Global Counsel

A global ESG reporting standard: where are we, and where are we heading?

8 July 2021 | Author: Felicity Hall

Summary

Reporting standards and frameworks are a crucial tool for addressing environmental, social and governance (ESG) issues. They help organisations to measure, understand and communicate their exposure to ESG risks and opportunities, promoting transparency with stakeholders and informing strategy. Over the past few years, various guidelines for ESG reporting have emerged, including voluntary standards, reporting frameworks, and national legislation. But these have all introduced slightly different requirements for businesses, leading to calls for a global ESG reporting standard. The hope is that such a standard could aid consistency and comparability of information, as well as increase the quality of disclosure. Recently, the International Financial Reporting Standards foundation (IFRS) has emerged as a frontrunner in creating this standard, building optimism that we could soon see the harmonisation of standards and a clearer path ahead for ESG reporting.

On June 7th 2021, G7 finance ministers announced a commitment to mandate climate reporting in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). The TCFD, which was developed by the Financial Stability Board, has been a key driving force in cultivating transparent and comparable climate reporting across the globe. As such, the commitment marked a significant step in the harmonisation of global ESG frameworks. However, with the so-called 'alphabet soup' of ESG standards continuing to cause confusion among investors and corporates, several gaps and unknowns remain. How will the commitment of the G7 fit with the desire to develop a single global framework? How will the various standards interact? And how will reporting on other ESG issues, especially social issues, be addressed?

Where we are: voluntary standards and frameworks

Until recently, reporting on ESG issues has remained predominantly voluntary. Whilst investor pressure has moved disclosure from a 'nice to have' towards a 'need to have', mandatory reporting has remained localised, sporadic, and issue focused. Most voluntary reports have been based on one or more of five key standards which have been developed to aid corporates with reporting on sustainability issues. Key members of the so-called "group of five" include the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB).

The question-and-answer format of the information presented through the CDP (formerly the Carbon Disclosure Project) has also long proved a popular format for disclosure which investors request from corporates. Slightly more on the fringes are the Climate Disclosure Standards Board (CDSB) and the International Integrated Reporting Council (IIRC). Notably in the journey towards a unified standard, the IIRC and SASB concluded their merger on June 9th 2021, creating the Value Reporting Foundation.

These voluntary standards are designed to be complementary, and were developed to support different sets of stakeholders through their divergent focuses and definitions of materiality. To illustrate this, consider the two core standard setters, SASB and GRI. SASB was developed predominantly with investors in mind. As a consequence, the SASB standards focus on ESG issues which are expected to have a financially material impact. GRI standards, on the other hand,

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focus on making sustainability reporting as simple and straightforward as possible for corporates. They consider the economic, environmental, and social impacts of businesses as they relate to sustainable development, thereby taking into account the interests of a broader group of stakeholders beyond investors.

In September 2020, the group of five announced a shared vision for a comprehensive corporate reporting system, committing to collaborate in order to achieve this. This marked an acknowledgement of the need to ensure consistency and comparability between standards; a nudge towards a global ESG reporting framework.

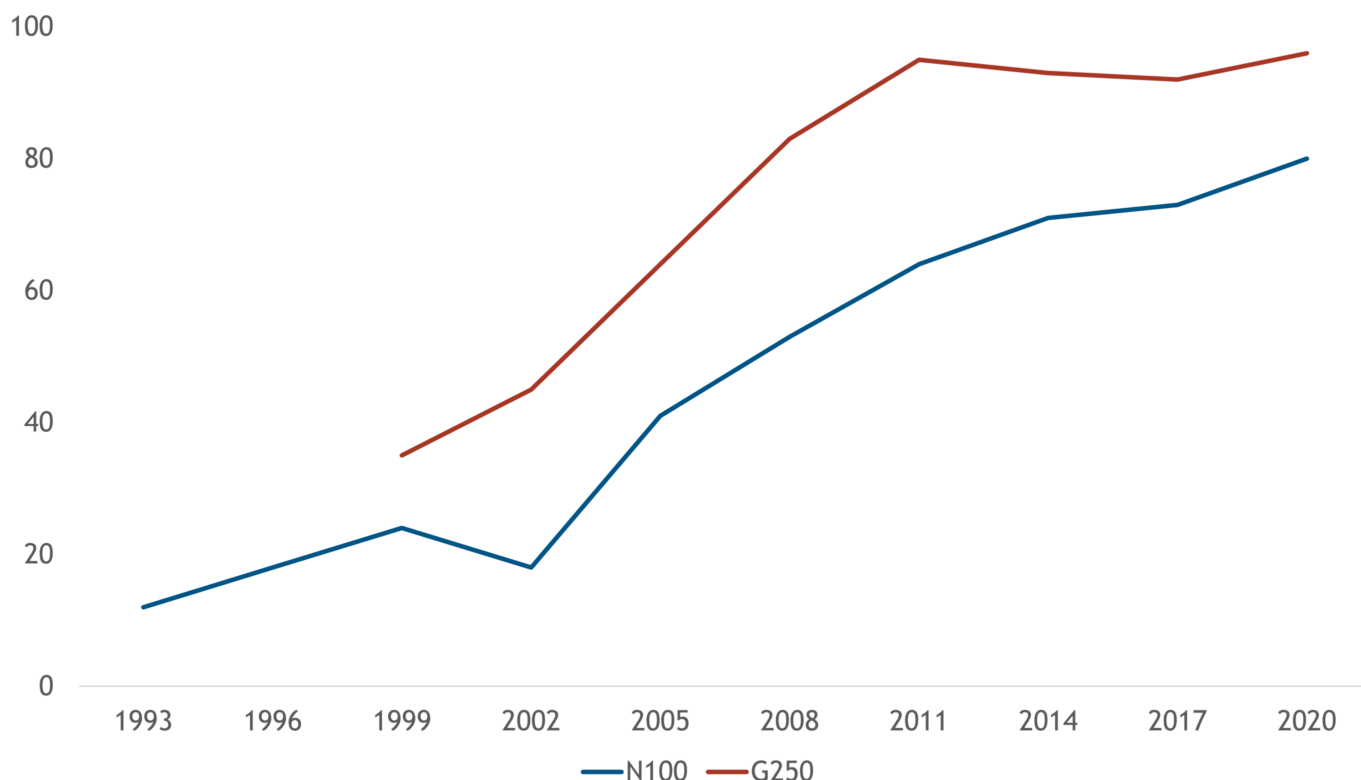
In addition to these voluntary standards, the TCFD reporting framework was developed. It is important here to distinguish between ESG reporting standards and reporting frameworks. The likes of SASB and GRI are examples of ESG standards; they provide specific guidance on what should be reported on ESG issues, accompanied by information on which metrics should be disclosed.

Frameworks, on the other hand, offer principles-based guidance on what topics companies should report on and how the information should be structured. Reporting standards and frameworks are therefore designed to be used together. Indeed, the idea of the TCFD was to create a framework on which others could build, and to encourage disclosure around four core areas which businesses are already used to reporting on: governance, strategy, risk management, as well as targets and metrics.

As the chart below illustrates, ESG reporting rates over the last few years have increased significantly despite the voluntary nature of these standards. However, regardless of the commitment of voluntary standard setters to work together, the information disclosed by corporates remains fragmented. This is driven in part by the ability of companies to select the issues they consider to be the most material to them, and thus what information to disclose in light of this.

In other words, the sceptic would suggest that by having several different standards, companies are able to select the guidelines which enable them to paint their business in the most flattering light. Frustratingly, most assurance given against the standards by accountancy firms has also continued to be high-level, desk-based analysis, rather than detailed verification of data provided or performance, meaning there is no particularly simple way to detect this. Given these dynamics, there are calls from various stakeholders, including NGOs, investors and governments, to address the lack of comparability and move towards harmonisation in ESG disclosure.

Growth in global sustainability reporting rates



Source: KPMG. N100 represents a worldwide sample of 5,200 companies, comprising the top 100 companies by revenue in 52 countries. G250 represents the world's largest companies by revenue in the Fortune 500 (2019)

Current legislation

Given these calls, and an increasing lack of tolerance for greenwashing, policymakers across several countries have weighed in on ESG reporting, with the G7's TCFD announcement marking the latest commitment. Several countries had already mandated - or been leaning towards mandating - disclosure against the recommendations of the TCFD ahead of the G7 announcement. Most vocal perhaps was the UK, where TCFD reporting was already set to become mandatory for large pension schemes from as early as October this year, and applicable to the majority of large businesses by 2025. Nevertheless, the G7 announcement is a step towards unified action on compulsory disclosure on climate issues. Similar proposals are due to be discussed by the G20.

Beyond the move of the G7, the most advanced policy on ESG disclosure is found in the EU. The EU's green taxonomy is the world's first framework which attempts to define what constitutes a sustainable activity. On April 21st 2021, the European Commission adopted its first Delegated Act (the legally binding acts which enable the Commission to amend EU legislative acts) under the Taxonomy Regulation. The move came after months of division between stakeholders on which activities should be included.

The Delegated Act is essentially a list of thresholds which activities must meet in order to be considered as contributing to climate change mitigation and adaptation. Examples include electric and zero emissions vehicles and all fossil-free heat and power production that emits fewer than 100 grams of CO_2 per kilowatt-hour. But the process of developing these definitions proved far from simple for policymakers. Notably, some of the most contentious areas addressed in the legislation - including natural gas, nuclear and agriculture - had to be carved out at the last minute, and will now be addressed in a Complementary Delegated Act later this year.

The EU's green taxonomy is important for ESG reporting as it will be used as a foundation for various other pieces of legislation. Corporates will be required to disclose information against the taxonomy framework under the Corporate Sustainability Reporting Directive (CSRD). The CSRD expands the scope of previous requirements for large corporates operating in the EU to disclose ESG-relevant information under the Non-Financial Reporting Directive (NFRD). The CSRD onboards, completes and replaces the NFRD, expanding the scope to approximately 49,000 businesses, from 11,000 under the original legislation. Notably, this will include all large companies, listed SMEs and EU subsidiaries of non-EU businesses.

Likewise, investors will need to report against the Sustainable Financial Disclosure Regulation (SFDR) which came into effect on March 10th 2021. The SFDR sets out the information that investors will need to collect from investee companies regarding how they are addressing ESG risks. Investors will also need to report on how they are addressing ESG in their investment decisions for any product which is marketed as green or sustainable.

Other countries are now looking to adopt similar frameworks to the EU taxonomy. On June 9th 2021, the UK announced the creation of its new Green Technical Advisory Group (GTAG). The aim of the group is to provide independent oversight of the development of the UK's green taxonomy, with initial recommendations due in September. Given that several members of the GTAG also worked on the EU's green taxonomy, it is expected that the UK framework will largely follow the EU's blueprint. Likewise, taxonomy frameworks have featured in policy discussions of several other countries, including China, Japan, Canada, and Malaysia.

Indeed, it is not just developed markets which have stepped up to the mark when it comes to mandating ESG reporting, with a significant push from developing nations to increase disclosure on ESG issues. For example, in March this year, regulators in India announced plans to update mandatory sustainability reporting requirements for listed companies. The revised requirements bring more businesses into scope, whilst also increasing the demands in terms of the scale and detail of disclosure. Others are reviewing their existing legislation too. The Central Bank of Brazil launched a public consultation in May on a proposed regulation for mandatory disclosure of ESG risks by financial institutions, whilst Chile's financial regulator is likewise considering introducing mandatory ESG disclosure for listed companies.

National ESG reporting requirements mark an important move from voluntary to mandatory sustainability disclosure. They also ensure a degree of consistency and comparability in the information which is shared, even if only within a country's borders. Whilst this is clearly a significant shift, in many ways national legislation has also added to the confusion for corporates by introducing different requirements in different countries. As the sustainability reporting vanguard, the EU had hoped to avoid this issue, remaining adamant throughout the development of its taxonomy that the framework could be adopted globally.

Yet most countries are developing their own version of the framework, tailored to support their particular challenges and goals. Indeed, the EU taxonomy itself is based on EU legislation, meaning it is tailored to the European context and therefore

not able to be easily adapted to other countries except in terms of high-level concepts (and potentially thresholds). This illustrates that even with national legislation maturing, there remains a gap in finding agreement on a single global framework if we want to ensure straightforward comparability of ESG information across borders.

Where we are heading: A global standard

After an extended period of confusion over how to unify existing standards on ESG, a clear frontrunner has emerged. In February 2021, the International Financial Reporting Standards foundation (IFRS) announced that it would be taking the next steps towards establishing its global sustainability reporting standard, following a three-month consultation period on the topic. Many consider this a natural move for the non-profit, given its experience in developing global accounting standards.

Explicit support for the work of the IFRS has been noted by multiple stakeholders, including the IMF, the UN, the Financial Stability Board, and - most importantly perhaps - the US who are looking to address the level and nature of ESG disclosure which will be necessary to support Biden's ambitious climate agenda. The IFRS has confirmed that it hopes to update on progress on the work at or around COP26, with draft standards due to be developed by the middle of 2022. Importantly, the work of the IFRS was also endorsed by G7 finance ministers as an extension of the TCFD framework.

Harmonisation

This leaves us with three core pillars of ESG reporting; the voluntary frameworks and standards, national legislation, and the IFRS's global standard currently under development. This naturally leads to a question of how all these frameworks and standards will fit together; will they aid the confusion or simply add an extra layer of requirements for corporates? The way that the IFRS working group is structured suggests that we can expect to see a good level of unity between the existing voluntary standards and the IFRS's Sustainability Standards Board. The working group, which was announced in March 2021, includes either input from, or a commitment to engage with, all of the group of five standard setters (Table 1).

In this sense, the work of the IFRS should help significantly with the harmonisation of existing standards, building on the shared vision the group of five endorsed last year. It is less clear, however, how varied national requirements will interact, and how these will fit with the IFRS standard. Despite the EU's best efforts to push the taxonomy as a global framework, it seems likely that countries will continue to develop their own versions. This will have significant implications for multinationals who could be required to disclose different information and meet different standards to be considered sustainable across the various geographies in which they operate. If there is a push towards mandating disclosure against the recommendations of the IFRS, then this could be where we start to see dual requirements on sustainability reporting adding to the administrative burden of corporates.

Table 1: group of five standard setters

Representatives participating in the IFRS working group	Commitment from IFRS to engage with closely
▪ TCFD ▪ Value Reporting Foundation (IIRC + SASB) ▪ Climate Disclosure Standards Board (CDSB)	▪ Global Reporting Initiative (GRI) ▪ CDP

Beyond climate change

The majority of ESG standards and disclosure frameworks currently focus predominantly on climate issues. To address the full spectrum of ESG, topics falling under the social and governance brackets, as well as environmental issues beyond climate change, will also need to be addressed. Social and, to a lesser extent, governance issues are included in several of the voluntary standards which we explored above. But climate change has remained the core focus of most national legislation. Likewise, the IFRS has indicated that it will be prioritising climate-related reporting initially, whilst also working towards a standard which meets the needs of stakeholders on broader ESG issues.

Although there has been a more narrow focus so far on climate, recent developments have indicated that the guidance which has been issued, such as the TCFD, can be adapted easily to address other ESG issues. One example of this is the development of the Taskforce on Nature-related Financial Disclosures (TNFD). The TNFD, which is the biodiversity-focused equivalent of the TCFD, was first announced in July 2020, and officially launched on June 4th 2021.

The TNFD aims to create a framework for companies and financial institutions to assess, manage and report on their dependencies and impacts on nature. Likewise, the tactic has been picked up by policymakers, as evidenced by the EU's commitment

to develop a social taxonomy. At the end of May 2021, the EU's Platform on Sustainable Finance confirmed that it will publish a draft of its social taxonomy before the summer break. The new taxonomy will be the social equivalent of the green taxonomy, and will draw on human rights, labour rights and social goals.

But even with these two examples demonstrating that a rolling ball should help us scale standard setting for other areas of ESG much faster, it seems that there is still significant work to be done. There remain several fragmented areas falling under social and governance topics which will require careful consideration in global standards. For example, there is now expansive national legislation covering topics such as modern slavery and labour practices, and increasingly policymakers are looking to legislation in order to address issues such as diversity and inclusion. The work of the IFRS is an opportunity to build on the expertise within existing standards setting bodies on these issues, whilst at the same time ensuring that ESG topics beyond climate receive the attention they deserve.

Even with multiple questions remaining unanswered, it is clear that significant progress towards a global ESG reporting standard is underway. Stakeholders will continue to follow discussions closely in the lead up to COP26 and beyond, looking to make sure that policymakers and standard-setters prioritise consistency and comparability of ESG information. Those who have not yet memorised the entire alphabet-soup of ESG acronyms may breathe a sigh of relief that the route towards harmonisation is becoming clearer.

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