ESMA
European Securities and Markets Authority

The Chair
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Ref: EFRAG's due process on the IASB's Exposure Draft Climate-related and Other Uncertainties in the Financial Statements (proposed illustrative examples)

Dear Wolf,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's due process with regards to the Exposure Draft ED/2024/6 *Climate-related and Other Uncertainties in the Financial Statements (Proposed illustrative examples)*. We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS.

ESMA welcomes the IASB's proposals – supported by EFRAG – to provide illustrative examples showing how an entity may apply the requirements in IFRS Accounting Standards to report the effects of climate-related and other uncertainties in its financial statements. Whilst ESMA is of the view that the IFRS Accounting Standards already provide for entities to account for the impacts of climate matters in their financial statements, ESMA is convinced that the examples will further assist entities to improve the quality of financial information disclosed to the market. Given the increased importance of climate matters, ESMA urges the IASB to finalise this project as expediently as possible.

At the same time and notwithstanding the overarching principles in IAS 1 *Presentation of Financial Statements*[1] (which implicitly cover connectivity), ESMA, similarly to EFRAG, also considers that further examples and some targeted standard setting activities may be necessary to enhance the consistent application, auditability and supervision of the concepts related to **connectivity, consistency and coherence** between financial statements and information disclosed elsewhere in the annual report, for example, in sustainability information.

ESMA considers that connectivity, consistency and coherence are not only relevant when assessing the interplay between financial and sustainability information. These concepts are also important to understand the connection between financial information and information, other than sustainability, which is disclosed elsewhere in the annual financial report.

In this vein, connectivity, consistency and coherence within the annual report can be analogised to a two-way street whereby information included in financial statements is connected to information disclosed in sustainability information and vice-versa. Therefore,

[1] *Mutatis mutandis,* IFRS 18 *Presentation and Disclosure in Financial Statements*

explicit requirements connecting financial and sustainability information may be necessary in IFRS Accounting Standards in the same vein as sustainability reporting requirements (e.g. ISSB S1/S2, ESRS) connect sustainability reporting to information included in financial statements. In light of the increased relevance and demand from market stakeholders (e.g. investors, non-governmental organisations, lenders or the general public), as a starting point, the IASB may consider including an overarching principle specifically addressing the concepts of consistency, coherence and, in particular, of connectivity in IAS 1 (IFRS 18) and monitor if further changes to the standards are necessary.

Finally, ESMA views that further examples regarding recognition and measurement[2] could further assist issuers to establish connectivity between the information included in sustainability reporting and financial statements and to showcase how climate-matters can be tackled in IFRS Accounting Standards. However, it also considers that the additional examples should not significantly delay the finalisation of this Exposure Draft and, in particular, the publication of the examples related to IAS 1 (IFRS 18). To this end, where relevant, the IASB may consider including the examples suggested by ESMA in this letter (please refer to Questions 1 and 2) when proposing changes to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or as part of the new requirements regarding *Business Combinations—Disclosures, Goodwill and Impairment*.

Our responses are included in the Appendix to this letter. In case you have any questions or comments, please do not hesitate to contact me or Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit (Isabelle.Grauer-Gaynor@esma.europa.eu).

Yours sincerely,

[Verena Ross]

[2] For example, illustrating how the commitments, policy actions or targets disclosed in sustainability information may impact financial statements.

Appendix

Question 1: Providing illustrative examples
The IASB is proposing to provide eight examples illustrating how an entity applies the requirements in IFRS Accounting Standards to report the effects of climate-related and other uncertainties in its financial statements. The IASB expects the examples will help to improve the reporting of these effects in the financial statements, including by helping to strengthen connections between an entity's general purpose financial reports. Paragraphs BC1–BC9 of the Basis for Conclusions further explain the IASB's rationale for this proposal. (a) Do you agree that providing examples would help improve the reporting of the effects of climate-related and other uncertainties in the financial statements? Why or why not? If you disagree, please explain what you would suggest instead and why. The IASB is proposing to include the examples as illustrative examples accompanying IFRS Accounting Standards instead of publishing them as educational materials or including them in the Standards. Paragraphs BC43–BC45 of the Basis for Conclusions further explain the IASB's rationale for this proposal. (b) Do you agree with including the examples as illustrative examples accompanying IFRS Accounting Standards? Why or why not? If you disagree, please explain what you would suggest instead and why.

1. Similarly to EFRAG, ESMA welcomes the proposal of including illustrative examples on how an entity applies the requirements in IFRS Accounting Standards to report the effects of climate-related and other uncertainties in its financial statements.
2. Although the IFRS Accounting Standards do not explicitly refer to climate-related matters, the principles of several standards require the consideration of climate-related uncertainties when the effect of those uncertainties is material in the context of the financial statements of an entity. Therefore, ESMA is of the view that the current IFRS Accounting Standards already provide for entities to account for the impacts and the implications that climate and other uncertainties may cast on financial statements.
3. This being said, given the novelty that climate-matters introduce in the economic and financial sphere, ESMA considers that the illustrative examples will further assist entities to assess their impacts and to enhance the quality of the information disclosed to the market. While ESMA believes that these illustrative examples, as a first step, will be an important tool for entities to consider with respect to IFRS accounting principles, it also invites the IASB to take further actions to enhance connectivity between financial and sustainability information or between financial statements and information disclosed elsewhere in the annual financial report (please see response to Question 3).

4. With regards to the approach taken when preparing the illustrative examples, ESMA is of the view that the proposed examples generally allow for a widespread application by entities operating in different industries, while pointing to specific aspects that raise attention to climate-related or other uncertainties for entities' consideration. Nevertheless, ESMA suggests targeted improvements to some of the proposed examples to encapsulate additional information that entities (i) should take into account when assessing how to report climate-related and other uncertainties in their financial statements, or (ii) should consider disclosing to connect the information included in other sections of the annual report with the financial statements.

5. ESMA agrees with the addition of the proposed examples as stand-alone illustrative examples accompanying IFRS Accounting Standards, as an acceptable median point between educational material and a direct inclusion in the IFRS Accounting Standards, as this approach offers:

    a. as opposed to direct inclusion in the Standards: a timelier delivery of guidance material on how to apply the Standards in light of climate-related and other uncertainties which is gaining traction as a concern faced by entities across different industries and jurisdictions; and

    b. as opposed to educational material: a more robust resource for auditors, audit committees and regulators to support compliance with IFRS Accounting Standards, and a more permanent, accessible and translated resource for entities that is included alongside other guidance accompanying the Accounting Standards. In addition, the illustrative examples benefit from consultation and input from external stakeholders.

6. ESMA would also welcome the publication of the illustrative examples as one separate document to allow readers to understand the connections between the different examples.

7. Finally, similarly to EFRAG, ESMA is of the view that the publication of the examples should not create additional undue burden on preparers, nor require any specific additional time for entities to take the examples onboard in the preparation of their IFRS financial statements. Therefore, given that the examples demonstrate the application of current IFRS requirements and do not amend IFRS requirements, ESMA suggests that the IASB removes BC 49 of the ED.

Question 2: Approach to developing illustrative examples

Examples 1–8 in this Exposure Draft illustrate how an entity applies specific requirements in IFRS Accounting Standards. The IASB decided to focus the examples on requirements:
(a) that are among the most relevant for reporting the effects of climate-related and other uncertainties in the financial statements; and
(b) that are likely to address the concerns that information about the effects of climate-related risks in the financial statements is insufficient or appears to be inconsistent with information provided in general purpose financial reports outside the financial statements.

Paragraphs BC10–BC42 of the Basis for Conclusions further explain the IASB's overall considerations in developing the examples and the objective and rationale for each example.

Do you agree with the IASB's approach to developing the examples? In particular, do you agree with the selection of requirements and fact patterns illustrated in the examples and the technical content of the examples? Please explain why or why not. If you disagree, please explain what you would suggest instead and why.

8. ESMA agrees with IASB's general approach to developing the examples, in particular, ESMA welcomes the additional guidance addressing the application of the overarching principes included in IAS 1. ESMA considers that the proposed examples will assist issuers, auditors and regulators in the application, audit and supervision of these overarching principles in particular when these requirements need to be assessed in isolation (i.e., not in combination with specific requirements in other standards). Although real life cases are difficult to replicate, as they may require extensive explanations, specific and detailed fact patterns, ESMA is of the view that the context and the rationale that accompanies each example provide additional valuable input that will assist issuers in the application of the referred IFRS requirements to analogous situations or to different fact patterns on the basis of the rationale described.

9. ESMA is of the view that once an example is included in a standard (or in the accompanying material), it cannot be ignored or easily dismissed because it showcases how the IASB considered that the IFRS requirements could apply to a specific set of circumstances. Therefore, ESMA believes that the inclusion of examples will improve the application of the IFRS Accounting Standards and this, consequently, will result in a positive effect in the auditing, supervision and enforcement of IFRS Accounting Standards and in the quality of the information disclosed to the market.

10. This being said, ESMA notes that the examples focus excessively on disclosures. ESMA considers that climate matters should (or have the potential to) impact recognition, measurement and presentation of assets, liabilities, revenue, expenses and cash flows. However, none of the proposed examples illustrates how issuers should consider IFRS requirements to (de)recognise or (re)measure material items in the financial statements. Furthermore, none of the proposed examples establishes a connection between the recognition or (re)measurement of assets, liabilities, expenses or costs in the primary

financial statements on one hand, and the information included in the sustainability statement, management report or other sections in the annual financial report on the other.

11. In this context, as also supported by EFRAG, ESMA suggests that the IASB develops additional examples illustrating the application of other IFRS Accounting Standards, dealing with measurement, recognition and presentation, and that are not addressed in the Exposure Draft, but which are, in ESMA's view, highly pertinent in relation to climate-related and other uncertainties:

    a. an example focusing on the interplay of climate-related uncertainties and the determination of fair value of assets or liabilities in accordance with IFRS 13 *Fair Value Measurement*. The example could address how assumptions underpinning unobservable inputs for Level 3 fair value measurements may consider the risks that stem from climate-related or other uncertainties.

    b. an example illustrating how climate matters may be considered when determining expected credit losses. The example could illustrate, for example, various scenarios with regards to an increased transition risk or a scoring system that combines the exposure of debtors to transition and physical risks.

    c. an example illustrating how transition plans may affect the recognition or remeasurement of assets, liabilities or income and expenses. The example could showcase changes in useful lives of assets or recognition of impairments due to the implementation of transition plans or government-mandated obsolescence of some technologies (for example establishing connections between locked in GHG emissions and potential stranded assets).

12. Finally, similarly to EFRAG, ESMA also suggests targeted improvements on some of the proposed examples to encapsulate additional information that entities should take into account when assessing how to consider the impacts of climate-related and other uncertainties in their financial statements. ESMA believes that adding such additional information to the examples would ultimately increase their added value.

13. The following table provides feedback on the individual examples:

Proposed Illustrative Example	ESMA comment
Example 1 and **Example 2**	ESMA supports the inclusion of Examples 1 and 2 as accompanying IAS 1 (IFRS 18) requirements as juxtaposing scenarios that encourage entities to consider whether it is necessary to disclose information in relation to climate-related and other uncertainties. In relation to Example 1: • ESMA strongly agrees with the rationale included in paragraphs 1.5 to 1.7 of Example 1, as ESMA believes that, in some circumstances, entities may need to include negative statements in the financial statements to bridge the gap between users' expectations and entities assessments in relation to certain events (e.g., Russia's invasion of

	Ukraine or COVID-19) and/or between plans, commitments and actions described elsewhere in the annual financial report which may entail certain uncertainties (e.g., climate transition plans). • ESMA notes that paragraph 1.3(c) refers to "asset retirement obligation". However, IFRS Accounting Standards uses the term "decommissioning or restoration costs" (e.g., paragraph 19 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds)*. Therefore, ESMA suggests that the IASB aligns the terminology used in paragraph 1.3(c) with the terminology used in IAS 37 and IFRIC 5. • Finally, ESMA considers that paragraph 1.9 should be better connected with paragraph 1.3. Currently paragraph 1.9 only notes that the entity should explain why the transition plan has no effect on its financial position and financial performance. However, it does not provide any additional guidance regarding what kind of information entities should disclose to explain the assessment made. One could infer that entities should consider disclosing the reasons referred to in paragraph 1.3; however, this may not be evident. The IASB may consider making this link more explicit in the example or provide more guidance regarding what issuers may disclose to comply with paragraph 31 of IAS 1.
Example 3	ESMA supports the inclusion of this example, given that IAS 36 is one area where more judgement is required. Nevertheless, to increase the usability of the example, ESMA also suggests including quantitative information rather than just reiterating the language of the standard. ESMA recommends that IASB staff consider a consistent approach across the examples, by either having a general caveat or a systematic inclusion of a footnote to reflect that some and not all requirements within a standard are covered by the example.
Example 4	ESMA supports the IASB's reasoning included in paragraph 4.6 of the Exposure Draft concerning the application of paragraph 125 of IAS 1. To enhance the consistency in the application of paragraphs 125 to 129 of IAS 1 among entities, ESMA strongly supports the inclusion of this example. In addition, with respect to paragraph 4.9, the example could further illustrate which specific elements or information would be disclosed by the entity to meet the objective set out in paragraph 129 of IAS 1. Given the reference in paragraph 4.3 to scenarios, the information in paragraph 4.9 could address the

	judgements made and description of scenarios used by the entity when determining the recoverable amount and the weighting of such scenarios.
Example 5	While ESMA supports the rationale underlined in this example (e.g., the interplay between paragraphs 31 and 125 of IAS 1), ESMA expresses some reticence as to its inclusion given that it is not clear to which extent the fact pattern described could be applied in practice or is likely to occur. ESMA considers that the illustrative examples should be sufficiently realistic to allow an application by analogy if situations differ from those described in the example. Therefore, ESMA suggests the IASB to apply the reasoning explained in paragraphs 5.7 to 5.11 to a more realistic scenario with another set of facts and circumstances. In addition, ESMA would find it beneficial if an example addressed the application of IAS 12 *Income Taxes* requirements with respect to uncertainties related to the recognition and measurement of deferred tax assets (DTA) arising from tax losses. The example could illustrate a situation where the positive evidence that could support the recognition of DTA is not sufficient to outweigh the negative evidence arising from a history of tax losses. In this case, although the entity does not recognise DTAs, it discloses the amount (and expiry date) of unused tax losses in accordance with paragraph 81(c) of IAS 12 and information regarding the assessment made pursuant to paragraph 31 of IAS 1.
Example 6	ESMA is of the view that the current drafting of this proposed example, which by only referring to drought and flood risks, may give the indication that similar fact patterns, would only consider physical risks in the context of deriving expected credit losses. ESMA would encourage the IASB to consider, in the proposed example, a reference to transition risks which impact the real estate sector, for instance. ESMA also suggests that the IASB includes references to paragraphs 33 and 34 of IFRS 7 and illustrates the interplay between IAS 1 and IFRS 7 requirements in the example. Furthermore, the descriptions under paragraphs 6.3 and 6.4 appear to be disconnected from the fact pattern presented under paragraph 6.2. The example would benefit from specifying the inclusion of quantitative information (similar to our comments regarding Example 3) with respect to collateral (for example, the fair value of the collateral, the restrictions to its disposal and quantification of those restrictions).
Example 7	ESMA welcomes that the example is not strictly linked to climate only, but to a wider environmental issue. ESMA is of the view that the disclosures required

	by paragraph 85 of IAS 37 could be complemented by sensitivity analyses regarding the main assumptions used (i.e., interplay with paragraph 129 of IAS 1), for instance regarding the discount rate used to discount the liabilities. It would also be useful if the entity's disclosure included the (undiscounted) size of outflows that will be required to settle the obligation. Additionally, the IASB could also consider including an example connected to net zero commitments linked to the recent agenda decision (AD) on IAS 37[3]. The example could either (i) not lead to the recognition of a provision as further elaborated in the AD, but information would be disclosed in accordance with paragraph 31 of IAS 1 to connect the information included in the sustainability section regarding net zero commitments and the non-recognition of provisions or (ii) lead to the recognition of a provision, building on fact patterns where the recognition of a provision would be necessary (e.g. a present obligation resulting from past emissions) *vis-a-vis* the climate commitments disclosed by the entity. In the latter case, the example could focus on the assessment that an entity performs leading to the conclusion that it had a constructive obligation which required a liability to be recognised in the financial statements under IAS 37 which derived from the commitments made and disclosed in the sustainability section of the annual report.
Example 8	ESMA is supportive of this example as it adds an additional consideration that an entity may need to disaggregate information regarding tangible assets. However, ESMA encourages the IASB to develop a variation of this example addressing the disaggregation of revenue (paragraph 114 of IFRS 15 *Revenue from Contracts with Customers*). For instance, an entity may change its disaggregation of revenue as result of changes in the business model (e.g., as described in sustainability information section of the management report) due to investments into new business lines or into new types of revenue streams linked to climate-related matters.

Question 3: Other comments
Do you have any other comments on the Exposure Draft?

14. The IFRS Accounting Standards, as they stand, outline principles which currently provide for the consideration of the effects of climate-related and other uncertainties in entities' financial statements. In this respect, ESMA agrees with the IASB that, in the absence of specific requirements, issuers should use the overarching principles included in IAS 1 (e.g., paragraph 31, 112c or paragraphs 125-129 of IAS 1) to account for climate uncertainties.

[3] Climate-related Commitments (IAS 37 Provisions, Contingent Liabilities and Contingent Assets).

ESMA strongly supports the overarching principles in IAS 1 (IFRS 18) and the need for issuers, auditors and supervisory audit committees to consider them when preparing, auditing and supervising IFRS financial statements given that it is not possible that IFRS Accounting Standards are able to anticipate and specifically address all events and transactions that may arise.

15. Based on the ED and on current practice, the scope of application of paragraph 31 of IAS 1 seems to cover a wide range of information, including but not limited to negative statements, connectivity considerations, climate uncertainties, other uncertainties (e.g., IAS 12), unexpected events (e.g., COVID-19) or economic phenomena or transactions for which no specific requirements exist at a given moment (e.g., disclosures regarding power purchase agreements or supplier finance arrangements[4]).

16. However, the urgency of recent trends and events (e.g., climate concerns) demonstrate that connectivity, consistency and coherence between information included in and outside financial statements have increased in relevance. Financial statements are no longer the sole focus of investment decision making. Other factors, such as Environmental, Social and Governance disclosures play an important role when investors and lenders finance entities. Users of corporate reporting disclosures demand consistency, connectivity and coherence between the front and back of financial reports.

17. At the same time, ESMA considers that connectivity, consistency and coherence are not only relevant when assessing the interplay between financial and sustainability information. These concepts are also important to understand the connection between financial information and information disclosed elsewhere in the annual financial report. For instance, they may play a role when assessing if the information included in the management report regarding business segments is consistent with the operating segments in financial statements or when assessing if the business plan and strategy described in the management report are consistent and coherent with the assumptions used in impairment testing calculations and/or the recognition of DTAs.

18. ESMA considers that the demand for connectivity, consistency and coherence is not transitory, and it is likely that it will further increase in the future. Therefore, to enhance consistent application by issuers, auditability by auditors and enforceability by regulators, concepts such connectivity, consistency and coherence between information included in the financial statements with information elsewhere in the annual financial report should be explicitly referred to in IFRS Accounting Standards and not be implicitly captured in paragraph 31 of IAS 1. This paragraph should be mainly used to address unforeseeable events and transactions and/or on a temporary basis until specific requirements are developed.

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[4] Before the amendments to IAS 1 were developed.