The Evolution of ESG Disclosure Standards: Norming?

by **Kate Rebernak**

In 1993, an estimated 12 percent of the world's companies engaged in sustainability (now often called ESG, short for environmental, social, and governance) reporting: disclosure of their impacts on people and the Earth and their efforts to address them. As of 2022, the consulting firm KPMG estimates, all of the top 100 U.S. companies engage in ESG disclosure, and 95 percent of the world's largest 250 are engaging in "some form of sustainability reporting."[1]

Alongside the growth in reporting grew a dizzying array of frameworks and standards for sustainability reporting. These include those issued by the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), International Integrated Reporting Committee (IIRC), the Task Force on Climate-related Financial Disclosures (TCFD), the Task Force on Nature-related Financial Disclosures (TNFD), and the UN Global Compact, among others. All were established with the intent to drive more consistent, higher-quality disclosures that are useful to stakeholders in making decisions about those companies: where to work, where to shop, where to invest.

1. The 2022 KPMG Survey of Sustainability Reporting.

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The many and often competing disclosure standards and frameworks have created a complex and confusing array of requirements and expectations for disclosure and performance that, without significant convergence and consolidation, may have opposite the intended effect. The result is often confusion–and tension–over what to disclose, and with how much detail, and how to show progress on complex and business-critical issues and create value for employees, customers, and investors. As noted by the law firm Morrison Foerster in reporting the results of its annual survey of general counsels and ESG, "[w]hile companies are making ESG considerations, they have been making minimal adjustments to operations to drive change. Part of this may be due to lack of guidance and metrics for how to integrate ESG considerations into operations."

Enter two new disclosure schemes that could signal a "norming" of company disclosures around ESG issues: the International Financial Reporting Standards' (IFRS) Sustainability Disclosure Standards (IFRS S1 and S2) and the European Sustainability Reporting Standards (ESRS), mandated by the **EU Corporate Sustainability Reporting Directive** (CSRD). Both IFRS and ESRS aim to standardize corporate reporting and lead to better, more useful information for the capital markets. They are different enough, however, that companies, in particular those operating in multiple jurisdictions, will have to navigate both standards unless and until there is further alignment.

What follows is a high-level overview of the CSRD/ESRS and IFRS S1 and S2, areas of alignment, and key areas of divergence.

CSRD and ESRS

On July 31, 2023, the EU Commission adopted the European Sustainability Reporting Standards (ESRS) for use by companies that are subject to the CSRD, which the European Parliament formally adopted in November 2022. The CSRD went into effect on January 5, 2023.

The CSRD and, by extension, the ESRS as a delegated act thereof[2] expand the scope of mandatory annual sustainability reporting from approximately 11,700 primarily European companies to about 49,000 global companies starting between 2025 and 2029. Applicable initially to companies covered by the EU Nonfinancial Reporting Directive (NFRD)[3] beginning in 2025 for the fiscal year 2024, the CSRD will expand in scope in later years to any major business, public or private, doing substantial business in the EU, even if the parent company is headquartered elsewhere. The CSRD applies to EU-based companies, the EU subsidiaries of some 10,000 multinational corporations, and eventually, to non-EU parent companies with substantial operations in the EU.[2] It is estimated that more than three thousand US companies will be subject to the CSRD in the next few years.[4]

The ESRS requires disclosure of "material impacts, risks and opportunities [(IROs)] in relation to environmental, social, and governance sustainability matters" and covers a broader range of topics than IFRS S1 and S2. In addition, ESRS requires companies to consider value-chain impacts in determining what to disclose.

Though ESRS is intended to serve the information needs of the capital markets, the perspectives and needs of other stakeholders must be considered in the determination of material issues for disclosure. Key to determining the materiality of an IRO is an impact and financial materiality assessment, also known as a "double-materiality" assessment, which requires two lenses:

- **Impact materiality:** actual and potential positive and negative impacts (*e.g.*, impact of products on customers); and
- **Financial materiality:** risks and opportunities (*e.g.*, impact of GHG emissions on cash flows via carbon pricing mechanisms)

2. **EFRAG Welcomes the Adoption of the Delegated Act on the First Set of European Sustainability Reporting Standards (ESRS) by the European Commission**, July 31, 2023.
3. The CSRD integrates and replaces the EU Nonfinancial Reporting Directive, which went into effect in 2018.
4. **At Least 10,000 Foreign Companies to Be Hit by EU Sustainability Rules (wsj.com)**

If an IRO is determined to be material from even one lens, it is material for purposes of CSRD.

It's important to note that the CSRD requires that information reported under ESRS be subject to limited assurance, which will represent a not-insignificant added cost to reporting entities. Some estimates are that the reporting process can cost from 0.004% to 0.008% of a company's annual revenue.[5]

IFRS S1 and S2

On June 26, 2023, the **International Sustainability Standards Board (ISSB)** announced the official launch of the new IFRS 1 and 2 global sustainability and climate disclosure standards. These new standards, which focus on information for capital markets, are expected to form the basis for sustainability reporting by regulators around the world.[6]

IFRS S1 requires companies to disclose information about sustainability-related risks and opportunities that would be useful to "primary users of general purpose financial reports." The core considerations for such information are governance, strategy, risk management, and information on metrics and targets.[7]

IFRS S2, to be used with S1, defines required climate-related disclosures. Climate-related metrics include Scopes 1, 2, and 3 greenhouse gas (GHG) emissions. The ISSB has announced, however, that it will allow companies extra time to report on Scope 3 emissions.

The IFRS standards will apply beginning January 2024, and companies will begin to issue disclosures against them in 2025. Several jurisdictions, including **UK, Canada, Australia, New Zealand, China, Hong Kong, Singapore, Malaysia, Nigeria, and Japan**, have already introduced or are preparing mandatory sustainability reporting requirements. Many of these are, or will be, heavily influenced by the IFRS standards.[8]

In a signal of how the standards may evolve, ISSB Chair Emmanuel Faber recently stated that the ISSB may add requirements to the climate reporting standard covering connections to natural ecosystems such as deforestation and biodiversity.

The good news for both companies and investors: IFRS integrates some of the existing standards noted above, including those of the SASB, the TCFD, and the Climate Disclosure Standards Board (CDSB). As many companies already use these frameworks and standards, they won't necessarily need to adapt their disclosures to a completely new set of indicators. It's also worth noting that the IFRS standards are designed for interoperability with several other standards and frameworks, including ESRS and GRI. And finally, the SEC proposed climate disclosure rule is aligned to a large extent with the IFRS standards related to TCFD consolidation and financial materiality.[9]

5. Ibid.
6. The formation of the ISSB was announced at COP26, the UN global summit to address climate change, in November 2021. The ISSB's charge was to develop "in the public interest—a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs[.]"
7. Susan H. Mac Cormac, Alfredo Silva, and Oluwabamise Onabanjo, Morrison Foerster LLP, on Tuesday, August 22, 2023, **Inside the IFRS S1 and S2 Sustainability Disclosure Standards (harvard.edu)**, August 22, 2023.
8. **issb-releases-final-global-sustainability-disclosure-standards.pdf (kirkland.com)**
9. Susan H. Mac Cormac, Alfredo Silva, and Oluwabamise Onabanjo, Morrison Foerster LLP, on Tuesday, August 22, 2023, **Inside the IFRS S1 and S2 Sustainability Disclosure Standards (harvard.edu)**, August 22, 2023.

Convergence at last? Not so fast.

While the two new standards aim to bring consistency in information flow around sustainability issues, there are areas of divergence that companies will need to navigate in the short to medium term.

Key differences between ESRS and IFRS are that, while ESRS requires a double-materiality assessment that considers impacts on people and the environment, IFRS requires only an assessment of financial materiality ("single materiality") to determine what information to disclose. And while ESRS requires that material disclosures be assured by a third party, IFRS does not require information reported to be assured. Local jurisdictions that adopt the IFRS as part of their regulatory schemes may require assurance, however.

SNAPSHOT: KEY AREAS OF CONVERGENCE AND DIVERGENCE BETWEEN ESRS AND IFRS

	ESRS	IFRS
EFFECTIVE DATES	Requirement for companies subject to the NFRD to begin reporting in January 1, 2025, for FY2024; other large companies will be required to begin reporting in 2026 for F2025.	January 1, 2025, for FY2024; jurisdiction specific
STAKEHOLDER FOCUS	Multiple stakeholders	Investors
MATERIALITY	Impact + financial	Financial only
TOPICS COVERED	• **General** 1: General requirements: process requirements applicable to all reporting entities, including reporting boundaries and structure, and quality and consistency of information to be reported 2: General, strategy, governance, and materiality assessment • **Environmental** E1: Climate change E2: Pollution E3: Water and marine resources E4: Biodiversity and ecosystems E5: Resource use and circular economy • **Social** S1: Own workforce S2: Workers in the value chain S3: Affected communities S4: Consumers and end-users • **Governance** G1: Business conduct Industry-specific standards to come.	**S1:** General principles; entities required to report across all sustainability-related risks and opportunities. **S2:** *Climate impacts*. Reporting entity is encouraged to disclose cross-industry metrics, industry-based metrics, qualitative targets, and quantitative targets and metrics set by the entity or required by law. The entity is also encouraged to refer to the *Industry-based Guidance on Implementing IFRS S2*, derived from the SASB standards.[10]
ALIGNMENT WITH, INTEGRATION OF, REFERENCE TO OTHER STANDARDS AND FRAMEWORKS	Numerous significant differences in subject matter and methodology vis à vis, *e.g.*, the GRI, SASB, and TCFD. The ESRS significantly differs in subject matter and methodology from the GRI, SASB, and TCFD.	**TCFD, SASB, NFRD** Reporting entities are required to "refer to and consider the applicability of the disclosure topics in the SASB Standards in identifying sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects."[11]
ASSURANCE REQUIRED	Yes, limited initially, with reasonable assurance requirements to be established over time.	None required by standard. Information designed to be verifiable; assurance requirements will be jurisdiction specific.

10. IFRS - IFRS S2 Climate-related Disclosures
11. IFRS - IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information, IG11.

These two new standards represent a sea change in disclosure of sustainability information and should lead to greater certainty and simplification in meeting the information needs of the capital markets. And in the challenges of presenting more comprehensive information lie opportunities for companies to better understand and communicate how their efforts to address material issues can create long-term value. Our hope and expectation is that over the next several years, these two standards will evolve to work together to bring more consistency and simplicity to the disclosure landscape.

Additional resources:

EU Adopts Long-Awaited Mandatory ESG Reporting Standards (harvard.edu)

Comparing Sustainability Reporting Requirements (kpmg.com)