CONVERGING GLOBALLY ON SUSTAINABILITY STANDARDS

LEE WHITE

Executive Director - IFRS Foundation

A global baseline of sustainability-related disclosures for capital markets

The International Sustainability Standards Board (ISSB) issued its inaugural standards in June. The standards mark a new era for sustainability-related disclosures in capital markets worldwide, enabling companies to communicate sustainability-related risks and opportunities to investors, including the effect climate-related risks and opportunities have on its prospects.

This article aims to delve into the significance of the ISSB Standards and their potential impact on the global investment landscape.

IFRS S1 provides a proportionate set of disclosure requirements that enable companies to communicate their sustainability-related risks and opportunities over the short, medium, and long term.

IFRS S2 is designed to be used with IFRS S1 and focuses specifically on climate-related disclosures. It incorporates the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), further enhancing transparency of climate-related risks and opportunities for investors.

As a result, on 6 July the Financial Stability Board has announced that the work of the TCFD has been completed – with the ISSB Standards marking the 'culmination of the work of the TCFD'. Furthermore, the Financial Stability Board has asked the IFRS Foundation to take over the monitoring of the progress on companies' climate-related disclosures from the TCFD.

The adoption of both IFRS S1 and IFRS S2 will empower investors to make informed decisions based on consistent and comparable disclosure of sustainability-related information provided alongside financial statements – in the same reporting package.

The Standards, which are suitable for application around the world, have been developed to be used in conjunction with any accounting requirements. They are also built on the concepts that underpin the IFRS Accounting Standards, which are required for use – fully or partially - by more than 140 jurisdictions.

The ISSB developed IFRS S1 and IFRS S2 in response to calls from corporates, investors, the G20, the Financial Stability Board, and the International Organization of Securities Commissions (IOSCO). This broad support demonstrates the urgent need for a comprehensive global baseline of sustainability-related disclosures.

Adoption of the ISSB Standards

Now that IFRS S1 and IFRS S2 are issued, the ISSB is committed to supporting their adoption in jurisdictions and by companies. A Transition Implementation Group is being established to assist companies applying the Standards, and capacity-building initiatives will be launched to facilitate effective implementation.

The ISSB is also collaborating with jurisdictions seeking to require incremental disclosures beyond the global baseline, ensuring flexibility while maintaining consistency. Furthermore, the ISSB is working with the Global Reporting Initiative (GRI) to support efficient and effective reporting when the ISSB Standards are applied in combination with other reporting standards.

Endorsed by securities regulators

On 25 July, IOSCO endorsed the ISSB Standards following a comprehensive review. IOSCO now encourages its 130 member jurisdictions, regulating over 95% of the world's securities markets, to consider how they can incorporate the ISSB Standards into their regulatory frameworks. The endorsement from IOSCO confirms that the ISSB Standards are fit for capital market use. This endorsement, reminiscent of the endorsement of IFRS Accounting Standards, underlines the potential of the ISSB Standards to become the global language of sustainability disclosure.

High degree of alignment

On 31 July, the European Commission issued the European Sustainability Reporting Standards (ESRS), which will come into effect in 2024. To ensure alignment and interoperability the European Commission, EFRAG, and the ISSB have worked jointly on their respective climate-related disclosure requirements.

The collaboration between these entities has led to a high degree of alignment, reducing complexity and duplication for entities using both the ISSB Standards and ESRS climate standards. A navigation tool will assist entities in efficiently applying both sets of climate-related standards and identify incremental disclosures required by only one set of standards. One of the main differences is the inclusion in ESRS of impact materiality requirements, beyond an investors' perspective.

Better information for better decisions

As we confront the risks and opportunities posed by sustainability, it is important to apply the same rigour to achieve the same consistency in sustainability information as applies to the accounting.

The ISSB Standards mark a crucial milestone in sustainability reporting, providing a global baseline that fosters consistency and comparability of information in capital markets. By offering a common language for sustainability disclosures, these standards will empower investors to make informed decisions, build trust in companies, and allow markets to price in sustainability-related risks and opportunities.

UGO BASSI
Director, Financial Markets, DG for Financial Stability, Financial Services and Capital Markets Union - European Commission

ESRS: striking the right balance between transparency and proportionality

The Corporate Sustainability Reporting Directive (CSRD) entered into force at the start of 2023. The centrepiece of the directive is the introduction of mandatory European sustainability reporting standards (ESRS) for companies in scope. Once adopted, these reporting standards will facilitate the delivery of the European Green Deal and underpin the EU's sustainable finance agenda. The standards confirm the EU's position as the global front-runner in terms of ambitious rules on sustainability reporting.

The ESRS cover the full range of sustainability issues, from climate to social and human rights. As required by the CSRD, mandatory reporting standards will ensure that companies are fully transparent about their impacts on people and the environment, well as about the risks and opportunities they face from climate change and other sustainability issues. They will be a key tool to combat greenwashing. These standards will also help companies to communicate and manage their sustainability performance more efficiently.

One of the objectives of the Commission in adopting the ESRS was to ensure a balance between the provision of relevant, comparable sustainability information which promotes greater transparency and facilitates sustainable investments, while also ensuring that the standards are proportionate and do not impose excessive burden for companies.

Stakeholder feedback received during the public consultation recognised that the draft standards would achieve the proposed policy objectives, but also underlined the challenging nature of many of the reporting requirements, in particular for companies that will be reporting sustainability information for the first time. In light of this feedback and in line with reporting reduction efforts, the Commission has made a number of targeted modifications to the draft ESRS submitted by EFRAG. These modifications will ensure that the ESRS are proportionate, without undermining the achievement of the policy objectives.

Firstly, the Commission is proposing additional phase-ins for some of the reporting requirements, on top of certain phase-ins already proposed by EFRAG. These additional phase-ins mainly apply to companies with fewer than 750 employees and focus on reporting requirements considered to be particularly challenging for companies. The additional phase-ins will give these companies more time to prepare and to spread the initial start-up costs over a number of years.

The ESRS provide for ambitious sustainability reporting, while ensuring proportionality.

Secondly, the Commission has made a limited number of reporting requirements voluntary instead of mandatory. The draft ESRS submitted by EFRAG already included many voluntary datapoints. The Commission has further converted a number of the mandatory datapoints proposed by EFRAG into voluntary datapoints. This includes, for example, reporting a biodiversity transition plan and certain indicators about self-employed people and agency workers in the undertaking's own workforce.

Thirdly, the Commission has given companies more flexibility to decide exactly what information is relevant in their particular circumstances. In the jargon, this is referred to as making more of the reporting requirements "subject to materiality" (i.e. it allows companies to omit information if it is not relevant in their particular circumstances), as opposed to being mandatory for all companies.

The materiality approach means that if the information is relevant in the case of the reporting company, it must be reported. The alternative approach – saying a reporting requirement is mandatory for all companies regardless of any materiality assessment – runs the risk of requiring companies to spend time and money reporting irrelevant information. The ESRS require undertakings to perform a robust materiality assessment to ensure that all information necessary to meet the objectives and requirements of the CSRD will be disclosed.

Furthermore, all reporting will be audited, and the CSRD specifically requires the auditor to check the company's materiality assessment. In the case of listed companies, the reporting must also be supervised by national competent authorities. Together with the discipline that will come from scrutiny by financial markets and other stakeholders, there are sufficient safeguards to ensure that companies will report all required information.

Mandatory common standards will provide a cost-efficient solution for companies, allowing them to use one coherent set of standards to report credibly about their sustainability performance instead of having to use multiple different standards and frameworks. Moreover, the cost of ESRS needs to be weighed against the benefits to users of sustainability information, including investors, and the overall benefits of progress towards a sustainable economy.

DANIELA MARILUNGO
Head of International Government Relations and International ESG Policy - Bank of America

EU and ISSB: aligning sustainability reporting standards

Given the scale of the effort needed to transition the global economy to net zero carbon emissions by 2050, the world cannot afford to maintain multiple, disparate climate reporting standards. Such duplication risks confusing investors and increasing operational costs for businesses, thereby diverting resources away from the transition. Globally recognised sustainability standards are key to setting high quality and interoperable reporting worldwide.

At an international level, the ISSB's second published standard, IFRS S2, is built upon the strong foundation provided by the Task Force on the Climate-Related Financial Disclosure (TCFD) framework. TCFD is well understood by reporting entities and their investors, and its use has proliferated, becoming a core element in corporate climate reporting.

This proliferation demonstrates that the cost-benefit equation regarding its application appears justified; we can expect that balance to continue as S2 is adopted and implemented. It is likely that, in time, several major economies will adopt climate reporting standards that are based on S2. This is supported by the successful track record of the IFRS accounting standards which are now used by over 145 countries around the world. Globally accepted standards are better understood by investors and other market participants, decrease the cost of capital and facilitate capital flows.

The ISSB standards were in part shaped by the Stakeholder Capitalism Metrics initiative, itself developed by the World Economic Forum's International Business Council. The IBC, under the chairmanship of Bank of America, organized the work with the global big 4 accounting firms EY, Deloitte, PWC and KPMG. Nearly 200 companies are committed to reporting according to the IBC framework. Building on that collaboration, the WEF and ISSB have recently agreed to convene a group of sustainability professionals to provide insight and practical examples to encourage voluntary reporting, following the release of the ISSB's standards.

Globally recognised sustainability standards are key to setting high quality and interoperable reporting.

In the EU, the European Sustainability Reporting Standards (ESRS) adopted by the Commission provide a comprehensive sustainability reporting framework. Yet significant reservations remain about the feasibility of in-scope businesses implementing this framework effectively. Concerns centre on obtaining reliable data from companies in the value chain, as well as the practicality of complying with all the provisions, notably the impact materiality assessment, within the specified timelines. Moreover, rushing the implementation will lead to poor quality data and inconsistent disclosure practices, that in turn might result in a loss of credibility in ESRS reporting. A timely interpretation mechanism by the Commission and application guidance by EFRAG is needed to help achieve high-quality disclosure, notably on how to identify and assess the impact on people or the environment.

Striking the right balance between the need for more transparency while not overburdening companies with reporting is vital. That's why materiality should be the cornerstone of reporting, as it establishes which disclosure a company needs to provide under the ESRS. However, the ESRS risk placing an unnecessary burden, including when companies are required to assess materiality at multiple levels – for example at the consolidated, country and subsidiary levels. As large companies generally operate across different countries, with multiple subsidiaries, the assessment at different levels creates additional complexity but without the benefit of decision-useful information.

Since the publication of the draft ESRS by EFRAG in November 2022, there has been significant progress between the European Commission and the ISSB to ensure coherence and improve the interoperability of both disclosure standards. This cooperation has indeed resulted in a greater degree of alignment between the ESRS and the ISSB, streamlining complexity and eliminating duplication for entities seeking to adhere to both sets of standards. The aligned definition of financial materiality in the ESRS and ISSB is not only beneficial for companies, which could conduct a single financial materiality assessment for both standards, but also for users, benefitting from greater comparability of reported data.

Although the two frameworks have been developed with a different approach to materiality, greater interoperability will allow entities applying the ESRS to avoid duplication of effort and will contribute to the global comparability of reported sustainability information.

Meanwhile, in the US, the Securities and Exchange Commission's (SEC) Spring 2023 Regulatory Flexibility Agenda of April 2023, indicates that the agency's rulemaking on climate change disclosure is expected to be finalised in October 2023. However, this proposed rule's expected finalisation date has been deferred once already and it is difficult to be certain about its ultimate timeline for implementation. The SEC's proposed approach has elicited a record number of comment letters, containing a myriad of views, illustrating how contentious this topic is for stakeholders in the US economy.

We will continue to make the case for international coordination on this vital topic.

HIROTAKA HIDESHIMA

Counsellor on Global Strategy, TNFD Taskforce Member - Norinchukin Bank

TNFD package to be published on 18 September: beyond ISSB S1 and S2

ISSB's sustainability reporting standards

The International Sustainability Standards Board (ISSB) published on 26 June the first set of global sustainability reporting standards: IFRS S1 for sustainability-related risks and opportunities in general, and IFRS S2 for the effect of climate-related risks and opportunities on a company's prospects. The International Organization of Securities Commissions (IOSCO) has endorsed these standards on 25 July and has concluded that the ISSB Standards are appropriate for the purpose of helping globally integrated financial markets accurately assess relevant sustainability risks and opportunities, and that they form an appropriate basis for the development of a robust assurance framework to apply to such disclosures. This provides the much-needed common global baseline upon which different jurisdictions can build their own domestic standards.

Next steps

The next step will be for the individual jurisdictions to make decisions on the adoption of these standards. It should be noted that, while some jurisdictions may decide to directly adopt IFRS S1 and S2 as developed by the ISSB, jurisdictions such as the European Union, the United States, or Japan are to develop their own domestic standards. This was also the case in the realm of accounting standards, with the IASB producing IFRS globally, the European Commission creating a European standard, the FASB a US standard and the ASBJ a Japanese one. While it would be ideal for these domestic standards to be consistent with the global baseline, there are likely to be some differences. It may be premature to make any assessment on such differences in the case of sustainability reporting standards, when the national standards are still under development (the Japanese draft standard is yet to be published).

ISSB's Agenda consultation

The ISSB is also consulting until 1 September on its priorities for the next two years. The ISSB has identified four potential projects: three sustainability-related research projects- 1) biodiversity, ecosystems and ecosystem services; 2) human capital; 3) human rights- and a fourth project researching integration in reporting.

The ISSB is also balancing advancing new projects in a timely manner with its focus on ensuring that its initial two standards are implemented effectively.

The ISSB needs to take up nature as its next project as a priority over implementation of S1 and S2.

While the intention to promote implementation of the newly published standards is understandable, there may be a need to place priority on advancing new projects, at least in the area of biodiversity, ecosystems and ecosystem services, for the following three reasons.

First, the draft European sustainability reporting standards already covers the area of biodiversity and nature along with human capital and human rights. It would be desirable to provide a global baseline for these areas too without too much delay.

Second, given the climate-nature nexus, having a climate only standard for too long of a period will send the wrong signal. Non-nature-based solutions to climate change, such as cutting down forests to build wind turbines or solar panels, for example, damages nature, but may look entirely desirable from a climate only perspective. It is crucial to follow up on the ISSB's message "*climate first, but not climate only*" with action.

Third, the TNFD framework will be published on 18 September, and it is expected that a number of firms will start disclosing using that framework (some already have). Similar to the case of TCFD, it is desirable for the ISSB to provide a global baseline as a follow up to market led initiatives in developing disclosure frameworks.

In the area of nature too, the consistency between different standards can become an issue. As for the time being, the TNFD framework seems to be well aligned with the European draft standards, especially since the relevant officials have been communicating with each other closely. Extending such alignment with an ISSB standard would be a benefit.

The implementation challenge is likely to be greater in the area of nature, but there may be common elements with climate. It may be more efficient to deal with these challenges together rather than working in the sequence of implementation, standard development, and then implementation again.

TNFD publication

The TNFD will be publishing its first full package on 18 September after two years of work, four beta versions (first in March 2022, second in June 2022, third in November 2022, and the fourth in March 2023), and input from the market. There are already some firms around the world disclosing nature-related issues using these beta versions, but there will probably be more after the release of the September package.

The leaders of the Group of Seven (G7) have stated in their Communique released after their meeting in Hiroshima in May that they "look forward to the publication of the Taskforce on Nature-related Financial Disclosures' (TNFD's) market framework and urge market participants, governments and regulators to support its development."

WANG LEI
Deputy General Manager -
Bank of China (Europe) S.A.

Sustainability reporting practice in China and comparison with EU

ESG and sustainable development are becoming more and more a global consensus. ESG concept has been widely integrated into Chinese social and financial eco-system. Chinese authority has formally committed to the objective of "peak carbon emissions by 2030 and become carbon neutral by 2060". However, the regulatory requirement of sustainability reporting are not as standardized or comprehensive as in European Union (EU). Chinese companies were encouraged to report on their ESG performance voluntarily, although many large state-owned enterprises and a significant portion of listed companies have initiated the practice to publish sustainability report, alongside the annual financial report.

Chinese ESG related policy framework development

The Chinese ESG has recorded a rapid development despite some lag compared to the western countries. The policy framework become more precis and the requirements are more granular. It covers non-financial corporations, financial institutions and financial instruments. The policies can be classified as three categories, taking into consideration of the policy objectives. First category takes form of guidelines, which encourage the financial and non-financial companies to incorporate the ESG concept into their business practice. The second category prevails "incentive mechanism", which grant preferential treatment (e.g. advantageous tax regime or interest rate reduction) to those companies that have demonstrated positive ESG impact realization. Finally, the third type is to encourage ESG related information disclosure transparency.

Despite the voluntary nature of sustainably reporting, Chinese regulators have been actively pushing for greater transparency and disclosure. Several milestones have been accomplished by now. Earlier in 2010s, the Chinese Securities Regulatory Commission (CSRC) and Shanghai Stock Exchange, among others, have issued guidelines and encouraged listed companies to adopt sustainability reporting practices. Additionally, the 2016 Environment Protection Tax Law required companies to disclosure their environmental performance, further stimulating sustainability reporting. In 2021, People's Bank of China has issued a package of Environmental and Green Finance information disclosure guidelines, encouraging financial institutions to publish the information related to their environmental risk management, the impact of their activities on environment and carbon emission.

Global standardization of ESG related reporting has still a long way to go.

More recently in June 2022, the Banking and Insurance Green finance guidelines issued by China Banking and Insurance Regulatory Commission (CBIRC) requires Banks and Insurance companies to promote green finance from a strategic level and integrate ESG goals into internal management procedure and comprehensive risk management framework.

Key figures of ESG related disclosure practice in China

Among all listed companies in mainland China, 28% of them have published annual ESG related disclosure report in 2021, while only 23% of them adopted such practice in 2018. The proportion of the companies that adhere voluntarily to the transparency disclosure has been increased steadily over the last years. The larger companies have a higher disclosure rate. The companies whose market cap exceeded 100 billion CNY (Equivalent 12.5 billion EUR), have more than 90% of disclosure rate, whilst small cap companies of less than 10 billion CNY (Equivalent 1.25 billion EUR), only have less than 30% of disclosure rate.

Comparison of ESG Information Disclosure practice between China and EU

Both China and EU have formed ESG-related information disclosure regulatory framework, which regulate disclosure scope, content, and degree of enforcement.

EU has more specific and mandatory information disclosure requirements for financial institutions, framed mainly by SFDR, CSRD, Taxonomy regulation and upcoming ESRS. The disclosure covers a wide range of topics, including carbon emissions, energy usage, water consumption, labor practice, board diversity, executive remuneration and other social and environmental issues. China's disclosure has been mainly on environmental factors, with less emphasis on social and governance aspects. Nevertheless, this may change in the future as awareness and interest in ESG issues increase.

Overall, the EU has been at the forefront of ESG reporting and disclosure initiatives. China has been making progress in this area, but there is still room for improvement in standardization, comparability and enforcement of the publication.