its agenda consultation for the period 2022-2026, the IASB has added a narrow-scope project on Climate-related Risks in the Financial Statements to its project pipeline. The IASB intends to run a maintenance and consistent application project on climate-related risks that aims to investigate the underlying causes of deficiencies (if any) raised by stakeholders in reporting on climate-related financial implications in current financial statements and to decide if any narrow-scope amendments to the Accounting Standards are needed.

ISSB activities

- 2 At its 14 December 2022 meeting, the ISSB discussed potential projects to be included in a request for information that will gather stakeholder feedback (expected to be issued in H1 2023) to inform the ISSB's two-year work plan. The ISSB tentatively decided in particular to seek feedback in the request for information regarding a potential joint project with the IASB on connectivity in reporting, building on the IASB's Management Commentary project and the Integrated Reporting Framework.
- 3 The Request for Information will include a proposal to undertake a joint project with the IASB to develop comprehensive disclosure requirements and guidance that enable entities to report a connected discussion and analysis of their financial statements and sustainability-related financial disclosures.
- 4 The ISSB request for information is planned for H1 2023, and it will cover the activities over two years after the consultation (2024-2025).
- 5 The IASB has also already undertaken a project to deliver a comprehensive overhaul of IFRS Practice Statement 1 Management Commentary to enable an entity to bring together, in a single concise and coherent narrative, information about financial, sustainability and other factors that have affected the entity in the reporting period or could affect the entity's prospects. The exposure draft published by the IASB in May 2021, focused on information that investors and other capital market participants need in assessing the entity's ability to create value and generate cash flows, including in the long term.
- 6 In developing its initial proposals, the IASB sought to consolidate and build on national and international innovations in reporting, including the Integrated Reporting Framework (which is now part of the materials of the IFRS Foundation), and to target shortcomings in practice.
- 7 In their responses to the public consultation on the exposure draft, many stakeholders (including EFRAG) encouraged the IASB to advance the Management Commentary project in collaboration with the ISSB and asked for clarity on the interaction between management commentary and sustainability-related financial disclosures. The Chairs of the IASB and the ISSB have already committed to considering opportunities to address similarities and differences between the IASB's proposals in the Management Commentary project and the Integrated Reporting Framework.
- 8 As part of its agenda consultation, the ISSB will seek views on whether and how a project on connectivity could build on the work done on the Management Commentary project, analyse the feedback on the IASB's proposals on this project and explore similarities and differences between those proposals and the Integrated Reporting Framework, seeking to further build on the principles and concepts of the Integrated Reporting Framework. The project would also consider its relationship

with IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and findings in other projects.

International Forum for Accounting Standard Setters (IFASS)

- 9 At the 12 January 2023 IFASS meeting, the UK Endorsement Board (UKEB) staff presented a paper regarding the connectivity between sustainability and financial reporting.
- 10 The paper identified key connectivity and alignment themes and proposed solutions for consideration. Following discussion at IFASS and consultation with the Board, the UKEB Secretariat may develop further papers, in collaboration with other NSS, on the key themes identified in this paper or during the discussion with IFASS. The paper examines comments made by IFASS members in relation to connectivity and alignment between sustainability disclosures and financial reporting in their Comment Letters to the ISSB on draft IFRS S1 and draft IFRS S2. These comments were based on both stakeholder outreach within their jurisdictions and their endorsement experience with IASB Accounting Standards. The paper also considers the potential implications for connectivity arising from the articles published by an IASB member (Nick Anderson) in 2019 and 2022 on the effects of climate-related matters on financial statements identified and illustrated how companies should consider climate-related matters through the application of IFRS Accounting Standards.
- 11 The paper identifies several themes to be explored by the IASB and ISSB to foster connectivity. The identified thematic areas include;
 - (a) Differences and connectivity between the IASB and ISSB Standards;
 - (b) Conceptual framework-related themes (develop the Conceptual framework for SR or update the conceptual framework for FR to
 - (c) Assets (develop additional application guidance on costs related to climate-related risks and opportunities, accounting treatment of carbon credits and financial assets with ESG-linked features, consider application guidance on impairment)
 - (d) Liabilities (ensure stakeholders understand financial statement implications of sustainability risks in sustainability report)
 - (e) Fair value measures (additional guidance to standards to assist entities to fully consider the potential impact climate-related matters may have on the fair value measurement of assets and liabilities).
 - (f) Disclosures (objectives-based disclosures)
 - (g) Management commentary
- 12 In reaction, to the identified thematic areas, IFASS members suggested the prioritisation of addressing conceptual framework-related themes (i.e., the development of a conceptual framework for SR), addressing the recognition of assets and liabilities, and disclosures (i.e. having objectives-based disclosures). They also called for a definition of connectivity and a view was expressed that direct connectivity should be the priority.

Appendix 2: Illustrative Examples of ESRS monetary and non-monetary metrics (Climate change, biodiversity and own workforce)

ESRS	Required disclosure metrics (monetary and non-monetary metrics)	Possible connection to IFRS financial reporting information as stated in ESRS	EFRAG Secretariat Comments
ESRS E1 <i>Climate Change</i> metrics			
E1-5, E1-6	Energy intensity based on net revenue, GHG intensity based on net revenue	Revenue in financial statements, segment reporting	These two metrics are examples of direct connectivity (i.e. revenue used in the ratio) is expected
E1-8	GHG Emissions		<p>The application requirements illustrate how GHG emissions can be used in the calculation of potential liabilities.</p> <p>GHG emissions can be material from both financial and impact materiality perspectives. GHG Scope 1, 2 and 3 emissions can inform on an entity's susceptibility to transition risk (e.g., high emitters face a higher risk to their business model when authorities pursue net-zero goals).</p>
E1-8	Internal carbon prices	Consistency with carbon prices used in carbon pricing schemes with useful life and impairment of assets and fair value of acquired assets	This is an example of indirect connectivity
E1-9	Assets at material physical and transition risk including stranded assets	Assets at material physical and transition risk including stranded assets	Direct connectivity- Information of assets at risk is expected to be derivable from current financial statements

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E1-9	Net revenue vulnerable to material physical and transition risk	IFRS 15 revenue; segment reporting information	Direct connectivity- Information of revenue at risk is expected to be derivable from current financial statements
E1-9	Potential liabilities (e.g., due to failure to meet emissions targets)	Unrecognised liabilities; contingent liabilities IAS 37	May not necessarily translate to financial statements liabilities
E1-9	Climate opportunities-Cost savings	Cost savings are undefined under IFRS requirements	Could be direct connectivity or indirect where reference is made to related line item
ESRS E2 Pollution metrics			
E2-4, E2-5	Air pollutants, Water emissions, Inorganic pollutants, Ozone-depleting substances, Microplastics, Substance of concern generated		
E2-6	Potential financial effects from pollution-related risks	IFRS 15 revenue; segment reporting information	Direct connectivity- Information of revenue at risk is expected to be derivable from current financial statements
E2-6	Potential financial benefits from pollution-related opportunities	IFRS 15 revenue; segment reporting information	
E2-6	Substances of concern used based on revenue	IFRS 15 revenue; segment reporting information	Direct connectivity
E2-6	Operating and capital expenditures incurred from major incidents and deposits	IAS 37 Contingent Liabilities	
E2-6	Provisions for environmental protection and remediation costs	IAS 37 Provisions	May not necessarily translate to financial statements liabilities
ESRS E4 Biodiversity metrics			
E4-3	Biodiversity offsets key performances		

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E4-3	Financial effects of biodiversity offsets		
E4-5	Number and area (in hectares) of sites owned, leased or managed in or near protected areas or key biodiversity areas		
E4-5	Number of individuals of a species per specific areas		
E4-5	Area coverage per ecosystem		
E4-6	Potential financial effects from biodiversity and ecosystem-related impacts	IAS 37 Provisions, Contingent Liabilities and Contingent Assets	May not necessarily translate to financial statements' liabilities
E4-6	Potential financial effects from biodiversity and ecosystem-related risks	IAS 37 Provisions, Contingent Liabilities and Contingent Assets	May not necessarily translate to financial statements' liabilities
E4-1 AR	Suppliers' facilities in risk-prone areas (in percentage)		
E4-1 AR	Procurement from suppliers' facilities in risk-prone areas (in percentage)		Could be pre-financial
ESRS S1 Own Workforce metrics			
S1-6, S1-7	Total number of employees; Total number of employees' turnover; Total number of non-employees	IAS 37 Provisions, Contingent Liabilities and Contingent Assets	
S1-8	Total employees covered by collective bargaining agreements in percentage		
S1-8	The global percentage of employees covered by workers'- representatives		
S1-9	Gender distribution at top-management level		
S1-9	Age distribution		

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S1-12	Percentage of persons with disabilities		
S1-13	Percentage of employees that participated in regular performance and career development reviews		
S1-13	Average hours of training per employee		
S1-14	Percentage of employees covered by health and safety management system		
S1-14	Total fatalities during working hours		Could be pre-financial
S1-14	Rate of work-related accidents		Could be pre-financial
S1-14	Total of work-related ill health		Could be pre-financial
S1-14	Total days lost to work-related injuries and fatalities		Could be pre-financial
S1-15	Percentage of employees entitled to take family-related leaves		
S1-15	Percentage of entitled employees that took family-related leaves		
S1-16	Male-female pay gap		Could be pre-financial
S1-17	Total number of incidents of discrimination		Could be pre-financial
S1-17	Total amount of fines for social and human rights violations, incidents	IFRS 2.51(a)	

Appendix 3: Links to relevant literature

1. [ESRS PTF Report of Workstream 4](#)
2. Appendix available on page 21 of the [draft European Sustainability Reporting Guidelines 1 Double materiality conceptual guidelines for standard-setting](#)
3. [Draft ESRS Set 1](#) focus on ESRS 1 chapters 3 and chapter 9 + ESRS 2 SBM 3 + the topical standards: focus on disclosure requirement on financial effects)
4. EFRAG FRB discussion on scope and approach to the connectivity project: [June 2022 ISSB meeting agenda paper](#)
5. ISSB Agenda Paper meeting 13-15 December [Project to be included in the Request for Information](#)