ISSB ESG Disclosure Standards:

The Beginning of a Global Disclosure Regime?

So-called "ESG investing" or "sustainable investing" exploded over the last decade.[1] But with it came significant confusion as to what businesses actually mean by "ESG" or "sustainable," and how and to what extent these concepts are actually being put into practice.[2] The absence of government regulation or agreed metrics led to two basic concerns: first, that investors and other stakeholders cannot compare ESG claims across funds and companies; and, second, that investors and other stakeholders might be inadvertently or deliberately misled by "greenwashing." These concerns prompted, at recent count, over *300* proposed voluntary ESG disclosure standards and metrics. Such standards have been proposed by, among many others, the Global Reporting Initiative, the Sustainability Accounting Standards Board, the United Nations Global Compact, the Task Force on Climate-Related Financial Disclosures, and the Climate Disclosure Project.[3]

The International Sustainability Standards Board (ISSB) was formed to bring some uniformity to these overlapping frameworks. At the COP26 conference in Glasgow in late 2021, representatives from the parties to the United Nations Framework Convention on Climate Change announced their intention to create a set of *global* ESG disclosure standards.[4] In June of this year, the ISSB made good on its promise by announcing two new sets of standards for ESG disclosures (the "Standards").[5] These standards are an explicit attempt to provide a "comprehensive global baseline" for corporate ESG disclosures[6] and represent a potential resolution to several outstanding issues in the ESG space—particularly when it comes to climate-related disclosures.

I. Overview of the Standards

After 18 months of input gathering, the ISSB released the new standards on June 26, 2023. The Standards are quite broadly applicable and, in principle, purport to cover the ESG disclosures of nearly any entity that provides regular financial disclosures "irrespective of whether the entity's related general purpose financial statements are prepared in accordance with IFRS Accounting Standards or other generally accepted

[1] *See generally* Karin Rives, *Even As ESG Market Narrows, Money Managers in the Space Prioritize Climate*, S&P GLOBAL (Dec. 14, 2022), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/even-as-esg-market-narrows-money-managers-in-the-space-prioritize-climate-73499895. While in 2022 the amount of capital under management dropped for the first time since the emergence of ESG investing, in 2022 $8.4 trillion were still under management in ESG funds in the United States alone.

[2] QUINN EMANUEL, *ESG and Its Critics* (Oct. 22, 2022) https://www.quinnemanuel.com/media/5xynejp0/client-alert-esg-and-its-critics-final.pdf

[3] For a fuller comparison of these standards, *see* David A. Cifrino, *The Rise of International ESG Disclosure Standards*, HARV. L. SCH. FORUM ON CORP. GOV. (June 29, 2023), https://corpgov.law.harvard.edu/2023/06/29/the-rise-of-international-esg-disclosure-standards/.

[4] IFRS, *IFRS Foundation Announces International Sustainability Standards Board, Consolidation with CDSB and VRF, and Publication of Prototype Disclosure Requirements* (Nov. 3, 2021), https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/.

[5] IFRS, *ISSB Issues Inaugural Global Sustainability Disclosure Standards* (June 26, 2023), https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/.

[6] *Id*..

accounting principles or practices."[7] The Standards carry forward the original structure envisioned in an ISSB working paper published soon after the body's creation.[8] Specifically, there are two separate sets of standards relating to different sets of disclosures: (1) general disclosure requirements for all sustainability-related risks and opportunities, and (2) specific climate-related disclosure requirements. These standards are respectively labeled International Financial Reporting Standard (IFRS) S1 and IFRS S2. Each standard includes within it several key policy determinations intended to clarify outstanding points of confusion in the ESG space.

IFRS S1: General Disclosure Requirements

IFRS S1 is the broader of the two standards and sets forth a generally applicable method for identifying the subjects that should be disclosed and the content of those disclosures.

First, IFRS S1 prescribes what a business should disclose. The standard requires disclosure of all "sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term."[9] The term "sustainability-related risks and opportunities" is intentionally broad. It covers all risks and opportunities that "arise out of the interactions between the entity and its stakeholders, society, the economy and the natural environment throughout the entity's value chain."[10] This is intended to include both a business's "dependencies" and "impacts"—meaning, that businesses should disclose both how environmental and other socio-political issues will impact them ***and*** how they will impact the environment and society.[11] To date, one of the most troubling issues with ESG has been that investors often expect ESG disclosures to address the latter set of considerations, when in reality many disclosures address only the former.[12] IFRS S1 attempts to clarify this issue by providing that both facets of ESG must be considered and disclosed.

To balance this broad applicability, IFRS S1 includes a materiality threshold similar to Rule 10(b) in the United States, which requires public companies to disclose information that would impact a reasonable investor's decision to invest in the company.[13] However, the definition of materiality under IFRS S1 is arguably even broader. Under the standard, information is material if it would "influence decisions that *the primary users of general purpose financial reports*" would make, rather than just a "reasonable investor." No further

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[7] IFRS S1- General Requirements for Disclosure of Sustainability-related Financial Information ¶ 8, *available at* https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/ifrs-s1-general-requirements.html/content/dam/ifrs/publications/html-standards-issb/english/2023/issued/issbs1/ [hereinafter "IFRS S1"].

[8] *See* IFRS TECH. READINESS WORKING GRP., SUMMARY OF THE TECHNICAL READINESS WORKING GROUP'S PROGRAMME OF WORK at 6-8 (Nov. 2021), available at https://www.ifrs.org/content/dam/ifrs/groups/trwg/summary-of-the-trwg-work-programme.pdf.

[9] IFRS S1 ¶ 3.

[10] IFRS S1 ¶ B2.

[11] *Id. See also* IFRS S1 ¶ B3 ("For example, if an entity's business model depends on a natural resource—such as water—the entity could both affect and be affected by the quality, availability and affordability of that resource.").

[12] John Quinn, *How The Lack Of Unified ESG Metrics Creates Litigation Risk*, FORBES (Mar. 15, 2022), https://www.forbes.com/sites/forbesbusinesscouncil/2022/03/15/how-the-lack-of-unified-esg-metrics-creates-litigation-risk/?sh=28b8d9d35522.

[13] *Compare* IFRS S1 ¶ D8 ("Information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide information about a specific reporting entity.") *with Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38 (2011) ("[the] materiality requirement is satisfied when there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.") (internal quotation marks and citation omitted)

clarification of these terms is provided, and given that materiality is an entity-specific inquiry, the standard seems to leave some ambiguity as to what businesses must uniformly disclose.[14]

Second, IFRS S1 sets forth broad guidelines for the content of disclosures. For each risk or opportunity as defined above, the standard prescribes that businesses should disclose four categories of information:

- **Governance**: How risks and opportunities are identified and managed, including the governing body and officer(s) responsible for identifying risks and opportunities.
- **Strategy**: A summary of the risks and opportunities faced by the business (see above) and a summary of its strategy for addressing them.
- **Risk management**: How risks and opportunities are incorporated into the larger corporate strategy.
- **Metrics and targets**: Metrics and progress toward any internal targets set by the business to address risks and opportunities.[15]

Of these four categories, metrics and targets are the most important. IFRS S1 does not mandate any particular ESG-related goals. But it does require businesses to disclose how they measure progress toward their own goals and the methods underpinning the analysis. The standard requires disclosure of how each metric used by the business is calculated, defined, and whether it has been validated by a third party (and, if so, which third party).[16] Where a business uses qualitative metrics and targets to measure its progress toward ESG-related goals, Appendix D of the standard sets forth several requirements, such as comparability to alternative metrics or targets and verifiability with corroborating evidence reviewed by the business's board.[17] The standard does not clarify what a qualitative target may be, but the ISSB likely contemplates that companies will use external rankings or evaluations that are not easily quantified.[18] These requirements are the ISSB's chief attempt to limit "greenwashing," a practice where companies make unverifiable or inflated claims about their environmentally and socially conscious practices.[19]

Overall, IFRS S1 sets forth a two-step approach to ESG disclosures. First, the definitions of "sustainability-related risks and opportunities" and "materiality" are designed to create a uniform but flexible standard for identifying ESG-related issues that should be included in a business's disclosures. Second, the four categories described above clarify the content of required disclosures. Rather than mandating specific disclosures, IFRS S1's focus is on making disclosures verifiable. Arguably, this is consistent with the ISSB's intention of creating a global baseline, rather than a complete, universally applicable set of disclosure requirements.

IFRS S2: Climate-Related Disclosure Requirements

IFRS S2 relates specifically to a company's climate-related disclosures. While IFRS S2 deals with a narrower subject matter, it requires broader disclosures for the risks and opportunities that fall under its

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[14] IFRS S1 does, however, incorporate by reference prior industry specific ESG standards like those of the Sustainability Standards Accounting Board to assist companies in evaluating materiality. *See, e.g.*, IFRS S1 ¶¶ 58(a), B20.
[15] IFRS S1 ¶ 25.
[16] *Id.* ¶ 50.
[17] *Id.* ¶¶ D17-D24.
[18] *See, e.g.*, *id.* ¶ 50(b) (providing examples of qualitative metrics, including "such as a red, amber, green—or RAG—status").
[19] *See, e.g.*, BBC, *Oatly Ads Banned Over 'Misleading' Environmental Claims* (Jan. 26, 2022), https://www.bbc.com/news/business-60128075.

umbrella. And the standard provides more specific guidance than IFRS S1 on what businesses must disclose when it comes to climate change.

While both IFRS S1 and IFRS S2 require disclosure of "risks and opportunities," IFRS S2 further breaks out climate-related risks into two categories. First, the standard requires disclosure of climate-related *physical* risks, which relate to how the business's operations may be affected by the physical results of climate change (e.g., sea level rise).[20] Second, the business is required to disclose "climate-related *transition* risks," which detail how its operations will be affected by its own efforts or any legislative/regulatory action to mitigate climate change.[21] Notably, the standard lacks a materiality threshold, and instead provides only that businesses need not disclose risks and opportunities that "could not reasonably be expected to affect an entity's prospects."[22] This is somewhat more rigid than IFRS S1, in that it is not dependent on what a primary user of the company's disclosures (the standard under S1) would consider. It reflects an apparent policy judgment by the ISSB that climate impacts are always material, as opposed to the broader set of risks that could be disclosed under IFRS S1. Nonetheless, the standard does attempt to balance the burden of identifying climate-related risks and opportunities by requiring only that the company consult "all reasonable and supportable information that is available to the entity at the reporting date *without undue cost or effort*."[23]

In several key respects, IFRS S2 is more specific than IFRS S1. While IFRS S2 requires the same four categories of disclosure as IFRS S1 (governance, strategy, risk management, and metrics and targets), the metrics and targets requirements in IFRS S2 are significantly more prescriptive in terms of scope and methodology. IFRS S2 requires disclosure of the business's progress toward its own climate targets, as well as a summary of all the business's carbon emissions, including Scope 1, Scope 2, and Scope 3 emissions.[24] The standard requires several specific disclosures about the business's internal emissions reduction targets, including the scope of emissions (1, 2, and/or 3) covered by the target; the year the business expects to reach its target; and whether the business intends to use carbon credits to satisfy its target.[25] The inclusion of Scope 3 emissions requires the business to disclose all emissions caused by other actors in the business's value chain, which has previously been controversial in the ESG space. This is because it can be extremely burdensome—if not infeasible—for a business to reliably estimate all emissions throughout a complex supply chain.[26] To address this uncertainty, the ISSB has also promulgated industry-specific supplementary guidance on what Scope 1, 2, and 3 emissions a company must disclose.[27]

Equally notable, IFRS S2 prescribes how business must measure the impact of climate change on their operations. Namely, the standard requires an exact calculation of the amount and percentage of the business's assets that are exposed to identified climate-related risks and opportunities, as defined above.[28]

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[20] IFRS S2- Climate-related Disclosures ¶ 1, *available at* https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/ifrs-s2-climate-related-disclosures.html/content/dam/ifrs/publications/html-standards-issb/english/2023/issued/issbs2/ [hereinafter "IFRS S2"].
[21] IFRS S2 ¶ 3
[22] IFRS S2 ¶ 4.
[23] IFRS S2 ¶ 11 (emphasis added).
[24] IFRS S2 ¶ 29(a).
[25] IFRS S2 ¶¶ 33-37.
[26] U.S. ENVIRONMENTAL PROTECTION AGENCY, *Scope 3 Inventory Guidance*, https://www.epa.gov/climateleadership/scope-3-inventory-guidance (last visited Aug. 17, 2023).
[27] *See* IFRS, ACCOMPANYING GUIDANCE ON CLIMATE-RELATED DISCLOSURE (June 2023), available at https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards-issb/english/2023/issued/part-b/issb-2023-b-ifrs-s2-climate-related-disclosures-accompanying-guidance-part-b.pdf.
[28] IFRS S2 ¶ 29(b-d).

The business is also required to disclose how it calculates its internal carbon price, and how the price factors into its costs and pricing analyses.[29]

The inclusion of specific climate-related metrics in IFRS S2 is a further policy choice on behalf of ISSB. While many other environmental and political issues are covered in IFRS S1, the second standard represents a determination that a business's relationship to climate change is among the most important factors to many ESG investors, and therefore warrants more detailed treatment with a more specific set of disclosures

II. Impact of the Standards

The ISSB expects that businesses will begin implementing the climate-related disclosure standards in 2024 but Scope 3 emissions will not need to be calculated under IFRS S2 until 2025 and no aspect of IFRS S1 will need to be implemented until 2025.[30] Given that the ISSB has no regulatory power, the standards' impact will depend on how broadly they are adopted *and* the size of the markets that adopt them.[31] Right now, those prospects seem mixed. An impressive list of large economies has indicated that they are strongly considering adopting the standards, including Australia, Canada, Japan, Hong Kong, Malaysia, New Zealand, Nigeria, Singapore and the United Kingdom.[32] However, while both the United States and European Union have announced that they will align with the ISSB, they appear unlikely to adopt the standards because of their own approaches to regulating ESG disclosures. For instance, the EU has already implemented a Corporate Sustainability Reporting Directive which came into force on 5 January 2023, and adopts a 'double materiality' standard. Further, in the United States, the SEC appears on pace to finalize ESG rules that will take a different approach from the ISSB in some material respects. For example, unlike IFSR S2, the SEC's proposed rule would require disclosure of Scope 3 emissions only if they are material or already considered in the company's internal emission-reduction goals.[33] Given growing political opposition to regulation of ESG investing in the United States, it is uncertain whether the SEC's final rule will require the disclosure of Scope 3 emissions.[34]

Nonetheless, there is reason to think the standards may become an informal benchmark across the global economy. *First*, they were developed with significant input from many of the world's largest asset managers and owners, which would suggest that many prominent businesses support at least large portions of the standards.[35] Several voluntary reporting organizations have also expressed their support for the

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[29] IFRS S2 ¶ 29(f).

[30] IFRS, *ISSB Decides to Prioritize Climate-Related Disclosures to Support Initial Application* (April 4, 2023), https://www.ifrs.org/news-and-events/news/2023/04/issb-decides-to-prioritise-climate-related-disclosures-to-support-initial-application/.

[31] *See* IFRS, *supra* note 5.

[32] Rochelle Toplensky, *Forget the SEC, International Climate Reporting Standards Could Become the Global Baseline*, WALL ST. J. (June 26, 2023), https://www.wsj.com/articles/pro-take-forget-the-sec-international-climate-reporting-standards-could-become-the-global-baseline-ea01d05a.

[33] *See* SEC, *SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors* (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46. However, as discussed above, IFRS S2 does not have a materiality standard.

[34] NAT'L L. REV., *ISSB Takes The Lead On Global Sustainability Disclosure Standards – Will The U.S. Follow?* (July 6, 2023), https://www.natlawreview.com/article/issb-takes-lead-global-sustainability-disclosure-standards-will-us-follow.

[35] IFRS, *supra* note 5 ("The ISSB developed IFRS S1 and IFRS S2 with the benefit of extensive market feedback and in response to calls from the G20, the Financial Stability Board and the International Organization of Securities Commissions (IOSCO), as well as leaders in the business and investor community.").

Standards, such as the Sustainability Accounting Standards Board (which was folded into the ISSB).[36] *Second*, within the United States, political considerations have made the future of ESG disclosure rules uncertain. A large number of stakeholders have voiced opposition to the current draft of the SEC climate disclosure rule and litigation challenging the rule is almost certain. *Third*, and perhaps most importantly, global ESG disclosure standards may be more appealing to businesses than a patchwork of inconsistent national regimes.[37] Therefore, even if the standards do not obtain sufficient international buy-in to become truly binding, there is a likelihood that many businesses will treat them as a useful tool.

Indeed, this appears to be a result that the ISSB has anticipated to some extent. The ISSB has announced the creation of a "Transition Implementation Group," which is designed to assist entities using the standards to prepare their first ESG disclosures.[38] Therefore, while the standards' path to widespread implementation by national governments may be unclear, there is a good likelihood that they will become a common voluntary baseline for ESG disclosures.

If widely adopted, the standards could be a meaningful step towards more consistency and transparency in ESG-related disclosures. Currently, many investors are forced to rely on a plethora of ESG metrics published by different companies and rating agencies that employ inconsistent methodologies.[39] However, while IFRS S2 prescribes a relatively detailed set of climate-related metrics and targets, IFRS S1 (covering other ESG considerations) is more nebulous and may not lead to a truly uniform set of disclosures. For example, IFRS S1's failure to prescribe when qualitative or quantitative metrics should be used could allow businesses to select between them—and their different disclosure requirements—to conceal or accentuate certain ESG factors. Ultimately, while the standards should provide more consistent disclosure—and therefore reduce opportunities for business to make misleading ESG-related statements—they are, alone, unlikely to eliminate the risk of confusion and greenwashing.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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[36] SASB, *SASB Standards and Other ESG Frameworks* (last visited Aug. 16, 2023), https://sasb.org/about/sasb-and-other-esg-frameworks/.

[37] Mike Scott, *Investors Hail End to 'Alphabet Soup' of Sustainability Disclosure with New ISSB Standards*, REUTERS (July 31, 2023), https://www.reuters.com/sustainability/sustainable-finance-reporting/esg-watch-investors-hail-end-alphabet-soup-sustainability-disclosure-with-new-2023-07-31/

[38] *See* IFRS, *About the Transition Implementation Group on IFRS S1 and IFRS S2* (last visited Aug. 8, 2023), https://www.ifrs.org/groups/tig-ifrs-s1-and-ifrs-s2/.

[39] Kelly Anne Smith, *Greenwashing And ESG: What You Need To Know*, FORBES (Aug. 25, 2022), https://www.forbes.com/advisor/investing/greenwashing-esg/.

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