Beyond the GAAP

Forvis Mazars' monthly newsletter on financial and sustainability reporting

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The drafting of the present issue was completed on 3 July 2024.

Editorial

At the end of May 2024, the IASB published amendments to IFRS 9 and IFRS 7 on the classification and measurement of financial instruments, which are mandatory for financial periods commencing on or after 1 January 2026. In this issue, we look in detail at the content of these amendments, which introduce some changes and clarifications relating to financial liabilities settled using an electronic payment system, financial assets with contingent payment features, financial assets with non-recourse features, and contractually linked financial assets. They also require additional disclosures to be presented in the notes.

As regards sustainability reporting in Europe, the month's big news was the publication by EFRAG and TNFD of a correspondence table mapping their respective reporting frameworks. It shows the high level of commonality achieved between the ESRS environmental standards beyond climate change and the TNFD recommendations. At the international level, the ISSB has finalised its work plan for 2024-2026 and has decided that, in addition to supporting implementation of IFRS S1 and IFRS S2, it will work on two research projects, one on biodiversity, ecosystems and ecosystem services, and the other one on human capital.

IFRS Highlights

New appointments to IFRS Interpretations Committee

On 11 June 2024, the IFRS Foundation announced the appointment of three new members to the IFRS Interpretations Committee (IFRS IC).

Mark Mahar (Partner at EY in the United States), Natsumu Tsujino (investor and Senior Fellow at Sompo Holdings in Japan) and Leon Yongbum Kim (Head of Finance Office for KT&G Corporation, a company listed on the Republic of Korea stock exchange) will succeed Guy Jones, Goro Kumagai and Jon Nelson respectively, from 1 July 2024.

New research projects to be undertaken by the ISSB

Following the public consultation launched by the International Sustainability Standards Board (ISSB) in May 2023 to decide the content of its work plan for 2024-2026 (see Beyond the GAAP no. 177, 2023), it published a feedback statement on 24 June 2024.

The ISSB's priority over the next two years is to support consistent and high-quality implementation of the standards IFRS S1 – *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 – *Climate-related Disclosures*, published in June 2023. However, it has also announced that it will commence two new research projects:

- biodiversity, ecosystems and ecosystem services, building on the standards issued by the Sustainability Accounting Standards Board (SASB), the Climate Disclosure Standards Board (CDSB) and the Taskforce on Nature-related Financial Disclosures (TNFD); and
- human capital, including consideration of employees and workers in the value chain.

It is not yet clear whether, and when, these projects will lead to the development of new reporting standards. Other projects considered by the ISSB, but which are not being advanced at this time, include human rights and further integration in reporting.

ISSB seeks greater harmonisation of sustainability disclosure standards

The ISSB has set out plans to further harmonise the landscape for sustainability reporting as part of its new two-year plan. These plans include enhanced strategic relationships with other standard setting bodies with the intention to:

- streamline standards for transition plan disclosures, with the ISSB taking responsibility for supporting materials for disclosure-related aspects of the Transition Plan Taskforce's work (the Transition Plan Taskforce was announced at COP26 in Glasgow and launched in April 2022 to establish a standard for transition plans to support the UK government's pledge to achieve net zero by 2050) and ensuring alignment with IFRS S2;
- enable closer alignment between IFRS S2 and the GHG Protocol. A Memorandum of Understanding has been signed to put in place governance arrangements enabling the ISSB to be actively engaged in updates and decisions made in relation to the GHG Protocol standards and guidance;
- ensure alignment of IFRS S2 and disclosures made using the Climate Disclosure Project's platform;
- collaborate more closely with the Global Reporting Initiative (GRI), seeking "to create a seamless global sustainability reporting system for companies looking to meet the information needs of both investors and a broader range of stakeholders" by ensuring full interoperability of the standards to enable reporting on impacts, risks and opportunities. In a pilot exercise, the two standard setting boards will focus on identifying and aligning disclosures in GRI 101 Biodiversity Standards and the ISSB's upcoming project on Biodiversity and ecosystems; and
- incorporate the recommendations of the TNFD in its new project on biodiversity, ecosystems and ecosystem services.

Jurisdictional guide to adoption of ISSB Standards

The IFRS Foundation has published the final version of its Jurisdictional Guide for the adoption or other use of ISSB Standards(see Beyond the GAAP no. 185, 2024). The guide is intended to assist jurisdictions in planning the adoption of the ISSB Standards.

Alongside the jurisdictional guide, the IFRS Foundation also published a Regulatory Implementation Programme Outline which provides more detailed support for regulators and other authorities in implementation of the standards.

Updates on jurisdictional adoption of sustainability reporting

The latest developments in adoption of the IFRS Sustainability Disclosure Standards around the world include:

- Australia – in a welcome development, it appears that the Australian Accounting Standards Board (AASB) may be moving to closer alignment with the IFRS Sustainability Disclosure Standards global baseline standards. In its original proposals, the AASB limited the scope of disclosure to climate-related matters only, replacing references to 'sustainability' in IFRS S1 with "climate" in its own standards. The AASB is due to finalise the standards by the end of August 2024, and is considering a voluntary standard aligned with IFRS S1 and a mandatory climate-related standard aligned with IFRS S2; and
- China – comments on proposed 'basic' Standards for Corporate Sustainability Disclosure, issued by the Ministry of Finance of the People's Republic of China, were due to be submitted by 24 June 2024.

Strengthening sustainability reporting in emerging markets

The IFRS Foundation and the International Finance Corporation (IFC), a member of the World Bank Group, have announced a strategic partnership to improve sustainability reporting in emerging markets and developing economies.

The focus will be on building capacity and promoting consistent application of the IFRS Sustainability Disclosure Standards in emerging markets through publications, tools and training as well as technical support for jurisdictions adopting the standards.

European Highlights

EFRAG and TNFD publish correspondence mapping

On 20 June 2024, EFRAG and the Taskforce on Nature-related Financial Disclosures (TNFD) jointly published a mapping of the correspondence between the ESRS standards and TNFD recommendations (see press release available here). It shows the high level of commonality achieved between the two reporting frameworks.

EFRAG and TNFD have been working together since 2022 to ensure consistency between the two frameworks. Readers will remember that the ESRS standards were adopted by the European Commission at the end of July 2023 and the TNFD recommendations were published in September 2023 (see Beyond the GAAP no. 180, 2023). EFRAG and TNFD then signed a cooperation agreement in December 2023 to support companies and financial institutions with disclosure and management of nature-related issues, including those related to biodiversity and ecosystems (see Beyond the GAAP no. 183, 2023).

The correspondence mapping is intended to help companies that are required to publish a sustainability statement in accordance with ESRS and that also wish to apply the TNFD recommendations to identify the commonalities between the two reporting frameworks, as well as the remaining differences.

The comparative analysis carried out by EFRAG and TNFD highlights the following key points:

- concepts and definitions: the two reporting frameworks both recommend to disclose nature-related impacts, risks and opportunities, as well as dependencies on nature to the extent that they generate material risks for the company. In practice, ESRS and the TNFD recommendations both cover the four nature realms, namely land, ocean, freshwater and atmosphere. The two frameworks use the terms ’biodiversity’ and ’ecosystems’ based on the United Nations Convention on Biological Diversity definitions;
- approach to materiality: ESRS require a double materiality assessment as the basis for sustainability disclosures, while the TNFD recommendations permit use of this approach;
- the LEAP approach (Locate, Evaluate, Assess, Prepare): this approach was developed by TNFD to help preparers identify, evaluate, manage and disclose their nature-related issues. Under ESRS, companies may use this approach to carry out their materiality assessment for environmental topics other than climate change;
- reporting pillars: TNFD and ESRS are structured into four pillars based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), namely:
    - governance;
    - strategy;
    - risk management (technically, risk and impact management for TNFD, and impact, risk and opportunity management under ESRS); and
    - metrics and targets; and
- disclosures: the 14 TNFD recommended disclosures are all covered by ESRS, though there are some differences in the details.

For each of the TNFD’s recommended disclosures, the correspondence mapping identifies the corresponding ESRS disclosure requirements, highlighting differences in semantics, scope or level of granularity (e.g. the breakdown of data). The mapping also shows the additional disclosures that a company may include in its sustainability statement in order to fully comply with the TNFD recommendations.

Lastly, the document also makes the link with the IFRS Sustainability Disclosure Standards. For example, the IFRS Sustainability Disclosure Standards also use the TCFD’s four-pillar reporting structure. The LEAP approach is also consistent with the financial materiality approach used under the IFRS Sustainability Disclosure Standards.

EFRAG publishes initial paper on connectivity considerations and boundaries of different annual report sections

In June 2024, as part of its research project on connectivity, EFRAG published an initial paper on *Connectivity Considerations and Boundaries of Different Annual Report Sections*. The document is a review of the literature and the outcome of discussions held by EFRAG’s Connectivity Advisory

Panel and its financial and sustainability governance bodies.

In Part 1, it discusses connectivity, which is mentioned in ESRS but not defined. The various aspects of connectivity (consistency, complementarity, coherence, concision, etc.) can be used to help structure the various annual report sections to provide better information, without duplication, and to reduce the expectation gap between published disclosures and stakeholders' requirements.

Part 2 of the document shows that connectivity also depends on an understanding of the boundaries between the three main parts of the annual report, i.e. the financial statements, the sustainability section of the management report (in future, the sustainability statement) and the other components of the management report. Connectivity involves ensuring the consistency and coherence of the information presented in these different parts (in line with their objectives and their audience) or explaining why their different lenses may lead to apparent differences.

The document focuses particularly on connectivity between sustainability reporting (required under ESRS or IFRS S1) and the financial statements. Some connections may arise from disclosures that are required under both frameworks. Others may arise over time: a sustainability issue may 'migrate' to the financial statements once it begins to have concrete financial effects. This relationship means that the information presented in the sustainability statement is all the more useful thanks to its predictive and complementary function. Conversely, some sustainability information should not be reflected in the financial statements so as to avoid needless repetition, or because it is immaterial, too uncertain or forward-looking and does not meet the thresholds for financial reporting, or could even incur legal risk. This means that the location of information within the annual report is key. The document sets out some proposed recommendations on the location and connectivity of information.

The full paper and a summary are available on EFRAG's website.

This initial paper will be followed by a discussion paper to be published for public consultation in the second half of 2024.

Amendments to IFRS 9 and IFRS 7: what are the changes to the classification and measurement of financial instruments?

On 30 May 2024, the IASB published amendments to IFRS 9 and IFRS 7 on the classification and measurement of financial instruments. In this special feature, we present the content of the new amendments.

On 30 May 2024, the IASB published amendments to IFRS 9 – *Financial Instruments* and IFRS 7 – *Financial Instruments: Disclosures* on the classification and measurement of financial instruments. This follows the IASB's analysis of the feedback received in response to the exposure draft published in March 2023 (see Beyond the GAAP no. 176, 2023) and several months of re-deliberations (see Beyond the GAAP no. 182, 2023, and Beyond the GAAP no. 184, 2024). The amendments introduce changes and clarifications on financial liabilities settled using an electronic payment system, financial assets with contingent payment features, financial assets with non-recourse features, and contractually linked financial assets. They require additional disclosures to be presented in the notes.

Derecognition of financial liabilities settled using an electronic payment system (IFRS 9.B3.1.2A and B3.3.8 to B3.3.10)

Paragraph B3.1.2A of IFRS 9 reiterates the general rules for recognition and derecognition of financial assets and liabilities. For financial liabilities, it states that they shall be derecognised on the settlement date. This is the date on which the liability is extinguished, i.e. it is discharged or cancelled or it expires. However, for financial liabilities settled using an electronic payment system, the amendments introduce a choice of accounting policy, allowing liabilities to be derecognised before the settlement date.

This must be applied consistently to all payments settled using the same electronic payment system. The option is available if the following three conditions are all met (IFRS 9.B3.3.8):

- the entity does not have the practical ability to withdraw or cancel the payment instruction;
- the entity no longer has the practical ability to access the cash to be used for settlement; and
- the risk that the payment will not be settled is insignificant, which means that:
  - completion of the payment instruction follows a standard administrative process;
  - there is only a short time period between the moment when the first two conditions are met and the moment when the counterparty actually receives the cash; and
  - conversely, the amendments specify that the risk of non-payment would not be insignificant if completion of the payment instruction were subject to the entity's ability to deliver cash on the settlement date, e.g. in the event of default by the entity.

Financial assets with contingent payment features (IFRS 9. B4.1.8A, B4.1.10-B4.1.10A & B4.1.13-B4.1.14)

The amendments introduce two clarifications to the SPPI test for financial assets with contingent payment features that are not directly correlated to credit risk, such as achieving an ESG performance target.

Clarification on the concept of a 'basic lending arrangement'

The first clarification relates to the principles underlying the concept of a 'basic lending arrangement', which apply to all the different elements of interest received by the lender (IFRS 9.B4.1.8A).

The assessment of each element focuses on the qualitative nature of the risks or costs that the lender is being compensated for. In order to pass the SPPI test, the contractual cash flows of the instrument must be directly correlated with a variable that represents the risks or costs of a basic lending arrangement. An instrument would not pass the test if it were indexed to the price of a share, commodity, carbon index or the entity's own economic performance, even if such contractual terms are common in the market in which the entity operates.

Secondly, the amount of adjustments to the remuneration component of the loan must also be considered: if the adjustments make a significant difference to contractual cash flows, the instrument may not pass the SPPI test.

Clarification on how these principles are applied

The second clarification relates to how these principles are applied. Thus, paragraph B4.1.10A of IFRS 9 states that if the nature of a contingent event does not relate directly to changes in the risks and costs of a basic lending arrangement (e.g. the debtor achieves a reduction in carbon emissions), the instrument may still pass the SPPI test provided that:

- the contractual cash flows, considered in isolation before and after the occurrence of the contingent event, and irrespective of the probability of it occurring (IFRS 9.B4.1.10), are solely payments of principal and interest; and
- the contractual cash flows resulting from a contingent event are not significantly different from the contractual cash flows on a similar financial instrument without such a contingent feature (this may be assessed qualitatively or, failing that, quantitatively).

Two illustrative examples are provided to show how this approach would work for loans indexed to ESG performance criteria that would (IFRS 9.B4.1.13) or would not (IFRS 9.B4.1.14) pass the SPPI test.

Financial assets with non-recourse features (IFRS 9.B4.1.16A-B4.1.17)

A financial asset has non-recourse features if the lender's or investor's rights are limited to the cash flows generated by specified underlying assets – regardless of whether these are explicitly designated or held in an ad hoc vehicle or SPV or not – rather than having the right to the totality of the debtor's assets. In other words, the lender is exposed to the assets' performance risk rather than the lender's credit risk (IFRS 9.B4.1.16A).

The amendment specifies that to carry out the SPPI test for a financial asset with non-recourse features, an entity must:

- assess ('look through to') the link between the underlying assets or cash flows and the contractual cash flows of the financial asset; and
- consider other contractual arrangements, such as any credit enhancements arising from equity instruments (e.g. subordinated debt) issued by the debtor (IFRS 9.B4.1.17).

Contractually linked financial assets (IFRS 9, B4.1.20-B4.1.23)

Contractually linked instruments (CLIs) are issued by an SPV and backed by underlying financial assets held by that vehicle.

For the purposes of assessing whether they pass the SPPI test, the amendment states that these instruments meet the definition of financial assets with non-recourse features, and have additional specific characteristics. It specifies that the requirements on CLIs set out in IFRS 9.B4.1.21 to B4.1.26 apply when the following conditions are met:

- payments to investors are prioritised through a waterfall payment structure; and
- the prioritisation of payments results in a disproportionate reduction of the contractual rights of some investors in the event that insufficient cash flows are generated by the underlying financial assets.

However, some transactions in which an SPV issues several tranches of debt instruments, which at first glance appear to meet these conditions, must be subject to a more in-depth analysis. In fact, if the SPV issues junior debt instruments, and these instruments – which cannot in practice be sold to a third party – are held by the entity that sold the receivables to the SPV (the sponsor), the rules on CLIs shall not be applied to these instruments. Indeed, in this case, the SPV has issued only one tranche of instruments that can be sold to third parties, namely the senior debt instruments. The junior debt instruments are there to provide enhanced credit protection. The holders of the senior debt instruments must apply the rules on debt assets without recourse features to determine whether or not their assets pass the SPPI test (IFRS 9.B4.1.20A).

Lastly, when applying the 'look through' assessment to CLIs, the amendments expand the scope of eligibility to certain financial assets that are partially outside the scope of IFRS 9, such as lease receivables, provided that their cash flows are 'equivalent' to solely payments of principal and interest (IFRS 9.B4.1.23). The equivalence condition is not met if the lease receivables are subject to residual value risk or are indexed to a rental yield index.

Disclosures in the notes (IFRS 7.11A-11B & 20B-20D)

The amendments to IFRS 7 introduce additional required disclosures:

- for equity instruments measured at fair value through equity (with no recycling to profit or loss):
    - changes in fair value over the reporting period, distinguishing between those relating to instruments derecognised over the period and those relating to instruments still held at the closing date (IFRS 7.11A); and
    - any transfers of the cumulative gain or loss within equity related to the investments derecognised during that reporting period (IFRS 7.11B).

Application guidance has been added to paragraph IG 11A of IFRS 7 to illustrate the new requirements.

- for financial instruments with contingent payment features that are not directly correlated to credit risk, detailed disclosures must be presented for each class of financial assets, including (IFRS 7.20C):
    - a description of the contractual terms that could change future cash flows;
    - quantitative information on the range of possible changes to future cash flows; and
    - the gross carrying amount of financial assets and the amortised cost of financial liabilities that include such features.

This information shall be presented separately for each class of financial assets measured at amortised cost or fair value through OCI, and for each class of financial liabilities measured at amortised cost.

First-time application of the amendments (IFRS 9.7.1.12-13 and 7.2.47-49)

The amendments are mandatory for reporting periods beginning on or after 1 January 2026. Entities may elect to apply the amendments early, either in full or only the part relating to the classification of financial assets (plus the related disclosures). As regards financial assets specifically, the entity must present the measurement category and carrying amount of the financial assets before and after applying the amendments.

The amendments shall be applied retrospectively, and entities are permitted to restate prior periods only if it is possible to do so without the use of hindsight.

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