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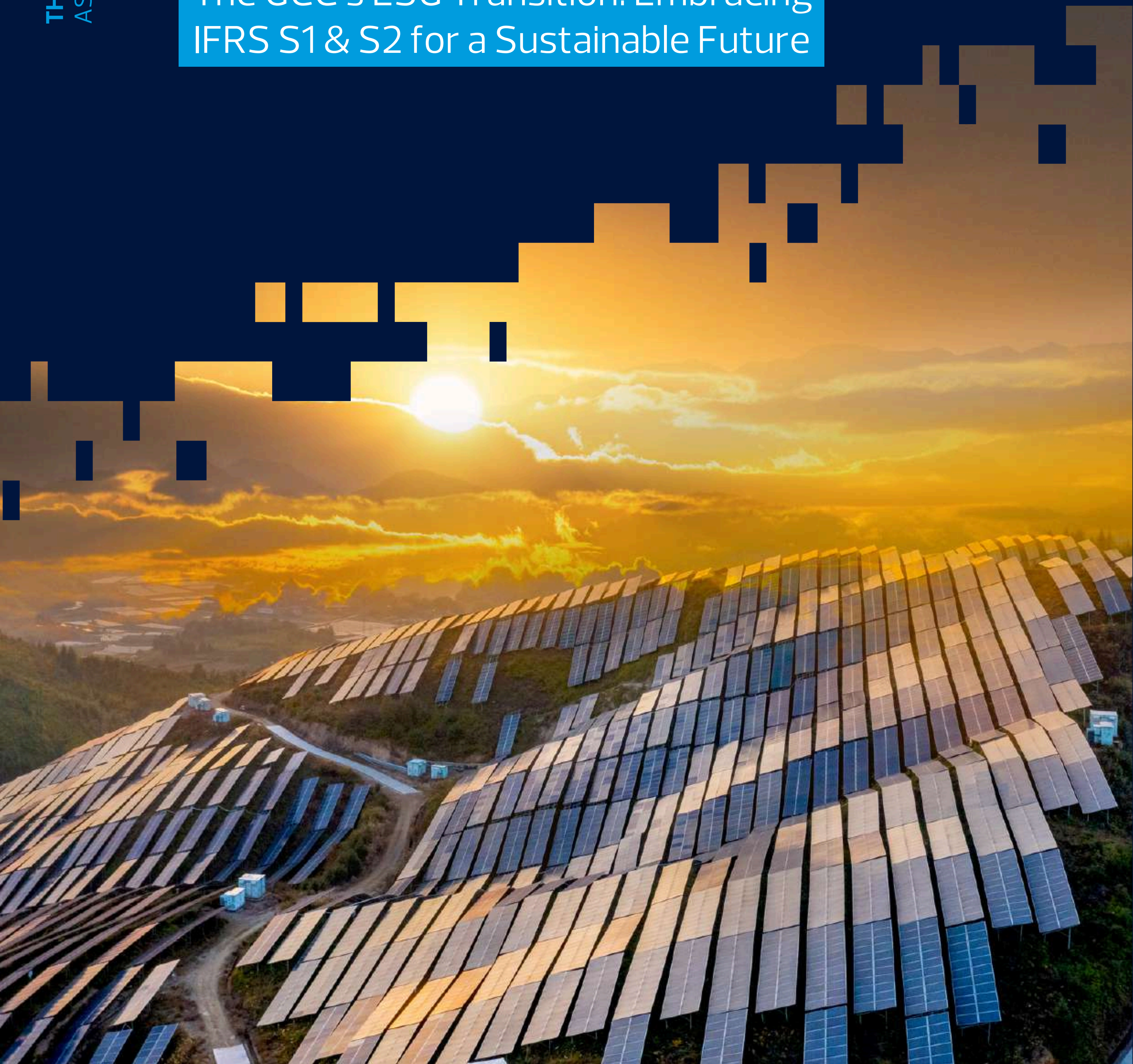
NEWSLETTER

# Navigating the Future of Sustainability Reporting

## The GCC's ESG Transition: Embracing IFRS S1 & S2 for a Sustainable Future



# Background

The global landscape of sustainability reporting is undergoing a significant transformation with the introduction of the International Sustainability Standards Board's (ISSB) inaugural standards, IFRS S1 and IFRS S2, which were issued in June 2023 by the International Financial Reporting Standards (IFRS), the global accounting standard-setting body. These standards represent a landmark achievement in establishing a unified global baseline for sustainability disclosures.

## Purpose of Sustainability Standards

IFRS S1 and S2 aim to help investors make informed decisions by requiring companies to disclose relevant information about their sustainability-related risks and opportunities, specifically those affecting financial performance in the short, medium, or long term.

These risks and opportunities arise from a company's interactions with its stakeholders, society, the economy, and the natural environment, and can be concentrated within the company itself or throughout its value chain. IFRS S2 focuses particularly on climate-related risks and opportunities, both physical and transitional, that could reasonably be expected to affect a company's financial future.

While the standards offer guidance on identifying these risks and opportunities, it is ultimately up to each company to determine what is relevant to its specific circumstances.

By integrating ESG into their business strategies, reporting, and adhering to global standards like IFRS S1 and S2, companies can showcase their commitment to responsible practices, attract investment, and contribute to a stronger economy. This alignment with international best practices enhances transparency, builds stakeholder trust, and leads to improved access to capital, lower costs, better cash flow, and increased long-term value. Investors are also increasingly recognizing the importance of ESG integration and ESG investment decision-making. Companies attract more investments from responsible investors when they engage in comprehensive and transparent ESG disclosure practices.

(Refer Note 2: Principles of Responsible Investing (PRI). https://www.unpri.org/)

## Primary Users and Other Stakeholders

The ISSB has specified existing and potential investors, lenders, and creditors as the primary users of sustainability information. Capital market regulatory authorities generally specify categories of companies that should disclose sustainability information complying with IFRS S1 and S2 to investors for making informed decisions about resource allocation to companies. Key areas involved are:

1. Trading equity and debt instruments,
2. Providing or selling loans and other forms of credit, or
3. Influencing management decisions regarding the use of a company's resources.

(Refer Note 3: IFRS – Sustainability-Knowledge Hub)

There has been a significant shift in stakeholder expectations, including those of employees, governments, customers, and communities, who are increasingly demanding greater transparency and accountability regarding a company's ESG performance. Consequently, companies are now expected to consider the interests of all stakeholders, not just investors, in their decision-making processes.

Such disclosures are intended to be consistent, comprehensive, and comparable information on a company's sustainability-related risks and opportunities over both the shorter and longer terms, and the information complements the financial reporting in its financial statements.

## Applicability

ISSB expects companies to implement sustainability reporting in addition to their financial reporting for financial years starting on or after January 1, 2024. It provides companies that may have been reporting sustainability-relevant information in a more qualitative rather than quantified way, or under different prevalent standards or existing frameworks, with a new comprehensive framework for disclosing sustainability-related risks and opportunities, including climate-related disclosures as its priority.

While IFRS S1 and S2 are not mandatory, the ISSB encourages companies to comply with data collection and disclosures at reasonable costs and efforts. Earlier adoptions were mainly driven by jurisdictional adoption, stakeholder expectations, peer competitiveness, or urgent need to manage sustainability risks. Recognizing that an early effective date for reporting could lead to incomplete data and poor-quality disclosures, the ISSB expects IFRS S1 and S2 to be implemented in a phased manner by companies allowing sufficient time to implement.

# Navigating Sustainability Challenges in the GCC

The GCC region faces unique challenges in its pursuit of sustainability. As major producers of oil and gas, GCC countries have a significant role to play in the global energy transition. While this transition presents challenges, it also offers immense potential for growth and innovation in renewable energy, green technologies, and sustainable practices. ESG and sustainability reporting present many challenges for organizations including but not limited to:

## Lack of standardized frameworks

Multiple standards exist, creating inconsistencies and hindering comparisons.

## Data collection and management

Gathering accurate and reliable ESG data is complex and time-consuming, often requiring specialized personnel, tools, and expertise.

## Defining materiality

Determining relevant ESG issues can be subjective, with varying priorities among stakeholders.

## Measuring impact

Quantifying ESG initiatives' effectiveness is difficult, especially for social and environmental impacts.

## Integration with existing systems

Incorporating sustainability reporting into current systems can be technically challenging and resource-intensive.

## Greenwashing concerns

Companies must ensure transparency to avoid accusations of misleading or exaggerating their ESG performance.

## Value chain complexity

Assessing ESG performance across the entire value chain requires extensive collaboration and data collection.

## Resource constraints

Smaller companies may lack the financial resources and expertise to implement robust sustainability reporting programs.

Addressing these challenges is crucial for credible and effective sustainability reporting, which is increasingly important for investor confidence, regulatory compliance, and long-term value creation.

# The Complex Landscape of Sustainability Standards and Frameworks

The world of sustainability reporting is characterized by a multitude of standards and frameworks, each with its unique focus and approach. Understanding these frameworks is essential for companies seeking to navigate this landscape effectively:

## IFRS S1 and S2

These new global standards, released by the International Sustainability Standards Board (ISSB), are poised to revolutionize sustainability reporting. They align with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), and along with industry specific standards, ensure global comparability and demonstrate a commitment to international best practices.

## The IFRS sustainability disclosure taxonomy

Issued recently in April 2024, this includes elements for tagging sustainability-related financial information prepared by IFRS Sustainability Disclosure Standards. These elements enable a company to tag information about its sustainability-related risks and opportunities in its general-purpose financial reports. Tagging makes the information computer-readable, enabling investors to extract, compare, and analyze sustainability-related financial information more efficiently in a digital format.

(Refer Note 4: https://www.ifrs.org/issued-standards/ifrs-sustainability-taxonomy/)

## SASB standards

Developed by the Sustainability Accounting Standards Board (SASB), these are integrated with and recommended by ISSB. These industry-specific standards (77 industries covered to date) identify the ESG issues that are most financially material to different sectors. This helps investors make informed decisions by providing comparable data across companies within the same industry. By aligning with SASB standards, companies can communicate their sustainability performance in a way that captures industry-specific risks and opportunities relevant to investors and stakeholders.

## GRI standards

The Global Reporting Initiative (GRI) is the most widely used sustainability reporting framework globally. It offers a comprehensive set of standards that cover a broad range of ESG topics, promoting transparency and accountability in reporting. GRI standards are designed to be flexible and adaptable to different organizations and industries, making them valuable tools for companies at all stages of their sustainability journey.

## ESRS

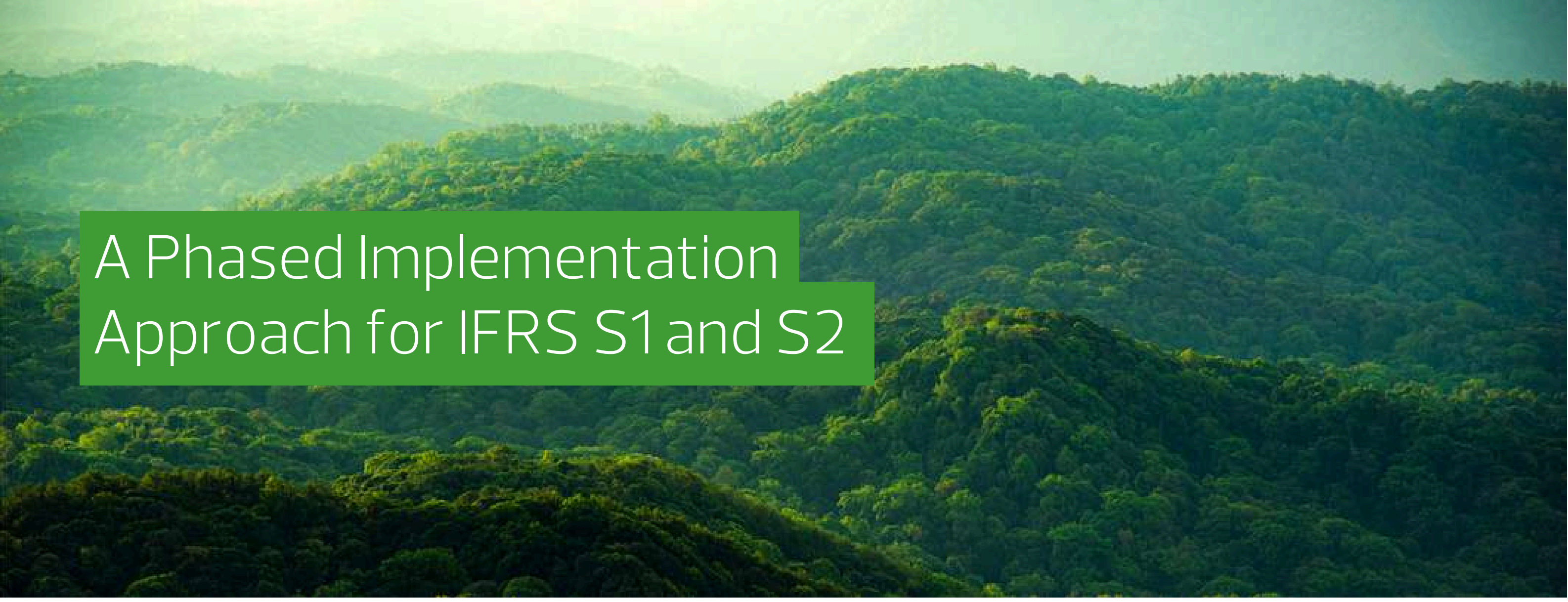
The European Sustainability Reporting Standards (ESRS), although primarily applicable to European companies, can have indirect implications for GCC companies with operations or supply chains in the EU. Understanding these standards can help companies prepare for potential future regulatory changes and ensure their reporting practices are globally aligned. The ESRS emphasizes double materiality, considering both the impact of sustainability issues on the company and the impact of the company on the environment and society.

## Integrated Reporting (IR) framework

This emerging trend, now under the IFRS, involves combining financial and non-financial information in a single report, demonstrating the interconnectedness of ESG factors and financial performance. Integrated reporting offers a relatively holistic view of a company's value creation and long-term sustainability. It allows companies to communicate their sustainability strategy and performance in the context of their overall business goals and objectives.

## GHG Protocol

This globally recognized standard for measuring and managing greenhouse gas (GHG) emissions is a crucial tool for companies to understand their carbon footprint, set reduction targets, and track progress over time. The GHG Protocol provides a standardized methodology for measuring and reporting Scope 1, Scope 2, and Scope 3 (indirect) emissions, allowing companies to compare their performance with peers and assess their contribution to climate change.



# A Phased Implementation Approach for IFRS S1 and S2

To effectively implement IFRS S1 and S2, GCC companies can adopt a phased approach tailored to their organization based on a range of factors, including but not limited to:

## Phase 1

- Develop and align sustainability strategy with operational goals, prioritizing material ESG issues identified through SASB or other frameworks
- Identify material sustainability risks arising from diverse operations, ascertain how material they are, and set priorities to develop mitigating opportunities
- Assess current reporting practices against IFRS S1 and S2 baseline requirements, identify gaps, and develop a roadmap for implementation
- Establish robust data collection and management systems, leveraging the GHG Protocol for carbon accounting
- Build internal capacity and expertise in sustainability reporting
- Develop a comprehensive sustainability strategy that encompasses the entire value chain, including Scope 3 emissions, and
- Collaborate with suppliers and partners to gather accurate data on Scope 3 emissions and identify opportunities for reduction.

## Phase 2

- Disclose Scope 3 emissions, even if it is not yet mandatory, to demonstrate transparency and a commitment to addressing the full value chain impact
- Conduct climate scenario analysis, considering various climate change scenarios and their potential financial impacts on the business
- Ensure that jurisdictional sustainability compliance, if more stringent than IFRS baseline, is also addressed in sustainability reporting
- Engage with stakeholders through regular communication channels, such as reports, websites, and social media, to provide updates on sustainability performance and address any concerns, and
- Strengthen internal controls and governance mechanisms to ensure the accuracy and reliability of ESG data.

## Phase 3

- Ensure full compliance with IFRS S1 and S2, including measurable disclosure of Scope 3 emissions
- Explore green financing options, such as green bonds or sustainability-linked loans, to fund sustainability initiatives and demonstrate commitment to investors
- Seek external assurance for sustainability disclosures to enhance credibility and trust among stakeholders, and
- Continue refining sustainability strategy and reporting practices based on ongoing assessment, benchmarking, and stakeholder feedback.

The above-phased implementation is only a high-level implementation approach. However, companies need to consider several factors, including applicable compliance requirements, and market benchmarking, among others.

# Key Considerations

## Materiality assessment

Conduct a comprehensive double materiality assessment to understand the financial and impact materiality of ESG issues.

## KPIs and targets

Develop clear, measurable, and ambitious KPIs that align with the company's sustainability strategy and benchmark against industry norms and peers.

## Integrated reporting

Move towards integrating sustainability disclosures into financial reporting to provide a holistic view of the company's performance and long-term value creation.

## Avoiding greenwashing

Ensure transparency, accuracy, and avoid vague or unsubstantiated claims in sustainability reporting. Use clear and specific language, provide evidence to support claims, and seek external verification if necessary.

## Use of estimates

IFRS S1 permits the use of estimates when sustainability-related information cannot be directly measured. This allows companies to provide relevant information to users of financial statements even when precise data is not available. However, the standard requires companies to disclose if an estimate is used, (a) the fact that the information is an estimate, (b) the assumptions, approximations, and judgments made in arriving at the estimate, (c) any changes in estimates from prior periods and the reasons for those changes, and (d) the effects of measurement uncertainty on the reported amounts.

## Uncertainties

IFRS S1 also addresses uncertainties and encourages companies to disclose the nature and extent of any material uncertainties in their sustainability-related financial disclosures. This helps users understand the limitations of the reported information and make informed decisions.

## Confidential information exemption

IFRS S1 recognizes that some sustainability-related information may be confidential or commercially sensitive. In such cases, companies are permitted to omit this information from their disclosures, provided they disclose (a) the fact that the information has been omitted, (b) the reason for the omission, and (c) the nature and extent of the omitted information.

This exemption allows companies to protect their confidential information while still complying with the overall requirements of IFRS S1, where such information is truly confidential, and its omission does not significantly affect the usefulness of the disclosures to users.

# IFRS S1 and IFRS S2 Transition Reliefs

These are some reliefs granted by IFRS to companies in sustainability reporting and intended to facilitate the initial implementation of IFRS S1 and S2:

## Climate first

Preparers can limit disclosures to climate-related information in the first year IFRS S1 is used (other sustainability-related risks and opportunities must be disclosed from the second year).

## Scope 3 GHG disclosure

Companies will not be required to disclose Scope 3 emissions in the first year of implementation.

## Timing of reporting

Sustainability reporting can be provided later than financial statements in the first year - annual information can be provided with half-year financial reports.

## Comparative reporting

Not required in the first annual reporting period (and if only report on climate in year one – in the second year, comparative information only required for climate information).

## GHG Protocol

This method of carbon accounting need not be applied in the first year of implementation if prepared already using a different measurement approach.

(Refer Note 5: Center for Financial Reporting Reforms: (https://cfrr.worldbank.org/))

# How we can help

RSM Kuwait is committed to supporting our business community in navigating the complexities of ESG integration. Our team of experts can assist in various services such as, but not limited to:

### IFRS S1 and S2 Readiness Assessment and Compliance

Ensuring the entity's sustainability reporting disclosures meet the new standards, reducing risk, building investor confidence, and improving accountability and transparency. These services may include as agreed:

- Gap Analysis to assess your current reporting practices against IFRS S1 and S2 and frameworks
- Data Collection & Analysis to leverage our expertise in data management and analysis, and
- Training & Workshops to equip your team with the knowledge and skills needed for sustainability reporting.

### ESG Strategy Development

Assessing the entity's current ESG performance, setting ambitious targets, and developing a roadmap for implementation.

### Climate Risk Assessment

Identifying and quantifying climate-related risks in your portfolio, and developing strategies to mitigate and adapt to these risks.

### Sustainable Reporting Solutions

Assisting entities in implementing sustainability reporting systems for meeting disclosure requirements and sharing innovative technology-driven OnG best practices that can reduce carbon footprint and align with ESG principles.

### Assurance Services

Performing ESG attest and review engagements that provide entities with limited or reasonable assurance on adherence to sustainability reporting standards.

### Underwriting Services

Evaluating sustainability performance of entities or projects for investment purposes, to advise on funding sustainability projects including through corporate finance, issuing green bonds or in line with evolving practices.

# Conclusion

Embracing sustainability reporting is a strategic imperative for long-term success. The transition to a more sustainable future presents challenges, but also immense opportunities for innovation, growth, and resilience.

By aligning their business strategies with ESG principles, proactively addressing risks and opportunities, and transparently communicating their progress, GCC companies can not only meet the demands of the global market but also contribute to a more sustainable and equitable future for the region and the planet.

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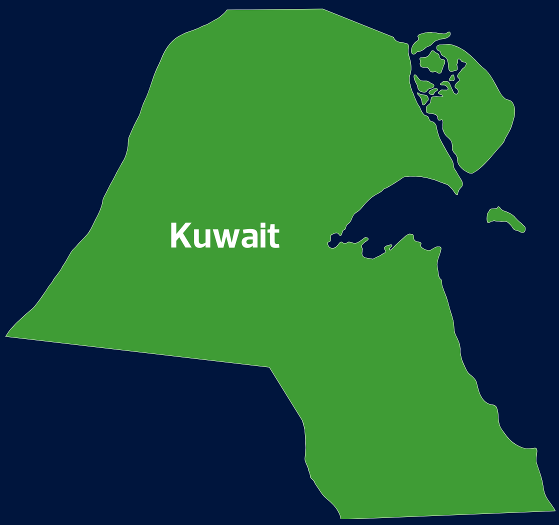


**RSM Kuwait**
Arraya Tower, Floors: 41 & 42, Abdulaziz Hamad Alsaqar Street, Sharq, P. O. Box 2115, Safat 13022, Kuwait
**T:** +965 22961000
**F:** +965 22412761
**E:** connect@rsm.com.kw
W: www.rsm.global/kuwait

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1. Note 1: United Nations Global Compact (UNGC). (https://www.un.org/en/un-chronicle/un-global-compact-finding-solutions-global-challenges)
2. Note 2: Principles of Responsible Investing (PRI) (https://www.unpri.org/)
3. Note 3: IFRS – Sustainability-Knowledge Hub (https://www.ifrs.org/sustainability/knowledge-hub)
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5. Note 5: Center for Financial Reporting Reforms: (https://cfrr.worldbank.org/)