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Point OF VIEW

Edition 1

ASSESSING THE PROMISES AND LIMITS OF IFRS S1 AND S2 SUSTAINABILITY STANDARDS

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ABOUT

Turritopsis, Strategic Institute of Sustainable Development, is an institute with the selfless goal of promoting sustainable development in economic and social life on an international scale.

The AISBL aims to contribute to ensuring development that places environmental protection, social responsibility, and governance at the core of economic and societal activities.

Turritopsis is based in the heart of Europe, in Brussels, Belgium, and focuses its efforts on the French-speaking world (Africa/Europe/French-speaking Arab world) while remaining open to the rest of the world.

1. Introduction

In June 2023, the International Sustainability Standards Board (ISSB) unveiled its first two sustainability reporting standards - IFRS S1 General Sustainability-related Financial Disclosure Requirements and IFRS S2 Climate-related Disclosures.

IFRS S1 → General Financial Disclosure Requirements

IFRS S2 → Climate-related Disclosures

Established under the auspices of the IFRS Foundation in 2021, the ISSB aims to develop a comprehensive global framework for corporate sustainability reporting. The IFRS S1 standard sets out general principles and requirements applicable to companies disclosing sustainability information in their regular financial reports. The IFRS S2 standard specifically focuses on climate-related risks and opportunities.

IFRS S1 requires companies to disclose sustainability-related risks and opportunities that could have a significant impact on their business model, strategy, cash flows, and access to capital over time. Information must be provided on governance, strategy, risk management, and performance indicators related to environmental, social, and governance (ESG) factors.

IFRS S2 is largely inspired by the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). It requires information on governance, strategy, risk management, and parameters/objectives related to physical and transition risks and opportunities related to climate change. Scenario analysis is mandatory to assess strategic resilience.

Both standards aim to provide consistent, comparable, and reliable information on sustainability, focusing on financial materiality. The goal is to enable investors to better understand sustainability factors that impact the company's value creation.

The new standards represent a significant step forward in integrating material sustainability factors into regular financial reporting. However, they also highlight some challenges inherent in balancing normative and flexible approaches as sustainability information matures.

2. Strengths and Advantages

The IFRS S1 and IFRS S2 standards offer several key advantages as the fundamental standards of the ISSB in sustainability reporting:

i) Global Consistency and Comparability

The standards provide a benchmark for globally consistent sustainability reporting, addressing the significant variability in ESG information provided by companies. They aim to enhance comparability across companies, sectors, and jurisdictions, facilitating performance benchmarking and investment analysis.

ii) Investor Focus

The emphasis on financial materiality focuses sustainability reporting on risks, opportunities, and performance that are relevant to the company's value creation. This approach facilitates the integration of sustainability with strategy and financial management, aligning it with capital allocation decisions.

iii) Integrated Thinking

By incorporating sustainability issues into regular financial reporting, the standards promote more integrated thinking about ESG factors in strategy, governance, risk management, and performance management. This can lead to more active management of sustainability rather than treating it as a separate domain.

iv) Emphasis on Climate Risks

The S2 standard places greater emphasis on climate-related risks and opportunities based on stakeholder priorities. Mandating the disclosure of climate-related information in line with TCFD recommendations ensures the full integration of these recommendations into global corporate reporting.

In summary, S1 and S2 guide sustainability reporting in a direction that seeks to link ESG issues to investor decision-making and entity value. Consistency, comparability, and integration in financial reporting are thereby improved. However, to harness these benefits, it is essential to address the inherent challenges associated with creating sustainability reporting standards and effectively communicating this information by companies.

3. Limits of the Standards

While they significantly advance sustainability reporting, the IFRS S1 and S2 standards have inherent limitations and raise some questions:

i) Limited Scope

One of the main concerns is that the standards adopt a narrow view by limiting the required sustainability information mainly to risks, opportunities, and impacts with clear financial relevance to the company›s value.

The IFRS S1 and S2 standards concentrate on sustainability information, evaluating it in terms of financial materiality for investors, creditors, and other capital providers. In particular, the S2 standard places emphasis on climate reporting, specifically addressing the financial risks and opportunities linked to the transition to a low-carbon economy.

Certainly, this selective scope allows for a closer alignment of sustainability reporting with the goals of financial reporting. However, it excludes the disclosure of broader information regarding context, impact, and sustainability performance, despite the potential high relevance of such information for a comprehensive understanding of the company; notably, it lacks clear financial connections.

For instance, the standards do not incentivize reporting on broader environmental or social impacts throughout the value chain, even though these might be concerns for external stakeholders. This could lead companies to overlook sustainability issues that are crucial for other stakeholders, even if they are not clearly financially significant for the companies themselves.

The standards also provide little guidance on aligning, on the one hand, information to be disclosed with best practices, and on the other hand, multipartite sustainability reporting. Consequently, the communicated information might present an incomplete picture of sustainability, overlooking essential ESG issues based solely on financial significance.

While the focus on investors helps connect sustainability with regular financial information, the IFRS S1 and S2 standards alone may not meet the needs of diverse stakeholders seeking a reasonable understanding of a company's performance, impact, and overall sustainability context. Their scope is thus too narrow.

ii) Flexibility Allows for Inconsistencies

The flexibility granted to companies in the application of IFRS S1 and S2 standards to determine important sustainability issues risks leading to inconsistencies and a lack of comparability in the reported information.

While they establish basic information requirements, the standards allow companies significant freedom to report on sustainability issues most relevant to their business models and markets.

Therefore, companies facing the same climate risks might have different perspectives on their significance and communicate different measures and objectives based on their own assessment of this significance. This selectivity threatens the necessary consistency for benchmarking sustainability performance.

Similarly, the flexibility in choosing climate scenarios and assumptions for resilience analysis could allow for selective picking that obscures risks. Topics covered by other sustainability information standards might be omitted under the pretext that they are not significant.

Certainly, exercising discretion in sustainability reporting is important, given the differences between sectors and entities. However, taken to the extreme, this freedom of judgment can become an excuse for selective or minimal disclosure.

The standards prioritize relevance over consistency, but this could lead to variability, even on sustainability issues generally considered significant such as climate change. Without common parameters, the published information becomes non-comparable across companies and sectors.

Flexibility has its merits in sustainability reporting, but it needs to be thoughtfully balanced with basic expectations regarding the consideration of key ESG concerns. Otherwise, investor decision-making could suffer from incomplete and disjointed sustainability information.

iii) Alignment with Best Practices

In the absence of sufficient guidance on aligning information to be disclosed with best practices in sustainability reporting, companies might use the standards to justify selective or minimal information on ESG issues.

The IFRS S1 and S2 standards focus on sustainability information from an investor perspective and provide little indication of connectivity with broader sustainability reporting frameworks. This raises the risk of 'cherry-picking' that takes information out of its context.

For instance, the standards require climate reporting on financially significant risks but not on broader climate performance indicators or the setting of science-based targets, as demanded by best practices in climate reporting.

As a result, key indicators may be excluded because they are not financially significant. Consequently, the standards might overlook aspects such as impact on local biodiversity, resilience measures to extreme weather events, or the company's efforts towards a sustainable energy transition. These elements, although crucial for a comprehensive assessment of a company's climate risks and impacts, could be sidelined due to their less immediate financial relevance, highlighting a significant gap in the standards' approach to climate risks.

This could result in information implying strong sustainability performance on selective covered indicators while disregarding information on problematic areas reflected in globally accepted sustainability frameworks.

Investor-focused sustainability information standards play a crucial role but do not replace the need to align with best practices that provide a more comprehensive sustainability context.

In the absence of adequate connectivity, sustainability information provided by IFRS S1 and S2 could enable «sustainability washing» based on narrow financial materiality. This could mislead investors and other stakeholders.

As standards evolve, it will be necessary to provide firmer guidance on considering interconnections and finding compromises with best practices in reporting. This will help avoid the impression of providing a comprehensive sustainability performance measure while actually offering only a minimal and selective subset of information.

iv) Lack of Addressing Verification

One of the main shortcomings of the IFRS S1 and S2 standards is the absence of requirements or guidance regarding external assurance and independent verification of sustainability information. This raises concerns about reliability.

The standards do not address the review, audit, or assurance of the quality and accuracy of sustainability information. Without verification, the reported information may include biases, errors, and omissions, presenting a potentially misleading picture of sustainability performance.

Investors and other stakeholders are likely to hesitate to fully trust unverified data and incorporate it into their decision-making. This could significantly limit the value of sustainability information communicated.

Verification becomes even more crucial as sustainability reporting transitions from fragmented information to standardized information. It would confirm that the disclosed information fully and accurately represents the underlying management, risks, and performance in sustainability.

The lack of guidance on verification is an omission in the IFRS sustainability standards. Similar to financial statements, appropriate assurance and audit frameworks for ESG information are essential to enhance investor credibility and trust as the quality and comparability of reporting improve.

It will be crucial to address this gap, not only by expanding the standards but also by encouraging companies to adopt best practices in external verification. Responsible assurance tailored to sustainability reporting remains a significant imperative.

v) Challenges Related to Implementation

The implementation of IFRS S1 and S2 could prove to be very challenging and costly for many businesses, especially small entities with limited experience and infrastructure in sustainability reporting.

To comply effectively, companies will likely need to enhance their data collection, tracking, and reporting systems. Many of them lack the necessary processes to efficiently provide comprehensive, accurate, and consistent sustainability data.

Scenario modeling and quantifying impacts also require specialized skills and analysis. Conducting rigorous assessments of climate resilience poses a hurdle, even for companies with strong analytical capabilities. The lack of resources could result in poor quality or purely formal information.

The standards require a shift in strategic mindset, with sustainability integrated into governance, risk management, and strategy. This transformation could pose a challenge for companies that consider sustainability a secondary issue.

If large multinational corporations can adapt more easily, small entities may find the costs prohibitive in the absence of standardized information systems and skills. Moreover, even large companies operating in sectors that have not yet adopted a robust sustainability reporting system will face difficulties.

For many businesses, the path to full compliance with IFRS sustainability standards could be long and demanding. Low-quality information may persist for years until reporting practices and thinking about information mature.

To truly make progress towards globally consistent, comparable, and reliable sustainability reporting, obstacles to implementation must be overcome by strengthening capabilities, improving reporting structures and skills, and evolving mindsets.

In summary, there is a concern that flexibility, reliability, and relevance may be compromised by a too-narrow view of investors, lax verification, and the pursuit of financial materiality at the expense of best practices in sustainability reporting. It is evident that the standards cannot go further without the commitment of businesses.

4. Finding a balance

The promises and limitations of IFRS S1 and S2 reflect the inherent challenges in balancing prescriptive and flexible approaches as sustainability reporting standards mature.

Standards must strike a compromise between establishing consistent baseline requirements and flexibility based on applicable principles in specific areas.

Their ultimate success relies on investors finding the information useful for decision-making and capital allocation. In other words, their success depends on real-world implementation.

As companies gain experience in applying the standards, the ISSB (International Sustainability Standards Board) must iteratively improve them to address limitations revealed through usage.

Finding the optimal balance between prescriptions and principles requires careful and progressive judgment, something initial standards may not fully achieve.

Even though sustainability reports cover a wide range of relevant ESG (Environmental, Social, and Governance) issues for businesses, no set of standards can single-handedly and instantly achieve the right balance between prescription and flexibility across the reporting landscape.

In the pursuit of this balance, standards heavily rely on principles and information based on financial materiality, but flexibility should not overshadow the comparability of fundamental data, especially for significant sustainability impacts such as climate change.

As standards undergo testing and improvement, the ISSB must question the preservation of flexibility when more consistent information is crucial for investment analysis, performance benchmarking, and obtaining valuable insights into sustainability performance.

Ultimately, standards will mature through rapid learning cycles guided by investor and market needs. However, it is also the responsibility of companies to judiciously apply principles, align with best practices, and ensure reliability.

With the commitment of all stakeholders, a shared journey awaits us to achieve the necessary blend of flexibility and prescription in sustainability reporting.

5. Conclusion

The publication of IFRS S1 and S2 standards represents a significant progress in the field of sustainability reporting, but it should be acknowledged that these standards are just a first step on a long journey.

By establishing a global framework for financially material sustainability information, the ISSB (International Sustainability Standards Board) is pushing sustainability reporting in the right direction. However, the promises and limitations inherent in the standards highlight the numerous challenges of developing truly comprehensive, consistent, and reliable sustainability reporting.

There is still much to be done to complete and refine the standards, enhance corporate capabilities, and align information with best practices in sustainability reporting. Assurance and verification frameworks must be established to instill confidence.

IFRS S1 and S2 standards do not represent a complete solution or the final word on corporate sustainability reporting. However, the ISSB has laid promising foundations that can be built upon quickly and iteratively adjusted based on evolving investor and market needs.

The true success of these standards will be measured by their ability to trigger a virtuous cycle of improving sustainability management, report quality, decision relevance, and ultimately, corporate sustainability performance. A long road lies ahead...

References and Resources

Guidance documents accompany the IFRS S1 and S2 standards, providing crucial clarifications and illustrative examples to aid in the application of these standards. For IFRS S1, the emphasis is on how companies should disclose financial information related to sustainability, adhering to the principles of materiality and consistency. The guidelines underscore the importance of integrating this information into regular financial reports, offering concrete examples to guide companies.

Regarding IFRS S2, the guidance focuses on disclosing information related to climate risks and opportunities. It includes practical examples on how to segment and present greenhouse gas emissions, considering different emission categories (Scopes 1, 2, and 3). Specific industry-specific advice is also provided, drawn from the Sustainability Accounting Standards Board (SASB) standards, helping companies identify and disclose relevant climate risks and opportunities based on their sector.

- IFRS S1 : General Requirements for Disclosure of Sustainability-related Financial Information

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THANK YOU!