ENFORCEMENT OF THE 2023 ANNUAL REPORTS PUBLISHED BY ISSUERS SUBJECT TO THE TRANSPARENCY LAW

Commission de Surveillance du Secteur Financier

Pursuant to Article 22 of the law of 11 January 2008 on Transparency requirements for issuers (hereinafter "Transparency Law"), the CSSF is monitoring that financial and non-financial information published by issuers is drawn up in compliance with the applicable reporting frameworks.

As issuers are now preparing their reporting for the 2023 financial year, the CSSF wishes to draw the attention of those preparing their financial statements in accordance with IFRS and/or their non-financial report in accordance with the law of 23 July 2016 which transposes the Directive 2014/95/EU (hereinafter "Non-Financial Reporting Directive" or "NFRD"), as well as of their auditors, to a number of topics and issues that will be the subject of a specific monitoring during the CSSF's enforcement campaign planned for 2024.

European Common Enforcement Priorities (hereinafter "ECEPs")

As in previous years, the European Securities and Markets Authority (ESMA), together with the European national accounting enforcers, including the CSSF, identified ECEPs for the 2023 annual reports to which particular attention will be paid when monitoring and assessing the application of the relevant reporting requirements. ESMA issued on 25 October 2023 a public statement which describes these 2023 ECEPs (ESMA32-193237008-1793). This document is available on the CSSF website under Enforcement of Issuer Disclosure. The CSSF encourages issuers to consider the ECEPs in addition to its enforcement priorities outlined below as the latter are derived from the ECEPs.

More information on inspections and findings by the CSSF within the framework of its mission under Article 22 (2) h) of the Transparency Law are given under Enforcement of Issuer Disclosure

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1 IFRS Financial Statements

1. Impact of Climate-related matters (1/2)

As climate-related matters had already been identified as an ECEP for the 2022 and 2023 campaigns, the CSSF carried out focused examinations of the 2021 and 2022 financial and non-financial information of issuers for which significant climate-related risks were identified.

The results of these examinations highlighted that this priority should remain particularly relevant for the 2023 annual reports. Therefore, the CSSF will tailor its review procedures to address both aspects covered by this ECEP and the follow-up of the observations made during its 2022 and 2023 campaigns thereon.

The CSSF stresses that, in the given context, boilerplate disclosures on climate-related topics are not what is needed by users of the financial statements. Such topics need specific and relevant information on how climate risks have been factored in the financial statements. Therefore, the CSSF invites issuers to pay attention to ESMA's recent report illustrating best practices in terms of Disclosures of Climate-Related Matters in the Financial Statements, report available on the CSSF's website.

Consequently, the CSSF would like to underline the importance of considering climate-related risks and opportunities in terms of impairment testing of non-financial assets. Physical and transition risks should be featured when assessing the existence of impairment indicators. Furthermore, cash flow projections in value in use measurements should be based on reasonable and supportable assumptions (related to climate matters) representing management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset.

When a parameter linked to climate-related matters is identified as a key assumption, it is expected that issuers disclose, unless impracticable, (i) the quantified assumptions used (e.g. the current and forecasted prices used such as CO_2 prices, timing and amounts of replacement of certain assets) and (ii) the basis of such quantifications (i.e. internal or external estimates – bearing in mind that a greater weight should be given to external evidence).

1 IFRS Financial Statements

1. Impact of Climate-related matters (2/2)

In light of the correlation and uncertainty pertaining to climate change, the CSSF invites significantly affected issuers to assess whether a multi-scenario approach to expected cash flows would not be more appropriate than the traditional "one scenario fits all" approach. This would imply envisaging various probability-weighted assumptions as well as a correlation between them. Such approach seems more relevant and demonstrable to external parties than building-in climate-related risks in the discount rate of a single cash flow forecast by applying opaque and/or arbitrary premiums or discounts thereto.

The CSSF would also like to point out that, whereas climate risks and opportunities are susceptible to affect cash flow forecasts, by nature climate change tends to reveal its insidious effects in the long term. Thus, embedding climate-related matters in the assumptions underlying the determination of the "terminal value" should particularly warrant the issuers' attention.

Finally, where applicable, the CSSF expects issuers to provide information when climate-related matters impact: (i) the business plan assumptions used when estimating the recoverable amount of assets, (ii) the period considered beyond the business plan and if and how cash flows are impacted in this context, or (iii) the financial assumptions used, such as the discount rate and the growth rate.

2. Macroeconomic environment

Increase in interest rates and impact on (re)financing

Recent interest rates hikes might have far-reaching consequences for issuers which are highly dependent on financial debt. It should be borne in mind that interest rate risk arises not only on interest-bearing financial instruments recognised in the statement of financial position, but also for some financial instruments not recognised on the balance sheet (e.g. certain loan commitments). Thus, issuers should provide specifics on how changes in the macroeconomic environment affect their risk exposures (distinguishing between floating rate and fixed rate financial instruments) and how such risks are managed.

The CSSF would like to stress the importance of a sensitivity analysis in this field, showing how profit or loss and equity would have been affected by reasonably possible changes in interest rates. Such reasonably possible changes may need to factor recent volatility of interest rates. Moreover, where the macroeconomic environment requires changes in the methods and assumptions used to prepare the sensitivity analyses, these changes should be disclosed together with the reasons for them.

It is worth mentioning as well that the effects of high inflation and volatile interest rates may impact an issuer's ability to meet the covenant requirements included in long-term loan arrangements. *Inter alia*, higher interest rates may lead to decreases in fair value of investment properties or a decrease in the issuers' equity, thus affecting compliance with covenants. Therefore, issuers should consider providing disclosures about covenants and the impact of any potential breaches.

Finally, the weakening of cash flows due to inflation and high interest rates may lead issuers to look for additional financing and/or to amend the terms of existing debt. Renegotiated financing during the year deserves adequate disclosures, notably as regards the main changes in the terms of debt agreements and their financial impacts. The CSSF would like to remind issuers that substantial modification(s) of a financial liability result(s) in its derecognition followed by the recognition of a new one.

2. Macroeconomic environment

Fair-value measurement and disclosures

The current macroeconomic environment exacerbates the level of uncertainty involved in determining fair values. Changes in the fair value may have a material impact on an issuer's financial position and performance, especially when issuers apply the fair value model to measure their investment properties or to estimate the recoverable amount of assets for impairment testing in accordance with IAS 36. It is expected that the current macroeconomic conditions (e.g. high interest rates, yields and vacancy expectations) are reflected in issuers' fair value measurement (in particular on Level 3 inputs) and in the related disclosures.

In the case of investment properties measured according to the fair value model, the CSSF reminds issuers to explain how they have determined all key valuation inputs, such as the capitalisation rate or the rate of return in order to comply with paragraph 92 (d) of IFRS 13. Moreover, the decline in the volume of real estate transactions should be taken into account when applying the market approach for the determination of the fair value as information on comparable transactions in recent periods might become scarce and prices observed in the past may not be representative of the macroeconomic conditions prevailing at the end of the reporting period. Therefore, issuers may need to apply additional valuation methods to ascertain that the price estimated using the comparable transactions approach is within a reasonable range of values.

IFRS 13 requires a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs might result in a significant change in the fair value measurement. Although IFRS 13 does not specifically require disclosure of a sensitivity analysis for observable inputs, issuers are encouraged to provide such analysis for key inputs. Additionally, when providing disclosures on the valuation techniques and inputs used, issuers should describe any significant changes (including transfers between levels) from the previous reporting period and the reasons for those changes.

As for financial assets or liabilities, the CSSF would like to draw the issuers' attention to paragraph 25 of IFRS 7 which requires the disclosure of the fair value for each class of financial assets and financial liabilities, including those that are measured at amortised cost. The current macroeconomic conditions shed particular light on the prominence of this disclosure as rising rates and yields are conducive to growing gap between the fair values and amortized costs of fixed-rate financial assets and liabilities. Indeed, especially issuers facing headwinds in terms of meeting their financial obligations, may need to realize financial assets to generate additional liquidity, thus the aforementioned disclosure would prove to be a valuable source of information for users of their financial statements.

2 Non-Financial Statements

1. Disclosures relating to Article 8 of the Taxonomy Regulation

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On 27 June 2023 the European Commission adopted delegated acts underpinning the Taxonomy Regulation which are expected to apply from 1 January 2024 for annual reports 2023. Such delegated acts include updated versions of the mandatory reporting tables and spell out technical screening criteria ("TSC") for additional economic activities contributing to climate change mitigation ("CCM") and adaptation ("CCA") objectives as well as TSC for economic activities' contribution to the remaining four environmental objectives. For this first year of reporting in relation to the TSC for the four remaining environmental objectives and the TSC for the newly added economic activities contributing to CCM and CCA, non-financial undertakings need only to disclose the proportion of Taxonomy-eligibility of such economic activities.

This new stage follows that of 2023, which saw issuers provide information for the first time on the alignment of their activities with regard to the climate change mitigation and adaptation objectives. As mentioned in its report released in December 2023 on the results of its review of these new disclosures, the CSSF will continue to challenge issuers on these outstanding issues and will thoroughly assess how they comply with the requirements set in the new regulation.

The CSSF would like to advise issuers that they can avail themselves of a number of free resources provided at EU level such as the European Commission's FAQs and International Platform on Sustainable Finance, the EU Taxonomy Compass or the Q&A on ESMA APM Guidelines.

2 Non-Financial Statements

2. Impact of Climate-related matters (1/2)

First of all, the CSSF would like to draw issuers' attention to the entry into force of the Directive (EU) 2022/2464 (better known as the Corporate Sustainability Reporting Directive or the "CSRD") as from 1 January 2024 for annual reports published in 2025 for issuers currently reporting under the NFRD. As the entry into force of the CSRD is phased over the next few years, the range of issuers falling within the scope of the CSRD will ultimately be much broader than that of issuers currently falling within the scope of the NFRD.

Thus, whereas it could reasonably be expected that those issuers would be able to leverage, to a certain extent, of their current reporting experience under the NFRD, the CSSF would like to warn against relying excessively on this fact. The transition from the NFRD to the CSRD reporting requirements is still expected to involve substantial efforts and time commitment. *Inter alia*, data collection and preparation, internal controls and procedures underlying the mandatory assurance requirements should be duly and thoroughly considered by the key decision makers. CSRD reporting requirements should be prepared according to the European Sustainability Reporting Standards ("ESRS") issued by the European Financial Reporting Advisory Group ("EFRAG") and adopted by the European Commission. These new reporting requirements are far more granular and extensive than those of the NFRD and underlying guidelines of the European Commission. Consequently, the CSSF exhorts issuers to anticipate as much as possible the entry into force of the CSRD and the related ESRS by adapting comprehensively and timely their organizations, policies, internal controls and procedures.

Irrespective of the above, the CSSF will continue to ensure that the reporting requirements of the NFRD as transposed by the law of 23 July 2016 are respected.

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2. Impact of Climate-related matters (2/2)

In this context, the CSSF would like to underline the importance of disclosures on climate-related targets, actions and progress. As a matter of fact, targets are most useful when they are measurable, defined in time and when they clarify: (i) the expected outcomes in terms of mitigation of, or adaptation to, climate-related risks, (ii) any benefits arising from climate-related opportunities, or (iii) any impacts on people or the environment. It is essential to describe how such targets enable issuers to meet any entity-level or public policy objectives and if they are science-based. Communication on the progress towards the pre-defined targets is key but the CSSF also urges issuers to re-assess the attainability of such targets in light of progress made and to provide transparent information if events or circumstances seem to cast doubts on the achievability of such targets.

The CSSF also highlights that issuers should clearly disclose the financial resources earmarked in order to achieve the targets and ensure connectivity of such information with the disclosures of the financial statements, of the Article 8 disclosures of the Taxonomy Regulation as well as other relevant sections of the annual report.

The CSSF advises that special attention is to be paid to greenhouse gas ("GHG") emission reduction targets. Issuers are encouraged to elaborate on the intended decarbonisation levers by their quantitative contribution to the target and by explaining whether these levers are internal (e.g. the application of cleaner technologies for reducing emissions) or external (e.g. collaborative actions with key actors in the value chain).

In particular, scope 3 GHG emissions warrant special care from issuers. Issuers should evaluate if reporting on GHG emissions could be construed as complete in all material aspects without scope 3 GHG emissions. If issuers deem scope 3 emissions to be immaterial, the CSSF calls for transparent communication of the rationale having led to such conclusion. When scope 3 emissions are deemed material, transparent disclosure should be made as to the boundaries of their calculation, including, where applicable, the rationale for excluding certain categories thereof and an indication of the quantitative impact of such excluded categories.

3 Alternative Performance Measures

Impact of Article 8 of the Taxonomy Regulation

In 2024, Alternative Performance Measures (hereinafter "APMs") will remain an important point of attention for the CSSF. Based on the results of the examination of 2022 annual reports, the CSSF would like to draw issuers' attention to the treatment of capital and operating expenditure (respectively "CapEx" and "OpEx") by referring to Question 19 and 20 of the Q&As on ESMA APM Guidelines. Thus, if a CapEx or OpEx measure is not calculated strictly in compliance with the definition provided in the Taxonomy Regulation, then it is to be considered as an APM and it should be treated in line with ESMA APM Guidelines. Moreover, the place of the disclosure may also be relevant. If a CapEx or OpEx measure is in a section of the management report, other than the one dedicated to Article 8 of the Taxonomy Regulation disclosure, it is likely that it is an APM. Conversely, if it is calculated following the definition included in the Taxonomy Regulation and disclosed in the section of the management report dedicated to Article 8 disclosures of the Taxonomy Regulation, it should not be considered an APM. Finally, if a CapEx or OpEx measure, calculated as per the Taxonomy Regulation definition is disclosed both in the section pertaining to Article 8 disclosures of the Taxonomy Regulation and elsewhere in the management report, then such measure is not to be interpreted as an APM.

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