IFRS Sustainability Disclosure Standards

Implementation challenges for preparers

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This paper discusses the challenges that preparers implementing sustainability reporting under the IFRS Sustainability Disclosure Standards ("IFRS SDS") will face. These challenges will be largely similar to those faced using other sustainability reporting standards (for example, the European Sustainability Reporting Standards ("ESRS") or the Global Reporting Initiative (GRI) standards), although there will be some variations due to differences in the requirements.

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How prepared are you?

During a UK-based sustainability reporting event focusing on IFRS SDS in November 2023, a poll was held to identify the state of preparation of entities attending. It showed that 43% had made a start, while 37% felt somewhat prepared and 18% were in need of help or had not even started yet.

43%
Made a start

37%
Somewhat prepared

13%
Help!

5%
Not started yet

2%
Fully prepared

What should you do now?

Assess your state of preparation for sustainability reporting, including your understanding of:

- The reporting requirements for your entity, including any extra-territorial impacts of the requirements of regulations like the Corporate Sustainability Reporting Directive (CSRD) in Europe and developments in the US
- The policies, procedures and controls that need to be in place (e.g. incorporating sustainability in your risk management and governance processes) and the associated qualitative disclosures
- The quantitative data you will need to collect, including for disclosure of greenhouse gas emissions and performance against any sustainability related targets

What are the biggest challenges?

At the same event a poll was held to assess the major challenges facing preparers. The results confirm a fairly widely held view that data quality is the biggest challenge, followed by value chain assessments. Capacity is clearly a concern, while more technical aspects like understanding the requirements and impact materiality were flagged by only 15% of attendees.

Interestingly, investors speaking at the event appear less concerned about data quality and the need to have accurate data as their focus is more likely on risks and opportunities than on the numbers. From an investor perspective, therefore, estimates are probably sufficient for many sustainability disclosures although it will be important to disclose the level of uncertainty.

What should you do now?

As part of considering your state of preparation, think about the impact of challenges around data collection, value chain assessments and how you can utilise existing capacity and/or increase resource to meet reporting requirements.

You should consider whether you have an appropriate skillset at Board level to ensure that there is sufficient expertise on sustainability matters, perhaps introducing a skills matrix for the Board. You can then assign responsibilities for sustainability (including climate risk) at Board, Committee and Management Levels, identifying the most appropriate structures and reporting lines for your business.

Review risk management policies and processes to embed steps for sustainability (including climate) risk identification, assessment and mitigation.

39%
Data quality

21%
Value chain assessments

11%
Understanding requirements

19%
Lack of skilled people

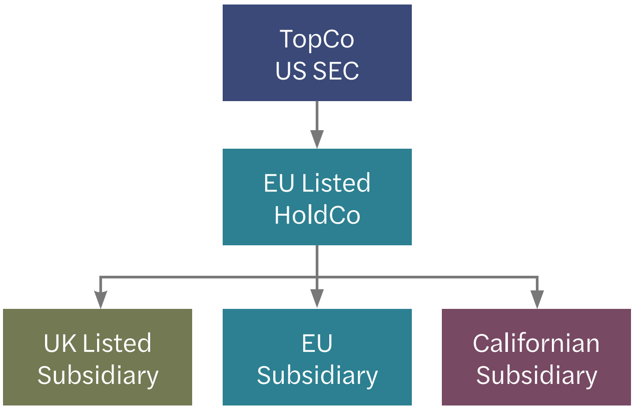
4%
Impact materiality

Identifying the scope of the sustainability report

Identifying the scope of the sustainability report is an important and challenging starting point. The reporting boundary for IFRS SDS reports is the same as the financial statements. While this seems simple enough in principle, entities need to consider whether there are any changes year-on-year in the group structure and also how best to aggregate and disaggregate sustainability reporting.

Segmental reporting in the financial statements may be an appropriate starting point. However, for many entities, it is likely that data may be more appropriately aggregated/disaggregated in different ways to reflect the difference between sustainability risks and opportunities and the financial position.

The diagram below shows a fairly simple group structure but illustrates the challenge in determining which reporting standards apply to which entities.



In this example:

- SEC TopCo – will have to apply the SEC rule as and when it is introduced. (It may also need to report under CSRD if it has large enough European operations)
- EU Holding Company – will comply with CSRD and report using ESRS for itself and its own subsidiaries (i.e. the UK, EU and Californian entities)
- UK Subsidiary – Assuming the IFRS SDS are adopted by the UK, as appears likely, will report under IFRS S1 & S2. However, if it has large enough European operations it may also need to report under CSRD in its own right.
- EU subsidiary – in scope of CSRD (may be able to avoid reporting as it is included in the group entity)
- Californian Subsidiary – caught by Californian sustainability reporting requirements, as well as being incorporated in EU HoldCo CSRD reporting and required to provide information for that report.

What should you do now?

Identify the reporting boundary for your sustainability reporting and consider the implications of the requirements of the various reporting standards and to which entities they apply.

Identifying material risks and opportunities

As a reminder, material risks and opportunities are:

> 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.

When it comes to identifying material risks and opportunities, key matters to bear in mind include that:

- Materiality is critical as only "material risks and opportunities" require disclosure. In the context of IFRS SDS, this means what information is material to primary users of the financial statements (i.e. investors, credit suppliers) and hence the focus is on financial impact.
- The assessment is based on "reasonable and supportable information". But what does that mean?
    a. An exhaustive search for information isn't required, as the information used should be available "without undue cost or effort"
    b. A balance needs to be struck between the cost of obtaining data, and the needs of users. The more useful information is to investors, the more effort you should put in to obtaining that information
    c. Information and data may come from internal and external sources
- IFRS SDS require reference to be made to the SASB standards when identifying risks and opportunities, but preparers may also wish to refer to other standards such as the ESRS, GRI and Climate Disclosure Standards Board (CDSB) framework.
- The assessment needs to consider risks and opportunities across the short, medium and long term.

Preparers we have spoken to have highlighted that short term risks are typically better understood given the focus of risk management over many years. Sustainability opportunities, as well as long term risks, on the other hand, are seen by preparers as more difficult to assess and support with good data.

When it comes to assessing materiality, you should focus on what you are trying to achieve, asking yourself the questions:

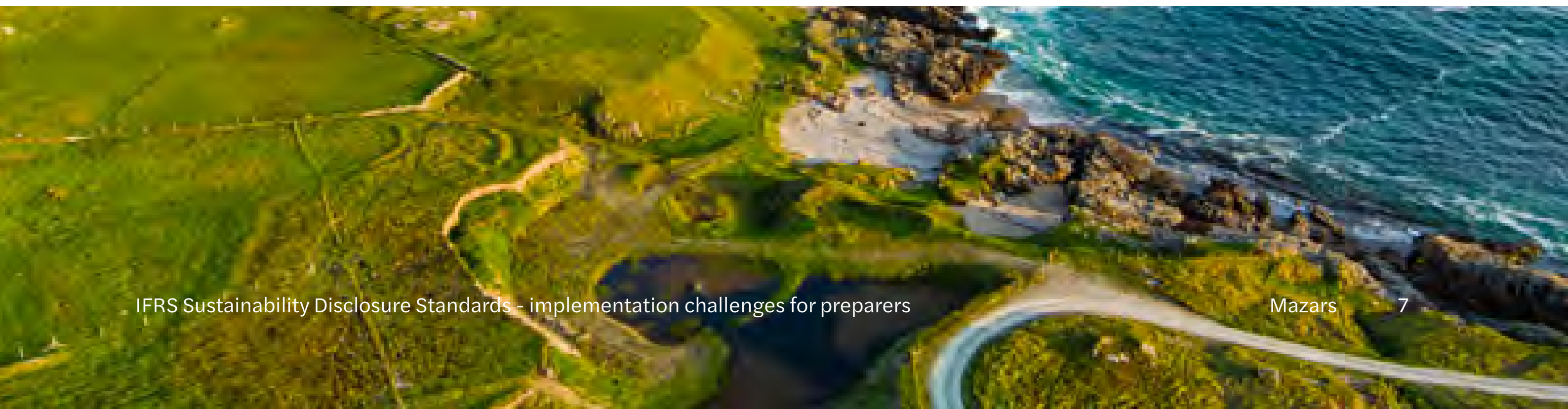
- what will have the biggest impact on your business? and
- what is most important to users?

What should you do now?

Undertake a full gap analysis to identify gaps (processes, controls, data) in your current arrangements and those required to comply with IFRS SDS. This should include:

- Undertaking an initial materiality assessment to identify your exposure to drivers of risks and opportunities, including transition and physical climate risks.
- Mapping the current and anticipated effects of sustainability & climate risks and opportunities on your business model and value chain.
- Performing scenario analysis to identify risks and opportunities in the short, medium and long term
- Identifying metrics and targets and the information available to report your performance.

Based on the outcome of the gap analysis, develop an implementation plan and roadmap, focusing on the key areas for improvement to ensure compliance with IFRS SDS requirements.



Defining and reporting on your value chain

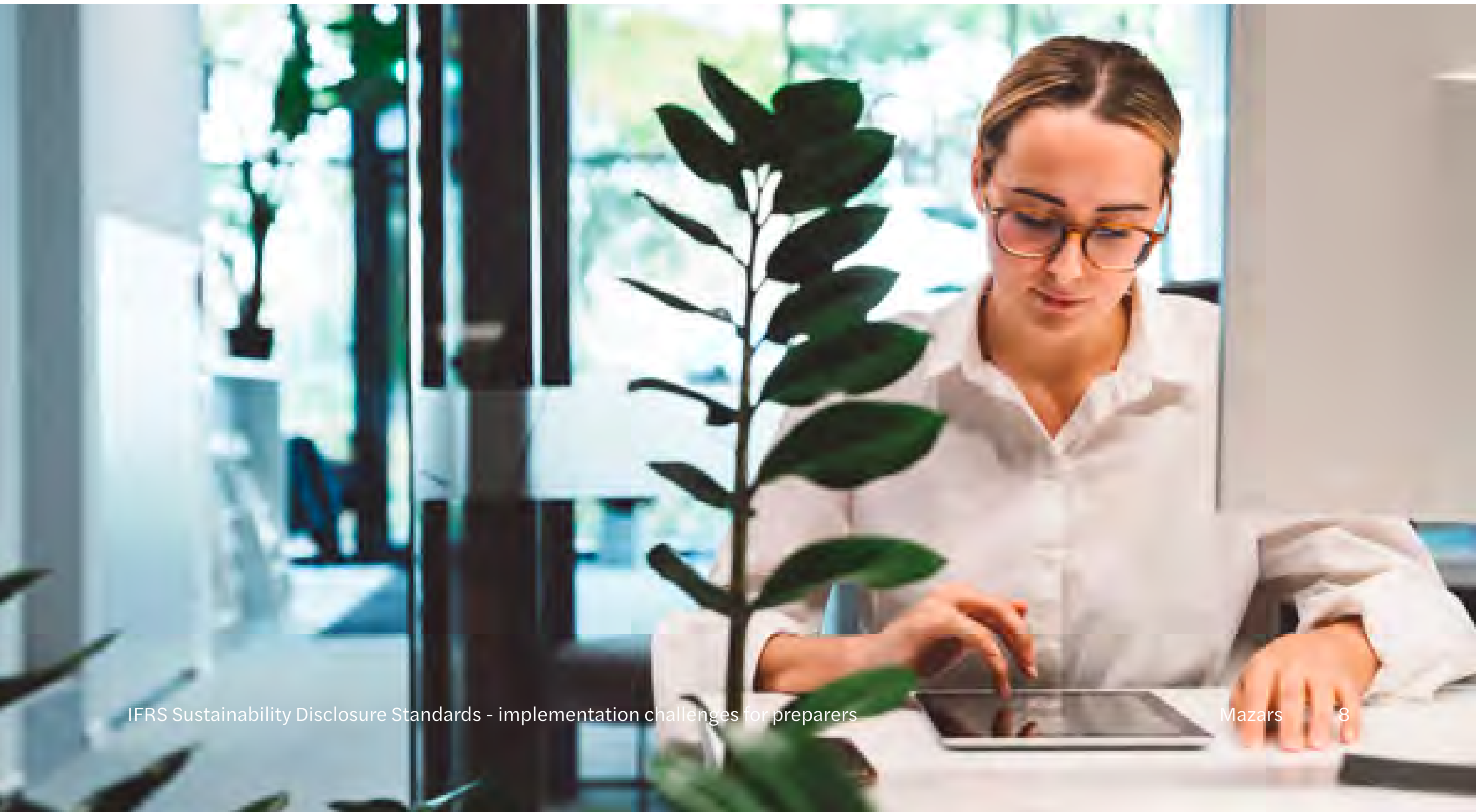
A significant challenge for preparers will be the need to report on aspects of the value chain. Key questions here include "how far up and down the value chain should you go?" when considering risks and opportunities and in initial attempts at gathering data to support disclosures. In a recent conference a comment was made that "the value chain of an entity like Shell or BP is pretty much the global economy" – clearly reporting the value chain cannot be that wide, especially in year one!

There are many factors which impact the determination of the scope of the value chain and the identification of material risks and opportunities. Where the following are relevant in your value chain, they are likely to lead to material matters which you should report:

- risks and opportunities in the value chain where an entity has a single or small number of suppliers or significant customers,
- risks which are actively managed by the entity or risks which may impact its brand,
- issues in jurisdictions impacted by the value chain, and
- sector specific risks or opportunities in the value chain.

Having considered the scope of the value chain, it is then important to identify how data can be obtained from entities in the value chain. Will the data be available and accessible? How reliable will the data be? Will it have been subject to assurance?

In the early years, in particular, and with many entities in a value chain being outside the scope of sustainability reporting, it is unlikely that reliable, complete, accurate data will be available. It is therefore important that any uncertainties or lack of reliability in the data is fully disclosed in the sustainability report, along with how you have defined your value chain for reporting purposes.



Preparer comments:

Some quotes from preparers at recent conferences include:

- "There is no one-size-fits-all approach. The value chain assessment can be done via a "bottom up" review of the full product life cycle if it is a small entity with few products."
- "We took a "top down" approach to identify the value chain, identifying common business cycles that cut across the value chain – there will need to be clear disclosure about what the value chain is and how the entity has gone about identifying/defining the value chain. The rationale will need to be disclosed and discussed with the auditor when the time comes for assurance."
- "You need to strike a balance between "boiling the ocean" and providing useful information for the users. It's similar to double materiality – do you need to speak to every conceivable potential stakeholder? Does that really make sense?"
- "The value chain is thinking about products from end-to-end, right the way through to disposal. However, don't try to cover your entire value chain in year one! Initially you need to identify and understand your value chain, consider how data can be obtained over the coming years, assess where particular problems may arise. And develop a plan."
- "We are comfortable with the information from our own sites, however suppliers and others in the value chain are more challenging with data not generally being available".
- "When it comes to reporting Scope 3 emissions, most organisations in the value chain don't have the data to make it possible to comply with reporting standards"

What should you do now?

Consider how you will define your value chain – will you take a top down or bottom-up approach. How far up and down your value chain will you look in year one, and what is your plan for extending to your full value chain in the coming years.

Consider the data that will need to be gathered from entities in your value chain to enable you to comply with the IFRS SDS (especially GHG emissions disclosures), and how you will obtain that data. Also consider the reliability of that data for your own reporting purposes. You may need to engage early on with suppliers to obtain reliable data, or to encourage them to start collecting data depending on their own progress. In the first instance you should focus on your key suppliers and customers.

Identifying and obtaining data to support disclosures

As noted earlier, it is clear that data is the number one concern for preparers. This message is consistently heard. So, how can you address this challenge?

Remember many of the disclosure requirements are narrative descriptions, relating to processes and controls under the Governance, Strategy and Risk Management pillars of IFRS SDS. Therefore, data is not needed to meet many disclosure requirements, although data will be important when reporting against metrics and targets.

Furthermore, it is important to accept that getting to high quality data for some sustainability disclosures may be a journey over a number of years as systems and controls are established. Disclosure of any uncertainties in the data, and the steps that are being made to improve it will be critically important when it comes to reporting.

A gap analysis will be needed to identify what data is needed to comply with IFRS SDS and what data is already available. When data is available, you also need to consider:

- Where does it come from? Bear in mind that, in contrast to financial reporting, data is likely to come from many sources, both internal and external and more effort may be required to obtain the information required.
- Is it readily available, and in a timely manner that fits your reporting cycle? Have you already started collecting, or have plans in place to collect, the required information for other purposes, for example group sustainability reporting or providing information to your own suppliers or customers for their own reporting.
- What confidence do you have in the reliability and accuracy of the data? Has it been subject to assurance? If so, you may need to consider whether the level of assurance received is appropriate for your needs, disclosing, for example, where only limited assurance has been obtained over key data.
- Will consistent data be available across entities within the group or value chain, in the same format, using the same units etc.? What about local laws and regulations – will these impact the availability of data and/or the way in which performance is measured (e.g. health and safety rules will differ with each jurisdiction applying their own targets and metrics). How can this disparate data then be collated and reported at group level?

For all data reported, it is important to develop and document a methodology for collecting the data, and any supporting information that underpins disclosures of metrics and key performance indicators (KPIs). The rigour applied to financial reporting is equally important for sustainability information and integrated finance and sustainability teams are increasingly common. Preparers we have spoken to have highlighted that most entities are aligning data collection and reporting processes across sustainability and financial reporting teams to benefit from the experience of finance teams in developing systems, processes and controls for collection and reporting of data.

What should you do now?

Undertake a data gap analysis to identify the data required to comply with IFRS SDS and what data is, or will be, available. This should include identifying:

- Metrics and targets to be disclosed
- Information/data needed to comply with disclosure requirements
- Availability of information/data now, including consideration of its reliability and accuracy
- Gaps in information availability and how they can be filled over time.

Based on the outcome of the gap analysis, develop an implementation plan and roadmap for obtaining the required data.

Consider how best to integrate sustainability reporting into existing financial and corporate reporting systems, processes and controls.

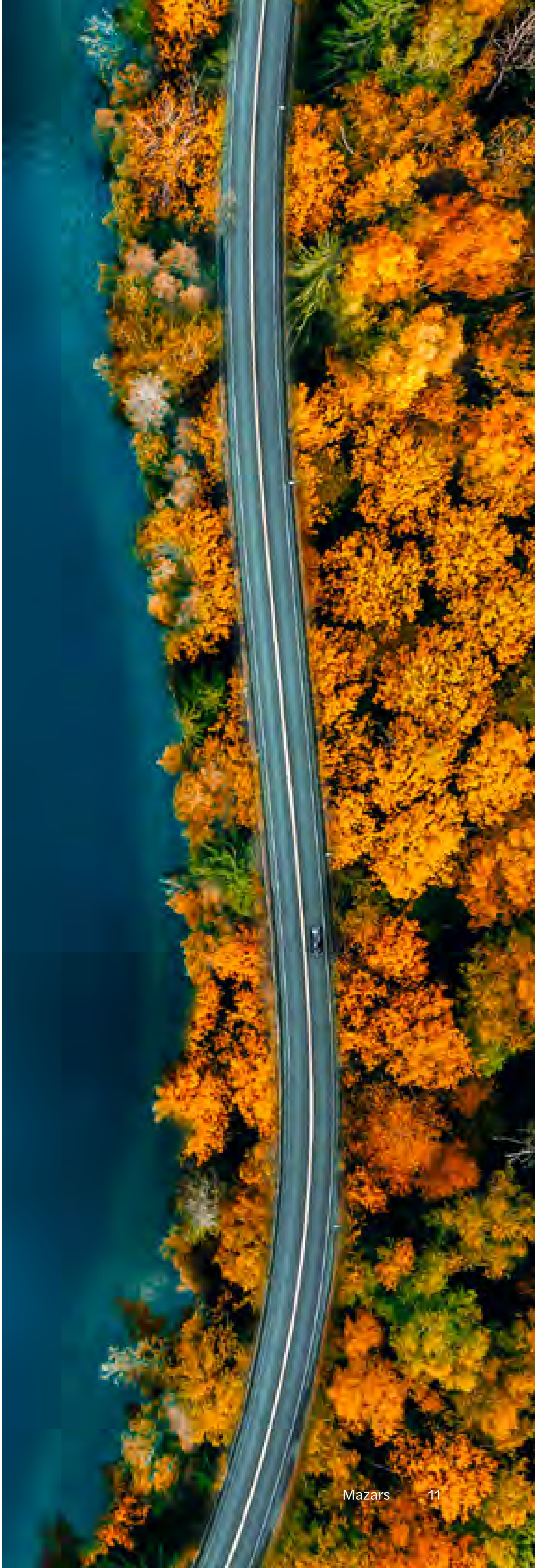
Establishing a robust control framework for sustainability reporting

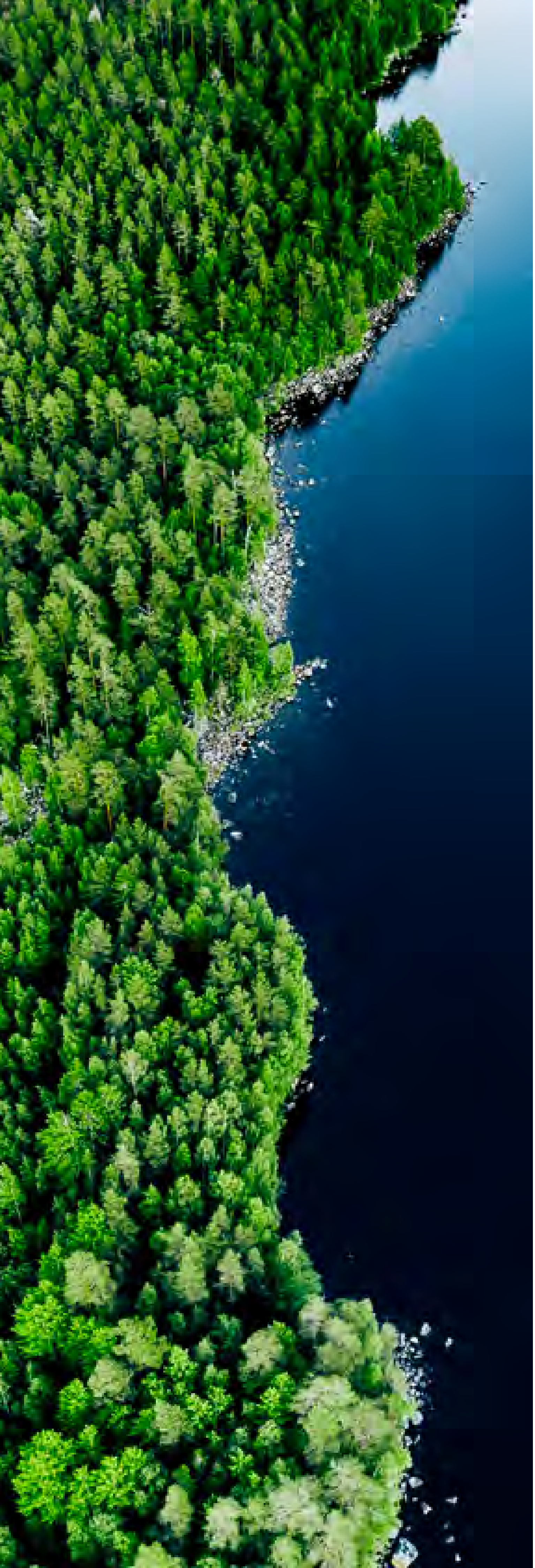
High quality systems, processes and controls will be needed to underpin the collection of data to support metrics, targets and other quantitative disclosures in the sustainability report, as well to gather information to form qualitative disclosures.

Sustainability controls will be less mature than financial reporting controls and are likely to be insufficient or perhaps even non-existent at the present time. Equally, group level sustainability reporting controls will lag behind group accounting policies and controls which are generally well established. Plus local laws and regulations might impact on systems, policies and controls over aspects of environmental, social and governance (ESG) reporting. Establishing a strong control environment will take time.

What should you do now?

Consider how best to integrate sustainability reporting into existing financial and corporate reporting systems, processes and controls. In particular consider how sustainability reporting can leverage from the experience of the finance and internal audit teams in establishing an internal control framework.





Retaining documentation and evidence to support disclosures (Data and Controls)

When collecting data and developing the system of internal control for sustainability reporting, consideration needs to be given to the documentation and evidence that is available to support disclosures in the sustainability report. This will be important when it comes to obtaining assurance.

Evidence of the operation of controls (including evidencing the review and approval of any processes and controls) and supporting information and data for both qualitative and quantitative disclosures will be required.

It is particularly important that the documentation for any estimates and forward-looking disclosures includes the judgements and assumptions made in developing the disclosures, the methodology and models used, any assumptions that drive the estimate and any scenario analysis used.

What should you do now?

Consider what required evidence is available to support disclosures made in the sustainability report and develop plans to ensure appropriate documentation is retained, leveraging the experience of financial reporting and internal audit teams.

Developing the sustainability report

When it comes to developing the sustainability report itself, challenges lie in three key areas (in addition to gathering the information & data, and ensuring compliance with the reporting standards themselves). These are:

- The need for the report to "present fairly" the risks and opportunities, and what the entity is doing to address them. This means ensuring:
  - Reporting is complete (contains all material risks and opportunities), neutral (fair and balanced reporting) and accurate (containing appropriate information to accurately describe the situation)
  - Greenwashing, in all its guises, at the "sustainability report level" is avoided – that is, ensuring that the overall tone and balance of the report are appropriate, that they do not paint a more positive picture than the real position or otherwise mislead the reader. This is different to the risk of greenwashing at the level of an individual indicator of performance (e.g. overstating performance against a target, or understating GHG emissions)
- Timing of reporting will be challenging, particularly in the first year. IFRS SDS requires that sustainability disclosures align with the financial reporting period and be published at the same time as the financial statements, although a first -year transitional relief is included in IFRS S1. For listed entities, this may present a significant challenge given the short reporting timetable for financial results to the markets. This timetable will also prove challenging to assurance providers given the need to gather and provide the report and supporting data in a timely manner for assurance work to be performed.
- Information can be connected in many ways. It could be connections between different risks and opportunities in the sustainability report or between the suitability report and the financial statements. In this regard, IFRS S1 requires the same financial data and assumptions to be used in both reports where possible, meaning that it is important for entities to ensure financial and sustainability reporting systems are integrated.

What should you do now?

Consider how best to incorporate IFRS SDS reporting into your governance and internal control framework, to ensure that the sustainability report is properly developed and subject to appropriate review and approval processes. This should include reviewing the connectivity and consistency between the disclosures in the sustainability report and the financial statements.

You should consider how the experience of your finance teams in developing internal financial and related controls, and financial reporting may be leveraged. Your internal auditors, where relevant, should be a useful source of help in developing and reviewing the internal control environment.

Getting ready for assurance

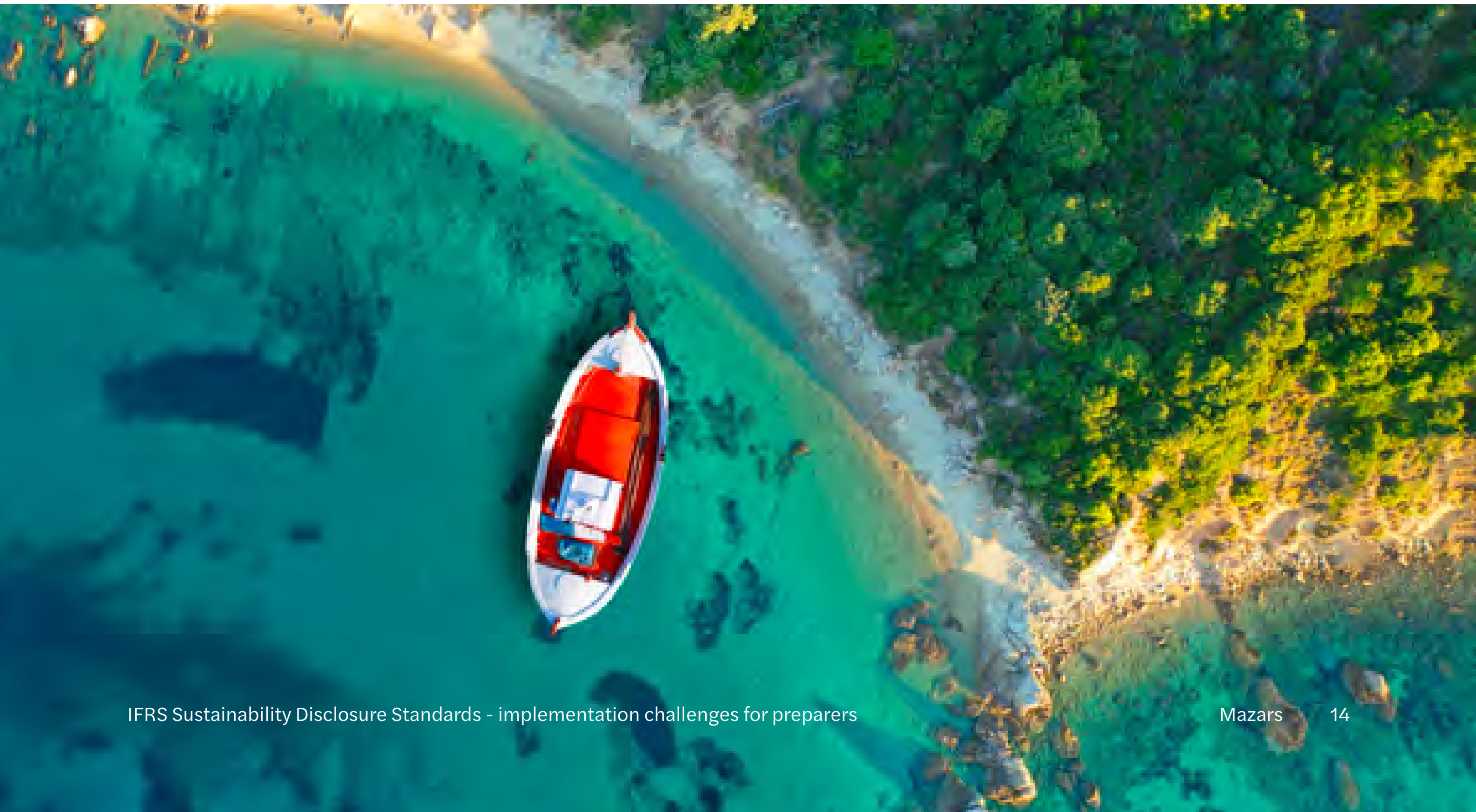
Finally, having addressed the challenges of developing the sustainability report, it is important to consider what you need to do to be ready for assurance when the time comes.

Sustainability teams will not be familiar with the rigour of external audit and will likely find assurance a challenging process. It is important again that finance and sustainability teams work together to prepare for assurance as the finance team will have an understanding of what the assurance provider will ask for. It's also important that the teams working on sustainability disclosures and financial statements work together to ensure that disclosures are consistent between the sustainability report/annual report (front end) and the accounts (back end).

Documentation and evidence needed to support the sustainability report will vary depending on the scope of the report and the nature of the assurance being provided (i.e. limited or reasonable) but as a minimum will include consideration of the scope of the report (reporting boundary and value chain), the process for identifying material risks and opportunities, operation of controls, supporting documentation for both quantitative and qualitative disclosures, including the detailed information on estimates and methodologies applied for calculating metrics and targets.

What should you do now?

In addition to taking the steps set out above, consider obtaining an independent audit-readiness assessment. For example on certain KPIs or other disclosures that you are particularly concerned about or your most significant risks and opportunities, to identify whether the supporting evidence is sufficient, reliable and relevant.



What do regulators say about the quality of sustainability reporting?

There has been limited reporting by regulators on the quality of sustainability reporting at the present time. However, the UK Financial Reporting Council (FRC) reported the results of its annual corporate reporting review in November 2023. This report included consideration of disclosures made in accordance with the Task Force on Climate-Related Financial Disclosures (TCFD) requirements by a sample of UK companies.

The FRC highlighted the following key characteristics of good reporting against TCFD requirements:

- Reporting should be clear and concise with key messages not obscured in an unnecessarily lengthy report
- Disclosure of relevant metrics and targets should be supported by a clear definition and description of the methodology
- Targets should be explained and supported by information such as comparatives and explanations for movements
- Consistency with other reporting (e.g. financial statements, directors remuneration report) is critical.

The FRC also highlighted some key considerations relating to greenwashing, including the need to:

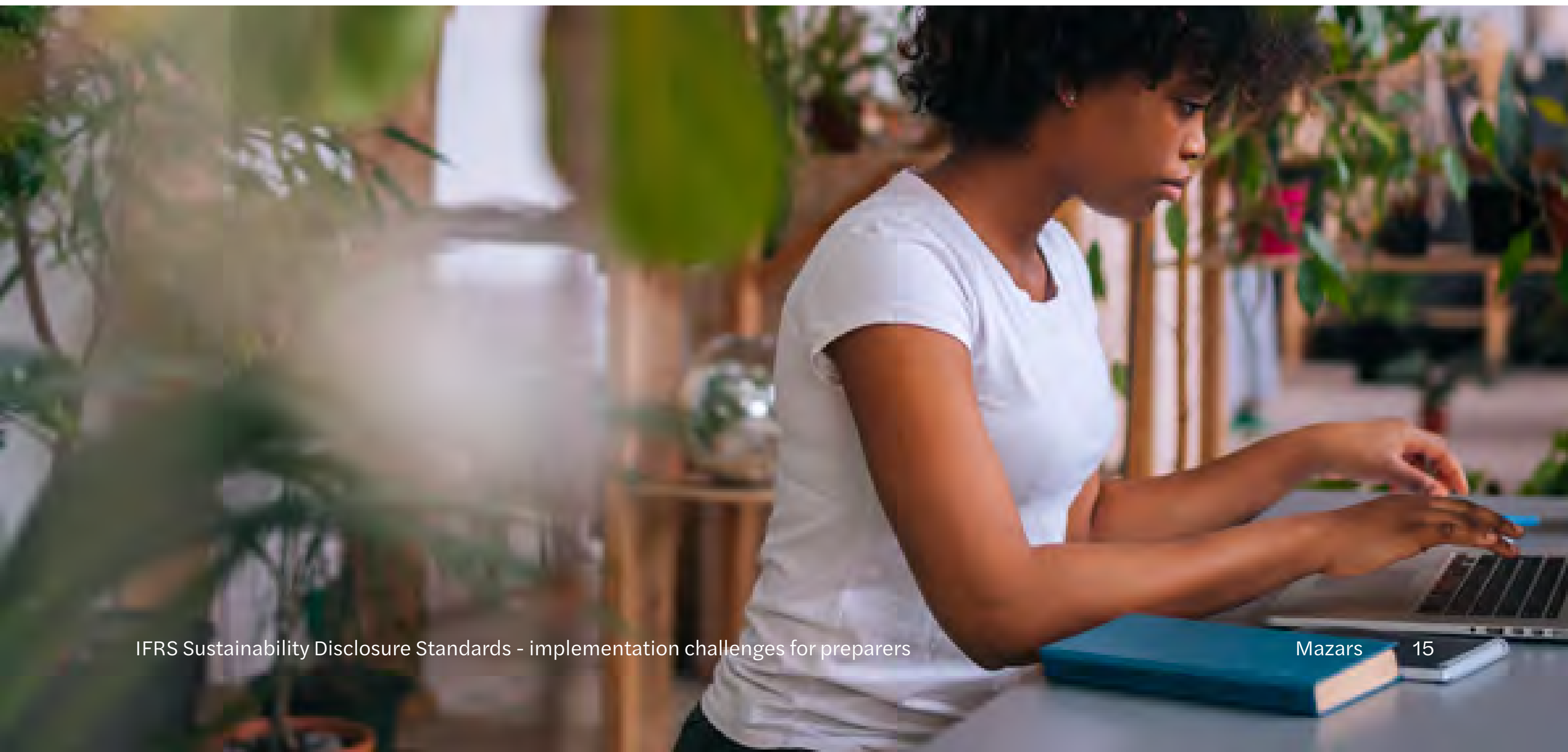
- Consider the clarity and balance/tone of the sustainability report, especially the terminology used to ensure it doesn't imply better performance than reality
- Avoid placing undue emphasis on immaterial "green" aspects of a business rather than more material activities and avoid misleading presentations of data
- Explain the methodologies used and scope of metrics, as well as disclosing uncertainties in estimates and ability to meet targets

What should you do now?

When developing your sustainability report, you may wish to consider some of the key considerations highlighted by the FRC to ensure that your sustainability report is a fair, balanced and reasonable representation.

Dr Paul Winrow

Partner, Global Leader, IFRS Sustainability Disclosure Standards



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