ISSB: A Significant Step Towards Global Climate Disclosure Standards

Last week, at COP26, the IFRS Foundation Trustees announced three significant developments to provide financial markets and investors with streamlined, high-quality investor-focused disclosures on climate and other ESG matters. These initiatives are a response to demands by the financial markets and multiple stakeholders for corporate disclosures on climate and other sustainability matters that are consistent, comparable and therefore decision-useful, reflecting broad dissatisfaction with, and confusion prompted by, the patchwork of voluntary (and inconsistent) reporting standards that have evolved out of a fragmented industry. These corporate disclosures also need to be compatible with financial reporting. The goal of the ISSB, simply put, is to become the global standard-setter for sustainability disclosures for the financial markets and investors.

The three developments are:

- the formation of a new International Sustainability Standards Board (ISSB) to develop a comprehensive global baseline of sustainability disclosure standards (to be known as IFRS Sustainability Disclosure Standards);
- a commitment to consolidate with the IFRS Foundation the technical expertise, content, staff and other resources of the Climate Disclosure Standards Board (CDSB, which is an initiative of the CDP) and the Value Reporting Foundation (VFR, which consolidated the Integrated Reporting Framework and the SASB Standards) by June 2022; and
- the publication of prototype climate and general disclosure requirements developed by the recently formed Technical Readiness Working Group (TRWG), which has consolidated content prepared by the CDSB, the International Accounting Standards Board (IASB), the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), the VRF and the World Economic Forum (Forum), with support from the International Organization of Securities Commissions (IOSCO) and its Technical Expert Group of securities regulators, into an enhanced, unified set of recommendations for consideration by the ISSB.

The ISSB will work in cooperation with the IASB (which is the standard setter for IFRS) to ensure compatibility between IFRS accounting standards (which is GAAP in over 140 jurisdictions, though not in the United States) and the ISSB's evolving IFRS Sustainability Disclosure Standards. The Sustainability Disclosure Standards will include requirements to address reporting companies' impacts on sustainability matters relevant to measuring enterprise value. These standards are to be developed in a manner compatible with "requirements that are jurisdiction-specific or aimed at a wider group of stakeholders" (*e.g.,* the EU's proposed Corporate Sustainability Reporting Directive). It will be up to jurisdictional regulators (such as the European Commission, the SEC and UK regulators) to determine whether to mandate the use of the ISSB's standards for reporting companies subject to their regulatory jurisdiction.

The Trustees created the TRWG (with representatives of the CDSB, TCFD, IASB, VRF and the Forum) to provide recommendations to the ISSB. Of the two complementary prototypes published by the TRWG, one focuses on climate-related disclosures that build on the TCFD recommendations and includes industry-specific disclosures, and a second sets out general sustainability disclosures.

The Climate-related Disclosures Prototype would apply to physical risks and transition risks, among others, as well as climate-related opportunities, and would call for information to allow readers to assess:

- ***governance***: the processes, controls and procedures used to monitor and manage climate-related risks and opportunities, including information about the governance bodies with oversight of climate-related risks and opportunities, management's roles with respect to these risks and opportunities and how the oversight bodies oversee management in those roles;
- ***strategy***: the climate-related risks and opportunities that could enhance, threaten or change the business model and strategy over the short, medium and long term, including:
    - whether and how information about climate-related risks and opportunities inform management's strategy and decision-making;
    - the current and the anticipated effects of climate-related risks and opportunities on the business model;
    - the impact of climate-related risks and opportunities on financial position, performance and cash flows, both at the end of the reporting period and the anticipated effects over the short, medium and long term; and
    - the resilience of strategy to significant climate-related risks associated with the physical impacts of climate change and the transition to a lower-carbon economy;
- ***risk management***—how climate-related risks are identified, assessed, managed and mitigated, and the extent to which, and how, these processes are integrated into overall risk management processes; and
- ***metrics and targets***—the metrics and targets used to manage and monitor performance in relation to climate-related risks and opportunities over time.

The General Requirements for Disclosure of Sustainability-related Financial Information Prototype would encompass:

- a requirement to disclose on an annual basis a "complete, neutral and accurate" depiction of the reporting company's significant sustainability risks and opportunities, to enable an evaluation of the value, timing and certainty of the reporting company's future cash flows;
- a definition of materiality focused on information that serves the needs of users and drives enterprise values (*i.e.,* information that provides insights into factors that could reasonably be expected to influence assessment of enterprise value, such as the ability to generate cash flows and the value attributed to those cash flows, and could include, but not be limited to, information about (i) impacts on society and the environment, if those impacts could reasonably be expected to affect future cash flows and (ii) events considered to have a low likelihood but a high potential impact on future cash flows);
- a consistent approach for the disclosure of information about significant sustainability-related risks and opportunities based on consideration of the reporting company's governance, strategy and risk management and supported by metrics and targets; and
- further requirements and guidance that support the provision of comparable and connected information

The TRWG recognizes that there are at least three categories of beneficiaries of corporate disclosure: stakeholders generally; investors, lenders and other creditors focused on issues that affect assessments of enterprise value (tied to future cash flows over the short, medium and long term); and investors, lenders and other creditors focused on historical financial statements.

Although there is significant overlap in the scope of disclosure for each of these categories, the IFRS Sustainability Disclosure Standards are intended to benefit the second category of users. These standards encompass, but are not restricted to, a reporting company's financial statements and its sustainability-related financial disclosures.

The IFRS Foundation recommends that companies continue to use existing voluntary frameworks and guidance as appropriate, pending issuance of the ISSB standards. This should not be a wasted effort as the IFRS Sustainability Disclosure Standards will build on the TCFD recommendations, CDSB framework, the Integrated Reporting Framework, the SASB standards and the WEF stakeholder capitalism metrics.

It will be interesting to see who is appointed Chair and Vice Chair of the ISSB and how quickly the process moves forward given the intention of both the EU and the UK to adopt mandatory climate disclosures.

Perhaps the most pressing question from the perspective of the creation of global standards is what role the SEC (a member of IOSCO, which has welcomed the IFRS Foundation efforts) and the FASB will play in this new paradigm. SEC reporting companies, unless they are foreign private issuers, are required to prepare their financial statements in accordance with US GAAP (and not IFRS). Will the US effort then sit side-by-side with the ISSB? One of the complaints from the US had been the overly broad mandate of the ISSB; that appears to have been addressed insofar as the focus of the ISSB standards will be to benefit financial markets and investors, and not the broader stakeholder ecosystem. Presumably, the SEC focus initially will be on its Management's Discussion and Analysis of Financial Condition and Results of Operations requirements (the narrative explanation of financial statements).

US SEC reporting companies should be mindful that while the SEC process is underway, and could likely face stiff resistance and challenges, a broader global effort is moving ahead quickly and will likely set the baseline for global investors.

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