Alignment with IFRS Sustainability Standards

Background and status

1 One of the changes in the revised text of the CSRD directive released the 30 June 2022 relates to the interoperability of ESRS with international initiatives, including IFRS Sustainability Standards.

(a) In the articles the following text has been included:

The standards shall avoid disproportionate administrative burden on undertakings, including by taking account to the greatest extent possible the work of global standard-setting initiatives for sustainability reporting as required by paragraph 3, point (a).

(b) In the recitals, the following text has been included:

To avoid unnecessary regulatory fragmentation that may have negative consequences for undertakings operating globally, European standards should contribute to the process of convergence of sustainability reporting standards at global level, by supporting the work of the International Sustainability Standards Board (ISSB). European standards should reduce the risk of inconsistent reporting requirements on undertakings that operate globally by integrating the content of global baseline standards to be developed by the ISSB, to the extent that the content of the ISSB baseline standards is consistent with the EU's legal framework and the objectives of the European Green Deal.

2 One of the topics recurring in the outreach activities and in the comments to the survey is the level of alignment of the content of the ESRS with the content of IFRS S1 and S2, including the demand to achieve a higher level of alignment.

3 The CSRD text also foresees that *European standards should contribute to the process of convergence of sustainability reporting standards at global level, by supporting the work of the International Sustainability Standards Board (ISSB).*

4 EFRAG Secretariat and EFRAG SR TEG are working to propose amendments to the ESRS EDs, in order to achieve highest possible alignment to the contents of the IFRS EDs, already for the release of Set 1 of ESRS by mid-November 2022.

5 One of the key considerations for EFRAG decision-making is the misalignment in timing. Set 1 of ESRS drafts will be delivered by EFRAG to the EC by mid-November 2022 (and the decision-making process of EFRAG should be completed by the end of October at the latest), while the ISSB will complete the deliberations on its two exposure drafts at the end of the year. The current text of the two IFRS EDs is subject to changes, in order to address the comments received during the ISSB consultation. It is likely that, whatever the level of alignment that can be finally achieved in Set 1, further changes will be needed and future amendments to the draft ESRS composing Set 1 will be needed in future periods to enhance further the interoperability, including due to the changes to the ISSB EDs in the finalization of the IFRS standards.

6 EFRAG should support the work of the ISSB and, where appropriate, IFRS sustainability standards could be amended to facilitate the alignment with the equivalent provisions in ESRS standards.

7 Representatives of EFRAG and the EC participated to the two meetings of the Jurisdictional Working Group of the IFRS Foundation on the 16 May 2022 and the 18 July 2022. At the same time, bilateral meetings with the ISSB staff have started in the second half of June 2022 and are still ongoing.

8 The EFRAG SR TEG has discussed:

(a) Whether additions to IFRS S2 in ESRS E1 were justified on the basis of a technical rationale (SR TEG meeting of the 11 July and 18 July) – See Agenda Paper 07.03 to this meeting.

(b) Possible changes to ESRS 1 and 2 to enhance the alignment to fundamental concepts and terminology in IFRS S1 (SR TEG meeting of the 20 July) - See Agenda Paper 07.02 to this meeting.

9 Contacts and bilateral meetings are continuing with the ISSB staff, in order to further align key concepts and terminology both for IFRS S1 and IFRS S2. This would be incremental to what already achieved so far and presented today.

Architecture

10 As part of the alignment of ESRS 1 and 2, SR TEG members considered also the <u>architecture</u>, including the differences between the 3 content areas in ESRS (cross cutting / PTAPR-implementation / Performance metrics) and the 4 pillars of IFRS/TCFD (Governance, Risk Management, KPIs). The differences in the EDs are graphically presented in the Appendix to this paper. EFRAG SR TEG members considered that the articulation of the cross-cutting/topical standards in ESRS was a strength of the ESRS architecture. <u>They tentatively agreed however to recommend to the SRB to proceed to the following changes to the Architecture in order to promote alignment with TCFD/IFRS (the public consultation feedback will provide further input for the SR TEG and SRB to consider when deciding on this point)</u>:

(i) Move IRO 2 and 3 to SBM (within ESRS2);

(ii) Move DP1, 2 and 3 from ESRS 1 to ESRS 2 IRO;

(iii) Align the titles (Strategy – instead of Strategy and Business Model, Governance – instead of Governance and Organization, Metrics and Targets – instead of Performance Measures). Risk management was not considered a good replacement for PTAPR for the need to cover impacts, risks and opportunities.

Key differences in the materiality concept

11 The concept of double materiality in ESRS 1 is broader and encompasses the concept of materiality in IFRS S1. In particular:

(i) For IFRS S1 (para 2 and 56) the reporting entity shall disclose material information about all of the significant sustainability related <u>risks and opportunities</u> to which it is exposed, in a context where information (necessary for <u>users of general purpose financial reporting</u> to assess enterprise value) is material if omitting, misstating or obscuring that information could reasonably be expected to <u>influence decisions</u> that the primary users of general-purpose financial reporting make on the basis of that reporting.

(ii) For IFRS S1 (par. 17) an entity's sustainability-related risks and opportunities arise from its dependencies on resources and its impacts on resources, and from the relationships it maintains that may be positively or negatively affected by those impacts and dependencies. (…) <u>When such impacts, dependencies and relationships create risks or opportunities for an entity,</u> they can affect the entity's performance or prospects, create or erode the value of the enterprise and the financial returns to providers of financial capital, and the assessment of enterprise value by the primary user.

(iii) For ESRS 1 (par. 43) (information) materiality reflects (i) the significance of the information in relation to the phenomenon it purports to depict or explain, as well as (ii) its capacity to meet the needs of the stakeholders of the undertaking, allowing for proper decision-making, and more generally (iii) the needs for transparency corresponding to the European public good. For ESRS 1 (par. 46), a sustainability matter meets the criteria of double materiality if it is material from either the impact perspective or the financial perspective or both perspectives. For ESRS 1 (par. 49) a sustainability matter is material from an impact perspective if it is connected to actual or potential significant impacts by the undertaking on people or the environment over the short-, medium- or long-term. For ESRS 1 (par. 53) a sustainability matter is material from a financial perspective if it triggers or may trigger significant financial effects on undertakings, i.e., it generates or may generate significant risks or opportunities that influence or are likely to influence the future cash flows and therefore the enterprise value of the undertaking in the short-, medium- or long-term, but it is not captured or not yet fully captured by financial reporting at the reporting date.

(iv) For ESRS 1 (par. 51) materiality of an actual impact is determined by the severity of the impact (scale, scope, and irremediable character), while the significance of a potential negative impact is determined by the severity and likelihood of the impact. In the case of potential human rights impacts, the severity of the impact takes precedence over its likelihood.

12 ESRS double materiality perspective encompasses two dimensions :

(a) Outside-in components (sustainability related risks and opportunities that have or may have an impact on enterprise value);

(b) Inside-out components/impact materiality.

13 With reference to impact materiality, the impact dimension is a distinct disclosure objective in ESRS 1 and covers material actual and potential impacts. On the contrary, the impacts are considered in IFRS S1 to the extent that they trigger significant risks and opportunities (outside-in perspective). Information of the two perspectives may overlap, such as when in the long-term impacts translate into risks and opportunities that are material for investors (i.e. impact their assessment of the enterprise value), however in principle the ESRS impact perspective is broader than the corresponding IFRS impact perspective. This is because (i) the ESRS impact perspective serves the decision-making needs of a broader group of stakeholders, and also more generally the needs for transparency corresponding to the European public good and because (ii) the criteria for assessing impact materiality (ESRS 1 par. 51) do not necessarily correspond to what would be material for investors when assessing the enterprise value.

14 With reference to financial materiality, the changes to ESRS E1 recommended by EFRAG SR TEG will allow to reduce the differences in wording (and in this way prevent diverging interpretations), removing the ambiguity of ‘financial effect’ in ESRS being different from ‘risks and opportunities that may ultimately impact enterprise value’ in IFRS S1. In terms of residual difference, while investors are a clearly defined sub-group of users in ESRS 1 (par. 44 b i)) and as such their perspective is served by the outside-in component of the ESRS double materiality, in theory it is questionable whether or not such outside-in component includes also elements that are not material for users of the general-purpose financial reporting. For the CSRD, investors are not the only users of sustainability reporting and categories of stakeholders other than investors could in principle also be interested

in information from the outside-in perspective. However, in practice the set of financially material information that an undertaking will prepare to respond to the needs of investors (IFRS concept) will likely be the same that will also be of interest for the other users (outside-in concept in ESRS).

15 A key expectation of stakeholders is to avoid double reporting, i.e. undertakings that are in scope of the CSRD and will prepare their reports adopting ESRS should in an ideal situation be able to claim compliance with IFRS Sustainability Standards. In this respect, it is worth noting that IFRS S1 par. 74 specifies that an entity might disclose information required by an IFRS Sustainability Disclosure Standard in the same location as information disclosed to meet other requirements, such as information required by regulators. In this case the entity shall ensure that the sustainability-related financial disclosures are clearly identifiable and not obscured by that additional information. The CSRD requires that the information prepared according to ESRS standards is presented in a separate section of the management report and such information will cover all the ESRS disclosure requirements, including those that are mandated by IFRS S1 and IFRS S2. A key element of the interoperability will therefore be the identification of the disclosures that correspond to the detailed paragraphs of IFRS S1 and IFRS S2.

Objectives of this session

16 For the SRB to approve the EFRAG SR TEG advice on:

(a) Changes to ESRS 1 and 2 to enhance the alignment to fundamental concepts and terminology in IFRS S1 (Agenda Paper 07.03);

(b) Additions to IFRS S2 in ESRS E1 (Agenda Paper 07.02);

(c) The changes in Architecture (par. 10 above) will be discussed in a separate meeting so will not be discussed in this session.

Next steps

17 The EFRAG Secretariat will process the consequential changes to the draft standards. All the changes will be made available to the SR TEG and SRB in markup for approval.

18 Bilateral meetings with the ISSB staff will continue, on both IFRS S1 and S2; the SR TEG and SRB will be regularly informed.

Papers for this session

19 In addition to this cover note, **Agenda Paper 06.02** (Alignment with IFRS S2) and **Agenda Paper 06.03** (Additions to IFRS S2 in ESRS E1) are provided.

20 As background, the two summaries of the meetings of the Jurisdictional Working Group are provided as **Agenda Papers 06.03 and 06.04**.

Questions to SRB

21 To what extent the SRB supports to amend ESRS to enhance the alignment at this stage, considering that the IFRS standards are still subject to change?

22 Do you agree with the EFRAG SR TEG advice on changes to ESRS 1 and 2 to enhance the alignment to fundamental concepts and terminology in IFRS S1 (Agenda Paper 07.03)? If not, on which specific item you don't agree? Please explain.

23 Do you agree with the EFRAG SR TEG advice on the additions to IFRS S2 in ESRS E1 (Agenda Paper 07.02)? If not, on which specific item you don't agree? Please explain.

24 Do you have any additional suggestions for further work on alignment?

Please note that the Architecture will be discussed in a separate SRB meeting.

Appendix – Architecture

High-level reconciliation (before changes suggested by SR TEG)