The Race for a Universal Sustainability Disclosure Standard

By Tara K. Giunta, Nicola Bonucci, Jonathan C. Drimmer & Caroline Wilson Roberts

Responding to demand by governments, policymakers, investors, and companies for reliable, comparable, and decision-useful sustainability information, governments and international organizations are increasingly proposing, and in some cases, requiring, sustainability-related reporting.

In an effort to establish a global disclosure standard, the International Sustainability Standards Board ("ISSB") and the European Financial Reporting Advisory Group ("EFRAG") seek to consolidate sustainability reporting guidance to ensure disclosure of consistent, comparable, and decision-useful information. In March 2022, ISSB, established under the oversight of the International Financial Reporting Standards ("IFRS") Foundation, announced two proposed standards, one outlining general sustainability-related disclosure requirements, and the other, climate-related disclosure requirements ("IFRS Sustainability Disclosure Standards"). In April 2022, the EFRAG released its initial draft of European Sustainability Reporting Standards ("ESRS"), which proposes sustainability-related reporting requirements in line with the European Union's Corporate Sustainability Reporting Directive ("CSRD"). These two proposals, discussed in more detail below, are similar in many regards, and either would likely increase disclosure requirements for most companies. Both organizations have expressed an intent to coordinate in an effort to ensure that lessons learned and best practices are incorporated into proposals. For instance, EFRAG noted its "[r]obust and constructive dialogue . . . with other leading international initiatives . . . with the common goal of both mutual understanding of approach and goals and search for ways to facilitate compatibility and convergence wherever possible."[1]

However, there is a risk that rather than resulting in greater clarity, this simultaneous—and, potentially, conflicting or inconsistent—development of disclosure requirements can create further uncertainty in this rapidly developing landscape. In this context, it is worth recalling that in November 2021, the G20 leaders explicitly welcomed "the work programme of the International Financial Reporting Standards Foundation to develop a baseline global reporting standard under robust governance and public oversight, building upon the FSB's Task Force on Climate-Related Financial Disclosures framework and the work of sustainability standard-setters."[2]

I. IFRS Sustainability Disclosure Standards

IFRS' Sustainability Disclosure Standards seek to develop a uniform standard of sustainability-related financial disclosures that "enables investors to assess the effect of significant sustainability-related risks and opportunities on [companies'] enterprise value[.]"[3] IFRS' proposed Sustainability Disclosure Standards build on the recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures ("TCFD") and incorporate industry-based disclosure requirements derived from Sustainability Accounting Standards Board ("SASB") Standards.

Under the proposed IFRS "S1 General Requirements for Disclosure of Sustainability-related Financial Information" ("General Requirements"), companies would be required to disclose material information about significant sustainability-related risks and opportunities. Information is material if the sustainability-related financial information is necessary for investors to accurately assess enterprise value. In addition to information reported in financial statements, information impacting enterprise value may also include non-financial information such as a "company's impacts and dependencies on people, the planet and the economy[.]" Disclosures describe a company's governance, strategy and risk management, and the metrics and targets it uses to measure, monitor, and manage significant sustainability-related risks and opportunities. Notably, disclosures should include material information about sustainability-related risks and opportunities across a company's value chain, including along its supply, marketing, and distribution channels and the financing, geographical, geopolitical, and regulatory environments in which the company operates.

The proposed IFRS "S2 Climate-related Disclosures" ("Climate-related Disclosures") would require companies to provide material information about their significant climate-related risks and opportunities such that investors are able to assess their effect on a company's enterprise value. Similar to the "General Requirements," disclosures are to focus on the governance, strategy, and risk management of the company's business, and the metrics and targets it uses to measure, monitor, and manage its significant climate-related risks and opportunities, including how climate change could affect a company's business model, strategy, and cash flows over the short, medium, or long term, as well as how climate change could impact a company's access to finance and its cost of capital. Companies should be prepared to convey their plans for responding to climate-related risks and opportunities. Importantly, companies would be required to disclose the metrics and targets they use to manage significant climate-related risks and opportunities, including the level and intensity of Scope 1, Scope 2, and Scope 3 GHG emissions.

IFRS is seeking feedback on the proposals over a 120-day consultation period closing on July 29, 2022, and after reviewing feedback, intends to issue new standards by the end of 2022. Corporations could adopt the draft disclosure standard voluntarily, or compliance may become mandatory if the requirements are adopted by national regulators.

II. EFRAG Corporate Sustainability Reporting Directive

In May 2021, the European Commission invited EFRAG to develop draft sustainability reporting standards to be considered for adoption by the end of 2022. Subsequently, in April 2022, EFRAG released its initial draft ESRS, which proposes sustainability-related reporting requirements under the European Union's future CSRD.[4] In developing these draft reporting standards, EFRAG engaged with other leading international organizations to "search for ways to facilitate compatibility and convergence wherever possible," including working with IFRS on its two recently issued proposed requirements.

ESRS includes "cross-cutting standards" that generally guide reporting on business strategy and business model, governance, and how companies identify and manage sustainability impacts, risks, and opportunities. The related disclosure requirements correspond generally to the governance, strategy, and risk management reporting pillars of the TCFD and the IFRS. One noteworthy aspect of the proposal is its use of "double materiality" (impact materiality and financial materiality) for establishing whether a sustainability matter must be reported. A sustainability issue is material from a financial perspective if it generates or may generate significant risks or opportunities that influence or are likely to influence the enterprise value of the company in the short, medium, or long term. In contrast, impact materiality refers to an actual or potential significant impact on people or the environment over the short, medium, or long term, including impacts directly caused or contributed to by the company in its own operations, as well as impacts directly linked to the company's upstream and downstream value chain. As such, ESRS more explicitly encompasses impact materiality than IFRS, as under IFRS, companies are only required to disclose information necessary to enable investors to assess the company's enterprise value.

ESRS' "topical standards" encompass information to be reported, including the relevant policies, targets, action plans, and resource allocation connected to a given sustainability topic or subtopic, along with corresponding performance measurement metrics. The EFRAG proposal includes a series of draft sustainability reporting standards that cover environment,[5] social,[6] and governance.[7]

Disclosure requirements are detailed, including, for example, disclosures that allow users to understand whether the company's past, current, and future mitigation efforts are in line with the Paris Agreement and limit global warming to 1.5°C. Requirements around the disclosure of climate-related targets include disclosure of GHG emission reduction targets on Scope 1 (direct emissions), Scope 2 (indirect emissions) and Scope 3 (emissions in value chain beyond Scope 1 or 2). Scope 3 emissions, which include emissions outside of companies' direct control, are to be broken down by (i) upstream purchasing, (ii) downstream sold products, (iii) goods transportation, (iv) travel, and (v) financial investments.

This version of the proposed ESRS disclosures did not include SME-proportionate standards nor sector-specific standards, but these standards are being developed and will ultimately be submitted to a separate public consultation. The proposed IFRS Climate-related disclosures do include industry-based disclosure requirements.

Public consultation on the draft disclosures will occur through August 8, 2022, and then a final first set of draft ESRS will be submitted to the European Commission. The ESRS are set to become mandatory in 2023, and are anticipated to affect 50,000 EU companies (up from approximately12,000 today) in line with the scope of the future CSRD.[8]

While the number of third parties involved in developing ESG-related standards is growing, potentially complicating the disclosure process, several involved entities have evidenced a willingness to work together. For instance, ISSB recently announced the launch of a working group to enhance compatibility between ISSB's proposal and other jurisdictional initiatives.[9] Members of the working group include the Chinese Ministry of Finance, the European Commission, EFRAG, the Japanese Financial Services Authority, the Sustainability Standards Board of Japan Preparation Committee, the United Kingdom Financial Conduct Authority and the U.S. Securities and Exchange Commission—which issued its own climate disclosure rulemaking proceeding in March 2022.[10]

III. Next Steps

In light of the global push for consistent, comparable, and reliable sustainability-related disclosures, companies should act now to ensure that they are well positioned to comply with upcoming reporting requirements, be they voluntary or mandatory. Further, by proactively working to develop reporting mechanisms, companies may demonstrate to investors and other stakeholders a genuine intent to transparently convey sustainability-related metrics, while incrementally incurring reporting-related costs and building this internal reporting muscle. Immediate next steps that companies may consider taking include:

- **Engage with experts.** Governments and governing bodies are increasingly focused on developing sustainability-related reporting requirements. While the scope of what must be disclosed is yet to be determined with certainty, it is likely that requirements will necessitate the disclosure of sustainability-related information beyond what is currently required. Disclosure requirements are likely to be detailed, requiring technical analysis and considerations. To ensure that your company fully understands what disclosures are required, and that any such disclosures are fully accurate and compliant with disclosure expectations, companies should engage with sustainability compliance and reporting experts.

- **Tone at the top.** Complying with evolving sustainability-related reporting requirements will require buy-in across the corporation, starting at the top. If companies have yet to do so, Boards and executive teams should be educated on the importance of these reporting requirements, understand the processes in place to ensure compliance, and appreciate their role in ensuring accurate and consistent reporting.

- **Prepare internally.** For companies that have not begun the process of reporting on sustainability-related metrics, the cost of adapting existing systems to these requirements can be substantial. Even for those corporations that have begun to ramp up sustainability-related reporting, the nuances and technical requirements of evolving reporting requirements can require additional man-hours, the purchase of new technologies, the onboarding of additional compliance employees, and/or engaging with third party experts. At the outset, companies should conduct a gap assessment to identify potential issue areas. Companies should also create a governance system that includes a task force comprised of internal stakeholders that "touch" sustainability, potentially including legal, compliance, corporate social responsibility, ESG, supply chain/procurement, enterprise risk management ("ERM"), IT, and others, as needed.

- **Prioritize accuracy.** In addition to encompassing sustainability-related disclosures, it is imperative that companies ensure that disclosures are consistent, accurate, and defensible. Companies should implement procedures that guarantee that more qualitative disclosures are methodically calculated such that disclosures do not appear inconsistent or otherwise misleading.

- **Remain flexible.** Shifting expectations can be burdensome, and it is anticipated that both sustainability-related disclosure expectations and requirements will continue to evolve as regulators work to understand what types of information are both reasonable for companies to disclose and decision-useful. Disclosure requirements are also likely to continue to evolve as understanding of the sustainability landscape develops.

- **Engage with regulators and organizations developing reporting standards.** Regulators and organizations working to develop disclosure standards frequently seek feedback on their proposals. Companies likely to be affected by these requirements should engage in discourse around the advantages and challenges that certain disclosure requirements pose.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 *Cover Note for Public Consultation, Draft European Sustainability Reporting Standards,* PROJECT TASK FORCE ON EUROPEAN SUSTAINABILITY REPORTING STANDARDS & EFRAG (April 2022).

2 *G20 Rome Leaders' Declaration*, UNIVERSITY OF TORONTO (October 31, 2021), http://www.g20.utoronto.ca/2021/211031-declaration.html.

3 *IFRS Sustainability Disclosure Standards – Snapshot,* IFRS (March 2022), https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/snapshot-exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financial-information-and-exposure-draft-s2-general-sustainability-related-disclosures.pdf.

4 *Cover Note for Public Consultation, Draft European Sustainability Reporting Standards,* PROJECT TASK FORCE ON EUROPEAN SUSTAINABILITY REPORTING STANDARDS & EFRAG (April 2022). The CSRD would extend the scope of non-financial reporting to all large companies and companies listed on a regulated market (except listed micro-companies), credit institutions, and insurance companies, and require more detailed and standardized information, improve accessibility of such information, impose a certification requirement, and require statutory auditors to perform a limited assurance engagement on a company's sustainability reporting.

5 Reporting guidance is provided for the environment categories of climate change, pollution, water and marine resources, biodiversity, and resource use and circular economy.

6 Social categories include categories of affected population, including own workforce, workers in the value chain, affected communities, and consumers and end users.

7 Governance categories include governance, risk management and internal control, and business conduct, including business ethics and board diversity.

8 *GRI remains committed to alignment as draft European Sustainability Reporting Standards unveiled*, GLOBAL REPORTING (May 2, 2022), https://www.globalreporting.org/about-gri/news-center/progress-on-corporate-transparency-in-europe/.

9 *ISSB establishes working group to enhance compatibility between global baseline and jurisdictional initiatives*, IFRS (April 27, 2022), https://www.ifrs.org/news-and-events/news/2022/04/issb-establishes-working-group-to-enhance-compatibility-between-global-baseline-and-jurisdictional-initiatives/#:~:text=The%20International%20Sustainability%20Standards%20Board,ongoing%20jurisdictional%20initiatives%20on%20sustainability.

10 Tara K. Giunta, Nicola Bonucci, Jonathan C. Drimmer, Alex M. Herman, Caroline W. Roberts, and Daye S. Cho, *A New Era: Mandatory Climate Disclosures*, PAUL HASTINGS (March 23, 2022).