Financial Reporting Newsletter
Bringing you the latest information on recent IFRS and Financial Reporting topics

January 2023

Dear all,

We are pleased to welcome you to the new edition of our Financial Reporting Newsletter.

Our aim is to keep you updated with all the latest news and developments on IFRS and financial reporting along with the potential impact they may have on your business.

In this issue, we discuss some financial reporting issues that may be relevant for years ending on or after 31 December 2022 in view of the current economic and geopolitical environment and also highlight areas of regulatory focus:

We hope that you find our newsletter insightful and if you would like to discuss any of the topics covered, please do not hesitate to contact us.

Best regards,

Dimitris Katsibokis
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Uncertainty and financial reporting

In an interconnected world it is not always possible to isolate the wider economics effects of, for example, Russia's invasion of Ukraine from the increase in energy prices, increase in the general cost of living, the ongoing effects of the COVID-19 pandemic or myriad national or regional factors. However, similar economic phenomena are being experienced across a wide range of jurisdictions. Major effects of some of these on financial reporting are highlighted below.

The European Securities and Markets Authority (ESMA) released a public statement on the implications of Russia's invasion of Ukraine on half-yearly financial reports. In its European common enforcement priorities for 2022 annual financial reports, ESMA considers that most of these messages are also relevant in the context of annual financial statements.

Increase in energy prices

The increase in energy prices and the possibility of energy shortages due to the depletion of gas reserves could have a significant effect on a wide range of entities and several aspects of financial reporting.

This could result in, amongst other things, disruption to production, higher costs (particularly in energy intensive industries), higher revenues for energy producers and lower revenues elsewhere (for example, in industries sensitive to levels of disposable income in a market where higher energy costs might limit consumers' spending power).

Such effects are clearly relevant to an impairment review conducted under IAS 36 *Impairment of Assets*, both in ensuring that forecasts are properly updated to reflect events and expectations as at the reporting date and in determining the appropriate disclosures to accompany that exercise. For example, a forecast of future energy prices might become a key assumption to be disclosed for the first time.

For some entities, as discussed in more detail below, the effect of energy prices might be severe and form a major part of disclosures explaining doubts over the entity's ability to continue as a going concern.

Less direct effects could include changes in the value of energy derivatives (for example, forward contracts to purchase or sell gas or electricity), with resultant impacts on hedge accounting or disclosures of market risks under IFRS 7 *Financial Instruments: Disclosures*.

General inflation and interest rate rises

Increases in energy prices have also contributed to the increase in general inflation levels. This has been accompanied by increases in interest rates reflecting lenders' perception of increased credit risk and interventions by central banks seeking to control inflation. Growing inflation and market interest rates affect multiple aspects of financial reporting which depend on forecasts of future cash flows and present value calculations.

In respect of impairment of non-financial assets, IAS 36 identifies an increase in market interest rates as an indicator to be assessed in determining whether an asset may be impaired and may lead to a full impairment review, unless the increase in market interest rate does not indicate the existence of a material impairment. This may be the case where an increase in market interest rates does not affect the appropriate discount rate for the asset in question (for example, if short-term interest fluctuations would not affect the rate of return demanded of a longer-life asset) or if the entity expects to recover higher interest charges through prices charged to its customers, or the increased rate is too small to raise concerns over the headroom of an asset's recoverable amount over its carrying amount. However, the possibility of an impairment loss should not be overlooked and a general increase in interest rates should lead to a proper consideration whether a full impairment review is required.

Inflation can have an impact on the measurement of longer-term provisions such as decommissioning obligations, as its effects on future outflows of economic resources should be reflected in either the forecast cash flows or the discount rate applied to longer-term liabilities. Entities should ensure that the inputs used in measuring provisions follow a consistent approach in incorporating the effects of inflation. Nominal cash flows, which include the effect of inflation, should be discounted at a nominal rate and real cash flows, which exclude the effect of inflation, should be discounted at a real rate.

Inflation and the resulting increase in the cost of living may lead to products becoming less affordable (either because of increased production costs or reduced customer spending power). Write-downs of inventory to net realisable value and recognition of onerous contract liabilities in respect of commitments to purchase inventory which cannot then be sold at a profit may be required. Inflation, specifically in salaries, can also be an important actuarial assumption factored in the measurement of defined benefit obligations accounted for under IAS *19 Employee Benefits*. Where inflation is a major source of estimation uncertainty, an entity should consider the need to disclose the information required by paragraphs 125-133 of IAS 1 *Presentation of Financial Statements*, such as a sensitivity analysis.

Both interest rates and inflation can affect measurement of lease liabilities and right-of-use assets under IFRS 16 *Leases*. They can also lead to additional exposure to credit losses as borrowers' ability to repay their obligations is reduced, resulting in:

- Increases in expected credit losses to be recognised under IFRS 9 *Financial Instruments*, if it is expected that levels of default might increase due to increases in borrowers' cost of living. Changes in expected models used by financial institutions or 'management overlays' to supplement those models should be accompanied by disclosures to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows and
- Expected credit losses becoming more significant to entities other than financial institutions if they expect increase in bad debts as customers struggle to pay outstanding amounts.
  Assumptions used for discount rates and cash flows should be internally consistent within a particular calculation and consistent across calculations performed for different purposes.

Government interventions

The current economic climate (particularly in respect of energy prices) has led to government interventions to, for example, limit prices that can be charged to customers or provide direct economic assistance to entities adversely affected by current economic conditions.

It will be important to correctly characterise these arrangements as a government grant in the scope of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, a tax credit in the scope of IAS 12 *Income Taxes*, a below-market loan subject to the requirements of IAS 20:10A or potentially (if, for example, a government acts to limit the rates a utilities supplier can charge) simply a lower cost than might otherwise be the case.

More broadly, government assistance may impact an entity's cash flow forecasts and assessments that utilise such forecasts (e.g. impairment reviews and going concern assessments). The assessment of an entity's best estimate of the impact of government assistance on cash flow forecasts, including the expected duration of a scheme, should be conducted carefully and, when significant to the outcome of the assessment, disclosed.

In many jurisdictions, governments have introduced (or announced plans to introduce) so called 'windfall taxes' targeted at entities operating in specific industries and that benefitted from higher profits as a result of rising prices, notably in the energy sector. Entities affected will need to assess the nature of the tax to determine if it should be accounted for as an income tax applying IAS 12 or as a levy applying IFRIC 21 *Levies*. This distinction is important as it will determine whether the related charge is presented in the income tax line in profit or loss or above that line. If IAS 12 applies, the entity will also need to consider whether to recognise a deferred tax asset or liability. Where the tax is announced but not yet effective, entities will need to consider whether they should disclose the expected impact of the tax on the entity's operations.

Restrictions on access to markets and cessation of operations

Following Russia's invasion of Ukraine, a number of entities announced their intention to exit the Russian market or experienced practical or political issues in continuing to access or manage operations in the region.

IAS 36 requires entities to assess whether there are any indications that an asset in the scope of IAS 36 may be impaired by considering internal and external sources of information. In making this assessment, entities should carefully consider whether the effects of Russia's invasion of Ukraine (direct and indirect) constitute an indication that one or more assets may be impaired. Decisions to abandon, dispose of or suspend operations, or cancel investments in Ukraine, Russia or Belarus could represent indicators of impairment necessitating a full impairment review of affected assets.

It is also possible that plans to dispose of operations give rise to classification of assets as held for sale or presentation as discontinued operations. Caution should be applied, however, as this is only appropriate when the strict criteria of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are met. In particular, a plan to abandon a non-current asset or disposal group does not result in its classification as held for sale and judgement may be required to assess whether a sale can be considered highly probable in an uncertain political environment.

At the point when an entity's relationship with a foreign operation changes (either through choice or otherwise), it will also be necessary to consider whether the level of influence has reduced such that control, joint control or significant influence have been lost.

Climate-related risks in financial statements

For some time, regulators have been urging entities to pay particular attention to climate-related matters and their effects when providing a balanced and comprehensive analysis of the development and performance of the entity's business and of its position together with a description of the principal risks and uncertainties that it faces (for example, climate-related matters are a repeated feature of the ESMA common enforcement priorities).

In particular, entities should consider whether the degree of emphasis placed on climate-related matters elsewhere in the annual report is consistent with how climate matters have been reflected in the judgements and estimates applied in the financial statements and whether the immediate actions necessary to meet a stated longer-term decarbonisation commitment are reflected in the financial statements. Forecasts used for financial reporting purposes should reflect the entity's strategic plans and planned actions at the reporting date and should be based on best estimates at the reporting date.

If climate-related matters are material, it is expected that they are considered in the preparation of IFRS financial statements, even if IFRS Accounting Standards do not explicitly refer to those matters. It cannot be assumed that investors or regulators will deem boilerplate disclosures stating that climate-related matters have been considered (for instance, in impairment tests) without further explanation as to how and to what extent it affects (or does not affect) financial statements as sufficient to provide information that is relevant to an understanding of the financial statements. For example, investors want to understand whether an entity's forecasts used for financial reporting are aligned with the goals of the Paris Agreement. There are multiple possible scenarios and ranges of possible outcomes under different climate change trajectories. It is important for entities to be clear about the assumptions used and to make greater use of sensitivity analyses.

Where entities have concluded, in particular in highly exposed sectors, that no material financial impact from climate-related matters on their operations and/or in the measurement of their assets and liabilities is expected, regulators expect those entities to disclose the assessments performed, judgements made and the time horizon used to reach such a conclusion. Disclosures should be tailored to the specific circumstances of individual entities.

Task Force on Climate-related Financial Disclosures (TCFD)

Pending finalisation of standards by the International Sustainability Standards Board (ISSB) and others (see discussion below), TCFD is used as a generally accepted framework for entities to explain their strategic response to climate change and its potential financial impacts. Many jurisdictions have incorporated TCFD disclosures into mandatory or recommended reporting requirements and regulators are increasingly focusing on the quality of that reporting.

For example, in 2022 the UK Financial Reporting Council (FRC) conducted a thematic review of TCFD disclosures and climate in the financial statements. The output of the review provides more clarity on expectations for entities who have taken a more traditional 'wait and see' approach to reporting and disclosure in these areas, as examples of best practice do exist. The FRC emphasised that climate reporting should now be firmly established as a board level topic.

The FRC thematic review noted key issues where entities can improve. These areas may provide useful consideration for entities that report on TCFD outside the UK or on sustainability information more broadly:

- Granularity and specificity - Entities should provide information about risks and opportunities across the entity, breaking this down by business, sector, and geography where appropriate.
- Balance - Discussion of climate-related risks and opportunities should be proportionate to their expected size, including a discussion of any dependencies on the development of new technologies when explaining the potential of climate-related opportunities.
- Interlinkage with other narrative disclosures - TCFD disclosures should be well integrated with other elements of narrative reporting, for example by

incorporating the results of scenario analysis into the entity's description of overall strategy within the narrative report.

- **Materiality** - Entities should provide an explanation of how they incorporate the TCFD all-sector guidance and supplemental guidance. Where disclosures are not given, a reason for the omission should be included. In particular, it should be clear whether the entity has considered these disclosures and determined them not to be material, or whether the matters covered by these disclosures have not been addressed in the entity's internal assessments.
- **Connectivity between TCFD and financial statements disclosures** - Climate risks and opportunities identified within TCFD reporting should be properly integrated into the judgements and estimates which underpin the financial statements. Entities should also consider re-evaluating the presentation of their segmental reporting and disaggregated revenue disclosures in response to climate change and transition plans.
- **Governance** - Entities should provide specific information on the oversight of climate-related matters, such as consideration of climate related performance objectives and the effect of climate on decisions about major capital expenditure, acquisitions, and disposals. Entities should also consider disclosing how climate-related risks are controlled and how climate-related metrics affect remuneration policies.
- **Strategy** - Information on strategy should be granular and the level of detail included in scenario analyses should be consistent, including quantitative measures. Entities' discussions of risks and opportunities should not be disproportionately weighted towards opportunities.
- **Risk management** - Climate-related matters should be integrated into overall risk management processes. Particularly, processes for assessing the priority and materiality of climate-related risks should be well explained.
- **Metrics and targets** - Metrics should not only focus on Scope 1 and 2 emissions but also include other climate-related risk and opportunity metrics. Historical data and explanation for movements should be provided to support the reader's understanding of progress against targets.
- **Assurance** - Entities should clearly explain the level of any assurance given and what it covered. Terms such as 'verified' should be avoided as it may imply a higher level of assurance than has actually been obtained.

In view of the pervasive nature and significance of climate-related risks and growing stakeholder expectations and regulatory focus, entities should consider the points above irrespective of whether they are providing voluntary or mandatory TCFD disclosures.

Sustainability and climate corporate reporting developments

Investors' and other stakeholders' demand for sustainability information relevant to understanding of how businesses create, sustain or erode value over time has led to a rapid move towards introduction of mandatory sustainability reporting.

International Sustainability Standards Board (ISSB)

The ISSB is emerging as the global standard-setter for standards on sustainability reporting for capital markets. In March 2022, the ISSB published two Exposure Drafts (EDs) for its first IFRS Sustainability Disclosure Standards:

- [Draft] IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*
- [Draft] IFRS S2 *Climate-related Disclosures*

The ISSB is currently redeliberating the proposals in the EDs in view of the responses received to its consultation and publication of the final standards is expected early in 2023. A recent Financial Stability Board report indicated that 14 out of 24 jurisdictions that are its members reported that they are putting in place structures and processes to bring the ISSB standards into local requirements.

IOSCO has set out its expectations that both disclosures and assurance standards should be ready for use by corporates for their end-2024 accounts. At COP 27 in November 2022, IOSCO Board Chair Jean-Paul Servais said, "In 2023, the ISSB will issue its standard for climate disclosures and general requirements. IOSCO will move promptly to decide on endorsement and will develop a support program for its members to assist them in moving forward immediately should IOSCO decide to endorse these standards. IOSCO also supports the efforts of the ISSB in seeking to be inclusive through its capacity building partnership initiative."

Jurisdictional developments with significant extraterritorial reach

In November 2022, the European Union's Corporate Sustainability Reporting Directive (CSRD) was adopted by the European Parliament and approved by the Council of the European Union. The CSRD aims to improve sustainability reporting in an entity's management report for investors, civil society and other stakeholders, thereby contributing to the transition to a fully sustainable and inclusive economic and financial system in line with the European Green Deal and the UN Sustainable Development Goals (SDGs).

The scope of the CSRD is very wide and extends to many non-EU undertakings not listed on an EU regulated market.

Entities will have to report on a wide range of sustainability matters using European Sustainability Reporting Standards (ESRS) developed by EFRAG.

The first set of draft ESRS was submitted to the European Commission (EC) in November 2022 and the EC will now consult EU bodies and Member States on the draft standards, before adopting the final standards as delegated acts in June 2023 (expected), followed by a scrutiny period by the European Parliament and Council.

In the US, the SEC consulted on climate-related disclosures in March 2021 and issued the proposed rule *The Enhancement and Standardization of Climate-related Disclosures for Investors* in March 2022. Among other things, the proposed rule would apply to foreign private issuers, and the SEC requested input as to whether foreign private issuers should be permitted to report under substantially similar requirements to those in the proposed rule.

Integrated reporting

In 2021, the International Integrated Reporting Council (IIRC) published revisions to the *International Integrated Reporting Framework* (*<IR> Framework*), originally released in 2013. The revisions place more emphasis on value creation, preservation and erosion; provide for more disclosure from those charged with governance to promote further the integrity of reporting; and expand the coverage of outcomes. The *revised <IR> Framework* is maintained under the auspices of the IFRS Foundation and is applicable for reporting periods commencing 1 January 2022. Where an entity chooses to adopt *the <IR> Framework* only in part, the Framework now encourages it to identify which requirements have not been applied and the reasons why.

Where can I go for more information?

This publication highlights just some of the recent IFRS and financial reporting topics that may be of interest to entities reporting under IFRS or another accounting framework. More detailed information can be found at www.iasplus.com

Contact Us

For any question you may have, please reach out to us at:

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