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Beyond the GAAP

Mazars' monthly newsletter on financial and sustainability reporting

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Editorial

On 22 June, and after political negotiations, the European Council and Parliament reached a provisional agreement on a slightly revised version of the European Commission's initial proposal for a Corporate Sustainability Reporting Directive (CSRD), published in April 2021. In this issue, Beyond the GAAP presents the highlights of this provisional agreement so far, bearing in mind that the final text is due to be published in a few days' or weeks' time.

All the initial key features of the CSRD proposal are confirmed, in particular the requirement to publish a sustainability report in accordance with European Sustainability Reporting Standards prepared by EFRAG and subsequently endorsed by the European Commission, and the mandatory audit of such reports in all EU Member States, initially on a limited assurance basis and subsequently on a reasonable assurance basis. The European rules for sustainability reporting are ultimately very ambitious and will affect a wider range of companies than the earlier Non-Financial Reporting Directive. The timetable for implementation has therefore been pushed back (to the 2024 reporting period, at the earliest) and phased over time to give entities enough time to prepare.

IFRS Highlights

Classification of liabilities with covenants: clarification of the scope of the amendment to IAS 1 proposed in November 2021

In November 2021, the International Accounting Standards Board (IASB) published an exposure draft of proposed limited-scope amendments to IAS 1, supplementing the initial exposure draft published in January 2020. The November 2021 amendments focused specifically on how covenants affect the classification of a liability as current or non-current, and the disclosures required on this topic (cf. Beyond the GAAP no. 160, November 2021).

In June 2022, after analysing the comment letters received, the IASB tentatively decided:

- to confirm that the classification of a liability as current or non-current is not affected if the right to defer settlement of the liability for at least 12 months is subject to compliance with covenants after the reporting period, while limiting the scope of this paragraph to loan arrangements;
- not to require separate presentation of non-current liabilities with covenants in the balance sheet, in contrast to what was proposed in the exposure draft;
- to confirm that entities must disclose in the notes the nature of covenants and the date on which the entity must comply with them, together with any objective evidence that the entity may have difficulty complying with the covenants at the specified date, when this is relevant. Such evidence could include steps taken by the entity to avoid breaching the covenants before or after the reporting date, or evidence that the entity would not have been able to comply with the covenants at the reporting date.

The amendments to IAS 1, which should be taken together with the January 2020 amendments, shall be applied retrospectively and may be early adopted.

The effective date of the amendments will be determined at a future meeting, but the IASB has already decided that it will be no earlier than reporting periods commencing on or after 1 January 2024.

Discussions on the equity method

Following the 2015 consultation on its work plan for 2017-2021, the IASB decided to add the equity method to its list of research projects. However, the project did not get going until October 2020, once the PiR of the consolidation standards (cf. our feature below) was almost ready to be launched. In fact, it was only recently that discussions began on identifying problems relating to the application of IAS 28.

At the June 2022 meeting, the IASB continued the discussions that began in April on the following topic: how should the equity method be applied when purchasing an additional interest (or disposing of an interest) in an associate while retaining significant influence?

The Board is currently considering two possible approaches:

- the IASB's preferred approach would require an investor who has significant influence to measure their interests as an accumulation of purchases (with different layers);
- the alternative approach would require the investor to remeasure their investment at fair value when they acquire an additional interest.

At the June meeting, the Board continued to consider the effects in practice of applying its preferred approach.

If the acquisition of an additional interest results in a bargain purchase, the IASB felt that the gain should be recognised in profit or loss. In other words, the Board is moving away from the option of offsetting the bargain purchase gain from any previously recognised goodwill and recognising any balance in profit or loss. It felt that this approach would not adequately reflect the existence of the multiple independent "layers".

In the case of a partial disposal where the investor retains significant influence, the IASB felt that the investor should measure the portion of the equity-accounted investment to be derecognised by either:

- using a specific identification method, if the investor can identify the specific portion of the investment being disposed of (and its cost). However, as shares are (by their very nature) fungible, this is not very likely in practice. It is nevertheless possible, for example if an investor purchased an additional interest and wrote a call option on the shares in question;
- or applying the last-in, first-out (LIFO) method, if the specific portion cannot be identified. The Board rejected the weighted average method as this treats the investment as a single asset, and is thus incompatible with the "layer" approach. The first-in, first-out (FIFO) method was also rejected, because it generally involves recognising a larger gain (assuming the value of the investment is increasing), and because it was the initial layer that granted significant influence.

While it makes sense to reject the weighted average method if a "layer" approach is being used, it is more difficult to understand why LIFO has been deemed preferable to FIFO. The IASB's desire to avoid recognising a larger gain is based on a questionable conceptual foundation. It is true that the objections to the use of LIFO for measuring inventories do not apply to shares (because shares do not have a

limited shelf life), but it is difficult to understand why LIFO was preferred to FIFO.

Discussions on the practical challenges of implementing the equity method will continue over the coming months. The IASB has not yet specified what type of document will be published once discussions are completed, or when this will be.

FICE project: discussions continue

At its meeting on 20 June, the IASB continued its discussions on the FICE (Financial Instruments with Characteristics of Equity) project, following a request from the IFRS Interpretations Committee (cf. Beyond the GAAP no. 159, October 2021). The Board discussed the reclassification of financial instruments issued by an entity from financial liabilities to equity or vice versa, when the substance of the contractual terms changes without a modification to the contract.

The IASB tentatively decided to add new requirements on reclassifications to IAS 32, such that reclassification would be prohibited other than for changes in the substance of the contractual terms arising from changes in circumstances outside the contract. This does not affect reclassifications already required under IAS 32.

The IASB also tentatively decided to add the following clarifications on changes in the substance of the contractual terms arising from changes in circumstances outside the contract:

- an equity instrument reclassified as a financial liability would be measured at fair value at the date of reclassification. Any difference between the carrying amount recognised in equity and the fair value of the financial liability would be recognised in equity;
- a financial liability reclassified as an equity instrument would be measured at the carrying amount of the financial liability at the date of reclassification. No gain or loss would be recognised;
- the reclassification would be accounted for in the reporting period in which the change in circumstances occurred.

Finally, the IASB emphasised the importance of disclosures in the notes to help readers to understand the change in classification and any impact on measurement of the instrument.

IPTF publishes document for discussion on hyperinflationary economies

The International Practices Task Force (IPTF) of the Center for Audit Quality (CAQ) SEC Regulations Committee has again updated its document for discussion identifying countries that are considered to have hyperinflationary economies. Ethiopia, Suriname and Yemen have been added to the list of countries with a three-year cumulative inflation rate exceeding 100%.

Reader will remember that the list already included Argentina, Iran, Lebanon, South Sudan, Sudan, Venezuela and Zimbabwe, with Turkey added in March 2022 (cf. Beyond the GAAP no. 164, March 2022).

However, the IPTF notes that the list is based on available data and does not claim to be exhaustive (e.g. Syria, Ukraine and Afghanistan are omitted).

For more details, the IPTF discussion document is available here.

New appointments make ISSB quorate

Since the formation of the International Sustainability Standards Board (ISSB) and the appointment of Emmanuel Faber as Chair and Sue Lloyd as Vice-Chair, the IFRS Foundations has been busy recruiting other Board members, with the final number set to be fourteen.

Given the tight deadline to publish the first two IFRS Sustainability Disclosure Standards by the end of the year, the IFRS Foundation implemented a two-stage appointment process.

It initially appointed six members (plus the Chair and Vice-Chair) to bring the number to the minimum of eight required by the Constitution for discussions to commence.

The first stage of the appointment process has now been completed, with the appointments of Professor Richard Barker, Ms Verity Chegar, Mr Bing Leng and Dr Ndidi Nnoli-Edozien announced on 8 June (the IFRS Foundation press release on these four appointments is available here), and the appointments of Dr Jeffrey Hales and Mr Michael Jantzi announced on 27 June (the IFRS Foundation press release on these appointments is available here).

Now that the Board has achieved its quorum of eight members, the first meeting has been scheduled for the week beginning 18 July, in the ISSB's offices in Frankfurt.

Further appointments will also be announced soon, with the goal of having the full complement of members by the third quarter.

European Highlights

Covid-19: publication of the Mazars study presenting impacts on the credit losses of European banks at 31 December 2021

Following our earlier study of the impacts of the Covid-19 crisis on the credit losses of European banks at 30 June last (see Beyond the GAAP no. 159, October 2021), we can now present the 31 December 2021 update, based on the audited annual reports published by the same sample of 26 European banks.

As before, this study aims to identify the main trends in expected credit losses over the period within the sample, with a breakdown by geographical area where relevant. The main findings at the 2021 year-end closing date are as follows:

- on average, the cost of risk (i.e. the impact on earnings recognised by banks in relation to expected credit losses – ECL) represents 20% of operating income before cost of risk, compared with 78% in 2020, and is back to its 2019 level. Nine banks in the sample (mainly UK and Irish banks) have actually recorded an ECL profit;
- the cumulative cost of risk impact of two years of Covid-19 crisis has not been neutral: the average cost of risk for the years 2020 and 2021 shows an average increase of 70% compared with 2019. The reversals and reductions recorded in 2021 have therefore not completely cancelled out the exceptional provisions made in 2020;
- the average amortised cost loan coverage ratios (i.e. the ratio of ECL amounts provisioned on the balance sheet to outstanding loans) have fallen very slightly since 2019, from 1.57% to 1.53%. This reduction is mainly due to a

lower coverage ratio for stage 3 instruments, not fully offset by the relative increase in the coverage rates of outstanding amounts in stages 1 and 2;

- almost all the banks continued to increase their post-model adjustments (overlays), mainly to limit the “positive” reactions of models against a background of persisting uncertainty, and to make additional provisions in sectors still perceived as vulnerable. No fewer than 22 banks in the sample have explicitly presented amounts associated with these post-model adjustments, which on average represent 17% of ECL balance sheet provisions in 2021 (compared with 14% at 31 December 2020). From a net earnings perspective, these overlays represented 48% of the cost of risk for the period (compared with 27% at 31 December 2020).

Other aspects of credit risk are also covered in the study (including forward-looking information and non-performing loans - NPLs), along with a first look at other topical issues such as sustainable finance indicators or banks' exposure to the war in Ukraine.

The full study is available here.

IASB publishes project report on PiR of IFRS 10, IFRS 11 and IFRS 12

On 20 June, the IASB published its project report and feedback statement (available here) on the Post-implementation Review (PiR) of IFRS 10, IFRS 11 and IFRS 12.

Readers will remember that the IASB carried out the PiR of the three standards between 2019 and 2022. It gathered evidence from preparers, investors, auditors, standard-setters, regulators and academics. In the second phase of the PiR, it held more than 35 events to engage with stakeholders and advisory bodies.

Having analysed the feedback from stakeholders and reviewed the academic literature, the IASB has concluded that the requirements of the three standards are functioning as intended, and their application has not given rise to any unexpected costs.

More specifically, the report concludes that:

- for IFRS 10, using the control model as the single basis for consolidation, including clarifications on applying that model to situations in which it can be difficult for an entity to assess control, enables entities to determine whether they control another entity;
- for IFRS 11, the classification of a joint arrangement based on a party's rights and obligations provides a faithful representation of an entity's interest in a joint arrangement. IFRS 11 overcomes previous obstacles to financial reporting that classified joint arrangements based on legal structure and permitted an entity a choice in accounting for jointly controlled entities;
- lastly, for IFRS 12, the information required by the standard enables users of financial statements to evaluate the nature of, and risks associated with, the entity's interests in other entities, including subsidiaries, joint arrangements, associates and structured entities, as well as the effects of those interests on the entity's financial position, financial performance and cash flows.

Furthermore, no unexpected costs arose from implementing or enforcing the requirements of IFRS 10, IFRS 11 and IFRS 12, or from using or auditing the information required by the standards.

Based on the findings, the IASB concluded that none of the questions arising from the PiR were of high or medium priority.

Five matters were deemed to be of low priority, and could potentially be explored further if identified as priorities in the IASB's next consultation on its work plan (the fourth consultation, focusing on 2027-2031).

These five matters were as follows:

- subsidiaries that are investment identities (there is a risk of a loss of information for groups with multiple layers of investment entities);
- transactions that change the relationship between an investor and an investee (i.e. the standards do not specify the accounting treatment for all transactions that alter the relationship between an investor and an investee);
- transactions that involve corporate wrappers, particularly transactions in which an investor acquires control of a subsidiary that does not constitute a business;
- collaborative arrangements that fall outside the scope of IFRS 11 (such arrangements are common in certain

sectors, such as real estate, telecoms, mining, pharma and entertainment);

- additional disclosures on interests in other entities (some stakeholders wanted additional information on significant judgements and assumptions used by management, subsidiaries with material non-controlling interests, unconsolidated structured entities and joint arrangements).

The IASB encourages stakeholders who need further guidance to submit questions to the IFRS Interpretations Committee (IFRS IC), provided that the questions meet the submission criteria.

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European Council and Parliament finalise political compromise on the Corporate Sustainability Reporting Directive (CSRD)

On 21 June, the Council and the Parliament of the European Union announced that they had reached agreement on an amended version of the draft CSDR issued in April 2021 (see the Council press release available here and the statement from the Parliament available here).

An amended version based on this compromise was finally endorsed by the Council and sent to the Parliament for approval during its plenary session in early July (available here). The directive will be final once it is published in the Official Journal of the European Union, and particular attention should be paid to the details of the final provisions. The Member States will then have 18 months in which to transpose it into national law.

All the transformative guidelines of the initial draft CSDR issued in April 2021 have been confirmed (see Beyond the GAAP no. 154, April 2021) and the amendments are in fact fairly limited. The main elements are as follows.

Mandatory European Sustainability Reporting Standards

- The sustainability reports published by European companies concerned will have to be prepared in accordance with the European Sustainability Reporting Standards (ESRS).
- EFRAG is confirmed in its role as technical advisor to the European Commission for the development of ESRS, which will have to be endorsed by the European Commission via delegated acts (see the EFRAG press release available here).

Mandatory audit of sustainability reports

- Sustainability reports drawn up under ESRS will be subject to mandatory audit in every EU Member State (readers will recall that the 2014 Non-Financial Reporting Directive allowed individual Member States to decide whether or not to introduce mandatory audits; only three countries – Spain, France and Italy – opted to do so). This audit will initially be based on a limited assurance engagement, and subsequently on a reasonable assurance basis (6 years after the CSRD comes into force).
- The definition of sustainability audit standards is entrusted to European Commission, which should issue delegated acts adopting limited assurance standards by October 2026, and reasonable assurance standards by October 2028. In the meantime (i.e. for the 2024 to 2026 reporting periods), Member States are authorised to apply national audit standards.
- Sustainability audits may be carried out by the statutory auditor or by an independent auditor.
  - Member States will be able to allow independent auditors to carry out sustainability audits, provided that they meet the same rules for qualification, quality and independence as statutory auditors.
  - The final choice between statutory auditor and independent auditor will be left to the entity.
- A Parliamentary amendment was also adopted, enabling an entity's shareholders to submit a resolution to the General Meeting requiring a third party other than the auditor of the

sustainability report (whether this is the statutory auditor or another auditor) to issue an independent report on some aspects of the sustainability report and to make this independent report available to the General Meeting:

- in a listed company subject to Directive 2007/36/EC on the exercise of certain rights of shareholders, if the right to table such a resolution is subject to the condition that the relevant shareholder or shareholders hold a minimum stake in the company, such minimum stake should not exceed 5% of the share capital;
- in an unlisted entity, not subject to that Directive, this right must be extended to shareholders individually or collectively representing more than 5% of the capital.

Consultation of workers' representative bodies

A new feature in the final version of the Directive is an obligation for entities to consult workers' representative bodies on the relevance of the sustainability disclosures concerned and how they are audited. Entities will need to ensure that the views of workers' representative bodies are communicated to the company's management and governance bodies. The text remains rather vague on the details and scope of this new obligation. It will therefore be necessary to monitor transposition into national law, which will have to remedy the imprecision in the European text.

An expanded scope to include some non-European entities

The obligation to produce an ESRS-compliant sustainability report applies to:

- public interest entities (PIEs): entities listed on a European regulated market, credit and insurance institutions and any other entity declared to be in the public interest by a Member State under Article 2 of the Accounting Directive;
- large entities defined as exceeding two of the following three criteria:
  - > 250 employees;
  - net turnover of €40 million;
  - balance sheet total of €20 million.

  For the record, the NFRD had made the definition of large companies more flexible by setting the bar at 500 employees, and left the choice of financial thresholds to Member States. The CSRD reverts to the definition of large companies in the Accounting Directive (Articles 19a and 29a) and no longer allows Member States to change these thresholds. Another important clarification removes any ambiguity: as the Taxonomy Regulation refers to Articles 19a and 29a of the Accounting Directive to define its scope, the CSRD stipulates that companies added to the scope defined by Articles 19a and 29a (i.e. those with between 250 and 500 employees and/or exceeding the now very low turnover and balance sheet total thresholds) will have to comply with Taxonomy reporting requirements.
- listed SMEs (except micro-enterprises with fewer than 10 employees);
- non-European entities with at least one branch (which has generated a turnover of more than €40 million during the reporting period) or a subsidiary (no annual turnover threshold) in the European Union and with a net turnover of at least €150m in the EU in the last two reporting periods. A Parliamentary amendment has been adopted to

include these entities, which will now be subject to the same mandatory reporting obligations as the European entities concerned.

Unlisted SMEs (those which do not meet the thresholds mentioned above) are not included in the scope of the CSRD and are not subject to reporting requirements. However, as part of the value chain of larger entities subject to such obligations, they will indirectly be required to provide the sustainability information needed by these larger entities. Consequently, the CSRD encourages these unlisted SMEs to publish sustainability information on a voluntary basis, using the SME-specific standards designed for use by listed SMEs subject to the reporting obligation.

Retention of the publication exemption for subsidiaries whose parent company publishes a consolidated report under ESRS

This aspect of the April 2021 draft was hotly debated in the trialogue. Some MEPs supported the publication of sustainability reports by all entities exceeding the thresholds, whether or not they belong to a group publishing a consolidated report. An amendment to this effect was proposed but not adopted.

A subsidiary whose parent company publishes a consolidated sustainability report covering it will therefore be exempt from publishing a sustainability report at its own level, even if it is a large company as defined by the thresholds, as long as it is included in the consolidated group report prepared in accordance with ESRS. This also applies to subsidiaries and branches of non-EU companies, provided that the parent company publishes a consolidated report (or an individual report in the case of a branch) prepared in line with the ESRS or with an equivalence regime to be determined by the European Commission. There is no indication of the date by which the Commission should define this equivalence regime.

However, this exemption will not apply to subsidiaries listed on a European regulated market (whether they are subsidiaries of European or non-European groups), for reasons of investor protection and the enhanced transparency of regulated markets.

A delayed timetable for the adoption of ESRS

Originally planned for October 2022 and October 2023, the adoption of ESRS – currently subject to public consultation (see Beyond the GAAP no. 166, May 2022) – has been pushed back to June 2023 for the sector-agnostic standards (i.e. applicable to entities regardless of their sector of operation) and to June 2024 for sector-specific standards and those specific to SMEs.

A deferred and phased implementation schedule, depending on entity size

Given the delayed adoption of the first ESRS standards until June 2023, the implementation timetable is also deferred by a year and phased to give companies that do not currently publish sustainability reports sufficient time to prepare to do so.

The first year of implementation will therefore be:

- 2024 reporting periods (i.e. reports published in 2025) for EIPs and large entities already in the scope of the NFRD;
- 2025 reporting periods (i.e. reports published in 2026) for entities not yet in the scope of the NFRD (mainly those with more than 250 employees);

- 2026 reporting periods (i.e. reports published in 2027) for listed SMEs (between 10 and 250 employees). These, however, may delay this implementation date until 2028 (reports published in 2029) provided they can justify this choice.

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The drafting of the present issue was completed on 4 July 2022

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