Beyond the GAAP

Mazars' monthly newsletter on financial and sustainability reporting

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Editorial

Almost seven months after EFRAG submitted the first drafts of the European Sustainability Reporting Standards (ESRS), and two months later than initially announced, the European Commission (EC) published the amended versions of these standards on 9 June *via* a draft delegated act. The uncertainties surrounding the nature of the changes introduced by the EC have now been resolved! In this issue, Beyond the GAAP presents the most significant changes to EFRAG's draft standards.

The definitive ESRS are expected to be adopted this month, right after the end of the four-week public consultation which closed on 7 July. Sustainability reporting is also very much in the international news. On 26 June, the International Sustainability Standards Board (ISSB) published the definitive versions of its first two standards, IFRS S1 - *General Requirements for Disclosure of Sustainability-related Financial Information*, and IFRS S2 - *Climate Change Disclosures*, laying the foundations for a globally recognised baseline for reporting on the financial effects of the risks and opportunities arising from sustainability issues.

IFRS Highlights

IFRS 15 PiR: IASB publishes Request for Information

On 29 June, the International Accounting Standards Board (IASB) published a Request for Information as part of the Post-implementation Review (PiR) of IFRS 15 – *Revenue from Contracts with Customers.*

The objective of a PiR is to assess whether the impacts of applying the new standards are in line with the IASB's goals when developing the standards. The IASB will study the feedback received (along with other information it has gathered) to determine whether it needs to take further action.

The Request for Information is available here. The comment period runs until 27 October 2023.

IASB plans to bring IAS 28 rules on contingent consideration into line with IFRS 3

At its June meeting, the IASB continued deliberations on the Equity Method project (for which the Board is planning to publish an exposure draft in 2024).

The IASB tentatively decided to bring the accounting treatment for contingent consideration related to the acquisition of an interest in an associate into line with the accounting treatment set out in IFRS 3.

More specifically, when an investor acquires an interest in an associate, it would measure contingent consideration at fair value. If the contingent consideration is classified as equity, the investor would then account for its subsequent settlement within equity. For other contingent consideration, the investor would measure it at fair value at each reporting date and recognise changes in fair value in profit or loss.

Redeliberations continue on Primary Financial Statements project

At its June 2023 meeting, the IASB continued its redeliberations on the proposals in the General Presentation and Disclosures exposure draft.

Two topics were discussed:

- Categories and subtotals in profit or loss: the rules for classifying income and expenses in specific situations; and
- IAS 29 – *Financial Reporting in Hyperinflationary Economies* and IAS 12– *Income Taxes:* classification in profit or loss.

Categories and subtotals in profit or loss

In its redeliberations, the IASB recognised a need to provide clarifications on the classification of income and expenses in specific situations.

It therefore reached the following tentative decisions:

1) Income and expenses arising from the derecognition of an asset or liability shall be classified in the same category as the income and expenses generated by that asset or liability immediately before derecognition.
2) Income and expenses arising from a transaction or other event that changed the category in which these income and expenses were classified (without derecognising the asset or liability) shall be classified in the category in which the income and expenses were classified immediately before the transaction or event occurs. The staff papers on the topic give the example of transfers into or out of investment property.
3) If the income and expenses (as described in 1) and 2) above) arise from a single transaction or event involving a group of assets and liabilities that generated income and expenses classified in different categories of profit or loss (such as loss of control of a subsidiary, which becomes an associate), the gain or loss arising from the transaction or event would be classified in:
    - the operating category, if any of the assets in the group of assets and liabilities generated income and expenses that were classified in the operating category immediately before the event or transaction;
    - the investing category, if all the assets in the group of assets and liabilities generated income and expenses that were classified in the investing category.

IAS 29 – *Financial Reporting in Hyperinflationary Economies* and IAS 12 – *Income Taxes*

Following its June redeliberations, the IASB reached the following tentative decisions:

- An entity that applies IAS 29 shall present the gain or loss on the net monetary position in the operating category of profit or loss, if the entity presents that gain or loss in a single line item.
- Foreign exchange differences arising from assets and liabilities that fall within the scope of IAS 12 (e.g. deferred tax assets and liabilities), and that are recognised in profit or loss in accordance with IAS 21, would be classified in the income tax category unless this would involve undue cost or effort for the issuer.

ISSB: publication of first IFRS Sustainability Disclosure Standards

On 26 June 2023, the International Sustainability Standards Board (ISSB) published the final versions of its first sustainability disclosure standards, IFRS S1 – *General Requirements for Disclosure of Sustainability-related Financial Information*, and IFRS S2 – *Climate-related Disclosures* (available here). The standards are intended to provide a globally recognised baseline for reporting on the financial effects of sustainability-related risks and opportunities. The publication of the standards was particularly welcomed by IOSCO (the International Organization of Securities Commissions) in a press release published by the IFRS Foundation Monitoring Board, of which IOSCO is a member (available here).

The standards are the culmination of a process lasting more than 18 months, building on preparatory work of the Technical Readiness Working Group that was published in late 2021. The ISSB then launched a four-month public consultation at end-March 2022 (cf. Beyond the GAAP no. 164 and Beyond the GAAP no. 169, March and September 2022), followed by several months of redeliberations to take account of the feedback on the draft standards.

IFRS S1 and IFRS S2 are built on the concepts set out in IFRS Accounting Standards, notably the concept of materiality of information, and are intended to ensure that companies disclose all information that is relevant to investors or other finance providers in their decision-making processes.

IFRS S2 takes account of the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and requires both sector-agnostic and sector-specific disclosures. For the latter, entities shall draw on the guidance based on the standards published by the Sustainability Accounting Standards Board (SASB).

The ISSB's Transition Implementation Group (cf. Beyond the GAAP no. 177, May 2023) will now work with jurisdictions and entities to facilitate the implementation of the standards, as well as any interactions with other sustainability reporting frameworks (particularly the standards published by the Global Reporting Initiative, as well as the European Sustainability Reporting Standards (ESRS)).

The ISSB is now planning to look at other topics, beyond climate, and on 4 May it launched a Request for Information on its future work plan (cf. Beyond the GAAP no. 177, May 2023).

A future edition of Beyond the GAAP will feature a detailed summary of the content of IFRS S1 and IFRS S2.

European Highlights

EC adopts new final delegated acts relating to green Taxonomy

On 13 June, just over a month after the end of the public consultation (cf. Beyond the GAAP no. 176, April 2023), the EC adopted on principle two delegated acts relating to the green Taxonomy, as part of a wider package of measures relating to sustainable finance. In this work, the EC drew heavily on the recommendations of the Platform on Sustainable Finance, published in March and November 2022.

In practice, these Taxonomy-related delegated acts (i) specify the technical screening criteria for economic activities that make a substantial contribution to one or more of the four non-climate-related

environmental objectives (sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems), and (ii) set out new criteria for the first two environmental objectives of climate change mitigation and adaptation, extending the scope to include more economic activities that contribute to these objectives (notably in the manufacturing and transport sectors).

The EC has also made amendments to the disclosure requirements set out in Delegated Regulation (EU) 2021/2178 of 6 July 2021 (available here) to specify the disclosure obligations for the new activities added to the scope of the green Taxonomy. These obligations will come into effect for financial reporting published from 2024 onwards. In the first year, only the ratios for eligibility of economic activities will be required for the four new environmental objectives.

By January 1, 2024, the whole package of measures will be translated into all official EU languages and formally adopted by the EC. They will then be submitted to the European Parliament and Council for examination (over a period of four months, which may be extended by two further months).

The press release and the associated documents are available here and here, respectively.

EFRAG creates Advisory Panel and Community on connectivity between financial and sustainability reporting

On 16 June, EFRAG launched a Connectivity Advisory Panel (CAP) and Connectivity Community (press release available here).

The CAP's objective is to advise the FR TEG (Financial Reporting Technical Expert Group) on its research project on connectivity between financial reporting and sustainability reporting information. The members of the CAP will share their practical experience to help EFRAG to identify, assess, prioritise and analyse connectivity themes and to gather examples of good reporting practice.

Noting the high level of interest in this topic, with over 150 applications received, EFRAG has also launched a Connectivity Community, enabling interaction and co-operation with a broader range of stakeholders. The Community will be kept informed regarding EFRAG's connectivity activities, and may be contacted with specific questions.

The CAP and Community will begin work from July, and the aim of the research project is to publish a Discussion Paper next year.

European Supervisory Authorities publish progress reports on greenwashing

On 1 June 2023, the three European Supervisory Authorities (the EBA, EIOPA and ESMA) published their progress reports on greenwashing in the financial sector. The publications are a response to the "Request for input related to greenwashing risks and the supervision of sustainable finance policies" sent by the EC to the European Supervisory Authorities (ESAs) in 2022.

In their reports, the three ESAs describe greenwashing as *"a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product or financial service"* that may be misleading to consumers, investors or other

market participants (greenwashing does not require investors being actually harmed). The ESAs noted that sustainability-related misleading claims may be spread intentionally or unintentionally, and that greenwashing may occur in relation to entities and products both within and outside the EU regulatory framework.

The report published by ESMA (the European Securities and Markets Authority) assesses the risk of greenwashing throughout the sustainable investment value chain (SIVC) and identifies the risk areas across four sectors: issuers, investment managers, benchmarks (such as climate and ESG benchmarks) and investment service providers.

As regards issuers, ESMA notes that, *"forward-looking information and pledges about future ESG performance appear to be particularly exposed to greenwashing risk. Enhanced transparency on underlying assumptions and parameters appears necessary to help investors make informed investment decisions taking into account the ambition and the credibility of sustainability commitments."* These observations echo two decisions recently published by ESMA, in which the enforcer concluded that disclosures in the notes to the financial statements did not take sufficient account of climate-related risks (cf. Beyond the GAAP no. 175, March 2023).

EC unveils the content of the first set of ESRS

On 9 June 2023, almost seven months after the European Financial Reporting Advisory Group (EFRAG) delivered its technical advice[1], the EC published the draft delegated act (accessible here) on the **first European Sustainability Reporting Standards** (ESRS)[2], which are applicable to all sectors and derive from the Corporate Sustainability Reporting Directive (CSRD)[3].

In order to take into account the feedback received from its stakeholders, the EC has made a number of changes to the first drafts submitted by EFRAG (introducing new transitional provisions, increasing flexibility in certain areas, etc.) while (i) **preserving the integrity of the work** carried out by its technical advisor and (ii) **maintaining the CSRD's ambition** in terms of disclosures on sustainability topics. The so-called “Set 1” still comprises 12 standards covering all environmental, social and governance topics (ESG), broken down into 82 disclosure requirements (DRs).

The EC will then have only a very short time to consider the final comments received during the public consultation which ended on 7 July.

It is therefore highly unlikely that any significant changes will be made between now and **the adoption of the final delegated act, expected in July** and certainly no later than 31 August 2023 (the deadline set by the CSRD).

This formal adoption will be followed by a review[4] by the European Parliament and the Council. The final text will therefore be published in the Official Journal of the European Union by the end of the year (assuming there are no objections from either of these two institutions), with Set 1 coming into force on 1 January 2024 for the first companies concerned[5].

Mazars has published **an analysis of the EC's approach and work** following the publication of the draft delegated act (accessible here). This study will not return in any detail to the development and content of the standards, which are in any case still tentative at this stage, but instead will present the most significant changes that the draft delegated act makes to EFRAG's November 2022 draft standards.

Changes designed to strengthen the proportionality and flexibility of Set 1

Alongside some editorial clarifications, the EC has strengthened (i) consistency with the European legislative framework and (ii) interoperability with other international sustainability reporting standards, together with making four major changes, as detailed below:

1. the expansion of the scope of the materiality assessment;
2. the reinforcement of the optional transitional provisions;
3. the now voluntary nature of certain disclosures;
4. the addition of targeted modifications.

[1] See Beyond the GAAP no 171 of November 2022.

[2] See Annex I of the draft delegated act.

[3] This Directive, which came into force at the begining of the year (see the Guide prepared by Mazars), must be transposed into French law by way of order no later than 8 December 2023.

[4] For a two-month scrutiny period (with a possible two-month extension).

[5] Large undertakings, as per the Directive 2013/34/EU, which are public-interest entities with more than 500 employees.

Expansion of the scope of sustainability-related information subject to materiality assessment

From now on, **only the general disclosures listed in ESRS 2 shall be mandatorily presented by all companies.** The following information, previously mandatory in the November 2022 draft ESRS, is *de facto* subject to the materiality assessment: (i) ESRS E1 on climate change, (ii) sustainability information required by other European regulations[6] and (iii) certain social indicators from ESRS S1 on own workforce.

The materiality assessment thus plays a central role in both (i) the identification and the scoping of the important information to be provided by a company to cover all its material ESG issues, and (ii) the work of the statutory auditor[7], as part of his assurance mandate.

This approach means that the company is not required to provide information on ESG topics that it has identified as immaterial, just as it is not required to provide *ad hoc* explanations to support its decision to omit certain immaterial information, including - and this is a change introduced by the EC - where all the DRs of a topical standard are omitted. This point will need to be confirmed once the final texts are published.

Reinforcement of the optional transitional provisions listed in ESRS 1

The following transversal measures, listed in ESRS 1 and available to all companies, have been only slightly modified by the EC:

- phasing-in of value chain information over a three-year period. The EC has clarified the practical considerations for implementing this measure;
- option to omit comparative information in the first year (i.e. for N-1);
- progressive enhancement of entity-specific information over the first three years, prioritising in particular sector-specific ESG issues (pending the development of sector-specific ESRS).

Additional **phase-ins have been introduced in less mature areas** through:

- for all environmental standards (ESRS E1 to E5), harmonisation of the transitional provisions regarding the anticipated financial effects arising from the material environmental impacts, risks and opportunities, in order to authorise (i) the omission of the relevant information in the first year and (ii) the option to provide only qualitative information for the first three years;
- additions to the list of phased-in ESRS S1 DRs on own workforce, incorporating other sensitive and difficult-to-collect information (for example, metrics relating to persons with disabilities and work-related ill-health).

Finally, **new optional transitional reliefs have been introduced for entities or groups not exceeding 750 employees**[8] who may omit:

- in the first year, (i) Scope 3 and total greenhouse gas emissions data and

[6] I.e. the SFDR (Sustainable Finance Disclosure Regulation), EBA (European Banking Authority) Pillar III sector-agnostic disclosure requirements, EU benchmark regulation and the EU Climate Law.

[7] Or, where applicable, the independent assurance services provider.

[8] According to the EC, this covers some 30 000 of the approximately 50 000 entities within the scope of the CSRD.

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(ii) the information listed in all the ESRS S1 DRs; and

- in the first two years, the DRs specified in (i) ESRS E4 on biodiversity and ecosystems and (ii) social standards other than ESRS S1 (i.e. ESRS 2 on value-chain workers, S3 on affected communities and S4 on consumers and end-users).

In this instance, and in order to ensure coherence with the requirements of the CSRD, a "minimum" layer of information[9] must nevertheless be provided by the company (or group) if one or more of the topics covered by ESRS E4 or by the social standards is material, which presupposes that these standards must have been considered beforehand when conducting the materiality assessment.

Extension of the scope of voluntary disclosures in ESRS

The EC has extended the scope of voluntary disclosures (information that a company "may" rather than "shall" disclose) by targeting the disclosures it believes would be the most complex to provide, due in particular to immature methodologies and anticipated difficulties in collecting the relevant data.

These changes particularly concern:

- ESRS E4 on biodiversity, where information relating to (i) the company's transition plan and (ii) the compatibility of its strategy and business model with the planetary boundaries is now voluntary;
- a number of disclosures listed in ESRS S1, in particular quantitative data on non-employees;
- disclosures on confirmed incidents of corruption under ESRS G1 on business conduct.

Additional targeted modifications

The EC's amendments have introduced:

- **safeguard measures,** e.g. authorising not to disclose information deemed sensitive or classified under European law, even if it is material;
- **more flexibility,** e.g. no longer imposing the LEAP approach (Locate, Evaluate, Assess, Prepare)[10] when conducting the materiality assessment for environmental topics other than climate change; or introducing a threshold of 10% of the total number of employees for the information required by ESRS S1 on the breakdown by country[11].

Next steps

Setting aside the legislative process described in the introduction, **EFRAG should shortly respond to the EC's request** and the need expressed by many stakeholders by publishing guidance to facilitate the application of Set 1 in the following three areas: (i) materiality assessment, (ii) value chain (including related disclosures) and (iii) details (in

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[9] As listed in ESRS 2 and including, in relation with these material topics, (i) an indication of how the company takes account of the associated impacts in its strategy and business model, (ii) a brief description of the time-bound related objectives, policies and actions it has set itself and (iii) relevant metrics.

[10] See the Taskforce on Nature-related Financial Disclosures (TNFD) framework. The fourth (provisional) version was published on 28 March (final recommandations expected in September 2023).

[11] A breakdown of employees by country is now required for countries in which (i) the company has 50 or more employees and (ii) which account for at least 10% of its total number of employees.

Excel) of the various datapoints to assist companies in conducting their gap analyses.

The ESRS framework will then be gradually complemented, but at a pace that will probably not coincide with the timetable set by the CSRD[12] (notably because of the European elections scheduled for early June 2024) in order to cover:

- the standard applicable to listed SMEs: EFRAG should publish an exposure draft by the end of this year, which the EC is expected to adopt by the end of 2024;
- sector-specific standards: the EC's adoption process is not expected to start until June 2025, and will probably be spread over several years.

Finally, EFRAG is due to publish a draft XBRL taxonomy in autumn 2023 to enable companies to tag the sustainability information and comply with the obligation to publish the management report in the European Single Electronic Format (ESEF). It is now very unlikely that this will happen as early as 2024, given the work that will then face the European Securities and Markets Authority (ESMA) to amend the applicable Regulatory Technical Standards (RTS).

[12] The CSRD calls for the EC to adopt a second set of sustainability reporting standards by 30 June 2024.

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[1] Where permitted under applicable country laws

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