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E. European Impact

International sustainability reporting standards: Competition or complementarity between different organizations and approaches

ESCP Impact Paper No. 2022-18-EN

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Abstract

Sustainability, globalization, geopolitics, and climate change are all issues that strongly affect every business and, consequently, should be transparently depicted in company reports. These issues often have an impact not only on a company's figures ("the bottom line") but require broader nonfinancial disclosures in order to inform both the company and the stakeholders about the risks and opportunities arising from sustainability matters.

The need for common standards that ensure high quality, transparency, and comparability in sustainability reporting has become quite urgent. Legislators and organizations worldwide are currently working on new sustainability reporting standards, of which two main sets of standards and approaches stand out.

The first is led by the International Sustainability Standards Board (ISSB), founded in November 2021. In its proposals for a global baseline for sustainability-related disclosures, the ISSB has adopted the so-called "single-materiality" approach.

The second was recently introduced by the European Union. The European Financial Reporting Advisory Group (EFRAG) was assigned the project to develop European Sustainability Reporting Standards (ESRS), whose use will be required by European firms based on the revised EU CSR Reporting Directive. The ESRS proposes adopting a "double-materiality" approach.

These two sets of standards could thus impair the drive for a universal set of sustainability standards, opening debate on the two different materiality approaches in particular and the overall approach to sustainability reporting in general.

Will this "competition" promoting a wider and more in-depth debate on the topic result in complementary approaches (building block approach) or will it lessen its effectiveness by polarizing positions and reducing international comparability in sustainability reporting?

Keywords: CSR, ESG, ESRS, sustainability reporting, nonfinancial disclosure

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Introduction

Financial reporting regulations can be considered as “harmonized” across the globe: International Financial Reporting Standards (IFRS) have been adopted in over 140 countries. Several other countries have committed to a transition to align their financial reporting standards with IFRS. Only a very few countries maintain “national” financial reporting standards for publicly traded (“listed”) firms.¹ The situation for sustainability reporting, previously also called non-financial or ESG (Environmental, Social, Governance) reporting, is fundamentally different.

Indeed, the current sustainability reporting landscape is characterized by a multitude of guidelines, frameworks, and standards that differ in terms of:

- originator: NGOs, investor-led organizations, regulators/legislators, multinational, international or national organizations (e.g., UN, GRI, ISSB, EU), multi-stakeholder organizations, auditors, etc.
- type of regulation: guidelines, frameworks, standards, voluntary or mandatory, etc.
- content of rules: themes, principles, indicators; management processes, indicator measurements, etc.
- subjects: environment & climate change, ESG, human rights, labour practices & safety, anti-corruption, responsible supply chains, gender, diversity, etc.

The voluntary adoption of sustainability reporting began in the 1980s and, until recently, three major sustainability reporting frameworks were largely dominant globally: the Global Reporting Initiative (GRI) Standards, the International Integrated Reporting Council (IIRC) Framework, and the Sustainability Accounting Standards Board (SASB) guidelines. In the last three years, there have been considerable advances in sustainability disclosure regulations, with different “actors” making significant progress, but not always in the same direction or in a coordinated way (Pronobis and Venuti, 2021). As presented in more detail below, the IFRS Foundation established the International Sustainability Standards Board (ISSB), consolidating other organizations and institutions. The European Union is working on significant expansion of its rules in the context of its Corporate Sustainability Reporting Directive (CSRD) and Sustainable Finance Disclosure Regulation (SFDR), while the US Securities and Exchange Commission (SEC) is also reviewing its climate disclosure rules.

Inevitably, this regulatory jungle hampers the development of comparable, high quality sustainability reporting and makes it difficult to “read” and “evaluate” companies' strategies, policies, targets, and performance measurement, as well as their risk exposure and impact regarding sustainability. It also allows companies to cherry-pick from the different standards to a certain extent, and to apply those that best suit their objectives, thereby potentially facilitating green-washing or the misleading depiction of sustainability issues. Given that sustainability information is becoming increasingly important, especially in a globalized world, the harmonization of sustainability reporting requirements – just like financial reporting – has become a necessity. At present, two major harmonization standard-setting efforts are concurrently ongoing: the ISSB is seeking a globally applicable baseline, while the European Financial Reporting Advisory Group (EFRAG), tasked by the EU

¹ Countries that do not require IFRS for domestic public companies include Cuba, North Korea, Sudan, and the United States of America (as of May 2022).

Commission, is working on harmonizing sustainability reporting at EU level. After providing some background to these initiatives, we will discuss one fundamental difference: the way they define materiality, and the consequences of this difference for sustainability reporting in particular and sustainability politics in general. Based on this discussion, we assess whether the two initiatives are in competition or complementary.

The ISSB as a global initiative

The International Accounting Standards Committee (IASC) was formed in 1973. It was the predecessor of the IFRS Foundation, which has governed the International Accounting Standards Board (IASB)'s work since 2001. Thus, this international organization has, for decades, been devoted to developing high-quality, understandable, enforceable, and globally accepted standards for general purpose financial reporting. The IFRS issued by the IASB are intended for (potentially) worldwide use. For many years, the IFRS Foundation restricted itself to financial reporting, refusing to engage in sustainability reporting (Hoogervorst and Prada, 2015). However, after growing demand from international investors for worldwide harmonized sustainability reporting and following a public consultation, the IFRS Foundation formed a new standard-setting board in November 2021, the International Sustainability Standards Board (ISSB), as a “sister organization” to the IASB. The purpose of the ISSB is to define “high quality, transparent, reliable and comparable” reporting standards for climate and other environmental, social, and governance (ESG) matters to enable investors and other market participants to make informed economic decisions².

To make use of the varied expertise, accomplishments, and technical work of organizations around the globe and to increase its legitimacy in the field of standard-setting for sustainability reporting, the IFRS Foundation included several pre-existing sustainability standard-setting organizations, such as the Carbon Disclosure Standards Board (CDSB) and (as of June 2022) the Value Reporting Foundation (VRF; see figure 1). The latter is the result of a 2021 merger between the International Integrated Reporting Council (IIRC; created in 2010) and the Sustainability Accounting Standards Board (SASB; created in 2011). The (planned) ISSB standards architecture is also consistent with recommendations by the Task Force on Climate-Related Financial Disclosures (TCFD). In addition, in March 2022, a “Memorandum of Understanding” was signed with the Global Reporting Initiative (GRI), one of the oldest and most widely used sustainability reporting standard-setters. The ISSB and the GRI have expressed their intention to coordinate their work programs and standard-setting activities to ensure the compatibility and interconnectedness of sustainability information.

² <https://www.ifrs.org/groups/international-sustainability-standards-board/>



Figure 1: integration of existing sustainability reporting standard-setting initiatives into the ISSB (KPMG, 2021)

On March 31, 2022, the ISSB issued (its first) two Exposure Drafts (ED) of Sustainability Disclosure Standards: "IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information" and "IFRS S2 Climate-related Disclosures". These two Exposure Drafts (ED) are open for comment until the end of July 2022. The date of application of these standards has not yet been fixed.

Sustainability reporting in the European Union

One important step toward sustainability reporting in the EU is the Non-Financial Reporting Directive (2014/95/EU), passed in 2014 and applied for the first time in 2017. In 2021, approximately 11,700 large European public-interest companies were required to publish a sustainability report, formally labelled "non-financial statement" (EU Commission, 2021). This directive was followed by disclosure guidelines on non-financial reporting (2017), on climate-related information (2019), and by the Sustainable Finance Disclosure Regulation (2019/2088/EU) for financial market participants. The EU Green Deal, a strategy including legislation to make the EU more sustainable, was presented in December 2019. Six months later, the taxonomy regulation (2020/852/EU) was adopted and, in April 2021, a proposal for a Corporate Sustainability Reporting Directive (CSRD) was adopted by the EU Commission to replace the Non-Financial Reporting Directive. The CSRD – in its current proposed form – would extend the number of companies subject to mandatory sustainability reporting in the EU to an estimated 49,000 (EU Commission, 2021). The CSRD would also require external sustainability information assurance. In preparing their sustainability reports, companies would be required to apply the European Sustainability Reporting Standards (ESRS), currently being developed by EFRAG.

IFRS need to be formally adopted into European law (by way of a so-called "endorsement process"), which involves various parties: the European Parliament, the Accounting Regulatory Committee (with representatives from EU member states), as well as EFRAG. EFRAG's role in this endorsement process is to provide the EU Commission with "technical advice".

Unlike IFRS, ESRS would be adopted not by an endorsement process, but directly by delegated acts of the European Commission. EFRAG's role would not be to provide technical advice, but rather to adopt the role of a standard-setter. In initiating a project task force (PTF) as requested by the EU Commission in May 2021 (dissolved in April 2022), EFRAG became a standard-setter. It has adjusted its structure accordingly and now has two legs: EFRAG's Financial Reporting Board (FR Board) in an advisory capacity in the EU's

endorsement process (and the IASB's standard-setting due process) and EFRAG's Sustainability Reporting Board (SR Board) as a sustainability reporting standard-setter (ESRS).

Preceding the formal creation of EFRAG's SR Board, the PTF published its working papers from January through March 2022. In April 2022, EFRAG's PTF published no less than 13 draft ESRS for public consultation (e.g., EFRAG, 2022a). The comment period ends 8 August 2022. Time is pressing, since the proposed effective date of the CSRD is 1 January 2023, including application of ESRS in its annual report 2023. However, the final CSRD is likely to postpone the application date by one year due to the negotiations between the EU Commission, the EU Council, and the EU Parliament ("Trilog") (EU Parliament, 2022).

The different materiality approaches and consequences

Materiality is an important concept in financial as well as in sustainability reporting. Basically, it determines which information "matters" and is important enough for a company to include in its report. As far as financial reporting is concerned, standard-setters, together with preparers, capital providers, and auditors have been discussing questions of materiality for decades. Despite ongoing debate regarding new accounting issues or company-specific aspects, there is a widely accepted common understanding of the concept of materiality in theory, based on qualitative and quantitative indicators. The application of the materiality concept, however, is often a matter of considerable judgement.

At the same time, there is no common understanding of the materiality concept for sustainability reporting yet, even on a theoretical level, making the currently discussed approaches even more interesting. The definition of materiality in the context of sustainability reporting will significantly impact the future boundaries of sustainability reporting.

Financial reporting focuses on a group of primary users of the information provided in the financial report: i.e., (financial) capital providers. From a sustainability perspective, the intended users are more diverse.

One view would extend providers of (financial) capital to include society as providers of nature-related capital (air, water, other resources). Companies' activities use these resources by polluting the air, producing climate-change-inducing greenhouse gases, impairing biodiversity, and generating waste. Reporting, including the materiality concept, would be geared toward measuring the sustainability profit or performance of a firm, based on a broader concept of resources, capital, and capital providers (sustainability reporting).

Another view further extends the intended users to include society, not only because the latter effectively acts as a provider of nature-related capital to companies, but because organizations have to consider corporate social responsibility under international agreements in areas such as avoiding corruption and bribery, and safe and fair working conditions (e.g., responsible supply chains, fighting child labour, gender and diversity management, etc.). Figure 2 illustrates the extension of the materiality concept taken from financial reporting adapted to include other capital providers and stakeholders (CSR reporting).

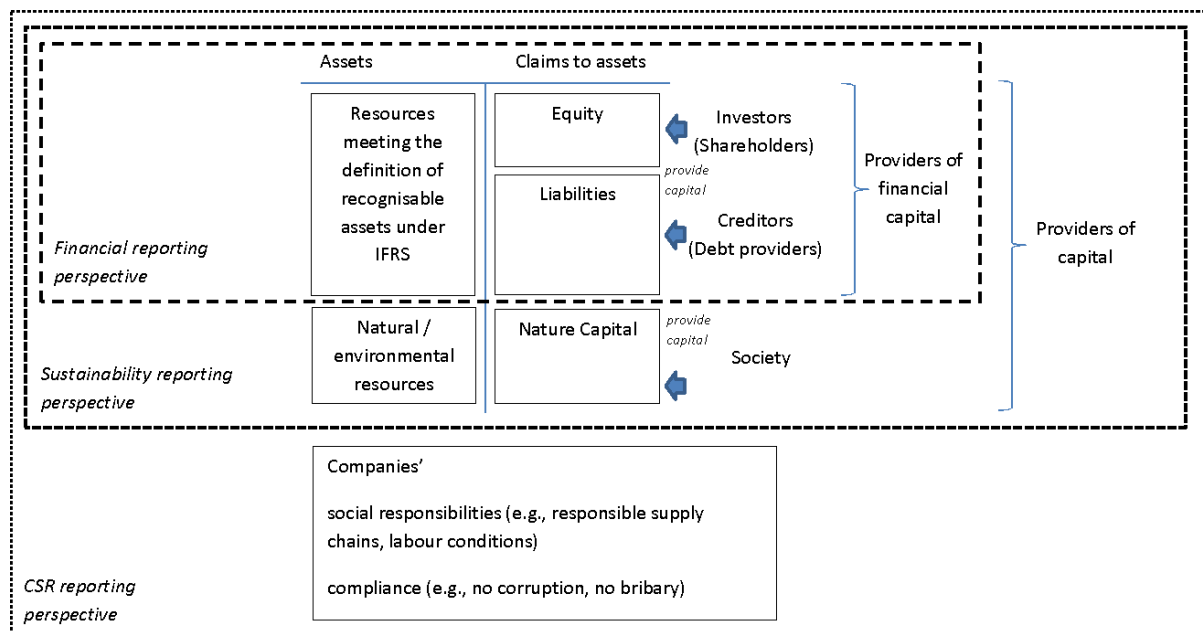


Figure 2: Extending the materiality concept from financial reporting to other capital providers and stakeholders

Companies therefore perform a “materiality analysis” to identify, estimate, and classify the sustainability elements which might impact a business and its stakeholders. The results and data from the materiality analysis are usually synthetically represented in the so-called materiality matrix in which companies showcase sustainability issues by generally referring to two dimensions: the degree of the issue’s importance for the organization and the level of importance for the stakeholders.

Single materiality as the ISSB’s approach

The ISSB proposal focuses on *financial* information. This focus results from the objective to disclose information that is useful for “primary users” of a company’s general purpose financial reporting in order to assess the firm’s enterprise value and decide whether to provide financial capital (equity, debt) to the company itself. According to ED IFRS S1, enterprise value “reflects expectations of the amount, timing and uncertainty of future cash flows over the short, medium and long term and the value of those cash flows in the light of the company’s risk profile, and its access to finance and cost of capital” (para 1-7). Primary users are defined as the providers of (financial) capital, and materiality is assessed from the following perspective: if an issue could impact the company’s ability to create value for the financial capital providers, then it must be relevant to the providers of financial capital, could thus influence their decisions based on the financial reporting information, and becomes reportable. As a result of this concept, entities are required to identify and disclose information about sustainability-related risks and opportunities to which the company is exposed, provided these risks and opportunities have a bearing on the company’s financial performance and/or company value. This concept is therefore sometimes referred to as an “outside-in” (or single materiality) perspective as it is concerned with “outside” matters that could impact the company (“internal”).

The advantages of this (narrow) concept of single materiality are that the user group (and their information needs) are relatively homogeneous and easy to identify. Consequently, its adoption could improve the clarity and focus of the report, with more straightforward, linear, and easier to compare disclosures. This narrow concept of materiality is also more closely

linked to the materiality concept traditionally applied in financial reporting, which helps to foster consistent application in practice.

Double materiality

The European Union, EFRAG, and GRI favour a broader understanding of the materiality concept by combining the investor focus (identical to the ISSB view) with a broader stakeholder view. This second stakeholder view could be described as an “inside-out” perspective as it is concerned with the company’s activities’ (“inside”) impact on the “outside”. This impact is to be assessed based on scale, scope, and ‘remediability’. The combination of these two views is commonly referred to as “double materiality”, and it may substantially extend the matters that are considered material and thus, reportable. Although commonly described as combining the two concepts (“and”), it should not in fact be understood as an intersection (a mathematical “and”, $\cap$), but as a union (a mathematical “or”, $\cup$). Hence, a topic/matter is reportable if it is material under the “investor perspective” or the impact perspective.

An example of this broader concept of materiality is the GRI’s definition of material topics (= reportable topics/matters). A material topic “reflects a reporting organization’s significant economic, environmental, and social impacts, or substantially influences the assessments and decisions of stakeholders.” (<https://www.globalreporting.org/how-to-use-the-gri-standards/questions-and-answers/pre-2021-gri-standards-system-faq/materiality-and-topic-boundary/>; last accessed 26 May 2022).

At first glance, the first part of this definition draws on what EFRAG refers to as the “impact materiality” (see figure 3), while the second part resembles the “financial materiality”, extended from financial capital providers and their decisions to include other stakeholders and their assessments. A view that broadens the group of capital providers to include society (as providers of nature capital) in addition to financial capital providers is also consistent with this definition. If, for example, the environmental impact of a company’s activities is so severe that society assesses the company’s business model as *unsustainable*, then society may decide to impose restrictions on the company, which is equivalent to society no longer being willing to allow the company use of (no longer willing to provide) the nature capital. Alternatively, society can decide to price the usage of nature capital. An example would be CO₂ emission certificates. Pricing helps to reduce externalities and shifts returns from providers of financial capital to society as the provider of nature capital. Corporate income tax has a similar effect but pricing the usage of resources has the advantages of transactional taxes: companies with high usage of natural resources (and thus, relatively less sustainable business models) will be required to pay higher transactional taxes.

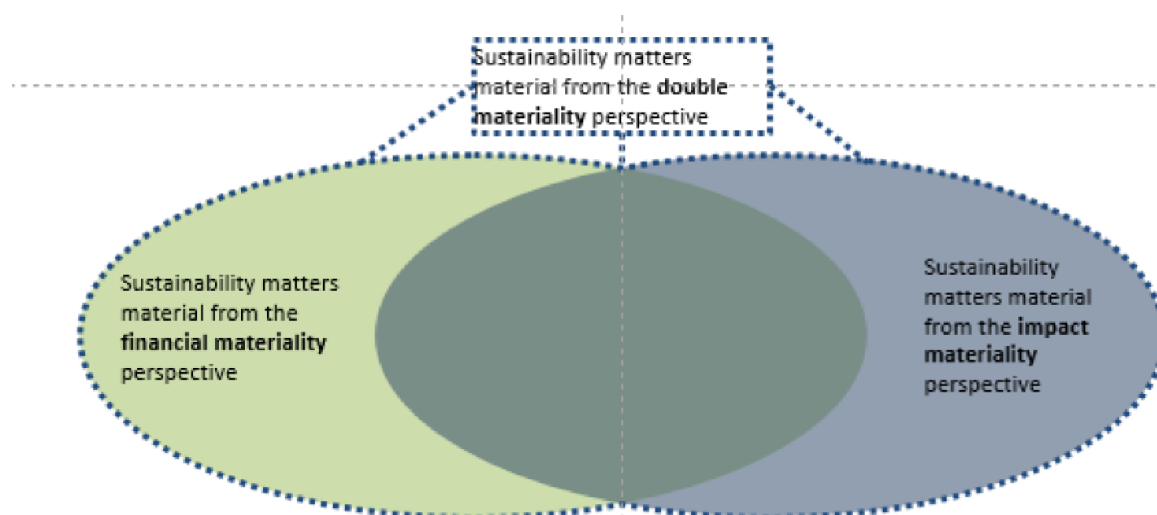


Figure 3: Double Materiality (EFRAG (2022))

While the double-materiality model might seem more complete, broader, and more inclusive (as it considers the perspectives of multiple stakeholders), it might involve a risk of excess complexity and a flood of information, which could potentially reduce the legibility and clarity of the disclosure.

ISSB's building block approach

One of the explicit objectives of the ISSB is “to facilitate the addition of requirements that are jurisdiction-specific or aimed at a broader group of stakeholders” (<https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/>, last accessed 26 May 2022).

By working with standard-setters from different key jurisdictions to address specific jurisdictional reporting requirements such as those outlined in the current EU proposals, a “building blocks” approach (see figure 4) could thus be adopted so that standards would “provide a globally consistent and comparable sustainability reporting baseline, while also providing flexibility for coordination on additional jurisdictional and multi-stakeholder reporting requirements.” (ISSB, 2022)

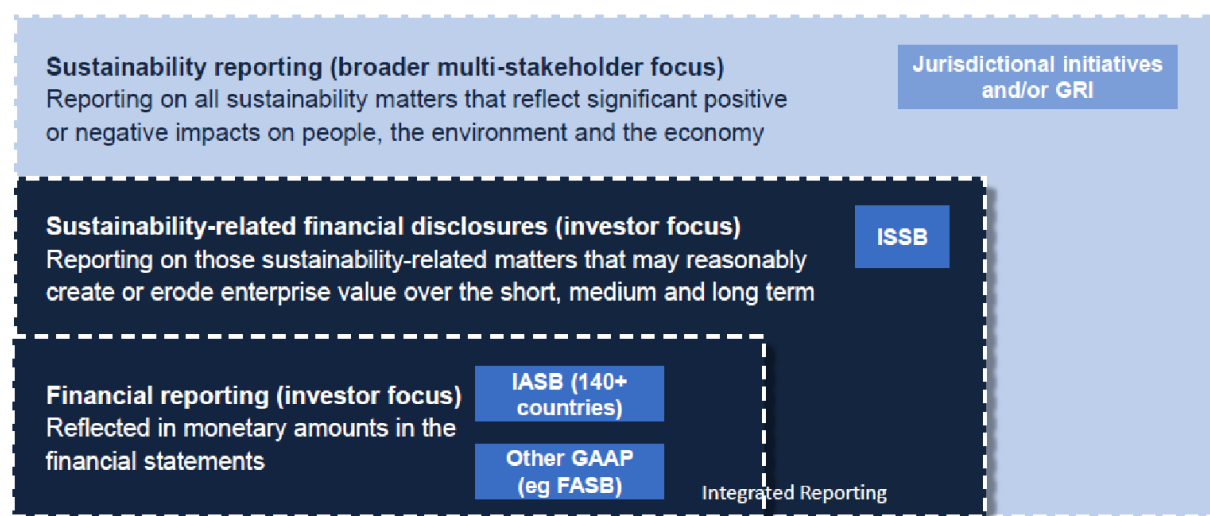


Figure 4: The building blocks approach (ISSB, 2022)

The ISSB recently formed a working group composed of representatives from several jurisdictions actively engaged in standard-setting in the field of sustainability disclosures. The working group will discuss the compatibility of the standard-setting initiatives. Members of the working group include, for example, the Chinese Ministry of Finance, the European Commission, EFRAG, and the US Securities and Exchange Commission. In addition, to ensure geographic diversity within the ISSB, three members must be from Asia-Oceania, three from Europe, and three from the Americas, one member from Africa, and four members may be from any area.

Discussion and Conclusion

Apart from the obvious issue that two different concepts of materiality (one narrow, one broader) impair comparability of reported sustainability information, there is the imminent danger of a “race to the bottom”. If some companies/countries apply the (narrow) ISSB single materiality concept, while others the broader double materiality concept, then this divergence may create pressure to move to the single materiality one. In that sense, the materiality approaches compete with one another.

On the other hand, we might ask whether there can be information that is material only under the “impact perspective” (and thus, under the double materiality concept), but not under the investor-oriented “financial perspective”. In times of accelerated climate change, with societies in many countries beginning to experience the consequences in their daily lives, is it possible that a company or business model with a severe negative impact on the environment will be tolerated in the long run? Or can we expect societies to be less and less willing to accept this impact and its associated externalities that shift wealth from societies to individual shareholders? If this is considered unlikely, then ultimately *all* topics/matters that are material from an “impact perspective” will become material under the “financial perspective”.

However, there could be a timing issue: there may be topics/matters that are only a focus for other stakeholders and parts of society initially. Only when the general public (society at large) becomes more aware of these topics/matters will they become material under a “financial perspective”, as customers consider the impact, for example, or because society considers legislating/regulating the impact, and only then will such topics/matters impact the company’s financial performance and/or value.

It is at least debateable whether the decision to report on these matters should be left to the discretion of companies. This decision is not left to the discretion of companies in the financial reporting domain and for good reason. Financial reporting standards, not the reporting firms, define what resources should be recognised as assets, and how changes in net assets are to be calculated to arrive at a profit.

Consequently, the ISSB’s single materiality approach might be easier and faster to implement in the short term. It may also be useful internationally, as many countries and jurisdictions have to (first) experience mandatory sustainability reporting. In the EU, however, the ISSB’s single materiality approach may only serve as a building block as part of the EU’s strategy to become more sustainable fast, based on the broader double materiality concept. Following this line of thought, we could say that the two materiality approaches are complementary over time.

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