CLEARY GOTTLIEB

ALERT MEMORANDUM

IFRS Releases New Global Sustainability Disclosure Standards

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I. Background

On June 26, 2023, the International Sustainability Standards Board ("ISSB") issued its inaugural sustainability reporting standards—IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information ("IFRS S1") and IFRS S2 Climate-related Disclosures ("IFRS S2") (together, the "Standards").[1]

The ISSB, which was established by the International Financial Reporting Standards Foundation in 2021, released the Standards with the express intent of creating a global baseline that would benefit investors and companies and, thus, the international capital markets.[2][3] The Standards have been viewed as an important step forward in Environmental, Social, and Governance ("ESG") approaches, as the ISSB attempts to bring some order to the ever-changing landscape surrounding sustainability disclosures. The Standards seek to consolidate various existing disclosure frameworks and apply across industries, geographies, and accounting principles.

[1] *ISSB Issues Inaugural Global Sustainability Disclosure Standards* (June 26, 2023), IFRS Foundation, https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/.
[2] *Ten Things to Know About the First ISSB Standards* (June 27, 2023), IFRS Foundation, https://www.ifrs.org/news-and-events/news/2023/06/ten-things-to-know-about-the-first-issb-standards/.
[3] *Effects Analysis: IFRS Sustainability Disclosure Standards* (June 2023), IFRS Foundation, https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/effects-analysis.pdf.

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The Standards have been well-received throughout the international community, garnering the support of oversight and regulatory bodies and several jurisdictions. Notably, the Standards employ a financial materiality standard as opposed to the stricter double materiality standard that has come under scrutiny by anti-ESG proponents and has been proposed in other sustainability disclosure regimes, such as the European Commission's draft European Sustainability Reporting Standards ("ESRS"). The Standards' sole focus on financial materiality is likely to further attract international support of the Standards.

The ISSB noted that it developed the Standards within 18 months and followed a transparent and inclusive process, soliciting more than 1,400 responses to its initial proposals. The ISSB's speed in developing the Standards comes in contrast to the long-awaited and delayed climate rules anticipated from the United States Securities and Exchange Commission (the "SEC").

II. Intent: A Global Baseline with Broad International Backing

The ISSB developed the Standards to serve as a global baseline for sustainability disclosure requirements and to consolidate and be interoperable with existing sustainability disclosure requirements worldwide. Although the Standards are built on concepts underlying the International Financial Reporting Standards Accounting Standards ("IFRS Accounting Standards"), the Standards may be utilized with any accounting principles, which makes them relevant for U.S. domestic companies utilizing U.S. Generally Accepted Accounting Principles as well. ISSB designed the Standards to allow investors to evaluate companies more easily by requiring disclosure of sustainability-related and climate-related information in the same reporting package alongside a company's financial statements, similar to how management's discussion and analysis, or MD&A, disclosure complements and enhances a company's financial statements.

Currently, sustainability-related disclosures are made under a multiplicity of frameworks, which limits comparability and can result in companies and investors cherry-picking the standards that are more favorable depending on the context. The ISSB indicated that it developed the Standards to help counteract this practice and to respond to calls from the Financial Stability Board, the G20, the G7, and the International Organization of Securities Commissions ("IOSCO") for more consistent, complete, comparable, and verifiable sustainability-related financial information that would better inform investment decisions in the global capital markets. The Standards consolidate and streamline various existing ESG initiatives, including the Financial Stability Board Task Force on Climate-related Financial Disclosures ("TCFD") recommendations, the Sustainability Accounting Standards Board Standards, the Climate Disclosure Standards Board Framework, the Integrated Reporting Framework and the World Economic Forum metrics. It is expected that the Standards' unification of divergent standards will allow companies to benefit from their prior sustainability disclosures while creating a pathway for companies to migrate to a single, consistent disclosure framework.

III. The Standards

ISSB developed IFRS S1 and IFRS S2 to be applied together and to complement one another. As outlined below, the Standards are based on "four content areas"—governance, strategy, risk management, and metrics and targets—as they relate to a company's risks and opportunities (sustainability-related under IFRS S1 and climate-related under IFRS S2) that could reasonably be expected to affect a company's cash flows, its access to capital, or cost of capital over the short, medium, or long term. The Standards' four content areas approach is influenced by the TCFD's four pillars of disclosure, which also further highlights how the Standards consolidate existing disclosure regimes and attempt to give a nod to different elements of the frameworks and recommendations of other organizations.

A. IFRS S1

Pursuant to the four content areas of the Standards, IFRS S1 requires companies to make disclosures about themselves on the following topics:

- **Governance.** The governance processes, controls, and procedures used to monitor and manage sustainability-related risks and opportunities;
- **Strategy.** Approaches to manage sustainability-related risks and opportunities;
- **Risk-management.** Processes to identify, assess, prioritize, and monitor sustainability-related risks and opportunities; and
- **Metrics and targets.** Performance relative to its sustainability-related risks and opportunities, including progress towards any targets the company has set or any targets it is required to meet by law or regulation.

Further, the disclosure requirements under IFRS S1 focus on disclosure of material and connected information. The IFRS S1 definition of "material information" aligns with the "material information" definition used in the IFRS Accounting Standards. For "connected information," IFRS S1 requires a company to disclose information that allows investors to understand connections, such as connections between various sustainability-related risks and opportunities and connections across sustainability-related financial disclosures and the financial statements.

B. IFRS S2

IFRS S2 requires companies to disclose information about the same four content areas as IFRS S1 but applies the four content areas to companies' climate-related risks and opportunities. IFRS S2 applies scenario analysis to assess a company's climate resilience and requires companies to disclose information relevant to cross-industry metric categories and requires companies to disclose information about the climate-related targets a company may have set or is required to meet by law or regulation. Similarly, like with IFRS S1, companies are required to disclose material information.

A significant feature of IFRS S2 is that it requires companies to disclose their Scope 1, Scope 2, and Scope 3 greenhouse gas ("GHG") emissions. Disclosure of Scope 3 GHG emissions has been particularly controversial in the United States due to the SEC's proposed climate rule requiring disclosure of Scope 1, Scope 2, and Scope 3 GHG emissions, if the Scope 3 GHG emissions are material or if the company has set a GHG emissions reduction target or goal that includes its Scope 3 GHG emissions. Like the SEC's proposed climate rule, IFRS S2 requires companies to disclose Scope 3 GHG emissions that are material. IFRS S2 sets out a framework for measuring Scope 3 GHG emissions that is largely based on the Greenhouse Gas Protocol Corporate Standards but also includes additional requirements such as categories that a company is required to include in its measurement of Scope 3 GHG emissions and the inputs a company is required to use to measure such Scope 3 GHG emissions.

IV. Effective Date, Applicability, Assurance, and Proportionality

Effective Date. The Standards are to be applied for reporting periods beginning on or after January 1, 2024; however, earlier application is permitted. If a company applies the Standards earlier, both IFRS S1 and IFRS S2 must be applied together, and the company must disclose its earlier application of the Standards accordingly. All public and private companies can apply the Standards regardless of the accounting principles they follow.

Applicability. The ISSB does not have the authority to mandate the application of the Standards; thus, adoption of the Standards is currently only voluntary. Companies can elect to apply the Standards, and jurisdictional authorities may decide whether to make the Standards mandatory. The ISSB expects to work with authorities across jurisdictions, including through IOSCO, to encourage endorsement and adoption of the Standards.

Assurance. The ISSB recognizes it cannot require external assurance for reported information, however, the Standards are designed to make the reported

information capable of being assured. The ISSB believes the quality and reliability of reported sustainability-related information will be higher if it is verified and/or assured by auditors or other independent parties. Attestation for Scope 1 and Scope 2 GHG emissions was also a component of the SEC's proposed climate rule that received a number of comments from issuers and investors alike. While third-party assurance is not currently part of the Standards, the market may evolve to make such assurance customary.

Proportionality. One major concern about the global progress in ESG requirements, particularly in a unified system of sustainability disclosure requirements, is the concern about the variation in resources of companies worldwide. To address this, ISSB has stated that it designed many of the requirements in the Standards to be applied "proportionate" to the capabilities and preparedness of companies. The ISSB's considerations of company resources and its allowance in the Standards' requirements of "reasonable and supportive information that is available to the entity at the reporting date without undue cost or effort" may help to reduce, though not eliminate, the costs of compliance with the Standards for companies of more limited resources.

Interoperability. Another key objective of the ISSB in adopting the Standards was to establish interoperability between the Standards and major jurisdictional requirements, such as the ESRS and the Global Reporting Initiative Standards. For example, the ISSB stated that it sought to identify common disclosures in ESRS and IFRS S2, and ensure the requirements were as aligned as possible to prevent redundant or conflicting reporting.

V. Next Steps

Now that the Standards have been announced, the question remains as to how widely the Standards will be adopted. So far, the Standards have garnered broad international support from investors, companies, policy makers, market regulators, and others including IOSCO, the Financial Stability Board, and the G20 and G7 Leaders. Additionally, a number of jurisdictions, such as the United Kingdom, Canada, Australia, New Zealand, China, Hong Kong, Singapore, Malaysia, Nigeria, and Japan, have already suggested plans to adopt the Standards. Further, IOSCO has stated its intent to review the Standards. If IOSCO approves the Standards, we can likely expect to see IOSCO's decision motivate wide jurisdictional adoption of the Standards. The SEC has been noticeably silent on the Standards to date.

The ISSB is also working to help encourage governments and companies to adopt the Standards and to ensure that the implementation of the Standards is done effectively. For example, the ISSB is creating a Transition Implementation Group to support companies in the application of the Standards. These efforts are also likely to increase the adoption of the Standards globally.

While ESG initiatives have sparked wide debate in the U.S., the Standards and the adoption of the Standards within the global ESG landscape will likely encourage regulators, companies and investors in the U.S. to move towards aligning with a global standard in sustainability disclosure requirements, unless the SEC's final climate rule complicates the landscape further.

VI. Considerations for Companies in Applying the Standards

In considering whether to adopt the Standards—while application is still voluntary—companies should consider:

— **How the Standards may interact with the proposed and final ESRS and SEC sustainability disclosure requirements.** The ISSB announced the Standards at a time when both the European Union and the U.S. are contemplating their own sustainability disclosure requirements. Notably, the proposed ESRS require more disclosure than the Standards, while the SEC's proposed rules call for slightly less disclosure than the Standards.

While the final ESRS are expected to be adopted no later than August 2023 and the SEC's final climate rules are expected to be announced in Fall 2023, there has been a great deal of speculation regarding both the timing and content of the SEC's final climate rule. Regarding timing, the current SEC regulatory agenda slots the climate rule to be finalized in October 2023; however, the rule has made a number of appearances on the agenda, only to have been moved to later periods. Further, as for content, the SEC's climate rules have been subject to extensive political debate since they were first proposed in March 2022, with much of the debate focused on the SEC's proposed requirement to disclose Scope 3 GHG emissions. The SEC's proposed climate disclosure rules have also raised concerns about the cost and burdens to companies of adopting the requirements.

Although the expectation is still that the SEC will release a final rule before the end of 2023, it is unclear to what extent the final SEC climate rule will consider the Standards or attempt to reconcile potential disclosure requirements to the Standards.

— **How and whether the adoption of the Standards could enhance other disclosure obligations**. Companies should also consider how the Standards' disclosure requirements may enhance their disclosure obligations under other sustainability disclosure requirements. For example, a company's disclosure of certain information pursuant to the Standards (such as information regarding Scope 3 GHG emissions) could trigger enhanced disclosure obligations under the SEC's proposed climate rule, because if a company discloses certain information under IFRS S2, then the company would likely have to disclose this information under the SEC's proposed climate rule as well.

VII. Conclusion

The Standards are an important development in the ESG landscape and interested parties should stay alert to follow the reaction of securities regulators, jurisdictional authorities, and early-adopters. Particularly, we expect many companies will take a wait and see approach to observe which jurisdictions adopt the Standards and how the finalized ESRS and SEC climate rule further influence the ESG landscape. The ISSB has made available several resources to better understand the Standards, such as the Standards' Project Summary, the Standards' Effects Analysis, Ten Things to Know About the First ISSB Standards, and the Basis for Conclusions on IFRS S1 and IFRS S2.

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