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Beyond the GAAP

Mazars' monthly newsletter on financial and sustainability reporting

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Editorial

At the end of October, the European Securities and Markets Authority, ESMA, published its common priorities at European level for the 2023 reporting period.

Unsurprisingly, the regulator expects the 2023 annual financial statements to take a transparent approach to disclosing the material impacts of climate change and current macroeconomic conditions. The section on non-financial reporting focuses in particular on the information to be provided under Article 8 of the Taxonomy Regulation, climate issues (in light of the increased requirements under the forthcoming CSRD directive) and scope 3 greenhouse gas emissions.

IFRS Highlights

IFRS IC decision on premiums receivable from an intermediary

At the end of October, the international Accounting Standards Board (IASB) approved the IFRS IC's September decision not to add a standard-setting project to its work plan to clarify whether the premiums receivable from an intermediary fell within the scope of IFRS 17 or IFRS 9.

The Committee was asked about the standard to be applied to the premiums receivable of an insurer from its intermediary when the policyholder has already paid the insurance premiums to the intermediary (discharging itself of its obligations under the contract, and obliging the insurer to provide its insurance contract services), but the intermediary has not yet paid the premiums to the insurer.

IFRS 17 is silent as to when future cash flows recognised in an insurance contract (excluding the simplified PAA model) are removed from the measurement of insurance contracts: when they are recovered or settled in cash or when the policyholder's obligation under the insurance contract is discharged?

In the first case, the insurer would apply IFRS 17; in the second case, the insurer would have a financial asset (IFRS 9).

The Committee concluded that, under these circumstances, the insurer develops and applies an accounting policy in accordance with IAS 8 to determine when cash flows are removed from the measurement of insurance contracts. It observed that both standards would provide users with useful information. It also observed that adding a standard setting project to the work plan would involve assessing whether changes to the accounting standards would have unintended consequences, which may take considerable time and effort to complete. Consequently, a project would not be sufficiently narrow in scope that the IASB or the Committee could address it in an efficient manner, which ultimately led them not to add a standard-setting project to the work plan.

The decision, which allows entities to apply either standard, should therefore not disrupt the practices adopted by insurers for the first-time application of IFRS 17 (and often IFRS 9 as well) this year.

Brazil adopts ISSB's IFRS Sustainability Disclosure Standards

On 20 October, the IFRS Foundation issued a press release (available here) stating that the IFRS Sustainability Disclosure Standards published by the International Sustainability Standards Board (ISSB), namely IFRS S1 – *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 – *Climate-related Disclosures* will be incorporated into the Brazilian regulatory framework, setting out a roadmap to move from voluntary use starting in 2024 to mandatory use on 1 January 2026. Since these two standards were published at the end of June 2023, Brazil has been the first country to announce its formal decision to adopt IFRS S1 and S2.

This move coincides with discussions between the IFRS Foundation Trustees and representatives of the region's key stakeholders (in particular financial institutions) on the need to build a more resilient, sustainable and competitive financial environment in Latin America given the increasing climate risk in these markets.

This approach is also in line with a series of initiatives launched by a number of jurisdictions in the region to standardise sustainability-related financial disclosures. Both Chile and Colombia have mandated use of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations and SASB Standards, which the ISSB's Standards build upon. Public discussions are also ongoing in Mexico concerning the adoption of IFRS Sustainability Disclosure Standards.

European Highlights

ESMA: 28th extract from IFRS enforcement decisions database

On 9 October, the European Securities and Markets Authority (ESMA), the European Union's financial markets regulator and supervisor, published the 28th extract from its database (available here) of IFRS enforcement decisions taken by regulators in the European Economic Area (EEA).

ESMA's periodic publications have a twofold objective:

- strengthening supervisory convergence between the 38 national enforcers and supervisory authorities in the EEA that participate in the European Enforcers Coordination Sessions (EECS); and
- providing issuers and users of financial statements with relevant information on the appropriate application of IFRSs from the perspective of the EECS.

Nonetheless, ESMA emphasises that these published decisions:

- are not interpretations of IFRS, as this remains the prerogative of the IFRS IC;
- were issued in relation to the IFRS requirements in force at the publication date of the financial statements reviewed, and that they may be superseded by subsequent changes in IFRS.

ESMA clarifies that decisions are published if they fulfil one or more of the following criteria:

- the decision refers to a complex accounting issue or an issue that could lead to different applications of IFRS;

- the decision relates to a relatively widespread issue among issuers or within a certain type of business and, thereby, may be of interest to other enforcers or third parties;
- the decision addresses an issue on which there is no experience or on which enforcers have inconsistent experiences; and
- the decision has been taken on the basis of a provision not covered by an accounting standard.

The decisions published in this 28th extract were taken in the period from June 2022 to July 2023. They concern annual financial statements from the years 2017, 2018, 2021 and 2022 and address the following topics:

- decision EECS/0124-01: Earn-out payments related to business combinations (IFRS 3, an IFRS IC agenda decision of January 2013);
- decision EECS/0124-02: Classification of a put-option liability related to a business combination (IAS 32, IFRS 3) ;
- decision EECS/0124-03: Recognition and measurement of distribution rights (IAS 38);
- decision EECS/0124-04: Loss of control (IFRS 10);
- decision EECS/0124-05: Assessment of control (IFRS 10, IFRS 11);
- decision EECS/0124-06: Principal vs. agent; recognition of revenue from resale of third-party licences (IFRS 15);
- decision EECS/0124-07: Power purchase agreements (PPA), own-use exemption (IFRS 9, IFRS 16). This decision concerns physical purchases of renewable energy and the own-use exemption under IFRS 9. This is a current topic, which the IFRS has recently decided to address;
- decision EECS/0124-08: Hedge accounting disclosures (IFRS 7);
- decision EECS/0124-09: Disclosures related to leases (IFRS 16).

ESMA posts on its website a list (accessible here) of all decisions that have been made public.

European Commission publishes its 2024 work programme

On 17 October, the European Commission (EC) published its work programme for 2024 (accessible here), setting out its policy priorities and detailing its legislative and non-legislative initiatives planned for the year ahead.

This plan has a particular focus on the simplification of rules for businesses and citizens alike. It reflects the commitment made in mid-March 2023 by the Commission President, Ursula von der Leyen, to reduce the burden of reporting requirements by 25%, in line with the European strategy designed to boost the Union's long-term competitiveness and to ease the burden on SMEs.

Some of the simplification measures in this work plan (section A of Annex II) have already been adopted by the Commission (15 proposals and initiatives since March 2023). 26 additional rationalisation initiatives are proposed (section B of Annex II) to reduce the reporting burden. They include:

- a proposal to postpone the deadline for the adoption of the sector-specific European Sustainability Reporting Standards (ESRS) to 30 June 2026 instead of 30 June 2024 as initially envisaged by the Corporate Sustainability Reporting Directive (CSRD), with the aim of reducing the immediate reporting burden on European companies in the scope of this directive (including SMEs). In this context, on 24 October the Commission launched a public consultation (accessible here), open until 19 December, seeking stakeholder feedback on this postponement and on the two-year deferral also envisaged for the adoption of the ESRS standards applicable to third-country entities (without affecting the date of first publication of a CSRD-compliant report by non-European entities);

- a proposal to adjust the thresholds of the Accounting Directive to take account of inflation, so more than a million companies will benefit from reduced financial and sustainability reporting requirements. A delegated directive on this subject was adopted by the Commission at the same time as it published its work plan (see below).

On the same day, the Commission launched a public consultation to support these initiatives (accessible here), open until 28 November in order to gather stakeholder suggestions as to which European reporting requirements could be abolished or streamlined without compromising the EU's policy objectives.

European Commission adopts the Delegated Directive amending company size criteria in the Accounting Directive

After a consultation period ending on 6 October, on 17 October the European Commission adopted the Delegated Directive amending the Accounting Directive (2013/34/EU) by adjusting the size thresholds (balance sheet total and net turnover) for micro, small, medium-sized and large companies/groups by 25% to take account of inflation (these thresholds had not been revised since 2013).

The directive adopted by the Commission:

- retains the 25% increase in the balance sheet and net turnover proposed in the draft submitted for public consultation and continues to leave the threshold for the number of employees unchanged. For example, under these adjusted thresholds large entities are defined as those meeting two of the following three criteria:
  - balance sheet total > €25 million (instead of €20 million);
  - net turnover > €50 million (instead of €40 million);
  - average number of employees during the financial year> 250 (unchanged);
- stipulates that Member States should apply these new thresholds at the latest from the 2024 financial year, and authorises early application for the financial year 2023. This option for early application did not appear in the draft text and is the result of the Commission's review of responses to the consultation.

However, the Commission's adoption of the Delegated Directive does not mark the end of the legislative process, since it will only enter into force if no objections are raised by the European Parliament or the Council within a two-month period (with a possible two-month extension) or if, before the expiry of this period, both the European Parliament and the Council have informed the Commission that they intend to raise no objections.

No objections to the adoption of ESRS Set 1 from the European Parliament and the Council

The legislative process for the adoption of the first set of European Sustainability Reporting Standards (ESRS) endorsed by the Commission on 31 July is now complete. The period of scrutiny by the European Parliament and the Council ended on 21 October, with no requests for extension or objections from either institution.

However, this scrutiny did lead to some debate when, on 11 October, a motion for a resolution on the delegated act (DA) on the ESRS proposed to object the ESRS DA with the support of around fifty MEPs. This request was ultimately rejected during the vote in the plenary session held on 18 October (359 votes against, 261 in favour and 11 abstentions).

The final adoption of the 12 sector-agnostic ESRS has been welcomed by the European Financial Reporting Advisory Group (EFRAG), the Commission's technical advisor, which sees this as an important milestone in improving the quality of sustainability reporting in Europe and beyond (its press release can be consulted here). EFRAG notes (i) its dedication to providing support for the successful implementation of this first set of sector-agnostic ESRS and (ii) the progress of ongoing work to develop ESRS applicable to SMEs and sector-specific standards (see below).

The final text of the ESRS is expected to be published in the Official Journal of the European Union (OJ EU) by the end of 2023, and will be effective from 1 January 2024 for the first companies in scope of the CSRD[1]. Minor changes to the texts adopted on 31 July are expected, in line with the proofreading work that has since been carried out at Commission and Member State level. Against this background, language improvements should also be subsequently incorporated into the translated versions that were released at the end of July. The French translation which will be published in the OJ EU by the end of 2023 will be the law in France.

EFRAG publishes its work programme for 2024

On 11 October, EFRAG published its 2024 work programme (available here), setting out both its priorities for ESRS Set 1 implementation support and its new deadlines, aligned with the European Commission’s most recent timetable (see the note on the Commission’s work plan above).

EFRAG’s priorities and deadlines for the coming months are as follows:

- by end-2023:
  - launch of the Q&A platform on ESRS implementation. This has in fact been up and running since mid-October (see below);
  - publication of draft implementation guidance, one on the value chain and one on materiality assessment, ahead of a month-long public consultation (expected mid-November). Final versions are expected at the start of 2024 after taking account of feedback;
  - publication of the list of datapoints deriving from ESRS Set 1 (expected no sooner than December). An initial draft was made public at the

[1] Large companies (or groups) with more than 500 employees that are public interest entities (including companies listed on a regulated market in the EU, whether based in the EU or outside).

  Sustainability Reporting Board meeting on 25 October (available here);

- in Q1 2024:
  - publication of the draft XBRL digital taxonomy applicable to ESRS Set 1. This will then be subject to a two-month public consultation before submission to ESMA, which will be tasked with incorporating this taxonomy into the European Single Electronic Format (ESEF) and developing the Regulatory Technical Standards (RTS) applicable to the tagging of sustainability information;
  - publication of exposure drafts for the ESRS that apply to SMEs (a mandatory standard for listed SMEs within the scope of the CSRD, and a voluntary standard for unlisted SMEs). These will be subject to a four-month public consultation, before EFRAG delivers its technical advice (for the standard for listed SMEs only) to the Commission, which is expected by November 2024 at the latest;
  - publication of exposure drafts relating to: (i) the general approach to sector-specific ESRS, (ii) the ESRS sector classification approach, and (iii) the first two sector-specific standards, Oil & Gas, and Mining, Quarrying & Coal. These will also be the subject of a public consultation (for an as yet unspecified period) before EFRAG delivers its technical advice to the Commission, which should be no later than November 2025;
- at the end of 2024 and during 2025: development and publication of (i) the exposure drafts relating to the other priority sector-specific ESRS (other high-impact sectors and the financial sector) and (ii) the exposure draft relating to ESRS for non-EU groups, with a view to a public consultation followed by the submission of a technical opinion to the Commission, again no later than November 2025.

In parallel, EFRAG will continue to work with international bodies (the ISSB and the Global Reporting Initiative in particular) to ensure the interoperability of ESRS with other standards and frameworks.

EFRAG's work programme must now be validated by the European Commission, which will consult with Member States on the matter.

EFRAG launches Q&A platform to support ESRS implementation

On 24 October 2023 EFRAG announced the launch of a Q&A platform (accessible here) to field technical queries from preparers and the public on the implementation of ESRS. This reflects the Commission’s wider intention to support the implementation of these standards.

Stakeholders can now submit their technical questions on ESRS Set 1 via the online questionnaire. These questions will be examined frequently by EFRAG and categorised for the purposes of the response. The list of questions and answers will be accessible on the EFRAG site here.

In its role of technical advisor to the Commission, EFRAG will issue clarifications, rejections, or additional implementation guidance. Depending on the nature of the questions posed, EFRAG will decide on the level of priority in responding to them in light of its work programme.

It should also be noted that the answers provided by EFRAG in this context will be non-authoritative; the provisions of the standards themselves will have precedence. Only questions of interpretation of the standards that might lead to amendments to the ESRS will be referred to the Commission, which alone has the legal power to amend these standards. However, EFRAG does not expect any amendments to ESRS to be issued in 2024.

Third set of Commission FAQs on the application of the green taxonomy regulation

On 20 October, the third set of FAQ on the application of the Taxonomy regulation (which had been adopted and published by the European Commission on 19 December 2022: see Beyond the GAAP no 172 of December 2022), was published in the OJ EU in all the official languages of the EU. The two documents in this 3rd set concern:

- the technical screening criteria (TSC) in the Climate Delegated Act used to demonstrate the alignment of economic activities with the Taxonomy;
- disclosure obligations under Article 8 Delegated Act.

These FAQ are available in English here and here.

ESMA publishes a report on Taxonomy reporting practices in the 2022 financial year

On 25 October, ESMA published a report (accessible here) on the Taxonomy reporting practices of a sample of issuers[2] based on sustainability disclosures for the 2022 financial year with regard to the eligibility and alignment of their activities regarding the first two climate objectives (mitigation and adaptation) The focus of this fact-finding exercise is to evaluate the quality of the disclosures with which issuers have responded to the new requirements under Article 8 of the Delegated Act on disclosures under the Taxonomy Regulation. With this report ESMA has focused in particular on the various points to which it drew the attention of entities in its European common enforcement priorities for the 2022 financial statements (see Beyond the GAAP no 170, October 2022).

The main lessons highlighted by ESMA are as follows:

- almost all the sample (96%) met the requirement to disclose Key Performance Indicators (KPIs) relating to alignment, bearing in mind that 2022 was the first year in which this obligation came into force;
- 70% of issuers used the identical mandatory templates provided in Annex II of Article 8 Delegated Act, while 30% of the sample modified these templates or did not complete them in full. ESMA observes that this practice may impact comparability and make access to the data more difficult for users, and notes that reporting using the complete templates is mandatory.
- at least some of the mandatory qualitative information regarding the issuers' assessment of their compliance with transparency requirements in relation to the nature of their activities and to (i) the technical screening criteria, (ii) the Do No Significant Harm (DNSH) criteria, and (iii) minimum safeguards was missing or insufficient for more than 40% of the assessed issuers. In addition, only 40% of the sample provided comments on their eligibility or alignment KPIs.

[2] 54 issuers of sustainability disclosure representing 22 EU Member States.

- no reporting (4%) or reporting as a zero value (26%) for the alignment KPI relating to operational expenditure (OpEx) in application of the materiality exemption offered by Article 8 Delegated Act. ESMA observes that the contextual information did not in general allow readers to assess whether the conditions and criteria for applying the exemption were met and/or respected.
- other areas of incorrect application of Article 8 were spotted, not least in relation to transparency about (i) the avoidance of double counting of activities contributing to both climate objectives (mitigation and adaptation), (ii) the screening of activities against one climate objective only or (iii) the reconciliation with financial statements.
- good reporting practices were also found, such as detailed explanations on the nature of activities and on the analysis of compliance with this new regulation, as well as links to the corporate sustainability strategy.

Accordingly, ESMA has formulated recommendations in line with the conclusions of this report, as well as additional recommendations on Taxonomy reporting, in its European common enforcement priorities for the 2023 annual financial reports (see the study in this issue). ESMA may carry out further analyses on the reporting areas where more clarity is necessary or for which material incorrect application has been identified. Additional steps may also be taken by national enforcers, if necessary.

Interestingly, it may also be noted that the report found that the average turnover alignment KPI for entities in the sample was 17.3%. It was 17.5% for OpEx and 28.1% for CapEx, signalling investment efforts to support the transition to a sustainable economy.

New appointments to EFRAG

On 6 October EFRAG announced a series of new appointments that had been made during September and October:

- Sébastien Godinot and Robert Ophèle: appointed as EFRAG Administrative Board members;
- Simone Scettri: appointed as EFRAG Financial Reporting Board member;
- Signe Lysgaard: appointed to EFRAG's Sustainability Reporting Technical Expert Group (SR TEG)

EFRAG's press release can be consulted here.

ESMA publishes recommendations for 2023 financial reporting

In October, the European Securities and Markets Authority (ESMA) published its European common enforcement priorities for the 2023 annual financial reports (available here).

As in 2022, the regulator's recommendations for **IFRS financial reporting** place great emphasis on climate-related issues, as well as the impacts of the current macroeconomic environment. They also address first-time application of IFRS 17 – *Insurance Contracts* from 1 January 2023, reiterating the importance of transparency around significant judgements and assumptions. Implementation of the amendments to IAS 12 – *International Tax Reform Pillar Two Model Rules* merits a briefer mention. Issuers are reminded of the disclosures required in the notes for the period between the adoption (or substantive adoption) of the OECD Pillar Two rules, and their entry into force.

The European common enforcement priorities also comprise a whole section dedicated to **non-financial reporting**. This section is broken down into three sub-sections: (i) disclosures relating to Article 8 of the Taxonomy Regulation; (ii) disclosures of climate-related targets, actions and progress; and (iii) Scope 3 greenhouse gas (GHG) emissions.

Our special feature provides a summary of ESMA's main recommendations for IFRS financial statements and for non-financial statements.

Recommendations for IFRS financial statements

The impact of climate-related matters on financial reporting

Having addressed this topic in 2021 and 2022, the regulator notes that its previous recommendations remain relevant for 2023 financial reporting. It also refers issuers to its benchmark report *The Heat Is On*, published in 2023.

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

The regulator reminds issuers of the **need for consistency** between the judgements and estimates used in the IFRS financial statements and those used in other reporting. Particular attention should be paid to climate-related commitments, such as reductions in GHG emissions and decarbonisation plans.

While progress has been made, ESMA emphasises that **issuers need to expand the disclosures presented in financial statements.**

Issuers should assess and, where relevant, describe in the financial statements the timetable and the financial impacts of planned investments and transition plans. Issuers should also explain any deviation between the assumptions used for impairment testing (including sensitivity analyses) and their climate-related commitments and strategies.

CO2 quotas and other certificates

ESMA recommends **describing the accounting treatment and impacts** of such schemes in the statement of financial position and income statement, with details for each jurisdiction where necessary. In certain circumstances, issuers may need to recognise provisions for such schemes (and disclose information on them in the notes).

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 or climate-related commitments;
- **assess whether there are any new key assumptions** relating to the climate (such as changes in the energy mix, the price of CO_2 or the cost of replacing certain assets). If such assumptions are identified, ESMA expects issuers to disclose the value assigned to the key assumption for the current period and future forecasts, as well as the internal and external sources used to calculate these (reminding issuers that under IAS 36, more weight shall be given to external sources);
- **explain how climate-related issues impact assumptions used** in the business plan, the period considered beyond the business plan, and the financial assumptions (discount rate, growth rate) used to calculate the value in use.

Power Purchase Agreements (PPAs)
The regulator recommends that issuers should **provide details on the characteristics and accounting treatment** of the PPAs used.

Climate-related risks and financial institutions
Financial institutions are encouraged to provide more information on financing linked to sustainability criteria and the significant judgements used to determine their accounting treatment (notably when assessing whether cash flows are payments of principal and interest).

Lastly, ESMA recommends that financial institutions should strengthen their efforts to incorporate the impact of climate risk into their provisioning framework, and expand their disclosures in the notes on this topic.

The macroeconomic environment

ESMA acknowledges that the current economic environment continues to be affected by various sources of uncertainty (geopolitical crises, high interest rates, a slowdown in the real estate market and the economy more generally, and so on). In the context of uncertainty, the recommendations from previous years continue to apply. In the 2023 recommendations, ESMA encourages issuers to pay particular attention to fair value measurement for investment property and financial instruments measured at amortised cost, and to provide detailed disclosures on financial risks (liquidity risk, interest rate risk and credit risk).

Fair values of investment property
If an issuer has chosen to measure investment property at fair value, **ESMA expects that valuation techniques and key assumptions will be described in the notes**, along with any change in techniques or assumptions. These recommendations arise from ESMA's annual review of the financial statements of real estate investment companies, some of which displayed shortcomings.

Also, in light of the **net slowdown in the real estate market** and the **building renovation obligations introduced under new energy laws** in some countries, ESMA encourages issuers to **assess whether these risks are appropriately reflected in the fair value measurement of investment properties**. They should also reassess the valuation methods used, particularly if comparable transactions are used to measure fair value. The regulator also encourages issuers to **present more detailed sensitivity analyses of fair values and to recalibrate those analyses**

to better reflect the current level of uncertainty.

Fair values of financial instruments measured at amortised cost

IFRS 7 and IFRS 13 require disclosures in the notes on **fair value and the fair value hierarchy, as well as a description of the valuation techniques and inputs used for financial instruments classified at level 2 or 3 of the fair value hierarchy.** ESMA emphasises **the importance of these disclosures in the current macroeconomic environment**, especially for issuers whose liquidity requirements may force them to sell financial assets to raise money.

Debt and other financial risks

With higher interest rates leading to **restrictions on access to credit, ESMA expects issuers to provide more detailed information on liquidity risk and debt.** In particular, the regulator emphasises the importance of providing details of the characteristics of significant debts, the conditions of covenants, the impact and risk of potential breaches of covenants, debts renegotiated over the year and their accounting treatment.

It also reminds issuers of the need to present the schedule of contractual undiscounted cash flows of financial liabilities and a description of how they manage the liquidity risk inherent in these liabilities, in accordance with IFRS 7 (paragraphs 39 and B10A to B11F). More specifically, if an issuer has derivative positions that may require significant additional collateral to be posted due to margin calls, ESMA recommends that it should present quantitative disclosures to allow users to understand the impact of these positions on liquidity risk, including the carrying amount of financial assets pledged as collateral for liabilities, together with the terms and conditions relating to this pledge (IFRS 7, paragraph 14).

If an issuer makes substantial use of factoring or supplier financing (reverse factoring) arrangements, ESMA recommends that it should disclose the main terms and conditions of the programmes and their impacts on the financial statements, as well as judgements exercised in determining their accounting treatment.

Lastly, where issuers have significant exposure to interest rate risk (e.g. through variable-rate debt), ESMA encourages them to recalibrate their sensitivity analyses to reflect the current interest rate volatility. Different analyses may be needed for different classes of financial instruments, and issuers should disclose any changes in the methods and/or assumptions used in their analyses.

Hedge accounting

ESMA points out that **the current economic environment may have an impact on issuers' ability to meet the qualifying criteria to designate or maintain a hedging relationship**, particularly if the hedged item is a highly probable future debt issuance, if the risk of default on the hedging instrument or hedged item becomes too high, or if banks observe significant withdrawals of hedged deposits. The regulator urges these issuers to provide detailed disclosures in the notes on the effectiveness of hedging relationships and on hedging relationships that were discontinued during the period.

First-time application of IFRS 17 – *Insurance Contracts*

IFRS 17 – *Insurance Contracts* came into force on 1 January 2023, and many insurance companies deferred application of IFRS 9 to the same date.

ESMA refers issuers to its Public Statement of 13 May 2022 (available here), which deals with the disclosures to be presented by entities on their implementation of IFRS 17, and to a similar Public Statement (available here) that it published in 2016, ahead of first-time application of IFRS 9.

Recommendations for non-financial statements

Disclosures relating to Article 8 of the Taxonomy Regulation

Non-financial undertakings: recommendations arising from ESMA's report on Taxonomy reporting practices in the 2022 financial year

Following on from its previous recommendations, ESMA carried out a limited-scope fact-finding exercise on **reporting practices under the Taxonomy regulation** in the 2022 financial year (see 'European Highlights' in this issue). In this period, non-financial undertakings were required for the first time to publish information 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. This exercise allowed ESMA to identify omissions and shortcomings in terms of both (i) the compliance of the reporting with the new requirements of the Article 8 Delegated Act, and (ii) the transparency of the analyses carried out by issuers.

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 Disclosure Delegated Act, with no adaptations or amendments, regardless of the level of eligibility and alignment of an issuer's economic activities;
- **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 environmental objectives (in other words, double counting is not permitted). In such cases, ESMA underlines that qualitative contextual information must be provided to ensure transparency, with issuers encouraged to explain in particular: (i) how compliance with the technical screening criteria was assessed with respect to multiple environmental objectives; (ii) the turnover, CapEx and OpEx that arise from the activities that contribute to multiple environmental objectives; and lastly (iii) how these double counting issues have been addressed, including the rationale for selecting one specific objective over the other available objectives;
- the importance of **assessing all economic activities** with regard to the criteria set out in the EC Delegated Acts relating to the various environmental objectives. This analysis must be carried out for each activity covered by the Delegated Acts **and for each objective for which relevant screening criteria for the activity exist**. This recommendation is particularly important for the 2023 financial year, as the Delegated Acts covering the last four environmental objectives come into force (for the eligibility assessment only);
- the necessity of **improving the contextual information**, both qualitative and quantitative, that accompanies the three KPIs, particularly with regard to (i) how an issuer has assessed compliance with all the alignment criteria (substantial contribution, Do No Significant Harm, and minimum social safeguards); (ii) the description of key assumptions used

when preparing Taxonomy disclosures, including significant judgements made; and (iii) the description of key changes that have occurred compared with the information presented previously. ESMA therefore encourages issuers to provide clear, exhaustive and entity-specific (non-boilerplate) explanations.

Moreover, ESMA notes that while some issuers have stated that they wish to extend their Taxonomy-aligned economic activities, very few have been **transparent about their CapEx plans** to achieve this. ESMA thus encourages issuers to pay close attention to disclosures on this subject, as they need to be underpinned by clear information on the **transition investments needed**, in accordance with the EC's recommendations on transition finance[3]. Moreover, ESMA reminds issuers that, if they develop CapEx plans in accordance with the requirements of the Taxonomy Regulation, the relevant CapEx should be included in the numerator of the associated KPI, and relevant contextual information should also be provided.

Finally, ESMA reminds issuers that the Taxonomy Regulation does not permit the omission of information about the KPIs, with the exception of OpEx, for which an exemption exists in specific and duly justified cases of non-materiality.

Financial and non-financial undertakings: new EU Taxonomy criteria and related disclosures

ESMA emphasises that on 27 June the EC adopted **final delegated acts supporting the Taxonomy Regulation** (cf. Beyond the GAAP no. 178, June 2023). The related reporting obligations will apply from 1 January 2024 (for the 2023 financial period).

ESMA reminds issuers that these delegated acts (i) include updates to the mandatory reporting templates; (ii) set out new criteria for the first two climate change objectives of mitigation and adaptation, extending the scope to include more economic activities that contribute to these objectives; and (iii) introduce the technical screening criteria for activities that make a substantial contribution to one or more of the four non-climate environmental objectives, consequently updating the disclosure requirements[4]. In the first year of reporting[5], undertakings are only required to disclose the proportion of Taxonomy-eligible and non-eligible economic activities vis-à-vis the four new environmental objectives and the new activities that contribute to the first two climate change objectives.

ESMA urges issuers to take into account the reporting implications of the new legislation when preparing their 2023 financial reporting.

Financial and non-financial undertakings: resources available to support EU Taxonomy reporting

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

- the FAQ published by the EC (available here);
- the EU Taxonomy Compass website (available here), which helps to navigate the various technical screening criteria used to assess Taxonomy eligibility and alignment;

[3] Commission Recommendation (EU) 2023/1425 of 27 June 2023 on facilitating finance for the transition to a sustainable economy, p.23

[4] As set out in Delegated Regulation (EU) 2021/2178 of 6 July 2021 (available here).

[5] Non-financial undertakings must publish disclosures on aligned and non-aligned activities from 2025 (for the 2024 financial period).

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- ESMA's guidelines on reporting Alternative Performance Measures (APMs), which were updated in April 2022 with the addition of questions 19 and 20, and which continue to apply (available here).

Disclosures of climate-related targets, actions and progress

General aspects

In line with its previous recommendations, ESMA continues to emphasise the importance of increased transparency in reporting on climate-related issues. This is all the more crucial in light of the forthcoming additional disclosure requirements set out in the CSRD. In this context, ESMA encourages issuers to pay particular attention when reporting on their **climate-related targets**.

ESMA points out that these targets are much more useful when they are measurable, time-bound and clarify: (i) the expected outcomes in terms of mitigation of, or adaptation to, climate-related risks; (ii) any benefits arising from climate-related opportunities; or (iii) any impacts on people or the environment.

The regulator emphasises the importance of clarifying (i) how the climate-related targets are linked and contribute to meeting any pre-set entity-specific or public policy objectives; and (ii) and whether they are based on scientific data[6]. For example, issuers may base their strategic ambitions on climate scenario analysis. When this is the case, climate-related targets should be presented in such a way as to enable users to assess the consistency of these targets with the associated strategic ambition[7].

ESMA also emphasises the need to present clear disclosures on **progress made** towards meeting targets, compared to pre-set target levels set out in a specific base year.

ESMA also reminds issuers that they must provide information about the **methodologies** and **assumptions** underlying those targets, as well as the **scope** of activities and the entities that they cover, specifying whether they address the issuer's own activities, its value chain or both.

The regulator emphasises the importance of setting targets as part of a **broader strategy**, in conjunction with **policies** and implementation **actions**, so that they can assess the effectiveness and orientate any possible revisions of those targets. It encourages issuers to explain (i) why they selected specific climate-related targets and (ii) the relationship between the targets and any pre-defined strategic objective, by presenting, in particular, a description of the actions and milestones put in place to meet those targets.

Lastly, ESMA highlights the importance of presenting disclosures on how climate-related targets are monitored and reviewed. Developing **climate transition plans** is one effective way of linking strategy, policies, actions and targets, and showing progress in meeting them. Issuers are encouraged to refer to ESMA's previous recommendations on transition plans (available here).

Specific disclosure: GHG emission reduction targets

In addition to the general recommendations detailed above, ESMA encourages issuers to address the following key issues in their reporting on GHG emission reduction targets:

[6] For example, an issuer might draw on reference material published by the Science-Based Targets Initiative.

[7] See for example the 2021 guidance on metrics, targets and transition plans published by the Task Force on Climate-related Disclosures.

- explain how the undertaking's targets and the underlying assumptions are **compatible** with commonly understood **European** and **international objectives**, most notably the objective of limiting global warming to 1.5°C compared to pre-industrial levels;
- specify which **emissions scopes** and **categories** are covered by these targets and, in particular, whether Scope 3 emissions are taken into account, in line with ESMA's recommendations for financial reporting;
- give details of the **decarbonisation levers** identified via (i) a quantitative indication of their contribution to the target; and (ii) an explanation of whether these are internal factors (e.g. the application of cleaner technologies to reduce emissions) or external factors (e.g. collaborative actions with key actors in the value chain). ESMA also encourages issuers to explain any **business implications** of the decarbonisation levers identified, such as, for example, potential changes in the issuer's product and/or service portfolio and any expected changes in technology;
- explain the **role of gross GHG emission reductions** in fulfilling broader **climate neutrality** claims compared to other measures, such as the use of carbon credits or GHG removals or storage;
- present disclosures on the **financial resources** and **investments** that are necessary to meet these targets (e.g. the CapEx required to implement the actions), with a reconciliation (where relevant) to the appropriate amounts already recognised in the financial statements or presented within Taxonomy reporting. In that regard, ESMA notes that the EC's guidelines on climate-related reporting encourage issuers to describe the impact of (i) climate-related risks and opportunities and (ii) how the management of these risks and opportunities impacts on the undertaking's financial planning and performance, if possible with reference to financial KPIs;
- present disclosures on **the potential risks of transition** and **locked-in GHG emissions** from the issuer's key assets and products.

Specific disclosure: targets supporting transition trajectories

ESMA highlights the role played by the use of targets in explaining issuers' **trajectories** towards **more sustainable business models**.

In this regard, ESMA draws attention to the EC's recommendations on transition finance (see reference above), which note that the green taxonomy can constitute a tool for setting targets, enabling issuers to specify both the timescale over which they aim to meet the technical screening criteria relating to one or more environmental objectives, and the investments necessary to meet these targets. If an issuer does set itself targets based on Taxonomy criteria, ESMA recommends that it should clarify that these objectives are not part of the mandatory disclosures required under Article 8 of the Taxonomy Regulation.

Finally, in line with the EC recommendations mentioned above, ESMA notes that issuers that set and publish GHG emission reduction targets, and that properly disclose their emissions, may benefit from an increased weight in the EU climate benchmarks, under specific conditions set out in Article 6 of the Benchmarks Regulation.

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Scope 3 GHG emissions

In its recommendations for 2022, ESMA drew attention to a number of points relating to Scope 3 GHG emissions reporting. The importance of these is further underlined by (i) the conclusions of ESMA's report on *Corporate Reporting Enforcement and Regulatory Activities*, published in March 2023 and available here; (ii) the significance of these disclosures for investors' decision-making around sustainable investment; and (iii) the expanded disclosure requirements that will be introduced by the CSRD. In this year's recommendations, ESMA reiterates these points, encouraging issuers to:

- assess whether the reporting on GHG emissions can be considered complete in the **absence of disclosures** on **Scope 3 emissions** and particularly, for financial institutions, in the absence of disclosures on **financed emissions**. If an issuer concludes that its Scope 3 emissions are not material, ESMA recommends that it should state this and explain the significant judgements underpinning this conclusion;
- be transparent on the **boundaries of the Scope 3 emissions calculation** if these emissions are material, including on the reasons for excluding certain categories (where relevant) and the quantitative impact of this;
- use appropriate labelling for Scope 3 emissions **calculated on a partial basis**, to clearly signal the partial nature of the calculation;
- be transparent on **categories of Scope 3 emissions** presented in accordance with the reporting methodology[8] applied. In such cases, issuers should specify: (i) whether Scope 3 emissions were determined based on estimates; (ii) the amounts of emissions covered by these estimates; and (iii) the methodology used, including the most significant inputs and assumptions;
- disclose gross amounts of GHG emissions **separately** from the effects of the use of carbon credits or any other measures (such as offsetting or storage), in accordance with the reporting methodology applied by the issuer;
- present **comparative information**, accompanied by explanations of the factors driving changes in emissions compared to previous periods;

provide further details of **additional breakdowns** of Scope 3 emissions by categories, main business lines or geographical areas.

[8] I.e. the GHG Protocol or any other permitted methodology.

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[1] Where permitted under applicable country laws

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