ISSB MOVES FORWARD ON ITS INTERNATIONAL SUSTAINABILITY DISCLSOURE STANDARDS BY LAUNCHING PUBLIC CONSULTATIONS ON ITS FIRST TWO STANDARDS

The International Sustainability Standards Board ("ISSB") has published for consultation two proposals (styled as exposure drafts) to create a comprehensive global baseline of sustainability disclosures that ultimately will form part of a number of IFRS Sustainability Disclosure Standards. These first two will be IFRS S1 and IFRS S2. The IFRS S1 exposure draft sets out general sustainability-related disclosure requirements and the IFRS S2 exposure draft specifies climate-related disclosure requirements. For more detail on the ISSB mission, including the prototypes issued last November, see my prior briefing note, available here. See also my climate lexicon, available here.

The proposals build on the recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD") and incorporate industry-based disclosure requirements derived from the standards developed by the Sustainability Accounting Standards Board, which now forms part of the Value Reporting Foundation and which, in turn, is being integrated into the ISSB ("SASB"), as well as from the Climate Disclosure Standards Board ("CDSB"), the Integrated Reporting Framework and the World Economic Forum (WEF) International Business Council (IBC) stakeholder capitalism metrics. It is noteworthy that earlier in March, the IFRS Foundation announced a collaboration with the Global Reporting Initiative ("GRI") to align their respective standards-setting boards, the ISSB and the Global Sustainability Standards Board. While the ISSB is tasked with developing a comprehensive global baseline of *investor-focused* sustainability disclosures for the capital markets, the GRI is a standard-setter for *multistakeholder-focused* sustainability reporting.

Separately, on the same day, the ISSB set outs its plan for how its work will build on the SASB standards and industry-based standard setting processes.

The consultation period for these two exposure drafts closes on July 29, 2022, with the expectation that the new standards will be issued by the end of the year. The ISSB envisions issuing other IFRS Sustainability Disclosure Standards over time; the exposure drafts published on March 31 are the first two.

In brief, the proposed standards:

- would require disclosure of information that enables investors to assess the effect of significant sustainability-related risks and opportunities on enterprise value; and
- would establish disclosure requirements specific to climate-related risks and opportunities.

The ISSB intends that the global baseline proposals will be compatible with jurisdiction-specific requirements. Compliance with the climate exposure draft would be tantamount to complying with the TCFD recommendations, which are becoming mandatory in an increasing number of disclosure regimes. For ease of reference, the ISSB published a list of the key differences between the Climate exposure draft and the TCFD recommendations.

I highlight below the key disclosure themes of the two exposure drafts, but note that both drafts contain comprehensive provisions that readers should review in detail.

General Sustainability-Related Disclosures (IFRS S1)

The core content requirements would be based on the following principles:

- A company would disclose material information about all significant sustainability-related risks and opportunities to which it is exposed. Materiality would be aligned with the definition in the IASB's Conceptual Framework for General Purpose Financial Reporting and IAS 1 (Presentation of Financial Statements) – namely that information "is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that the primary users of general purpose financial reporting make on the basis of that reporting, which provides information about a specific reporting entity."

  There are no specified thresholds for materiality in the exposure draft. Materiality would be reassessed each reporting period.

  A company would not be required to provide specified line item disclosure (whether stated as a specific line item requirement or as a minimum requirement) if the resulting information is not material and, similarly, if a specific requirements would be insufficient to meet users' information needs, a company would need to consider whether to disclose additional information (all, consistent with the requirements of IAS 1). If applicable law or regulations prohibit a company from disclosing that information, it need not, provided it identifies the type of information not disclosed and explains the source of the restriction.

  The materiality judgment would be made in the context of the sustainability-related financial information necessary for users of general purpose financial reporting to assess enterprise value. For this purpose, enterprise value is the total value of an entity's equity and net debt and reflects expectations of the amount, timing and uncertainty of future cash flows over the short, medium and long term and the value attributed to those cash flows light of the company's risk profile, and its access to financing and cost of capital.
- Information that could be relevant to the assessment of enterprise value is broader than information reported in the financial statements. These could cover a company's:
  - governance of sustainability-related risks and opportunities, and the strategy for addressing them;
  - decisions that could result in future inflows and outflows that have not yet met the criteria for recognition in the related financial statements;
  - reputation, performance and prospects as a consequence of the actions it has undertaken, such as its relationships with people, the planet and the economy, and its impacts and dependencies on them; and
  - development of knowledge-based assets.
- Information would need to be disclosed as a part of a company's general purpose financial reporting. As a result, sustainability-related financial disclosures would be published at the same time as the financial statements.

The proposed disclosure is based on the four-prongs of the TCFD recommendations, namely:

- governance (the processes, controls and procedures used to monitor and manage significant sustainability-related risks and opportunities);
- strategy (for addressing significant sustainability-related risks and opportunities);

- risk management (the process, or processes, by which sustainability-related risks and opportunities are identified, assessed and managed); and
- metrics and targets (how a company measures, monitors and manages significant sustainability-related risks and opportunities, including how it assesses its performance such as progress towards meeting the targets it has set).

Key components

Sustainability-related risks and opportunities arise from a company's dependence on resources and the company's impacts on resources, and the relationships the company maintains that may be positively or negatively affected by those impacts and dependencies. When the business model depends, for example, on a natural resource, such as water, it is likely to be affected by changes in the quality, availability and pricing of that resource. When activities result in adverse, external impacts, for example on local communities, the company could be subjected to stricter government regulation and consequences of reputational effects. Similarly, when business partners face significant sustainability-related risks and opportunities, a company could be exposed to related consequences of its own.

The exposure draft includes definitions and requirements consistent with the IASB's Conceptual Framework for Financial Reporting, IAS 1 (Presentation of Financial Statements) and IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors). The exposure draft was developed though so as to be applied by any company, whether it reports in IFRS or other GAAP. The sustainability-related information would cover the same consolidated group as is covered by the financial statements.

Sustainability-related financial information is broader than information reported in the financial statements. A company would disclose material information about all of the significant sustainability-related risks and opportunities to which it is exposed. Sustainability-related financial information should, therefore, include information about governance of, and strategy for addressing, sustainability-related risks and opportunities and about decisions made that could result in future inflows and outflows that have not yet met the criteria for recognition in the related financial statements. Sustainability-related financial information also covers reputation, performance and prospects as a consequence of actions that are undertaken, such as relationships with, and impacts and dependencies on, people, the planet and the economy, or about the company's development of knowledge-based assets. The exposure draft focuses on information about significant sustainability-related risks and opportunities that can reasonably be expected to have an effect on enterprise value.

Note that while materiality is framed in the context of enterprise value, the exposure draft Snapshot in effect ties materiality to a metric that is broader than financial materiality by noting that an assessment of enterprise value "includes information about a company's impacts and dependencies on people, the planet and the economy when relevant to the assessment of the company's enterprise value."

Presentation

To identify significant sustainability-related risks and opportunities, and their related metrics and targets, a company would:

- apply IFRS Sustainability Disclosure Standards;

- consider the disclosure topics in the industry-based SASB standards, the ISSB's non-mandatory guidance (such as the CDSB Framework application guidance for water- and biodiversity-related disclosures) and the most recent pronouncements of other standard-setters whose requirements are designed to meet investors' information needs; and
- consider the sustainability-related risks and opportunities identified by companies that operate in the same industries or geographical areas.

To identify appropriate disclosures, including metrics, a company would apply the relevant IFRS Sustainability Disclosure Standards, but in the absence of an IFRS Sustainability Disclosure Standard that applies specifically to a sustainability-related risk and opportunity, a company would use its judgment in identifying disclosures that would be relevant to the decision-making needs of investors.

There is no specific requirement as to location of the disclosure within a company's general purpose financial reporting. A company may disclose information in the same location as information disclosed to meet other requirements; however, the company would need to ensure that the sustainability-related financial disclosures are clearly identifiable and not "obscured" by that additional information. Cross-referencing (including to the financial statements) would be permitted.

The exposure draft covers comparative information (*i.e.,* prior period metrics, as well as prior period narrative and descriptive disclosures when relevant to understanding current period narrative and descriptive disclosures), sources of estimation and outcome uncertainty, and errors, based on corresponding concepts for financial statements contained in IAS 1 and IAS 8. However, rather than requiring a change in estimate to be reported as part of the current period disclosures, comparative information could be restated to reflect the better estimate, unless impractical, in which case that fact must be disclosed.

A company would identify metrics it has disclosed that have significant estimation uncertainty, disclosing the sources and nature of the estimation uncertainties and the factors affecting the uncertainties. Financial data and assumptions within sustainability-related financial disclosures must be consistent with corresponding financial data and assumptions used in the financial statements, to the extent possible. When considering future events with uncertain outcomes, for purposes of materiality determinations, a company should consider both the potential effects of the events on the value, timing and certainty of future cash flows, including in the long term (the possible outcome), as well as the full range of possible outcomes and the likelihood of the possible outcomes within that range.

A company would need to correct material prior period errors by restating the comparative amounts for the prior period(s) disclosed, unless it is impracticable to do so. Corrections of errors are distinguished from changes in estimates. Estimates are approximations that may need to be revised as additional information becomes known.

A company could decide how to aggregate the information it is required to present, but it could not reduce the understandability of its sustainability-related financial disclosures by obscuring material information with immaterial information or by aggregating material items that are dissimilar. Information would be aggregated when it shares those characteristics and disaggregated when it does not share them. Information about sustainability-related risks and opportunities might need to be disaggregated, such as by geographical location or in consideration of the geopolitical environment. For example, a company might need to disaggregate disclosures about its use of water to distinguish between water drawn from abundant sources and water drawn from high-stress sources.

Value chain

Disclosure would be required across the value chain, namely the full range of activities, resources and relationships related to a company's business model and the external environment in which it operates. Relevant activities, resources and relationships include those in the company's operations, such as human resources; those along its supply, marketing and distribution channels, such as materials and service sourcing and product and service sale and delivery; and the financing, geographical, geopolitical and regulatory environments in which the company operates.

The sustainability-related financial information relevant to a company would depend on many factors, such as the company's activities, the industry and locations in which it operates, its products and manufacturing processes and the nature of its reliance on employees and supply chains. The exposure draft sets out the following examples of the activities, interactions and relationships, and use of resources along the value chain, that might be covered:

- employment practices and those of its suppliers, wastage related to the packaging of the products it sells, or events that could disrupt its supply chain;
- the assets it controls (such as a production facility that relies on scarce water resources);
- investments it controls, including investments in associates and joint ventures (such as financing a GHG-emitting activity through a joint venture); and
- sources of financing.

Connected information

A company would provide information that allows investors to assess the connections between different sustainability-related risks and opportunities, and would address how sustainability-related financial information is related to its financial reporting. Doing so could require connecting narrative information on governance, strategy and risk management to related metrics and targets. For example, a company might:

- need to explain the effect or likely effect of its strategy on its financial statements or financial plans, or on metrics and targets used to measure progress against performance;
- need to explain how its use of natural resources and changes within its supply chain could amplify, change or reduce its significant sustainability-related risks and opportunities, and might need to link this information to the potential or actual effect on its production costs, its strategic response to mitigate such risks and its related investment in new assets;
- face decreasing demand for its products because of consumer preferences for low-carbon alternatives, and might need to explain how its strategic response, such as closing a major factory, affects its workforce and communities, as well as the effect of the closure on the useful lives of assets and impairment assessments; and
- need to explain how a decision to restructure its operations in response to a sustainability-related risk could have effects on the future size/composition of its workforce.

Climate-Related Disclosures (IFRS S2)

A company applying the proposal set out in the General Requirements exposure draft would apply the Climate exposure draft to provide material information about its significant climate-related risks and opportunities. The Climate exposure draft uses the same approach as the General Requirements exposure draft, namely requiring a company to centre its disclosures on consideration of the governance, strategy and risk management of its business, and the metrics and targets it uses to measure, monitor and manage its significant climate-related risks and opportunities.

The objective of the Climate exposure draft is to generate disclosure to enable investors to understand, as to any company:

- the effects of climate-related risks and opportunities on its enterprise value;
- how its use of resources, and corresponding inputs, activities, outputs and outcomes, support the company's response to and strategy for managing its climate-related risks and opportunities; and
- its ability to adapt its planning, business model and operations to climate-related risks and opportunities.

A company would disclose information about climate-related physical and transition risks and opportunities. For physical risks, a company would need to explain whether the physical risks are acute or chronic. In addressing both risk and opportunity, a company would refer to the disclosure topics broken down by industry (see Appendix B of the exposure draft).

Governance

On the governance side, when a company integrates its oversight of sustainability-related risks and opportunities, it should also integrate its disclosures on governance rather than providing separate governance disclosures for each significant sustainability-related risk and opportunity.

Strategy

For purposes of disclosure around strategy, there are various subgroupings of disclosure items for a company to address:

- the significant climate-related risks and opportunities that it reasonably expects could affect its business model, strategy and cash flows, its access to financing and its cost of capital;
- the effects of significant climate-related risks and opportunities on its business model and value chain;
- the effects of significant climate-related risks and opportunities on its strategy and decision-making, including its transition plans;
- the effects of significant climate-related risks and opportunities on its financial position, financial performance and cash flows for the reporting period, and the anticipated effects over the short, medium and long term, including how climate-related risks and opportunities are included in financial planning; and
- the climate resilience of its strategy (including its business model) to significant physical risks and significant transition risks.

Climate-related risks. A company would disclose information about how climate change could reasonably be expected to affect its business model, strategy and cash flows over the short, medium or long term, its access to financing and its. For example, continuing to operate a particular line of the company's business might be harmful to its reputation and could limit its ability to access financing.

A company would need to define what it means by short, medium and long term, and how those definitions are linked to strategic planning horizons and capital allocation plans. In its assessment of risk and opportunities and their effect on its business model, a company would also need to describe the effects of the risk and opportunities on its value chain and where in the value chain the risks and opportunities are concentrated.

Strategy and decision-making. A company would describe its plans for responding to climate-related transition risks and opportunities, such as:

- how it plans to achieve any climate-related targets, including how these plans will be resourced and how it will review targets;
- how it expects to adapt or mitigate climate-related risks (for example, through changes in production processes, workforce adjustments, changes in materials used, product specifications or through introduction of efficiency measures);
- how it expects to adapt or mitigate indirect climate-related risks in its value chain (for example, by working with customers and supply chains or use of procurement); and
- whether carbon-offsetting is part of its plan. If so, a company would disclose specific information to enable an investor to assess the offset schemes.

Financial performance. A company, among other topics, would:

- Include in its disclosures an explanation of how significant climate-related risks and opportunities have affected its most recently reported financial position, financial performance and cash flows. For example, the company might disclose a material asset impairment as a consequence of its strategy for managing a transition risk. Or, it could be the investment in new technologies to take advantage of a climate-related opportunity.
- Explain how it expects its financial position to change over time given its strategy to address significant climate-related risks and opportunities. Examples include the financial accounting consequences of increased revenue from, or costs of, products and services aligned with a lower-carbon economy, physical damage to assets from climate events and the costs of climate adaptation or mitigation. When providing quantitative information, single amounts or ranges of amounts are permitted.
- Disclose information such as whether it can continue to use its assets and investments the way it has been doing or whether a climate-related risk, such as an increased flooding risk, is likely to cause it to relocate, decommission or upgrade assets. It would also disclose whether it has sufficient financing available to withstand the climate-related risks and to take advantage of climate-related opportunities.

Resilience. A company would also address the climate resilience of its strategy, including its business model, to significant physical risk and significant transition risk. It would use climate-related scenario analysis to assess its risks and opportunities when it is able to do so, but the exposure draft also addresses other quantitative methods. A company would disclose how its climate-related analysis aligns with the latest international agreements on climate change (*e.g.,* the Paris Agreement).

Metrics and targets

A company would disclose its absolute gross Scope 1, Scope 2 and Scope 3 GHG emissions, and the intensity of those emissions, calculated using the GHG Protocol. A consolidated group would disclose GHG emissions by associates and joint ventures separately from those of the consolidated group.

It would also disclose:

- the amount and percentage of assets or business activities vulnerable to transition risks;
- the amount and percentage of assets or business activities vulnerable to physical risks;
- the amount and percentage of assets or business activities aligned with climate-related opportunities;
- the amount of capital expenditure, financing or investment deployed towards climate-related risks and opportunities; and
- the percentage linked to climate-related considerations and how those considerations are factored into remuneration.

Some companies use carbon prices to internalise the cost of emissions when they make capital expenditure decisions. The exposure draft would require a company to explain how it applies carbon pricing, and disclose the price it uses for each metric ton of GHG emissions.

As to climate-related targets, a company would disclose its targets, and for each it would also disclose:

- metrics used to assess progress towards reaching the target and achieving strategic goals;
- the specific target set for addressing climate-related risks and opportunities;
- whether the target is an absolute target or an intensity target;
- the objective of the target (for example, mitigation, adaptation or conformance with sector or science-based initiatives);
- how the target compares with those created in the latest international agreement on climate change and whether it has been validated by a third party;
- whether the target was derived using a sectoral decarbonisation approach;
- the period over which the target applies;
- the base period from which progress is measured; and
- any milestones or interim targets.

The exposure draft includes industry-based disclosure requirements. These are comprised of 77 industry classifications across 11 sectors. The related disclosure requirements are derived from SASB standards.

Building on the SASB Industry-Based Standards

Concurrently with the announcement of the exposure drafts, the ISSB announced plans to build on the SASB standards and embed the SASB standards in its own standards. SASB's approach for developing industry-based standards is based on identifying the sustainability disclosure topics most relevant to enterprise value for the typical company in an industry.

The ISSB intends to:

- embed the industry-based approach used by the SASB into its standard-setting process;
- include (as noted above) the SASB standards directly in the Climate exposure draft. In the case of the General Requirements exposure draft, the ISSB has provided that, in the absence

of specific IFRS Sustainability Disclosure Standards requirements, companies would consider SASB standards to identify sustainability-related risks and opportunities and develop appropriate disclosures. This allows the IFRS Sustainability Disclosure Standards to make use of the range of sustainability-related risks and opportunities covered by the SASB standards from inception with the status of implementation guidance;

- commit to improve the international applicability of the SASB standards;
- use the SASB standards as the starting point for ISSB industry-based requirements;
- transition ongoing SASB projects to the ISSB; and
- actively encourage the use of SASB standards.

Concluding Thoughts

The ISSB does not have the ability to mandate disclosure, but as jurisdictions move to impose mandatory reporting, it is entirely possible that the IFRS Sustainability Disclosures Standards could be incorporated into mandatory disclosure regimes, at least outside the United States. As previously reported (see my prior briefing note, available here), the Securities and Exchange Commission ("SEC") is moving forward with its own rulemaking proposals for mandatory climate-related disclosures and, while the SEC studiously avoided any discussion of merging its regime with the ISSB or any other any other disclosure regime, climate-related disclosure that borrows heavily from the TCFD recommendations is becoming a reality across key jurisdictions.

From a corporate disclosure perspective, a key driver of minimum standards will be stakeholder expectations, if not pressure. As for any individual company, its disclosure could form the basis for a range of others – asset owners, asset managers, other investors, lenders, insurers and other companies (*e.g.,* those reporting Scope 3 emissions, whose data will be derived from Scope 1 and Scope 2 emissions data of others) – to meet their own disclosure requirements (whether mandated by law or regulation, or investment guidelines or otherwise). Given the inter-connectedness of the global economy and the multiple components of the value chains of many companies, the system ultimately only works if consistent, comparable, reliable and decision-useful disclosure is widely available across the board. All to say that, while there is no single global template for climate-related disclosure (and, in fact, there are some key differences between the ISSB exposure drafts and the SEC proposal (*e.g.,* around Scope 3)), the broader, more comprehensive standards may well become the *de facto* standards.

In the meantime, there is more on the horizon. Later this year, the ISSB will consult on its standard-setting priorities, which will include seeking feedback on the sustainability-related information needs of investors when assessing enterprise value and on further development of industry-based requirements, building on the SASB standards, which address a broad range of sustainability matters. In addition, initial proposals for an IFRS Sustainability Disclosure Taxonomy, to permit electronic tagging of sustainability disclosures (similar to XBRL and Inline XBRL in the United States), are to be published shortly.

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