Beyond the GAAP

Mazars' monthly newsletter on financial and sustainability reporting

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Editorial

On 28 October, the EU's financial markets regulator, ESMA, published its European Common Enforcement Priorities for the annual financial and non-financial reporting for 2022.

Unsurprisingly, ESMA expects full transparency from issuers in their 2022 financial statements on the various material impacts of climate-related matters, the war in Ukraine and the current macroeconomic environment. As regards non-financial reporting, climate-related matters are the key focus, with increased disclosure requirements on the horizon under the upcoming Corporate Sustainability Reporting Directive (CSRD). 2022 is also the first year for which quantitative data is required on the taxonomy alignment of entities' activities under Article 8 of the Taxonomy Regulation.

IFRS Highlights

IASB publishes narrow-scope amendment to IAS 1 on the classification of liabilities with covenants

On 31 October 2022, the International Accounting Standards Board (IASB) published amendments to IAS 1 on *Non-current Liabilities with Covenants*, which sets out the way in which covenants are taken into account in the classification of a debt as current or non-current.

These amendments clarify that only covenants with which an entity is required to comply by the reporting date affect the classification of a debt as current/non-current. Therefore, classification is not affected if the right to defer settlement of a liability for at least 12 months is subject to compliance with covenants at a date after the reporting date.

These amendments also clarify the disclosures about the nature of covenants, so that users of financial statements can assess the risk that non-current debts accompanied by covenants may become repayable within 12 months.

The amendments are effective for annual reporting periods beginning on or after 1 January 2024, with early adoption permitted. They will be applied retrospectively, in accordance with IAS 8.

These amendments have still to go through the European endorsement process. No date for endorsement by the European Union has yet been announced.

IFRS IC Agenda Decision on SPACs: accounting for warrants on acquisition of a SPAC by an operating entity

In September 2022, the IFRS Interpretations Committee (IFRS IC) published a final agenda decision, accessible here, on accounting for warrants on acquisition of a Special Purpose Acquisition Company (SPAC) by an operating entity. This decision was discussed in October by the IASB, which did not oppose it.

As a reminder, a SPAC is a special purpose vehicle created at the initiative of its founders, listed from the outset by raising capital from market investors, and whose use is earmarked for the planned acquisition of a target operating company within a maximum period determined at the outset (for example 18 months).

In the fact pattern the Committee discussed:

- the economic target, an operating entity, is the acquirer for legal and accounting purposes of the pre-existing SPAC, the latter holding as assets the cash received from investors as part of its initial listing. The aim of the operating entity, by substituting itself for the SPAC, is to benefit from its market listing and to recover its cash. The SPAC does not meet the definition of a business in IFRS 3;
- at the time of its initial listing, and in addition to ordinary shares, the SPAC had also issued warrants to both its founder shareholders and public investors. When the operating entity acquires the SPAC, it issues new ordinary shares and new warrants to the SPAC's founder shareholders and public investors in exchange for the SPAC's ordinary shares and the legal cancellation of the SPAC warrants;
- the SPAC's founder shareholders and public investors are not SPAC employees, nor will they provide services to the operating entity after the acquisition of the SPAC;
- the fair value of the instruments the operating entity issues exceeds the fair value of the SPAC's identifiable net assets.

The main question posed to the IFRS IC was whether new warrants issued by the operating entity should be considered as:

- replacing the SPAC warrants, after the acquisition of the SPAC's assets and liabilities (the SPAC warrants being financial liabilities assumed by the operating entity as part of the acquisition); or
- as part of the instruments issued as consideration for the SPAC acquisition (the SPAC warrants not being assumed by the operating entity).

The IFRS IC ruled that the answer to this question depends on the specific facts and circumstances of the transaction, including the terms and conditions of all agreements associated with the acquisition. For example, the entity considers the legal structure of the transaction and the terms and conditions of the SPAC warrants and the new warrants the entity issues.

In the event that the new warrants are analysed as instruments issued by the operating entity as consideration for the acquisition of the SPAC, the IFRS IC considers that these warrants are within the scope of both IAS 32 and IFRS 2, insofar as they remunerate the acquisition of both the SPAC's cash and the stock exchange listing service (the acquisition of this service being evidenced, in accordance with paragraph 13A of IFRS 2, by the existence of a difference between the fair value of the instruments issued as consideration for the acquisition of the SPAC and the fair value of the SPAC's assets and liabilities).

This distinction matters because many warrants - such as those that are settled by issuing a variable number of shares - are classified as either financial liabilities or equity instruments, depending on whether they are within the scope of IAS 32 or IFRS 2 respectively.

The remuneration for the acquisition of the SPAC (the shares and warrants issued by the operating entity) should then be allocated between the acquisition of the SPAC's cash on the one hand and the listing service on the other.

In the absence of guidance in the standards as to how this allocation should be made, the entity, in accordance with paragraphs 10 and 11 of IAS 8, develops an accounting policy that produces reliable and relevant information.

The IFRS IC suggests that the allocation could be based on the relative fair value of the instruments issued by the operating entity. For example, if the fair value of the instruments issued by the operating entity was split, in percentage terms, between shares for 80% and warrants for 20%, and if the cash and the listing service acquired represented 90 and 10 currency units respectively, the warrants would be recognised under IAS 32 for 18 currency units (90 x 20%) and under IFRS 2 for 2 currency units (10 x 20%). However, prioritising allocation of the newly issued warrants to the acquisition of the stock exchange listing service solely to avoid their classification as financial liabilities would not meet the requirements in paragraphs 10–11 of IAS 8.

Hence the IFRS IC concluded that the principles and requirements of existing standards provide an adequate basis for answering this question, and decided not to add a standard-setting project to the IASB's work plan.

IFRS IC Agenda Decision *Lessor Forgiveness of Lease Payments*

In the absence of an IASB objection in October, the IFRS IC issued an Agenda Decision (see addendum to the September IFRIC Update, available here) addressing the recognition of rent concessions granted by the lessor in application of IFRS 9 and IFRS 16.

This final decision follows a question submitted to the IFRS IC concerning a rent concession that modifies the terms and conditions of a lease contract classified as an operating lease by the lessor.

In the request submitted to the IFRS IC, the lessor legally released the lessee from its obligation to make specifically identified lease payments, some of which were amounts contractually due but not paid, while others were amounts not yet contractually due. No other changes were made to the lease contract.

The request asked the IFRS IC to clarify:

- how the lessor should apply the expected credit loss model in IFRS 9 to the operating lease receivable before the rent concession is granted if it expects to forgive payments due from the lessee under the lease contract; and
- whether the lessor applies the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 in accounting for the rent concession.

In its Agenda Decision, the IFRS IC answered these two questions in turn.

In its response to the first question, the IFRS IC clarified that:

- in accordance with paragraph 2.1(b)(i) of IFRS 9, the lessor is required to apply the impairment requirements in IFRS 9 to the gross carrying amount of an operating lease receivable from the date it recognises the receivable; and
- in accordance with paragraph 5.5.17 of IFRS 9, prior to granting the lease concession, the lessor measures the expected credit losses on its operating lease receivable in a way that reflects 'an unbiased and probability-weighted amount', the 'time value of money' and 'reasonable and supportable information'. This measurement includes the lessor considering its expectations of forgiving lease payments recognised as part of that receivable.

In its response to the second question, the IFRS IC clarified that the lessor should account for the rent concession by applying:

- the derecognition provisions of IFRS 9 (paragraphs 2.1(b)(i) and 3.2.3(a)) to forgiven lease payments that are recognised as an operating lease receivable, at the date the lease concession is granted; and
- the lease modification provisions of IFRS 16 (paragraphs 81 and 87) to forgiven lease payments that have not been recognised as an operating lease receivable (since they were not yet contractually due), provided that the definition of a lease modification under IFRS 16 is met (i.e. a change in the consideration for a lease that was not part of the original terms and conditions of the lease).

Finally, the IFRS IC concluded that the principles and requirements of existing standards provide an adequate basis for answering these questions, and decided not to add a standard-setting project to the IASB's work plan.

IFRS IC Agenda Decision on the IFRS 17 multi-currency groups of insurance contracts

In October 2022, the IASB approved the decision taken in September by the IFRS IC (see addendum to the September IFRIC Update, available here) deciding that there is no requirement for a group of multi-currency insurance contracts to be broken down into subgroups to account for currency exchange rate risk, and on the interaction between IFRS 17 and IAS 21 for these contracts.

Paragraph 14 of IFRS 17 requires sub-groups of contracts with similar risks that are managed together to be distinguished within a portfolio. The IFRS IC has decided that while foreign exchange risk is indeed one of the many risks to be considered, 'similar risks' does not mean 'identical risks'. In other words, a portfolio could include contracts subject to different currency exchange rate risks, and the analysis of the nature and extent of the risks is a matter of judgment.

For the measurement of multi-currency contracts, the IFRS IC accepts that one or several currencies may be used. In the latter case, the IFRS IC observed that (i) paragraph 30 of IFRS 17 requires a group of contracts, including the contractual service margin, to be treated as a 'monetary item' for the purposes of IAS 21, and that (ii) the contractual service margin is a single contract margin: there are not several depending on the currency of the underlying flows. Consequently, the entity shall translate the cash flows and contractual service margin of a group of multi-currency contracts in accordance with IAS 21, considering the contractual service margin as a single amount.

The draft decision was widely supported by stakeholders and the application of this decision should therefore not be a problem.

IFRS 9: decisions arising from the PIR Phase 1– Classification and measurement

At its October 2022 meeting, the IASB continued its discussions on the topics identified in the context of the IFRS 9 Phase 1 post implementation review (for full details of the PIR of IFRS 9 – Phase 1, see Beyond the GAAP no. 159 of October 2021).

Equity instruments measured at fair value through other comprehensive income without subsequent recycling to P&L (FV-OCI-NR)

Following stakeholder feedback, the IASB tentatively decided to amend paragraph 11A of IFRS 7 to require disclosure of:

- the aggregated fair value of equity instruments for which the OCI

presentation option is applied at the end of the reporting period;

- changes in fair value recognised in OCI during the period.

In addition, the IASB asked the staff to explore the possibility of adding, for these instruments, an illustrative example showing changes over the period in fair value recognised directly in OCI.

Business model assessment

Following stakeholder feedback, the IASB tentatively decided to make no changes to IFRS 9 in this area.

Electronic cash transfers

The IASB tentatively decided to develop an accounting policy choice enabling an entity, subject to certain criteria, to derecognise a financial liability before the settlement date at which it effectively delivers cash.

Proposed amendments to IFRS 9 and IFRS 7 on the SPPI test for debt assets: disclosure and first-time application

At its September 2022 meeting, the IASB tentatively decided to amend IFRS 9 to clarify the application of the SPPI test to debt assets (see Beyond the GAAP no. 169 of September 2022).

At its October meeting, the IASB returned to this topic and tentatively decided:

- to amend IFRS 7 by adding a requirement to disclose for each class of financial assets and financial liabilities not measured at fair value:
    - a description of contractual terms – such as the nature of any contingent events – that could change the timing or amount of future cash flows;
    - quantitative information about the range of changes to contractual cash flows that could result from these contractual terms;
    - the gross carrying amount of financial assets and amortised cost of financial liabilities subject to these contractual terms;
- to clarify the arrangements for the first application of these amendments to the SPPI test, as follows:
    - retrospective application, in accordance with IAS 8, except that the entity would not be required to restate comparative information;
    - an obligation for the entity, when changing the measurement category of a financial asset, to disclose the previous and the new categories, as well as the respective gross carrying amounts in each category;
    - an effective date of these amendments which is not yet known, and will be determined after the publication of the exposure draft, with early application permitted.

New IASB appointment

On 13 October, the Trustees of the IFRS Foundation announced the appointment of Florian Esterer to the IASB for a five-year term from April 2023.

Mr Esterer brings investor experience, including experience in sustainable investment. He is also a member of the Capital Markets Advisory Committee which regularly provides the IASB with the views of the international community of users of financial statements.

For more details of this appointment, see here.

ESMA publishes recommendations for 2022 financial reporting

On 28 October, the European Securities and Markets Authority (ESMA) published its European common enforcement priorities for the 2022 annual financial reports.

As in 2021, the regulator's recommendations for IFRS financial reporting place great emphasis on climate-related issues, and underline the importance of a strong link between financial and non-financial reporting. The recommendations for 2022 also address the impact on the accounts of Russia's invasion of Ukraine, and, more generally, the current macroeconomic environment. The regulator also makes recommendations regarding the implementation of IFRS 17 (the new *Insurance Contracts* standard), and includes some reminders on Alternative Performance Measures (APMs) and electronic reporting (ESEF).

The European common enforcement priorities also comprise a whole section dedicated to **non-financial reporting**. This section is broken down into three sub-sections, which we present in this feature: (i) climate-related matters; (ii) disclosures relating to Article 8 of the Taxonomy Regulation; and (iii) cross-cutting issues, particularly reporting scope and data quality.

Our special feature has two parts: firstly, a summary of ESMA's main recommendations for IFRS financial statements, and secondly, a summary of its recommendations for non-financial statements.

The full statement on ESMA's European common enforcement priorities for 2022 financial reporting can be found here.

ESMA's recommendations for IFRS financial statements

The impact of climate-related matters on financial reporting

Having addressed this topic last year, ESMA notes that its previous recommendations remain relevant for 2022 financial reporting.

Consistency between IFRS financial statements, the management report and non-financial information

ESMA reminds issuers to ensure consistency between the judgements and estimates described in the IFRS financial statements, and the information presented on climate-related risks and opportunities in the management report and the non-financial reporting. ESMA states that such consistency is essential to prevent the risk of greenwashing.

Companies that are likely to have significant exposure in this area (due to their exposure to climate-related risks and/or ambitious commitments to work towards carbon neutrality) are recommended to provide further details on the judgements made (for example, by specifying the time horizons used). Generally speaking, issuers should avoid boilerplate disclosures simply stating that climate-related matters have been taken into account (for example, in impairment tests) without further explanation of how and to what extent these affect (or do not affect) the financial statements.

Entities are encouraged to present all relevant information in a single note to their IFRS financial statements, or else to provide a table of cross-references indicating the notes in which the information can be found.

Impairment testing of non-financial assets

ESMA recommends that, when applying IAS 36, issuers should:

- assess whether there are any indicators of impairment relating to climate change (ESMA gives the following examples: significant changes in the market, such as a significant decrease in demand for goods and services; significant changes in the regulatory environment in which the asset operates; changes in the planned use of the asset as a result of commitments related to climate change);
- reflect climate-related matters in the assumptions used, particularly with relation to value in use, and consider the most appropriate way to do this (cash flows, discount rate, terminal value – which, for industries that are heavily dependent on fossil fuels, may be calculated based on a zero or negative growth rate, as required when appropriate by IAS 36). ESMA reminds issuers that IAS 36 does not permit cash inflows or outflows arising from future improvements or enhancements to an asset's performance to be taken into account when calculating its value in use;
- provide full disclosures in the notes on these assumptions and adapt sensitivity analyses as appropriate, considering the relevance of assumptions and the range of variations tested.

Provisions and other line items in the financial statements

ESMA encourages issuers to consider the impacts of their commitments (whether legal or voluntary) to reducing greenhouse gas emissions, with regard to IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*

Power purchase agreements

Some companies have drawn up agreements fixing the future purchase price of "green" energy, in order to help them meet their objectives of reducing their carbon footprints and/or to hedge against price volatility. Such agreements may raise a number of accounting issues, particularly relating to the issuer's control of one or more entities under IFRS 10, or how these agreements should be accounted for under IFRS 16 or IFRS 9. ESMA encourages issuers to be transparent regarding the impacts and accounting treatment of such agreements.

Russia's invasion of Ukraine

ESMA reminds issuers of the continuing relevance of the messages in its previous statement, which addressed the impacts of Russia's invasion of Ukraine on the half-yearly financial reports for 2022.

Presentation of the impacts on the financial statements

Given the pervasiveness of the impacts of Russia's invasion of Ukraine, separate presentation of these impacts in the profit or loss statement could be misleading. Therefore, ESMA strongly encourages entities to present these impacts (both qualitative and quantitative) in the notes, in a clear and objective way. The regulator reminds issuers that the guidance on Alternative Performance Measures (APMs) also applies to APMs presented in other elements of financial reporting, such as the management report.

Assessment of control

ESMA emphasises the need to pay careful attention to all the facts and circumstances when assessing control or significant influence over investments in Ukraine, Russia or Belarus. ESMA also encourages issuers to provide details in the notes of the characteristics of transactions and how the assessment of these transactions was carried out, particularly if they included options permitting the entity to buy back the shares sold or to remain involved in local

management or the entity's operations. The regulator reminds issuers that such options may have to be recognised at fair value with changes recognised through profit or loss under IFRS 9.

Classification as non-current assets (or groups) held for sale and discontinued operations

ESMA encourages companies that have announced their plans to sell off operations in Russia or Belarus to carefully consider the requirements of IFRS 5. Entities must ensure consistency between the information presented in the financial statements, and other communications.

Impact on insurance contracts

Entities with insurance contracts should consider the appropriate accounting treatment for insurance claims (for example, as an asset representing a reimbursement under IAS 37, when it is virtually certain that the reimbursement will be received).

The macroeconomic environment

ESMA observes that the current macroeconomic environment is both a source of uncertainty and a challenge for companies and their operations, due to a combination of factors (ongoing impacts of the pandemic, the rise in interest rates, geopolitical risks). It strongly encourages entities to assess and measure the impacts of the macroeconomic environment on their financial statements, and adapt as necessary the disclosures provided in the notes on this topic.

Impairment testing of non-financial assets

In the context of higher interest rates and uncertainty, ESMA encourages entities to communicate transparently on the impacts of the key assumptions used for impairment testing of non-financial assets, particularly as regards discount rates.

Moreover, it expects that companies that are significantly impacted by the high volatility of commodities prices will provide detailed disclosures on how this is taken into account in the key assumptions (with regard to the impact of price increases on production costs, their ability to pass on these increases to their clients and, where appropriate, government measures to limit the impact of these increases).

Finally, the regulator encourages issuers to consider adjusting the range of reasonably possible variations in key assumptions in their sensitivity analyses.

Employee benefits

ESMA reminds companies that, when they are measuring employee benefits using actuarial methods, they must use assumptions that are mutually compatible and reflect the current economic outlook, particularly with relation to salary increases. It expects entities to present (and include an appropriate level of detail on) the disclosures required by IAS 19 on reconciliations (paragraphs 140-141), actuarial assumptions (144) and sensitivity analyses (145).

Revenue

In a context of high inflation, ESMA draws issuers' attention to the recoverability of costs to fulfil a contract under IFRS 15, and the increased risk that contracts will become onerous. As regards onerous contracts, the regulator reminds entities that certain disclosures are required in the notes under IAS 37.84-85 (notably, a description of the uncertainties about the amounts or timing of the outflows, and, where necessary, a description of the key assumptions made concerning future events).

More broadly, ESMA encourages companies to be transparent about the assumptions used regarding any increase

in sale prices to cover increases in costs, either when assessing whether contracts have become onerous, or when recognising variable consideration as revenue.

Financial instruments

In a context of higher interest rates and cost of debt, ESMA emphasises the importance of presenting disclosures that allow users to understand an entity's exposure to interest rate risks, commodity price risks and the related liquidity risks, in accordance with IFRS 7.31.

ECL modelling presents a significant challenge for financial institutions in this context, given the lack of precedent. ESMA therefore recommends that they should expand their qualitative and quantitative disclosures on the impacts of the current environment on the calculation of expected credit losses. As in 2021, ESMA emphasises the importance of transparent disclosures on the use of management overlays when measuring expected credit losses. Moreover, given that the current environment affects different sectors to different extents, ESMA suggests that financial institutions should take greater account of sector-specific factors in their ECL measurements, and present detailed disclosures in the notes on the risk concentrations related to specific sectors.

ESMA reminds issuers that the provisions of IFRS 9 on the reclassification of financial assets only apply in the event of a change in the business model for managing these assets. It thus expects such reclassifications to be rare, even in the current macroeconomic environment. If such a reclassification does occur, ESMA reminds issuers that detailed disclosures are required in the notes, in accordance with IFRS 7.12B-12D.

ESMA's recommendations for non-financial statements

Climate-related matters

In the current environment of increasing regulation on sustainability reporting, ESMA underlines the **heightened expectations from users and regulators for better transparency** on sustainability topics, particularly climate-related matters. In this context, ESMA reminds issuers of the useful guidelines published by the European Commission on reporting climate-related information (available here), particularly with regard to the following four topics: (i) transition plans; (ii) materiality; (iii) climate-related risks, dependencies and opportunities; and (iv) key performance indicators (KPIs).

Strategy

ESMA emphasises the importance of increased transparency in disclosures on issuers' **transition plans**, particularly as regards (i) identifying goals; (ii) reference scenarios used; and (iii) a description of the concrete methods that will be employed to achieve the goals. The European market regulator also draws attention to the need for caution in disclosures on carbon neutrality commitments, which should be specific to the entity. ESMA particularly encourages issuers to give concrete details of the levers for action they will use; to specify the base year they have used to calculate their reductions in greenhouse gas (GHG) emissions; and to make it clear whether these reductions will be achieved within the value chain or *via* levers for action outside the value chain (e.g. through carbon credits).

Metrics and targets

ESMA emphasises the relevance of publishing key performance indicators on GHG emissions, both forward-looking and backward-looking.

As regards **GHG emission reduction targets**, the European market regulator reminds issuers of the importance of:

- explaining how likely it is that the targets will be achieved, based on the latest scientific data and taking account of current and potential challenges. Entities should also report on their progress at year-end and explain, where necessary, why they have not achieved their targets;
- not omitting material information on other sustainability-related topics, such as potential negative impacts of the steps taken by the entity to reduce its GHG emissions. ESMA also encourages issuers to inform readers about any conflicts between the different environmental goals they have set themselves, as required by the NFRD (Non-Financial Reporting Directive) where this is necessary to understand the impact of an issuer's activities.

In relation to **metrics for GHG emissions**, ESMA emphasises the need for transparency on the methodological principles and assumptions used, as well as the scope applied. This is particularly important for Scope 3 emissions, for which issuers are encouraged to (i) clearly explain the boundaries used; (ii) justify, where necessary, why certain elements have been excluded from the calculation; and (iii) mention any uncertainties relating to the data collected. Where issuers have material Scope 3 emissions but have not disclosed any information on them, they should explain why.

In the specific context of Russia's invasion of Ukraine, issuers should provide details of any impacts of the conflict on their ability to achieve their objectives or to pursue their transition plans in 2022 (for example, where disruptions to the supply of natural gas have led them to use other energy sources that emit more CO_2).

Material impacts, risks and opportunities and connectivity with financial reporting

Just as with the preparation of financial statements, ESMA reminds issuers that they should keep enhancing their descriptions of **how they have identified the material impacts, risks and opportunities** related to climate change, and should ensure strong links with their financial reporting.

Disclosures relating to Article 8 of the Taxonomy Regulation

Non-financial undertakings: 2022, an important year for reporting on alignment with climate change objectives

Reporting published by non-financial undertakings in 2023 (for the 2022 financial year) will for the first time include disclosures on both the taxonomy eligibility and the **taxonomy alignment of their economic activities** vis-à-vis the first two climate change objectives: mitigation and adaptation.

In this context, ESMA reminds issuers of the following **key principles**:

- it is mandatory to use the templates provided in Annex II of the Article 8 Delegated Act;
- no more than 100% of turnover, CapEx and OpEx related to a given activity may be allocated, when that activity makes a substantial contribution to multiple objectives;
- the aggregation of eligible and non-eligible activities should always add up to 100% of the issuer's activities;
- issuers must present all of the disclosures required under the Taxonomy Regulation, regardless of

their materiality, with the exception of the materiality exemption permitted for OpEx (though specific disclosures are required if this exemption is applied);

- the three quantitative ratios **must be accompanied by contextual information**, in particular (i) a description of the nature of the entity's economic activities and whether they are eligible/aligned; (ii) an assessment of their compliance with the technical criteria for alignment, which may require the use of assumptions (particularly for activities outside the European Union); and (iii) the methodological principles used, including areas where significant use of judgement was required.

In addition, ESMA encourages entities to **explain any significant discrepancies** between (i) the eligibility rate of activities presented in 2023 and that presented in 2022 (which might result from new eligible activities or methodological adjustments); and (ii) the eligibility rate and the alignment rate (most likely resulting from stricter technical criteria).

Finally, issuers must pay particular attention to ensuring **consistency** between Taxonomy-related disclosures and other elements of non-financial reporting.

ESMA reminds issuers of the many resources available to support them when preparing their Taxonomy reporting, notably:

- the European Commission's guidance[1] on frequently asked questions;
- ESMA's guidelines[2] on reporting Alternative Performance Measures (APMs). These guidelines were updated in April 2022 to include specific questions on the use of financial measures related to ESG matters (and that are not defined in the regulatory framework), such as "green" turnover or "green" CapEx. ESMA notes that such measures do fall within the scope of its guidelines. Moreover, ESMA draws attention to the risk of possible confusion between APMs and measures determined in accordance with the Taxonomy Regulation or SFDR, and encourages issuers to (i) provide a reconciliation between the two, and (ii) be cautious when choosing labels for these APMs.

Financial undertakings: preparing for taxonomy alignment reporting in 2024

As financial undertakings prepare to report the alignment of their activities in 2024, ESMA reminds them to ensure that the systems that will support the new requirements are **secured and up-to-date**.

Reporting scope and data quality

ESMA reminds issuers that the scope of non-financial reporting must be **at least equivalent to the scope of financial reporting**.

Furthermore, ESMA encourages issuers to present **additional disclosures on risks** related to their operations, including, where relevant and proportionate, risks arising from their business relationships, products and services, where these are likely to have adverse impacts – an approach that will be reinforced in the future European Sustainability Reporting Standards (ESRSs).

ESMA invites issuers to consider reporting on a **larger scope** if this will permit them to capture material information on sustainability issues, e.g. by describing their supply and sales chains and explaining how

[1] European Commission FAQ 1, December 2021; European Commission FAQ 2, February 2022.

[2] ESMA, Questions and answers – ESMA Guidelines on APMs, April 2022 (questions 19 and 20).

these have been taken into account in their non-financial reporting.

Given the different approaches that could be taken to reporting on the value chain, ESMA recommends that issuers should state explicitly whether the scope of non-financial reporting is the same as the scope of financial reporting. Similarly, they should explain and justify any exclusions from the scope of non-financial reporting compared to financial reporting (including the type of exclusion, scale, etc.).

Finally, ESMA emphasises the importance of **robust information systems** to underpin data collection and management. The European market regulator encourages issuers to disclose information on (i) their data collection processes and (ii) the due diligence carried out by the Board or other relevant internal decision-making body.

The ESRS reporting framework, due for submission to the European Commission by EFRAG in mid-November, is taking shape

At the end of October, the first revised drafts[1] of the European Sustainability Reporting Standards (ESRSs) were published by the European Financial Reporting Advisory Group (EFRAG). These drafts (issued on 24 October and available here) have been validated by the Sustainability Reporting Technical Expert Group (SR TEG) and take into account the discussions held to date in the SR TEG and the Sustainability Reporting Board (SRB).

While there are still revisions to come before the final drafts are submitted to the European Commission in mid-November (as there have been intensive redeliberations since the drafts were made public), these new versions of the standards, and the debates that underpin them, already provide interesting insights into significant aspects of the future ESRS framework and the main changes envisaged to the versions in the exposure drafts.

EFRAG is thus finalising these draft standards in light of the feedback received in the public consultation completed on 8 August, but also of the late June amendments to the draft Corporate Sustainability Reporting Directive, the CSRD (see Beyond the GAAP no. 169, September 2022).

Discussions are also being held in parallel with the International Sustainability Standards Board (ISSB) with a view to achieving alignment, as far as possible, with future international standards and thus contributing to the "global baseline" which should shortly be finalised by the international standard-setter (publication of IFRS S1 and S2 expected in early 2023).

The elements presented below reflect our best understanding of the redeliberations to date, which remain to be confirmed by the finalised drafts which should be available in November. This article is not intended to cover all October's debates, but focuses on the most significant aspects across the whole ESRS framework.

An overhaul of the general structure of the framework and of the disclosure requirements

Overall, **significant work has been carried out to reorganise and streamline** the framework, in particular to meet the requirements of the revised draft CSRD. As a result, not 13 but **12 draft standards** will be submitted to the European Commission, following the change in the scope of governance disclosures, which now only cover sustainability issues.

The original ESRS G1, which addressed governance in general, has been deleted and the few still-applicable provisions that the exposure draft contained have been transferred to ESRS 2 (with a focus on sustainability issues specifically), which is a cross-cutting standard listing general disclosures including governance. The former ESRS G2 on business conduct has therefore become ESRS G1, now the only topical standard on governance.

In practice, the first set of standards applicable to every sector will include:

[1] As compared with the initial versions released for public consultation on last April 29

- two cross-cutting standards (ESRS 1 and ESRS 2):
    - ESRS 1 will provide a kind of conceptual framework for the ESRSs, and will therefore not include any disclosure requirements.
    - ESRS 2 will correspond to the 'practical application' of all the main principles laid down in ESRS 1. This standard will be applied in conjunction with each of the topical standards - see below - with respect to disclosures about an entity's policies, targets and action plans. A cross-cutting approach to disclosure requirements means that the general information required by ESRS 2 will be supplemented by the relevant information demanded in the topical standards, where appropriate;
- five environmental standards: ESRS E1 on climate, ESRS E2 on pollution, ESRS E3 on water and marine resources, ESRS E4 on biodiversity and ecosystems and ESRS E5 on the use of resources and the circular economy;
- four standards on social topics: ESRS S1 on own workforce, ESRS S2 on workers in the value chain, ESRS S3 on affected communities and ESRS S4 on end consumers;
- one standard on governance: ESRS G1 on business conduct, as explained above.

The structural alignment of the standards with the **architecture adopted by the Task Force on Climate-related Financial Disclosures** (TCFD)[2] has been confirmed, although the standards have yet to be rewritten (except for ESRS 1) to more clearly reflect the four TCFD pillars of governance, strategy, management of impacts, risks and opportunities (linked to double materiality), and metrics and targets.

Disclosure requirements, which arise from the "implicit" materiality analysis conducted broadly by the SRB to define the content of the standards, are now exhaustively presented in the body of each standard. Thus, the annex to each standard, formerly known as "application guidance", and previously including additional mandatory disclosures, has been renamed "application requirements" (AR). In practice, ARs now include mandatory provisions for methodological purposes only (i.e. to explain the application of a particular disclosure requirement/data point appearing in the body of the standard). Guidance is also included to encourage entities to move towards best practice reporting.

Beyond restructuring the framework and each of the standards, the disclosure requirements have also been reviewed in detail to take into account not only the comments received from stakeholders and the need to keep to the disclosure requirements listed in the revised draft CSRD, but also to retain only sector-agnostic information in this first set of standards. In practice, this has significantly reduced **the number of disclosure requirements and the associated data points**. A precise inventory of these elements, in comparison with the exposure drafts, can be undertaken once the standards have been stabilised.

Finally, and to the extent possible given the differing expectations, **significant work on alignment with the ISSB's IFRS standards** has also been carried out and is

[2] The TCFD recommendations are now part of the list of voluntary guidelines that are non-mandatory and referenced in the NFRD (Non Financial Reporting Directive).

still in progress, bearing in mind that the work on the ISSB side is not yet complete. ESRS 1 should therefore be rewritten to align the definition of financial materiality with that adopted by the ISSB (see the October 2022 redeliberations presented in this issue). ESRS 2 should also be expanded to include general disclosure requirements to cover the full content of IFRS S1. In practice, the two cross-cutting standards ESRS 1 and ESRS 2 will match the content of IFRS S1.

Alignment between ESRS E1, the climate-related standard, and IFRS S2 is also pursued wherever possible. In practice, all the information required by IFRS S2 should be present in ESRS E1, the European standard being more demanding or more precise in a limited number of areas.

Removal of the presumption of rebuttable materiality, but disclosures related to materiality analysis remain complex to grasp

The rebuttable materiality presumption in the ESRS 1 exposure draft that allowed certain disclosures required by the ESRSs to be withheld on a justified basis - widely criticised by respondents to the public consultation - has been withdrawn.

The **general approach now adopted to identify disclosures in respect of significant impacts, risks and opportunities** should therefore be broken down into two key steps:

(1) the identification of the sustainability matters that are material from the entity's perspective, given the outcome of the double materiality analysis, it being understood that an appendix in ESRS 1 should clearly identify the issues whose materiality must be assessed (i.e. at what degree of granularity for each of the E, S and G topical standards, except ESRS E1 - as clarified below);

(2) the identification of the material information to be disclosed for those matters resulting from the analysis carried out in the first step, bearing in mind that a data point within a disclosure requirement may be omitted if the resulting information would not be material, and if the purpose of the information to be provided to cover that material matter is nevertheless achieved. However, this option - omitting information deemed non-material under one or more data points - will not apply to disclosures on policies, targets and action plans. In other words, these data points should be given in all cases, where applicable. In addition, and if necessary, an entity will have to supplement the information required by the standards with respect to a given subject, taking into account its particularities.

Consequently, where information is not provided for a particular data point, it should be implicitly assumed that such disclosures are not material to the entity, without the entity having to justify this (or needing to disclose the list of data points that have not been reported in the entity's sustainability statements). Instead, an entity should briefly explain the conclusions of its materiality analysis when all the disclosures required by a topical standard are omitted as immaterial. Where an entity has not implemented policies, targets and action plans for which disclosures would otherwise be required, it should also explain why these policies, targets or action plans have not been adopted and the timeframe over which the entity will do so.

In addition, ESRS 2 should include a requirement to provide a table showing all the disclosure requirements that have been

met (based on the outcome of the materiality analysis), together with the page and/or paragraph numbers where the information is presented.

By way of exception to the general approach presented above, and still subject to the SRB's final vote on the draft standards to be submitted to the Commission in mid-November, **the following should be considered as outside the scope of the materiality analysis**:

- the general information required by ESRS 2;
- climate aspects covered by ESRS E1 (which means, inter alia, that the disclosure of greenhouse gas emissions under Scopes 1, 2 and 3 would be mandatory in all cases);
- a list of indicators that must be disclosed under other European regulations[3], in particular the Sustainable Finance Disclosure Regulation (SFDR), or the ESG risks information required by the European Banking Authority (EBA) under Pillar 3

An additional short list of information which will be mandatory in all cases is still under discussion in the SRB (see "Fundamental ESG indicators not covered by SFDR" presented in Appendix D of ESRS 1, in the 24 October draft).

Given the extensive recent debates on the particularly "sensitive" topic of the information to be provided by each entity to cover the significant impacts, risks and opportunities identified, the factors presented above must be considered with the utmost caution. The approach ultimately taken will have to be reassessed in light of the forthcoming final draft of ESRS 1.

Focus on ESRS 1: some significant changes so far identified by comparison with the exposure draft.

At this stage of the debates within EFRAG, in addition to the information already presented above, and the identification of material disclosures in particular, significant changes to ESRS 1 include:

- explicit reference to pre-existing international **due diligence** procedures[4], which should serve as a reference for the information to be provided, pending the publication of the Corporate Sustainability Due Diligence Directive (CSDD). The draft ESRS 1 to be submitted to the Commission should make it clear that ESRSs impose no due diligence requirements in relation to sustainability, nor do they extend or change the role of governance bodies in this respect;
- a desire to further clarify the **reporting perimeter** to be taken into account when preparing the sustainability statements (i.e. the consolidation scope used for the consolidated financial statements) and how the **value chain** should "extend" this scope. The final draft on this subject will require particular attention, given the complexity of these issues, as reflected in the still recent debates at SRB level;
- the definition of the **time horizons** to be used by entities when preparing their sustainability statements, as follows:
  - a change to the exposure draft's definition of the short-term horizon, which now refers to the period

[3] This information should be identified in a dedicated appendix to ESRS 2 (and not ESRS 1, as shown in the 24 October draft) and in each of the relevant topical standards.

[4] *United Nations Guiding Principles on Business and Human Rights* and *ECD Guidelines for Multinational Enterprises*

adopted by the undertaking in its financial statements for current assets and liabilities (editor's note: this is in line with IAS 1, reflecting group reporting policies applied to the consolidated accounts drawn up under IFRSs.). The medium-term time horizon corresponds to the interval from the end of the short-term reporting period to five years, while for the long-term the period is more than five years (unchanged by comparison with the exposure draft);

  - there is an option to use different time intervals for medium and long term horizons, where this is justified by particular circumstances;

- the removal of the three options for the presentation of information that were initially foreseen, maintaining just **one presentation in a single dedicated section of the management report** (under four headings: general information, and information relating to the environment, social and governance aspects) and in a set order. The option to incorporate information by reference to other documents is confirmed, and these documents are not limited to other sections of the management report (it would be possible, for example, to refer to governance report);
- an emphasis on the notion of **connected information** in a broad sense, taking account of all elements of the entity's financial reporting, extending beyond connectivity with the financial statements (already present in the exposure draft);
- the easing and **phasing-in** of certain provisions, particularly those relating to information on the potential financial effects of significant environmental impacts, risks and opportunities, where such quantitative information may be deferred for up to three years from the year of first application.

The coming month will therefore be decisive, with the long-awaited submission of the finalised draft ESRS standards to the European Commission. The Commission will then carry out a number of consultations on this basis and will be responsible in particular for ensuring that these drafts are in line with the expectations of the CSRD. Further (marginal) changes can therefore not be excluded between now and the publication of the definitive ESRSs for this first batch in June 2023. Nevertheless, these EFRAG drafts will provide a solid basis for launching the transitional works in line with the CSRD timetable (to be confirmed when the final text is published in the Official Journal of the European Union in the near future).

First ISSB decisions on future IFRS S1 and IFRS S2 sustainability standards

In October, the International Sustainability Standards Board (ISSB) met in Montreal to begin redeliberations on the content of the future standards IFRS S1 – *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 – *Climate-related Disclosures*, following a public consultation on the two draft standards which finished at the end of July.

In this issue of Beyond the GAAP, we present a summary of the main decisions reached by the ISSB in October, although these decisions remain tentative until the final content is voted on prior to official publication of the standards. A full report on the October meeting is available here and the accompanying press release can be found here.

Clarifying fundamental concepts and the definition of materiality

As a reminder, the ISSB's approach in the IFRS S1 exposure draft was to focus on investors' needs, resulting in an approach based on financial materiality only with the objective of providing information on sustainability-related matters that is useful for assessing enterprise value.

To clarify the fundamental concepts underpinning IFRS S1, the ISSB has tentatively decided to:

- confirm that the objective of the standard is to require entities to meet the information needs of the primary users of general purpose financial reporting, who in practice, and according to the IASB's Conceptual Framework, are existing and potential investors, lenders and other creditors;
- to use the same definition of "material" – in the context of the materiality assessment to be carried out to identify the significant sustainability-related risks and opportunities to which the entity is exposed – as in the IFRS framework and IAS 1 in particular (i.e. information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity). At a future meeting, the ISSB will discuss whether further guidance is needed on how to determine whether information is material;
- to amend the draft IFRS S1 by removing the term "enterprise value" from the objective and the description of materiality, although the ISSB will continue to redeliberate the meaning of the term at a future meeting, along with how it could be articulated in the context of the materiality assessment;
- to remove the word "significant", which was used to describe the sustainability-related risks and opportunities that an entity would be required to disclose. The use of the term "significant" rather than "material" generated a lot of questions and caused confusion. The ISSB will continue discussions at a later date on how to apply the principle of relative importance, and the process to be used by preparers to identify sustainability-related risks and opportunities in order to provide useful information to primary users.

Interoperability of IFRS sustainability-related standards and other frameworks

The ISSB is currently in dialogue with other bodies, particularly EFRAG, to ensure interoperability of the ISSB's global baseline with the standards under development in particular jurisdictions, notably the European Union (cf. our feature in this issue on the development of ESRSs). In this context, the ISSB has tentatively confirmed:

- that it will use the four pillars identified by the Task Force on Climate-Related Financial Disclosures (TCFD) to structure the core content of the disclosure requirements in the IFRS S1 and S2 draft standards. Thus, information will be required on (i) governance; (ii) strategy; (iii) risk management; and (iv) metrics and targets;
- the meaning of the "global baseline", in particular:
  - that the disclosures required on sustainability under IFRS standards are designed to meet the information needs of investors, lenders and other creditors;
  - that the disclosures required are subject to a materiality assessment;
  - and that these disclosures may be presented alongside disclosures to meet other requirements, such as jurisdiction-specific regulatory requirements, provided that the additional disclosures do not obscure the IFRS disclosures.

Still with a view to making the global baseline as broad as possible, the ISSB also redeliberated the use of scenario analysis in the context of (i) defining and explaining transition plans, and (ii) carrying out climate resilience analysis. Most of the October redeliberations on the draft IFRS S2 standard simply resulted in the ISSB confirming the draft provisions. However, the international standard-setter also tentatively decided:

- to add a requirement for an entity to disclose how it uses climate-related scenario analysis to support its identification of climate-related risks and opportunities;
- to clarify that an entity's net greenhouse gas (GHG) emission reduction targets and its planned use of carbon credits must be presented separately from its gross emission reduction targets;
- to clarify the different types of targets and the role played by emission reduction targets in the transition to a low-carbon economy;
- to clarify that an entity shall be required to disclose all the emission reduction targets it has set itself (both net and gross emission reduction targets) and those it is required to meet under local legislation.

Disclosures required on Scope 1, 2 and 3 GHG emissions under IFRS S2

As regards the disclosures required on Scope 1 and 2 GHG emissions, the ISSB has clarified that these disclosures must be disaggregated into, firstly, the emissions generated by the consolidated group (using the same scope of consolidation as for the consolidated accounts, i.e. including the parent company and its subsidiaries); and, secondly, unconsolidated entities in which the group has invested (i.e. associates, joint ventures and unconsolidated subsidiaries that are not included within the scope of consolidation cited above).

The ISSB also reached other tentative decisions relating to the draft IFRS S2, of which the most significant were:

- to confirm the use of the GHG Protocol to measure GHG emissions, subject to reliefs in specific circumstances (e.g. if a jurisdiction requires the use of another method);
- to confirm the requirement for an entity to disclose the amount of its Scope 3 GHG emissions, in addition to Scope 1 and 2 emissions, but to propose reliefs to address the practical difficulties potentially raised by Scope 3 disclosures (e.g. the data availability and data quality challenges raised by stakeholders in the public consultation). Decisions will be reached on this topic at a future meeting, but the reliefs may likely involve deferring the effective date of the requirements.
- to confirm the requirement for an entity to disclose the categories it has used to measure its Scope 3 emissions, of the 15 Scope 3 categories set out in the GHG Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard.

Industry-based requirements

Appendix B of the draft IFRS S2 standard comprised industry-based requirements derived from standards developed by the Sustainability Accounting Standards Board (SASB). The ISSB tentatively decided to confirm the requirement for entities to present industry-specific disclosures, but is currently classifying the SASB standards as illustrative examples. In other words, and contrary to what was proposed in the exposure draft, these standards will not be mandatory, at least initially. The ISSB will carry out additional consultation to identify what amendments to make to these standards with a view to making them mandatory in the future, as they were heavily criticised in the initial consultation (as despite some tweaks that have already been made, these industry-based standards are still lacking in applicability outside the US).

ISSB priorities for the coming months

At its October meeting, the ISSB also discussed its priorities for the coming months. In view of the need to finalise IFRS S1 and S2 as quickly as possible, and the importance of these two standards which will form the bedrock of the IFRS sustainability disclosure framework, the ISSB has decided to postpone the launch of the public consultation on its two-year work plan until the first half of 2023 (rather than the fourth quarter of 2022 as originally planned).

The ISSB has also tentatively decided that its main work will involve:

- improving the international applicability of the industry-specific SASB Standards and continuing legacy SASB projects;
- developing the taxonomy for digital IFRS sustainability reporting;
- coordinating with the IASB and other sustainability-reporting standard-setting bodies to support connectivity and interoperability; and
- continuing with research and stakeholders outreach to identify targeted improvements to the draft IFRS S2, once finalised.

The ISSB will continue with further intensive redeliberations in November, and has additional meetings already in the calendar. In addition to the frequently-expressed need for an international framework of sustainability disclosure standards to be available as soon as possible (see for example the G20 statement published in

mid-October and available here), there are pressures on the standard-setter from the European side, if alignment between IFRSs and ESRSs is to be achieved. Currently, the ISSB is still aiming to publish IFRS S1 and IFRS S2 as early as possible in 2023.

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