

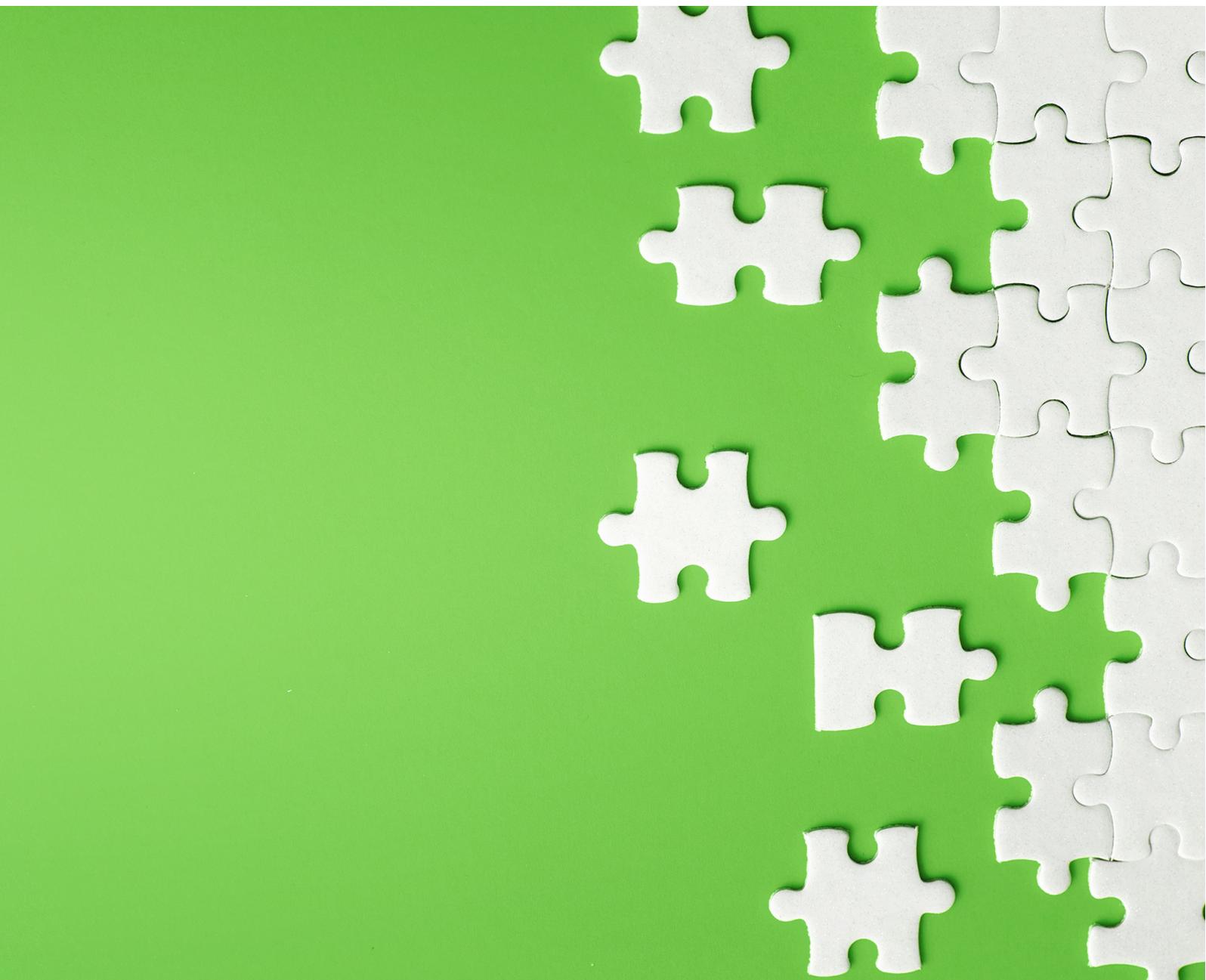
LOOSE CONNECTION - THE GAP BETWEEN FINANCIAL AND SUSTAINABILITY REPORTING

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WE HAVE BEEN HERE PREVIOUSLY



Before the development and wide global adoption of IFRS Accounting Standards, most countries set their own accounting standards to meet the needs of their local capital markets for financial reporting.

To facilitate the growth of these capital markets, many countries sought investment from international investors. However, these investors experienced challenges comparing local financial statements with those they were familiar with due to the disconnect in accounting standards applied.

The development of IFRS Accounting Standards evolved from this disconnect and in response to the demand for more consistent and comparable financial reporting.

A similar challenge now exists for Sustainability Reporting where many global and jurisdictional institutions and organisations have sought to individually develop reporting frameworks and standards for environmental, social and governance factors. This has led to a proliferation of inconsistent reporting frameworks and growing demand from global capital markets for consistent and comparable sustainability reporting.

Following this and the strong market demand for the IFRS Foundation to expand its remit, the International Sustainability Standards Board

(ISSB) was established in November 2021 at COP26 in Glasgow.

The ISSB's objective is to develop a common set of sustainability disclosure standards for global use. However, there is the risk that these standards will not interconnect with existing IFRS Accounting Standards. This may result in a continuation of the existing disconnect between the company's financial reports and their sustainability reports.

Consequently, the challenge now for the IFRS Foundation is to ensure that their respective accounting and sustainability standards allow for the interconnect of these two reports.

ADDRESSING THE DISCONNECT

In May 2003, ISSB published RFI/2023/1 Request for Information: *Consultation on Agenda Priorities* to seek feedback on its priorities for its next two-year plan. One of the four potential projects ISSB is seeking feedback is a research project on integration in reporting to explore how to integrate information in financial reporting beyond the requirements related to connected information in IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*.

Apart from the ISSB plan, there is also ongoing discussion amongst national standard setters concerning the level of connectivity required between sustainability disclosures and financial reporting. The UK Endorsement Board in consultation with the Canadian Accounting Standards Board has recently produced a staff paper discussing connectivity (the Paper). The Paper¹ recognises, amongst other matters, the

requirement by capital markets to be able to understand, assess and connect accounting information with the new more forward looking and longer-term sustainability disclosures.



SOME CONNECTIVITY MAY ALREADY EXIST

The International Accounting Standards Board (IASB)² published *Effects of Climate-related matters on financial statements* in November 2020³. This document included examples of existing IFRS Accounting Standards whose application could be affected by information provided on climate-related matters under the draft IFRS S2, including:

- *Recognition, measurement and disclosure of liabilities* - regulatory requirements to remediate environmental damage or levies imposed by government for failure to meet climate targets such as emission levels may require disclosure under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- *Inventories* - which could become obsolete or their selling prices to fall resulting in their realisable value being below cost and hence requiring markdown to net realisable value in accordance with IAS 2 *Inventories*.
- *Deferred tax assets* - future taxable profits may be reduced with the result that any unused tax losses recognised as a deferred tax asset may require adjustment under IAS 12 *Income Taxes*.

¹ See UKEB Staff Paper: Connectivity between sustainability disclosures and financial reporting (14 Dec 2022) <https://assets-eu-01.kc-usercontent.com/99102f2b-dbd8-0186-f681-303b06237bb2/98bdf7e5-05f4-4467-a02f-a7ed5b0cea3e/7%20Interconnectivity%20between%20financial%20and%20sustainability%20reporting%20%E2%80%93%20paper%20for%20IFASS.pdf>

The UKEB Secretariat has also presented to its Board a series of preparatory papers, focusing on connectivity between the IFRS Sustainability Disclosure Standards and International Accounting Standards. See <https://www.endorsement-board.uk/Connectivity-Projects>

² The IASB is the IFRS Foundation body charged with responsibility for setting IFRS Accounting Standards, and as such is the accounting equivalent of the ISSB.

³ See IASB education material: Effects of climate-related matters on financial statements November 2020 <https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf>

CONSIDERATIONS FOR DIRECTORS - CONNECTIVITY RESIDES NOT JUST WITH STANDARD SETTERS

IFRS S1 and IFRS S2 are expected to be published soon, with an effective date of 1 January 2024. In preparation, now is the time for directors to review management's plans and processes to facilitate the timely collection and reporting of sustainability data to meet and assess implications which the data may have for financial reporting.

This will require a whole of company approach as much of the necessary information is likely to be generated from outside the existing finance function or not readily available. This lack of availability has been recognised by the ISSB proposing to provide relief for one year from reporting Scope 3 GHG emissions under the upcoming IFRS S2. Apart from that, the ISSB also proposes to allow an entity to report on only climate-related risks and opportunities as set out in IFRS S2 in the first year it applies IFRS S1 and IFRS S2. The entity would be required to provide information about its other sustainability-related risks and opportunities in the second year it applies the two Standards. However, even with the reliefs, these and other requirements will require speedy resolution.

The IASB maintains that companies are already required to consider climate-related matters in their financial statements under IFRS Accounting Standards. However, in response to stakeholder concerns that this is not happening, the IASB has recently announced that it will commence a project on climate-related risk disclosures in the financial statements with the purpose to explore whether and how financial statements can better communicate information about climate-related risks. This project and the work of the ISSB complement each other in facilitating connectivity in general purpose financial reports⁴.



CONCLUSION - DON'T LOSE POWER IN THE CAPITAL MARKETS

Whilst the Financial and Sustainability Reports may not become fully integrated the gap between them is narrowing. In initiating the project on climate-related risks in the financial statements the IASB considered feedback from stakeholders indicating that climate-related risks are often perceived as remote, long-term risks and may not be appropriately considered in the financial statement. **Now is the time to become connected to the implications.**

⁴ <https://www.ifrs.org/projects/work-plan/climate-related-risks-in-the-financial-statements/#about>