Beyond the GAAP

Forvis Mazars' monthly newsletter on financial and sustainability reporting

Contents

The drafting of the present issue was completed on 6 November 2024.

Editorial

With a few weeks to go until the 2024 year-end, the European market regulator, ESMA, has published its recommendations for 2024 reporting. These cover both IFRS Accounting Standards financial reporting and the first ESRS sustainability statements. This issue includes special features on both sets of recommendations.

Also in this issue, we look in more detail at the exposure draft on the equity method, published by the IASB in September 2024. The aim of the exposure draft is to clarify specific aspects of accounting treatment, rather than to carry out a fundamental review of the principles of the equity method. It also proposes amendments to certain controversial aspects of IAS 28 – *Investments in Associates and Joint Ventures*.

IFRS Highlights

IASB concluded redeliberations on the proposed amendments to IFRS 9 and IFRS 7 on contracts for renewable electricity (PPAs and VPPAs)

In October 2024, the International Accounting Standards Board (IASB) concluded the redeliberations initiated in September 2024 (see Beyond the GAAP no. 191, 2024) on the feedback received on its proposed amendments to IFRS 9 – *Financial Instruments* and IFRS 7 – *Financial Instruments: Disclosures* on contracts for renewable electricity (see Beyond the GAAP no. 188, 2024) – which renamed 'Contracts Referencing Nature-dependent Electricity' in the last staff papers.

The October discussions focused on:

- hedge accounting;
- disclosures in the notes; and
- the transition requirements for the amendments.

Hedge accounting

The IASB tentatively decided:

- to clarify to which particular requirements in the section on 'Hedged items' (IFRS 9.6.3) the proposed amendments relate;
- to specify that an entity is permitted to designate as the hedged item a variable amount of expected purchases or sales that is equal to the amount of nature-dependent electricity produced by the facility referenced in the hedging instrument;
- to specify that the 'highly probable' assessment is not relevant if the cash flows of the hedging instrument are conditional on the occurrence of the hedged transaction (the IASB decided not to issue any additional guidance on the definition of 'highly probable', and the staff noted that the guidance on IAS 39 – *Financial Instruments: Recognition and Measurement* remained relevant, even though the examples were not carried forward to IFRS 9); and
- to add qualitative examples to illustrate application of the amendments.

General disclosures

The IASB tentatively decided:

- to limit the scope of the amendments to own-use PPAs and to VPPAs that are designated in a hedging relationship in accordance with the amendments;
- for own-use PPAs, to require entities to specify the terms and conditions that expose the entity to the risk of intermittency (contractual variability depending on the amount of electricity produced by the nature-dependent source) and volume risk (the risk of oversupply of electricity);

for VPPAs documented in hedging relationships, to require entities to present separately the disclosures required by paragraph 23A of IFRS 7, i.e. the terms and conditions of the contracts and how they affect the future cash flows of the entity;

- for own-use PPAs, to require entities to present:
  - the expected cash flows from buying electricity, aggregated into appropriate time bands; and
  - qualitative disclosures on the entity's management of the risk that a contract will become onerous, including the methods and assumptions used;
- for own-use PPAs, to require entities to present qualitative and quantitative information on how the entity determines whether it remains a net purchaser for the reporting period, specifically information about cash flows arising from:
  - total electricity purchases;
  - the unused portion of these purchases;
  - sales of unused electricity; and
  - subsequent purchases of electricity that offset sales of unused electricity;
- to amend paragraph 5 of IFRS 7 to include PPA contracts that are classified as own-use under the new amendments; and
- to require cross-references between notes to the financial statements if information about contracts within the scope of the proposed amendments is presented in several places in the notes.

Transition requirements

The IASB tentatively decided:

- to set the effective date of the amendments at 1 January 2026, with early application permitted;
- for the own-use amendments:
  - to confirm that the requirements should be applied retrospectively, without restatement of comparative information;
  - to require the assessment to be carried out based on the facts and circumstances at the date of initial application of the amendments (not the date when the contract was signed); and
  - to permit an entity to designate own-use contracts at fair value through profit or loss at the date of initial application (in accordance with paragraph 2.5 of IFRS 9); and
- for the hedge accounting amendments:
  - to confirm that the requirements should be applied prospectively; and
  - to permit an entity to discontinue an existing hedging relationship and designate a new hedging relationship applying the amendments.

The IASB plans to publish the final amendments by end-2024. They are not likely to be adopted by the European Union until 2025.

IASB seeks input from stakeholders on intangible assets project

At the end of October 2024, the IASB issued a call for investors and other stakeholders to help shape its project on intangible assets (see here).

The project was launched in 2024 in response to the IASB's third consultation on its work plan, which identified reporting on intangible assets, whether or not they are recognised in the balance sheet, as a high priority – particularly in light of new business models.

The request for input takes the form of two surveys, one targeted specifically at investors, the other aimed at companies and other stakeholders. The responses will help the IASB to identify:

- the problem that it needs to solve;
- the scope of the project; and
- how best to structure the project in order to deliver improvements in a timely fashion.

The surveys were open until 30 November 2024, and the IASB will discuss the feedback in early 2025.

Eleventh compilation of IFRS IC agenda decisions published

The eleventh compilation of agenda decisions taken by the IFRS Interpretations Committee (IFRS IC) between May 2024 and October 2024 was published in late October 2024 and is available **here**.

This "compilation" actually only contains a single agenda decision, which was published in the June 2024 edition of IFRIC Update and relates to the disclosure of revenues and expenses for reportable segments in accordance with IFRS 8 – *Operating Segments.*

New members appointed to ASAF

In late October 2024, the Trustees of the IFRS Foundation announced the new composition of the Accounting Standards Advisory Forum (ASAF) for the three years commencing on 1 January 2025. The new composition of ASAF, broken down into four major geographical areas (Africa, Americas, Asia-Oceania and Europe) can be found here.

ASAF is a technical advisory body to the IASB that brings together various national accounting standards boards. It is chaired by the Chair or Vice-Chair of the IASB.

Updates to the SASB Standards XBRL Taxonomy

The ISSB (International Sustainability Standards Board) has issued an updated version of the SASB (Sustainability Accounting Standards Board) Standards digital Taxonomy, reflecting changes to disclosure requirements from recent amendments to the SASB Standards, including:

- consequential amendments issued in June 2023 reflecting requirements of IFRS S2 *Climate-related Disclosures,* and
- amendments arising from the ISSB's International Applicability of the SASB Standards project issued in December 2023.

The final XBRL files and supporting materials are available here.

Updates on jurisdictional adoption of sustainability reporting

The latest developments in adoption of the IFRS *Sustainability Disclosure Standards* (SDS) around the world include:

- Mexico - The Comisión Nacional Bancaria y de Valores (CNBV) issued a Regulatory Proposal—Resolution Amending The General Provisions Applicable to Securities Issuers and Other Securities Market Participants. The proposal requires issuers (not financial entities or states and municipalities) to present financial sustainability information, prepared in accordance with IFRS S1 and IFRS S2. These disclosures are in addition to any sustainability disclosure requirements in the country of origin for foreign companies.
- A reminder that the latest on jurisdictional sustainability consultations is available on the IFRS Foundation website.

ISSB update – September 2024 meeting

At its monthly meeting (October meeting update) the ISSB discussed feedback from the survey on jurisdictional requirements related to the two topical research projects (Biodiversity, ecosystems, and ecosystem services and Human capital), and how the feedback will inform its ongoing research into these topics, including engagement with jurisdictional stakeholders. No decisions were required.

The ISSB also discussed a paper on connectivity considerations relating to the IASB's Management Commentary project and the location of IFRS SDS disclosures. The paper recommended that the ISSB consider amending IFRS S1 to require an entity that publishes the revised IFRS Practice Statement 1 *Management Commentary* (whether voluntarily or when required to do so) to include the information required by ISSB Standards in management commentary, unless local law or regulation prohibits this. No decisions were made and discussions on connectivity will continue.

European Highlights

ESMA publishes guidance on accounting for carbon allowances

In early October 2024, the European Securities and Markets Authority (ESMA) published guidance on accounting for carbon allowances, entitled Clearing the Smog: Accounting for Carbon Allowances in Financial Statements.

With this publication, ESMA is hoping to raise issuers' awareness of a topic which has become more significant for corporate reporting in recent years, and which is likely to attract more attention as the targets set out in the 2015 Paris Agreement draw nearer.

More specifically, the guidance:

- takes stock of the different accounting approaches currently used in the financial statements of listed European issuers;

- encourages issuers to consider which accounting standards could be used to account for carbon allowances; and
- provides recommendations on disclosures in the notes to the financial statements.

While ESMA does not specify a specific accounting method to be used for carbon allowances, it reinforces its previous recommendations, aiming to improve transparency and usefulness of information for decision-making by users of financial statements.

ESMA also emphasises connectivity of information and calls for consistency between the assumptions used in estimations and measurements related to climate issues and the information provided in the different sections of the annual financial report. ESMA emphasises that issuers must make careful and consistent links between the information that is provided on carbon allowances in the financial statements and the disclosures required under European Sustainability Reporting Standards (ESRS).

ESMA publishes report on first-time application of IFRS 17

In a report published in late October 2024, ESMA presents the findings of its analysis on a sample of 16 insurance companies at 31 December 2023.

The report looks at the impact of first-time application of IFRS 17 – *Insurance Contracts* (and IFRS 9 – *Financial Instruments*) on the financial statements and management reports published by companies in the sample. In particular, ESMA provides recommendations regarding disclosures on accounting policies, judgements and estimates. As many companies have introduced new performance measures as a result of the first-time application of IFRS 17, ESMA underlines the importance of complying with its guidelines on APMs (Alternative Performance Measures).

ESMA's recommendations for corporate reporting (see this issue's special feature) refer to this report.

Update on EFRAG's work on ESRS

First exposure drafts of future sector-specific standards

EFRAG's Sustainability Reporting Board (SRB) recently approved three exposure drafts (i.e. draft standards for public consultation) relating to the first sector-specific standards:

- the exposure draft of SEC 1, on sector classification. After various changes and discussions, the exposure draft was partially approved by the SRB in June 2024, with the exception of the bioenergy and financial institutions sectors. As of 18 September 2024, it has now been approved in its entirety. In practice, SEC 1 classifies economic activities into 35 sectors, based on the NACE codes (*Statistical classification of economic activities in the European Community*). Undertakings must classify their significant activities into ESRS sectors as set out in SEC 1, and refer to the appropriate sector-specific standard(s) when preparing their sustainability reporting. To identify the appropriate sector-specific standard(s), undertakings must use both the NACE codes and the sector description provided in each sector-specific standard;
- the exposure drafts for the oil and gas industry and for the mining, quarrying and coal industry were approved on 18 September 2024 and 16 October 2024 respectively. Aside from the implications for undertakings in those sectors, these two exposure drafts are particularly significant in that they are effectively pilot projects for EFRAG's future work on developing the other sector-specific standards.

In practice, EFRAG is waiting for the green light from the new European Commission (which has not yet been formally approved by the European Parliament) to launch the public consultation on this first batch of sector-specific exposure drafts. The public consultation will last four months and is not expected to start before early 2025.

EFRAG must now continue with its work to develop sector-specific exposure drafts for the other sectors that were identified as priorities by the European Commission when it decided to defer first-time adoption of the sector-specific standards by two years (i.e. until 30 June 2026).

Readers will remember that there are six more high-impact sectors to come, with the next in order of priority being the road transport and the textiles, accessories, footwear and jewellery sectors. Work is also progressing, with the support of dedicated advisory bodies, on three exposure drafts relating to the financial sector, which are also high priority.

First steps on standards for non-EU groups

Readers will remember that non-EU groups affected by article 40a of the Accounting Directive as amended by the Corporate Sustainability Reporting Directive (CSRD) must publish a sustainability report in accordance with specific standards from 2028. EFRAG has to deliver technical advice on the subject to the European Commission in November 2025 (with adoption of the standards scheduled for June 2026).

EFRAG's public meetings on the future standards have just started. The exposure drafts are expected to be published in early 2025. At this point, the EFRAG secretariat has shared the broad outlines of what the future standards might look like, in accordance with articles 40a and 29a of the Accounting Directive.

The new standards will broadly mirror set 1 of ESRS (i.e. the 12 sector-agnostic standards for EU companies). However, in accordance with articles 40a and 29a, the non-EU standards will differ in two significant ways:

- firstly, the concept of double materiality will be replaced by impact materiality only. As a result, most of the references to financial disclosures (on material risks and opportunities, resilience, etc.) will likely be removed, particularly the disclosures on CapEx and OpEx relating to climate change (to be confirmed); and
- secondly, the approach taken to extra-territoriality means that affected non-EU companies may elect not to publish disclosures relating to activities (goods/services) that are not related or only indirectly related to the European Union, for all the standards other than climate (to be confirmed). The exact definition to be used for these non-European activities has yet to be determined. However, for the cross-cutting standards ESRS 1 and ESRS 2, the scope is expected to include activities that extend beyond the European Union.

EFRAG's deliberations over the coming weeks will provide more detail on the likely content of the exposure drafts.

Other ongoing work

As the first wave of companies affected by the CSRD are preparing their first sustainability statement for publication in 2025, the draft implementation guidance on transition plans (IG 4) is due imminently. The document, which will be open for public consultation for one month, will help stakeholders to understand the expectations of ESRS E1 regarding transition plans. In particular, EFRAG must clarify one crucial question: does a transition plan as defined in ESRS mean that the undertaking itself must be aligned with the benchmark trajectory of the Paris Agreement, or is it sufficient for the undertaking to report on its targets for greenhouse gas emission reductions and compare itself with a benchmark trajectory set at the macro/sectoral level?

Many questions on the implementation of the first set of ESRS are still being submitted via the access point launched by EFRAG in October 2023. EFRAG will therefore continue to develop explanations in response to the questions submitted. A further Compilation of Explanations is expected by the end of 2024, following that published in July 2024. Many questions relating to errors, omissions or lack of clarity in IG 3 – which contains the list of datapoints in ESRS – have been collected and categorised. In response to these observations, the EFRAG secretariat has said that a revised version of IG 3 will be published in the near future. While awaiting this corrigendum, it is all the more important to consistently refer back to the standards to ensure that all the necessary material information is published in light of the results of the materiality assessment.

Finally, EFRAG is expected to submit its technical advice on the standard for listed SMEs to the European Commission by the end of this year. It is also in the process of finalising the voluntary standard for non-listed SMEs.

IASB publishes an exposure draft on the equity method (IAS 28)

The IASB has published an exposure draft on the equity method which aims at clarifying specific aspects of accounting treatment. It does not, therefore, represent a fundamental review of the principles of the equity method. The IASB is also proposing amendments to certain controversial aspects of IAS 28.

On 19 September 2024, the IASB published an exposure draft on the equity method, which proposes clarifications and amendments to certain requirements in the standard. The deadline for comments is 20 January 2025.

In addition to the amendments, the exposure draft proposes changes to the structure of IAS 28 – *Investments in Associates and Joint Ventures*, and therefore includes a table of concordance between the two versions of the standard.

An IFRS 3-inspired approach

One key clarification proposed by the IASB is that the cost of an investment should take account of the fair value of any previously held ownership interest. This is in line with the approach used in IFRS 3 – *Business Combinations* for step acquisitions.

The IASB is also proposing to measure contingent consideration at fair value on obtaining significant influence, again in line with IFRS 3. Price adjustments classified as equity instruments shall not be remeasured subsequently. Conversely, price adjustments classified as financial liabilities shall be remeasured at fair value through profit or loss.

The IASB is also proposing to clarify that the tax effects of any fair value adjustments should be taken into consideration when measuring the fair value of an associate's or joint venture's identifiable assets and liabilities. For example, if an associate's asset increases in value by 10,000, the tax rate is 40% and the investor owns a 25% interest in the associate, this would give rise to a fair value adjustment of 1,500 (the gross fair value adjustment of 2,500 minus tax effects of 1,000).

Furthermore, it can be deduced from Example 1 of the exposure draft that, in the event that significant influence or joint control is obtained following several acquisitions, the investor shall measure the fair value of the acquired identifiable assets and liabilities only at the point when it obtains significant influence.

As the example refers to both cost and fair value, the question remains open as to whether the acquisition costs related to the last acquisition should be included. Under the new definition of cost provided in Appendix A, it would seem to follow that these costs should be recognised as expenses (as under IFRS 3), which is not intuitive in the context of a cost-based approach.

Changes in ownership interest when the investor retains significant influence or joint control

Increase in ownership interest

In practice, if an investor's ownership interest increases when the investor retains significant influence or joint control:

- generally speaking, the value of the equity-accounted investment increases by the amount of the fair value of the consideration transferred;
- however, the investor must determine the fair value of the associate's or joint venture's identifiable assets and liabilities, so as to measure the portion of the consideration paid for the additional interest that corresponds to the share of net assets measured at the acquisition date of this additional interest;
- and thus calculate the goodwill (as the difference between the two). In other words, the portion of net assets already owned is not remeasured;

- in the event that the most recent transaction results in badwill, the value of the equity-accounted investment increases in line with the increase in the share of net assets held by the investor, while the difference between the fair value of the consideration transferred and the additional share of the fair value of the net assets transferred to the investor (i.e. the badwill) does not offset existing goodwill, but is instead recorded in profit or loss; and
- similarly, in the event that the investor has not been able to recognise the full amount of its share of losses, no adjustment is recorded when a subsequent acquisition is made (i.e. it does not make a 'catch up' adjustment at this point).

Decrease in ownership interest

In situations where an investor's ownership interest decreases, the carrying amount of the equity-accounted investment is reduced in proportion (therefore not allowing the use of cost formula like FIFO, LIFO or weighted average). As an example, if the carrying amount of the equity-accounted investment, representing 40% of the total, is 400, and the investor decides to sell 10%, it must deduct a quarter from the carrying amount, i.e. 100 in this example.

The IASB is proposing to clarify that a transaction of this type could also have an impact on profit or loss.

Increase or decrease in ownership interest resulting from transactions in which the investor is not involved

The IASB is proposing to apply the same logic to both transactions to which the investor is a party, and transactions carried out by the associate or joint venture that may increase or decrease the investor's ownership interest (such as the issue of shares to third parties by the associate or joint venture, or the repurchase of shares from other shareholders by the associate or joint venture).

In other words:

- if the associate or joint venture issues new shares to third parties, resulting in a decrease in the investor's ownership interest, the proceeds implicitly received by the investor are equal to its share of the issue price of the new shares by the associate or joint venture. This is illustrated in Example 2 of the exposure draft; and
- conversely, if the associate or joint venture repurchases shares from other shareholders, resulting in an increase in the investor's ownership interest, the price implicitly paid by the investor is calculated as its share in the repurchase price of the shares by the associate or joint venture.

However, the exposure draft does not address how an associate's or joint venture's IFRS 2 share-based payment arrangements impact the investor's accounts; nor does it address transactions carried out by the associate or joint venture with its own minority shareholders.

Allocation of losses

When the associate or joint venture's total comprehensive income is a loss that equals or exceeds its net investment in the associate or joint venture which brings the value of the equity-accounted investment to zero, and the associate or joint venture's other comprehensive income is negative, the IASB is proposing that the investor should first recognise its share of the result as a loss, and then (partially) recognise its share of other comprehensive income.

Thus, the IASB is proposing that the investor's share of the losses should be recognised first. This means that it need to recognise a share of losses when the carrying amount of its equity-accounted investment is already nil and its share of other comprehensive income is positive.

Thus, if the carrying amount of the investment is already nil, but the associate's or joint venture's profit or loss is negative while other comprehensive income is positive, the IASB is proposing that the investor should recognise both its (positive) share of other comprehensive income, and its share of losses, even if this does not change the carrying amount of the equity-accounted investment.

For example, if an investor has reduced its net investment to nil and its share of profit or loss is a loss of 250 and its share of other comprehensive income is a profit of 100, the investor recognises a loss of 100 in profit or loss and a profit of 100 in other comprehensive income.

Aside from these examples, the exposure draft does not set out a general principle that could be used in cases not addressed in the examples.

Similarly, the IASB has not addressed what happens if the associate or joint venture becomes profitable again. In other words, the exposure draft does not specify in what order the investor should recognise its share of profits made by the associate or joint venture and its (positive) share of other comprehensive income, in the event that the financial situation of the associate or joint venture improves.

An end to intercompany eliminations?

One of the IASB's most significant proposals is that it would no longer require adjustments for intercompany transactions – whether upstream or downstream – between the investor and the associate or joint venture. For example, under the current IAS 28, if an investor sells for 1000 an asset purchased for 800 to an associate in which it holds a 25% interest, it recognises a gain of only 150 (i.e. 75% of 200) and the other 50 is eliminated, as it is considered an unrealised gain in an intercompany transaction.

The IASB's proposal would also settle a very long-standing debate about the correct accounting treatment when an investor sells a subsidiary to an associate or joint venture.

The current requirements of IFRS 10 – *Consolidated Financial Statements* and IAS 28 are mutually contradictory. The IASB proposed amendments in 2014, but never set an effective date.

Other minor amendments

The minor amendments proposed by the IASB include the removal of the reference to a 'significant or prolonged' decline in fair value as an indicator of impairment. It will also clarify that a decline in the fair value of an equity-accounted investment to less than its carrying amount (not its cost, which some had interpreted as meaning its original acquisition cost) is an indicator of impairment.

The exposure draft also specifies that, as well as market prices, fair value may be observed from the price paid to purchase an additional interest (or received from a sale).

New disclosure requirements

As well as adding a new objective for disclosures in the notes, the IASB is proposing to require:

- disclosures on gains or losses on downstream transactions (only), as well as gains and losses resulting from changes in the investor's ownership interest in associates or joint ventures;
- various disclosures on contingent consideration arrangements:
    - firstly, for the period in which the investor obtains significant influence or joint control, or purchases an additional ownership interest: the amount recognised at the outset, a description of the arrangement and how the payment amount is calculated, and an estimate of the range of outcomes (or the reason why a range cannot be estimated); and
    - then, for future periods: any changes in the amounts recognised, any changes in the range of possible outcomes (undiscounted) and the reasons for those changes, and the valuation techniques and key model inputs used; and
- a reconciliation between the opening and closing carrying amounts of equity-accounted investments, presenting separately:
    - the investor's share of the profit or loss of the associate or joint venture;
    - its share of other comprehensive income;
    - distributions made by the associate or joint venture;
    - impairment losses; and
    - changes in ownership interest in the equity-accounted investment (including those in which an investor obtains or loses significant influence or joint control).

Initial application

No effective date has yet been set, but the provisions for initial application are as follows:

- the transition date is, generally speaking, the start of the comparative period presented. If the investor includes more than one comparative period in its financial statements, it may choose as its transition date either the start of the most recent comparative period (as in the general rule above) or the start of the first comparative period presented;

- gains or losses on upstream and downstream transactions that were partially eliminated prior to the transition date shall be recognised retrospectively, with a corresponding entry in equity;
- in the case of intercompany transactions carried out during the comparative period(s), the retrospective restatement will have an impact on profit or loss for the comparative period (and on the equity-accounted investment in the case of downstream transactions, or the assets acquired from the associate or joint venture in the case of upstream transactions);
- the investor should measure contingent consideration at fair value at the transition date, with a corresponding adjustment to the carrying amount of the equity-accounted investment;
- where relevant, if adjustments relating to the restatement of past intercompany transactions or to contingent consideration result in a carrying amount that is higher than the recoverable amount of the investment, the carrying amount shall be reduced to the recoverable amount, with a corresponding entry in equity; and
- other changes related to this exposure draft shall be applied prospectively.

ESMA publishes recommendations for 2024 financial reporting

ESMA has published its recommendations for 2024 financial reporting, aimed at companies preparing their financial statements under IFRS Accounting Standards, regardless of the sector in which they operate (industry, services, banking, insurance, etc.).

On 24 October 2024, ESMA published its European common enforcement priorities for 2024 corporate reporting.

Unsurprisingly, the regulator draws attention to the importance of connectivity between financial and non-financial information (published in the first sustainability statements under ESRS, where relevant). It also draws issuers' attention to IFRS 17 – *Insurance Contracts* (in light of the first financial statements published following its entry into force on 1 January 2023) and IFRS 18 – *Presentation and Disclosure in Financial Statements*, which was published last April 2024 (see Beyond the GAAP no. 187, 2024) and which is mandatory for financial periods commencing on or after 1 January 2027.

The regulator's specific recommendations for 2024 financial reporting focus on three specific areas: (i) liquidity risk; (ii) accounting policies, judgements and significant estimates; and (iii) ESEF reporting.

Our special feature provides a summary of ESMA's main recommendations for IFRS financial statements and ESEF reporting (for a summary of ESMA's recommendations for sustainability reporting, see the special feature in this issue).

New standards and regulations

Climate and connectivity

In line with the IFRS Interpretation Committee (IFRS IC)'s recent decision in April 2024 (see Beyond the GAAP no. 187, 2024), the regulator draws issuers' attention to the accounting consequences of commitments to reduce and/or offset future greenhouse gas emissions. Regardless of whether or not the entity recognises a provision, ESMA encourages it to provide information in its financial statements on its constructive or legal obligations, as well as on the assessment carried out to determine whether or not a provision should be recognised.

The regulator also emphasises that the IASB's current work on the exposure draft "Climate-related and Other Uncertainties in the Financial Statements" and the proposed illustrative examples may give a useful indication as to how climate-related matters could be taken into account in IFRS financial statements (see Beyond the GAAP no. 190, 2024).

Application of IFRS 17

Affected companies are encouraged to refer to the findings of ESMA's report on this topic (see European Highlights in this issue).

New standards

The regulator draws attention to the publication of IFRS 18 in April 2024. It encourages companies to anticipate the impact of IFRS 18 on alternative performance measures used in various documents other than the financial statements, and the work that will be required to update financial reporting systems and processes.

Recommendations for IFRS financial statements

Liquidity risk

Supplier finance arrangements

In the context of first-time application of the amendments to IAS 7 – *Statement of Cash Flows* and IFRS 7 – *Financial Instruments: Disclosures* on supplier finance arrangements (reverse factoring), which entered into force on 1 January 2024, the regulator reminds companies of the importance of identifying all material supplier finance arrangements and presenting all the required new disclosures in the notes.

It also emphasises the need for disclosures on the range of payment due dates, at an appropriate level of aggregation and including the judgements made when defining those ranges.

Finally, as this type of arrangement can provide the issuer with extended payment terms or the suppliers with early payment terms, ESMA underlines the importance of providing a description of how the entity manages the liquidity risk inherent in these liabilities, in accordance with IFRS 7 (paragraphs 39 and B11F).

Financing with covenants

ESMA reminds companies of the clarifications and the new disclosures required under the amendments to IAS 1 – *Presentation of Financial Statements* on non-current liabilities with covenants, as well as the disclosures already required under IFRS 7.18 and 19 in the event of default or renegotiations of loan agreements.

Although renegotiations or settlement of loans after the end of the reporting period do not affect whether the liabilities are classified as current or non-current at the closing date, the regulator nevertheless recommends that issuers should include disclosures on such events and their impact on the accounts, even if they meet the definition of a non-adjusting event under IAS 10 – *Events after the Reporting Period*.

Statement of cash flows

The regulator reminds issuers that cash flows should be presented on a gross basis in the statement of cash flows and recommends differentiating, in the notes, between changes in balance sheet line items that generate cash flows and changes that do not.

It also reminds entities that non-cash transactions cannot be presented in the statement of cash flows, and recommends that details of material non-cash investing and financing transactions should be disclosed elsewhere in the notes.

As regards accounting policies and methods, ESMA underlines the importance of transparency on the accounting policies and judgements made regarding the classification of cash flows into operating, investing and financing (e.g. interest, dividends, cash flows from leases, or supplier financing arrangements) and on components of cash and cash equivalents.

In addition, the regulator reminds issuers that bank borrowings and banking facility arrangements are generally considered to be financing activities, and only bank overdrafts that are repayable on demand and form an integral part of an entity's cash management are included as a component of cash and cash equivalents.

Accounting policies, judgements and significant estimates

Accounting policies and methods

ESMA notes that entities too often provide boilerplate descriptions of accounting policies and methods. Issuers should ensure that they provide entity-specific information. The regulator reminds entities that they should disclose the judgements made that have the most significant effect on the financial statements (IAS 1.125), the significant assumptions used in measuring and recognising assets and liabilities (IAS 1.122) and other sources of estimation uncertainties that have a significant risk of resulting in a material adjustment to the carrying amount over the next twelve months, particularly if they are affected by major current developments (macroeconomic, technological, social, geopolitical or climatic).

Control, joint control and significant influence

The regulator reminds issuers that having control or joint control does not always depend exclusively on the percentage of voting rights held. Other factors that are taken into account in the assessment constitute significant judgements and assumptions that must be disclosed in the financial statements in accordance with paragraphs 7 to 9 of IFRS 12 – *Disclosure of Interests in Other Entities*.

Revenue from contracts with customers

▪ Long-term contracts

The regulator notes that the current macroeconomic environment (fluctuating interest rates and inflation) can result in uncertainty as to the timing of revenue recognition from long-term contracts and the amount of costs associated with a contract. As a result, it encourages companies to ensure that forecasts used to estimate the progress made towards fulfilment of obligations and margins at completion are both reasonable and supportable. Finally, for onerous contracts, ESMA underlines the need to present disclosures on uncertainties about the amount and timing of outflows of economic benefits and (where relevant) the key assumptions made about future events.

▪ Principal versus agent considerations

The regulator reminds preparers of the importance of describing the key judgements made in determining whether the entity is acting as an agent or principal in the transaction, e.g. in the online shopping sector or provision of services such as software licences.

▪ Disclosures in the notes on the transaction price of performance obligations yet to be fulfilled (IFRS 15 “backlog”)

The regulator reminds issuers of the importance of these disclosures to enable users to assess risks relating to future revenue, and the need to provide disclosures on significant judgements used to produce this information.

ESMA recommends that these disclosures should be accompanied by a reconciliation between the opening and closing balances.

Finally, it reminds issuers that if they present a backlog outside the financial statements, in a different format from that required by IFRS 15 – *Revenue from Contracts with Customers*, they must include a reconciliation with the IFRS 15 disclosures.

ESEF reporting

The regulator has identified certain areas of common error following its examination of financial statements.

It also reminds issuers of the ESEF Reporting Manual, which was updated in July 2024 to reflect changes in some of the recommendations aimed at facilitating application of the ESEF Delegated Regulation.

ESMA's priorities for the first ESRS sustainability statements

The priorities published by ESMA in late October 2024 (see previous feature) also cover the forthcoming publication of the first sustainability statements in accordance with ESRS. The recommendations focus on the materiality assessment, the scope and structure of the sustainability statement, and lastly, the disclosures required under Article 8 of the Taxonomy Regulation.

With just a few weeks to go until the publication of the first sustainability statements in accordance with European Sustainability Reporting Standards (ESRS), ESMA has paid particular attention to this area in its priorities for 2024 (see Section 2 of the document, available here). The priority areas identified complement the public statement on first-time application of ESRS, published by the European financial markets supervisor at the start of July 2024 (see Beyond the GAAP no. 190, 2024).

ESMA's priorities for the sustainability statements focus on three areas: the materiality assessment in ESRS reporting, the scope and structure of the sustainability statement, and lastly, the disclosures required under Article 8 of the Taxonomy Regulation.

In this feature, Beyond the GAAP presents a summary of the key points of the regulator's priorities.

Priority 1: considerations relating to the materiality assessment

The materiality assessment is the cornerstone of ESRS reporting; in light of this, ESMA reminds issuers of some of the key principles that must be adhered to, namely:

- the need for transparency on the process used to identify and assess material impacts, risks and opportunities (IROs);
- the importance of the due diligence process and engagement with affected stakeholders; and
- disclosures required on the outcome of the materiality assessment and implementation of the principle of materiality of information.

ESMA also reiterates its recommendation, already included in the July 2024 public statement, that issuers should consult EFRAG's implementation guidance on the materiality assessment (IG 1) when implementing the principles of ESRS 1 – *General Requirements*.

Description of the processes used to identify material IROs

In accordance with ESRS 2 – *General Disclosures,* ESMA reminds issuers that it is essential to provide detailed disclosures on the various steps of this process, in accordance with Disclosure Requirement IRO-1 – *Description of the processes to identify and assess material impacts, risks and opportunities.* On this point, ESMA emphasises the need to disaggregate in the disclosures the processes followed for material impacts on the one hand (paragraph 53 (b)) and material risks and opportunities on the other (paragraph 53 (c)).

Due diligence process and engagement with affected stakeholders

ESMA reminds companies that have a due diligence process of the importance of using this as a basis for their assessment of impact materiality.

As well as ensuring the consistency of this assessment, ESMA reminds issuers that it is also important to take account of the views of key affected stakeholders, where relevant (see FAQ 16 of IG 1). Here, it is essential for the company to provide full transparency on the process used to identify and prioritise the stakeholders with which it engages, in accordance with Disclosure Requirements SBM-2 and IRO-1 of ESRS 2.

In addition to these inputs, ESMA notes that where possible, quantitative data should be used to determine which IROs are material (such as publicly available industry information or global reports, see FAQ 10 of IG 1).

Materiality regime for ESRS disclosures

In accordance with ESRS 1, section 3.2, ESMA reminds issuers that all Disclosure Requirements and datapoints specified by ESRS 2 are mandatory, regardless of the outcome of the materiality assessment. This also applies to Disclosure Requirement IRO-1 in topical standards, which complement ESRS 2.

What other disclosures are required in the sustainability statement depends on the outcome of the double materiality assessment, including Disclosure Requirements listed in topical standards, which complement ESRS 2 disclosures (with the exception of DR IRO-1, as stated above). Thus, the content of the disclosures will depend on which sustainability matters listed in paragraph AR16 of ESRS 1 are deemed to be material. ESMA also notes in passing that Application Requirements are an integral part of ESRS and have the same authority as Disclosure Requirements.

ESMA also highlights the specific approach under ESRS for disclosures on Policies, Actions and Targets: these disclosures are mandatory unless the company has no policy, action, or target for an IRO identified as material (and even then, specific disclosures stating this are required).

ESMA also notes the importance of entity-specific information, which must be published if a material IRO is not addressed, or is insufficiently addressed, by ESRS. However, this information should only be provided if it is material and if it meets the qualitative characteristics of information listed in ESRS 1 and detailed in Appendix B of that standard.

Finally, ESMA emphasises Disclosure Requirement IRO-2 in ESRS 2, which requires an entity to list the Disclosure Requirements it has complied with in preparing its sustainability statement. The list should include page and/or paragraph numbers indicating where the information can be found in the sustainability statement. ESMA encourages issuers to publish this list in the form of a content index, to help users to navigate the sustainability statement. ESMA also reminds entities that they must also include a table of all datapoints derived from other EU legislation, as listed in Appendix B of ESRS 2.

Priority 2: scope and structure of the sustainability statement

ESMA's second priority relates to the major issues around the scope and structure of the sustainability statement, which are key for the first year of application of ESRS.

As regards the scope of reporting, ESMA refers back to the key principle, namely that the scope of the sustainability statement should be the same as for the financial statements, as stated in section 5.1 of ESRS 1. The scope should be clearly stated, as required by DR BP-1 of ESRS 2. In accordance with this general principle, and unless specified otherwise in the topical standards, ESMA specifies that, once IROs have been identified as material for the consolidated reporting, the material metrics shall be calculated based on data for the entire group (see FAQ 22 of IG 1).

As regards the structure of the sustainability statement, ESMA points out that section 8 of ESRS 1 sets out the relevant principles, and also reminds issuers that section 9.1 permits the incorporation of information by reference. In practice, ESMA encourages companies to use the detailed structure provided as an example in Appendix F of ESRS 1. ESMA also recommends that companies that have made extensive use of alternative presentation formats should look closely at whether these approaches comply with the requirements of ESRS.

ESMA also recommends that companies that intend to make use of the possibilities of incorporation by reference and internal cross-referencing offered by paragraphs 115 and 119 of ESRS 1 should ensure that they comply with the general presentation objectives, including the requirement in paragraph 122 which states that the company must pay attention to the overall cohesiveness of the published information and ensure that any cross-referencing does not negatively impact the readability of the sustainability statement.

Finally, ESMA specifies that, for monetary amounts or other quantitative datapoints that are included in both the sustainability statement and the financial statements, the entity must, in accordance with paragraph 124 of ESRS 1, include in the sustainability statement a reference to the corresponding paragraph in the financial statements that includes the relevant information, to ensure direct connectivity between different reporting components.

Priority 3: disclosures relating to Article 8 of the Taxonomy Regulation

ESMA has determined its priorities for 2024 reporting in a context multi-objectives eligibility and alignment analysis.

As a reminder, for 2023 financial reporting, companies were required for the first time to assess their level of eligibility to the remaining four environmental objectives, in accordance with the Environmental Delegated Regulation (2023/2486), in addition to their existing obligations to assess eligibility and alignment to the two climate-related objectives (climate change mitigation and climate change adaptation).

The 2023 financial period also saw changes to the templates set out for non-financial undertakings in Annex II of the Article 8 Delegated Regulation (2021/2178) and amended by Annex V of the Environmental Delegated Regulation.

For 2024 financial reporting, non-financial undertakings are required for the first time to also assess alignment to the remaining four environmental objectives. Thus, this year will be the first in which preparers must assess both eligibility and alignment to all of the six objectives of the European Taxonomy, as set out in Article 9 of the Taxonomy Regulation (2020/852).

ESMA reiterates 2023 recommendations

In its recommendations for 2024 financial reporting, ESMA reminds issuers that the priority areas for last year (see European common enforcement priorities for 2023 annual financial reports) remain valid in the context of the extension of the assessment to cover all six objectives in the Taxonomy Regulation.

These priorities[1] were as follows:

- the correct use of templates;
- avoidance of double counting;
- the requirement to assess eligibility in the light of all six objectives;
- the need to improve qualitative information on how issuers have assessed their activities' compliance with the technical screening criteria; and
- transparency of disclosures on CapEx plans.

[1] See Beyond the GAAP no. 181, 2023

More detailed recommendations on the use of templates

ESMA places particular emphasis on the need to use and correctly fill out the regulatory templates provided, reminding issuers that:

- it is mandatory for all issuers, regardless of their level of eligibility or alignment, to use the templates set out in the Annexes of the Article 8 Delegated Regulation, as amended by the Environmental Delegated Regulation, without making any adaptations to the templates.
- the only possible omissions are the templates set out in Annex XII of the Article 8 Delegated Regulation, which cover activities related to nuclear energy and fossil gas, for issuers that do not carry out, fund or have exposures to activities mentioned in Template 1. In such cases issuers must publish Template 1, but may omit Templates 2 to 5; and
- when filling in the templates, issuers must closely follow the indications of the Article 8 Delegated Regulation, including by only using the allowed options in the columns for the substantial contribution criteria and the Do-No-Significant-Harm (DNSH) criteria.

Specific recommendations on filling in the templates in the context of an expanded range of objectives

ESMA also reminds issuers that they must carry out their eligibility and alignment assessment for all the objectives for which an activity is eligible, and report the level of eligibility and alignment accordingly. With this in mind, ESMA reminds issuers that they must publish the additional templates on the level of eligibility and alignment for each of the six objectives, as included in the footnotes to Annex II of the Article 8 Delegated Regulation.

In the main templates, if a single activity is aligned with multiple objectives, the issuer should put the code for the most relevant objective in bold in the 'Codes' column. To ensure an appropriate level of transparency, it may be necessary to disaggregate over several lines the turnover, CapEx and OpEx related to an activity that contributes to several objectives, depending on the number of relevant objectives and the proportion of the turnover, CapEx and OpEx that contributes to each.

Recommendations on connectivity between disclosures published under the Taxonomy Regulation, the financial statements and the rest of the sustainability statement

ESMA reminds non-financial undertakings that their Taxonomy disclosures must include the necessary cross-references to enable users to reconcile turnover and CapEx with the financial statements and their notes, in accordance with section 1.2.1 of Annex I of the Article 8 Delegated Act.

Referring back to the 2023 recommendation on the need for transparency in the publication of CapEx plans, ESMA reminds issuers that they must explain any objective or plans for the alignment of activities with the Taxonomy criteria, in the transition plan disclosures published in accordance with paragraph 16(e) of ESRS E1 DR E1-1. It also stresses the need for consistency between Taxonomy disclosures and transition plan disclosures, where relevant.

Financial undertakings: recommendations on application of the draft FAQ published in December 2023 by the EC

Lastly, ESMA encourages financial undertakings to consider in their 2024 reporting the FAQ in the Draft Commission Notice that was published by the European Commission in December 2023.

It also reminds them that voluntary disclosures published in accordance with this Draft Notice should be presented separately from the legally required disclosures, and accompanied by methodological explanations.

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