28 November 2023
ESMA32-1283113657-1139

Keynote speech "State of play in financial reporting"

EFRAG Conference 2023 – The Hotel, Brussels

Verena Ross

ESMA Chair

Good afternoon, Ladies and Gentlemen,

I would like to thank EFRAG and the President of the Administrative Board, Hans Buysse, as well as the Chairs of the reporting boards – Wolf Klinz and Patrick de Cambourg – for the invitation to join this year's Conference.

Last year, I joined you in celebrating the 21st anniversary of EFRAG's establishment and I have specifically addressed the topic of connectivity between financial and sustainability reporting. This is also the topic of the next panel. Therefore, I feel that in my remarks today I should touch on what ESMA has done in the past months to promote this connectivity. More importantly, I would like to explain what we plan to do in the coming period.

Before I get to this though, please allow me a short digression into the title of the next panel: "Building bridges".

Throughout my career, first in central banking and later on in financial supervision, I have experienced several instances in which cooperation was key to identify workable solutions to shared problems, especially during challenging times. I believe that today's *dual transition* towards a more digital and sustainable economy is one of those instances requiring cooperative, cross-sectorial solutions.

This is the case, for example, when we build bridges across organisations to face the challenge of making our financial system fairer and more sustainable. As ESMA we have a long-standing tradition of creating and fostering such cross-sectorial synergies. In my experience, though, creating synergies across different thematic areas, such as sustainability and financial reporting, may be more challenging.

In the rest of my remarks today, I will then try and describe some of the key factors that may facilitate cross-fertilisation between financial and sustainability reporting and improve connectivity.

One report, two communities of experts

The first element to support connectivity in corporate reporting has to do with the human and organisational infrastructure that stands behind the publicly reported disclosures.

In our recently published European Common Enforcement Priorities – the ECEP 2023 – we have pointed out the relevance of this human and organisational element, not only to adequately prepare for the application of the new European Sustainability Reporting Standards (ESRS), but also to build the necessary consistency between the sustainability statement and the financial statements.

With the entry into force of the Corporate Sustainability Reporting Directive (CSRD), sustainability reporting requirements were finally integrated into the mainstream reporting of a large group of companies. The management report shall now include a self-standing sustainability statement.

In other words, there is no longer an assumed primacy of financial reporting over sustainability reporting, but rather these are two pillars of the same *continuum* which are there to tell a consistent story. This has implications for the way in which various actors look at sustainability reporting *in comparison to* and *in combination with* financial reporting.

Two communities of professionals – the sustainability and the financial experts – are now required to sit together not to simply *combine* their respective reports, but to *prepare* what are two components of the same report. These groups of professionals will work together to develop a common control environment for the entire annual financial report. Internal control expertise and organisational capacities will need to entail sustainability alongside the more traditional financial reporting skills.

In this context, let me therefore emphasise the responsibility of management and supervisory bodies of issuers and the important oversight role of audit committees in ensuring the connectivity and overall internal consistency of the annual financial report.

Connected and consistent

Connectivity should also help bridge the timing disconnect between sustainability information, that is typically more forward-looking, and financial reporting that is more traditionally backward-looking.

There are a number of practical aspects to promote connectivity that include the adoption of the same terminology and concepts, the reliance on cross-referencing to signpost connected information and the use of digital tools to help investors promptly retrieve the relevant connections. However, in order to be useful and not misleading, connected information presupposes a good degree of underlying consistency between sustainability and financial reporting.

In this year’s enforcement priorities, in particular, we have further emphasised the fact that a consistent treatment of climate-related matters across the annual financial report is essential to mitigate the risk of greenwashing.

In the current environment characterised by significant dynamism due to high levels of geopolitical tension, rising inflation and tight financial conditions, modelling expected future scenarios is more challenging. This implies that information reported in the financial statements may be increasingly reliant on professional judgement.

In this context, transparency on the assumptions made to incorporate different sustainability scenarios into the estimate of expected future cash-flows and ensuring their consistency with more strategic ESG commitments of an issuer becomes even more critical to preserve investors' confidence, as well as the credibility of the sustainability transition as a whole.

While consistency between financial and sustainability reporting is an essential feature of connectivity, investors can only benefit from the complementarity of these two reporting pillars when the financial statements provide explanations of cases in which this consistency is not achieved and the reasons why this is not the case. In this year's enforcement priorities, ESMA also recommended that issuers include such information inside financial statements.

Given the importance of promoting consistency and, more generally, connectivity between financial and sustainability information, last October we have published a report on the disclosures of climate-related matters in the financial statements, which I encourage everyone to read as it provides more than twenty disclosure examples from the 2022 financial statements of some European issuers.

[I also believe that more work needs to be done to bring further clarity in the way IFRS address climate-related risks, thereby supporting issuers in improving the connectivity between the two pillars of their reporting. Therefore, we welcome the work that the IASB is doing in this area through its project *Climate-related and Other Uncertainties in the Financial Statements*. Through this project, new examples about the application of the definition of materiality will be available to help identify climate-related matters to be reported in the financial statements more clearly. Further examples on how an entity would apply the IFRS requirements to report the effects of climate-related matters will also be extremely useful.

From a legal perspective, we can also see some merit in further clarifying the obligation of connectivity between the two pillars of corporate reporting in both the Transparency Directive and the Accounting Directive. This clarity will strengthen the legal framework behind supervisory action in this area and create stronger incentives for issuers to build connectivity and consistency in their annual financial reports.]

ESMA's work to foster connectivity

Before leaving the floor to the distinguished panel of experts that will follow, let me spend a few words on what we can do in the future to further support this 'connectivity journey' and the building of bridges.

The activities already undertaken by ESMA and national authorities to strengthen the relationship between financial and sustainability reporting in the past years will continue and be further enhanced. Our flagship publication in the corporate reporting area, the annual enforcement priorities, will continue to look into connectivity. I expect that with the entry into application of the future European Sustainability Reporting Standards, our recommendations will become even more specific and targeted.

Alongside with our enforcement priorities, we also regularly publish extracts from the decisions taken by national enforcers in relation to financial reporting. In a recent extract, we have highlighted enforcement decisions about climate risks in financial information. We have particularly stressed the fact that climate risks may become material in the financial statements, not only due to the magnitude of their financial effects, but also due to qualitative aspects.

We will continue to give publicity to the conclusions of enforcers in relation to climate-related matters in our publications and I expect that poor connectivity between financial and sustainability information will increasingly give rise to questions from enforcers and, when infringements are found, to proportionate actions.

I would also like to stress the good cooperation with EFRAG on the work of connectivity. Our teams are keen to continue contributing to the educational efforts that EFRAG is putting in place. Similarly, we will continue to engage with the IFRS Foundation to monitor their ongoing work in this area and alert them to issues that we encounter as part of the supervisory activity on the ground.

Conclusion

Ladies and Gentlemen, let me conclude.

As the 28th UN Climate Change Conference of Parties (COP 28) approaches, we are reminded of the need to act quickly to support the financial sector in channelling the necessary resources towards sustainable investment in a way that does not destabilise our markets and that preserves investors' trust.

This is why, alongside our continued work on greenwashing – for which we expect to deliver a final reporting in May next year – we will continue to work on the interplay between sustainability and financial reporting to support national authorities in identifying the *red flags* with regards to theconsistency between companies' sustainability ambitions in public communications and the concrete financial implications of these ambitions.

At the same time, as a new season of major changes in the area of sustainability reporting opens up, with the new ESRS starting to apply from the beginning of next year for a first set of companies, there will be a learning curve for all parties involved, including market participants and supervisors. This suggests that continued cooperation and dialogue is necessary to successfully overcome this initial phase – at European level through EFRAG and at national level.

I believe that we should be proud that Europe is a frontrunner in the international sphere when it comes to sustainability investing and regulation, we should use this advantage to also become an example for best integration between sustainability and financial reporting requirements.

This brings me to the next challenge that lies ahead of us: ultimately, the language of connectivity between financial and sustainability reporting can only be as international as the level of global consistency of the respective sustainability and financial reporting pillars. Here too the ongoing work of EFRAG on interoperability with the ISSB and GRI is crucial. Again, building bridges – creating and enhancing cooperatively solutions that serve us all – will be key.

The EU's ability as a sovereign jurisdiction to set its own requirements should not be the excuse to diverge from international initiatives, but rather be the reason to build global acceptance of higher and stronger reporting standards. As David Attenborough's reminded us in his opening address as the People's advocate for COP 26 in Glasgow in 2021: "*If working apart we have force powerful enough to destabilise our planet, surely working together we are powerful enough to save it"*.

Thank you.