Financial Reporting Council

Sue Lloyd & Janine Guillot
International Sustainability Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf
London, E14 4HD

3 February 2022

Dear Sue & Janine,

Technical Readiness Working Group (TRWG) Sustainability Disclosure Prototypes

The FRC strongly supports the development of global standards for sustainability reporting and the UK adoption of those standards.

We have read the recently issued prototypes with interest and would like to share some of our preliminary thoughts. Our overarching comments on the development of ISSB standards are set out below with further detail provided in subsequent pages of this submission.

Architecture of standards

We are pleased to see the 'Architecture of Standards' as one of the deliverables in the TRWG's Programme of Work. We believe this component is important in outlining the overall framework within which the standards will be set. It would be helpful for stakeholders to have sight of this as a matter of priority to enable assessment of the General Requirements and Climate standards. On page 4 we include some ideas for the development of the architecture for sustainability standard setting.

Hierarchy

We recommend that the ISSB standards include a hierarchy similar to that set out in paragraphs 11 and 12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This will guide preparers in the absence of a specific standard on a sustainability matter and enable companies to use existing voluntary non-financial reporting frameworks as an interim step whilst ISSB standards on specific topics are developed providing that they are consistent.

Using the four pillars of TCFD

We note that standards are being developed using the four pillars in the TCFD Recommendations – Governance, Strategy, Risk Management, Metrics and Targets. We agree that these are important elements of the narrative reporting framework, however, we consider that these elements may not be sufficient on their own. For example, sustainability matters need to be considered in the context of a company's business model, yet this is not a prominent feature of the Climate prototype. As a minimum, we suggest that these disclosures could be linked into the 'areas of content' in Management Commentary.

Furthermore, we are concerned that repeating the four pillars in each standard produced by the ISSB could result in duplication.

We recommend that the ISSB consult with stakeholders at an early stage on whether this is an appropriate framing for all ISSB standards that follow.

Materiality

We support using the general principle of materiality that exists for IFRS financial statements. However, we recommend that the ISSB develops a separate practice statement on the application of materiality to sustainability information. In our view, this will be an area where companies will need further practical guidance given the qualitative, subjective nature of the information and the need to ensure that the information resulting from the application of ISSB standards is relevant to investors.

We believe there is merit in exploring the 'dynamic materiality' concept that was set out in the 'Statement of Intent to Work Together Towards Comprehensive Corporate Reporting'[1]

Reporting on impact

When developing principles for sustainability standards, we believe that sufficient emphasis needs to be given to reporting on the 'impact on society and environment' to the extent that they could affect the entities ability to create value or generate cash flows or otherwise influence investment decisions. This is highlighted in the General Requirements prototype.

We note that the Climate prototype, based on the TCFD recommendations mainly focusses on impacts of climate risk on the company with limited material on reporting on the impact on the environment.

Governance

In our view, governance is an important aspect of sustainability reporting. We encourage the IFRS Foundation, given its remit, to discuss how much governance reporting will be within the scope of the ISSB's standards. Given that many countries, such as the UK, have their own Corporate Governance Codes and there is already significant international alignment, the interaction will need to be considered to avoid any conflicts with local requirements when implementing the standards. Consideration should be given to whether it would be sufficient to link to existing disclosures that companies provide within their Corporate Governance Statement.

The FRC has extensive experience of the development of the UK narrative and non-financial reporting framework, and we would welcome further opportunities to collaborate and provide input into developments at the ISSB.

Finally, we offer our congratulations to the ISSB, and the organisations involved in the TRWG for this momentous achievement.

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[1] The statement is available at https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

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If you would like to discuss these comments, please contact Deepa Raval at d.raval@frc.org.uk or Gemma Clements at g.clements@frc.org.uk

Yours sincerely,

[redacted]

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Architecture of Standards

One approach to the development of a framework for sustainability reporting would be as follows:

- Management commentary - in our view, this should provide the overarching framework for narrative reporting covering financial and non-financial matters similar to the Strategic Report in the UK
- Conceptual framework for sustainability reporting – this would require consideration of how this links in with the IASB's conceptual framework
- General Requirements standard – covering general principles for disclosure of sustainability information regardless of the topic
- Industry agnostic standards on specific topics
- ISSB taxonomy
- Industry specific guidance and metrics
- IFRS Sustainability Disclosure Standards for SMEs
- Materiality Practice Statement - sustainability

We also suggest that the ISSB issues an information document outlining the framework and providing clarity on which elements are intended to be mandatory (subject to adoption in relevant jurisdictions) e.g. standards, and those that are voluntary e.g. Practice Statements such as Management Commentary.

We consider that having this architecture in place would ensure that:

- Each component of the framework that is developed has a clear objective which determines its content
- Duplication is reduced when components of the framework are being developed

We consider that it would be helpful for the ISSB to set out, in a similar manner to EFRAG[2], the 'universe' of potential sustainability topics it could consider and how these might fit together.

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[2] The relevant EFRAG Working Papers are available at https://www.efrag.org/Assets/Download?assetUrl=/sites/webpublishing/SiteAssets/Cover%20note%20for%20Batch%201%20WPs.pdf#page=9

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We understand that it may not be practicable for all elements of the architecture to be completed before standards are issued but it would be helpful for stakeholders to visualise the overall structure and understand the direction of travel.

As the ISSB develops its standard setting process, we encourage the ISSB to consider how quickly it reviews its standards. For example, the climate standard is likely to be released first and may benefit from an early review as its work programme develops.

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General Requirements for Disclosure of Sustainability-related Financial Information Prototype

High-level comments

In principle, we support the idea of having a standard that sets out the General Requirements for Disclosure of Sustainability-related Financial Information. However, we consider that there are a number of structural points that merit further consideration.

We consider that it is helpful that this prototype has a clear objective. Prior to issuing an Exposure Draft, it would be helpful for stakeholders to understand how this standard fits in with the overall architecture.

Following on from this, the content of the standard needs to be aligned with its objective. Currently, there is some material that would fit better within an ISSB Conceptual Framework (e.g. IN5, objective of sustainability reporting).

We also note that the prototype "seeks to enhance connectivity within the entity's general purpose financial reporting including the entity's financial statements and sustainability-related financial information". We support this aim but recommend that Management Commentary should also be referenced as it is part of the IASB's definition of general purpose financial reporting and is likely to be one of the locations for reporting sustainability information in practice.

Audience for sustainability-related financial information

We consider that it is helpful for the ISSB to define the term sustainability for the purposes of its standards (investor focus), as set out in Appendix B, and differentiating it from sustainability information that is relevant to a wider group of stakeholders.

We recommend that the ISSB sets out the framing of investor vs wider stakeholder information (people, environment, economy) in the Conceptual Framework. We also encourage the ISSB to use the term stakeholder with caution in its standards to avoid confusion about the intended audience of the information. For example, we are unclear on the meaning of the last sentence in IN2 "some stakeholders may be required to report on these matters".

We also suggest using Figure 1 in the *Statement of Intent* to illustrate the 3 lenses of sustainability disclosures.

Applying conceptual elements

Reporting boundaries

We agree with aligning the boundaries for sustainability related financial disclosures to those for an entity's financial statements. However, we consider that the definition may need some further development, for example in respect of joint ventures and associates; and where a company may be required to include information related to parties outside its reporting boundary.

General features

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We believe that this section of the prototype could benefit from re-structuring and being broken up into smaller parts.

We have identified the following elements within the general features:

- Disclosure content – governance, strategy, risk management, metrics and targets
- Presentation - comparability
- Qualitative characteristics
- Distribution – frequency of reporting, reporting channel

We consider that some of the areas above would be better suited for inclusion in the Conceptual Framework such as the qualitative characteristics.

Reporting channel

The range of corporate reports that companies produce is much wider than when accounting standards were first developed. We therefore consider that there would be benefit in the IASB and ISSB defining the boundaries of 'general purpose financial reporting'. The prototype seems to suggest that it would cover information typically found in an annual report.

In our view, it will be helpful to distinguish between annual reporting and other forms of reporting such as separate sustainability reports that some companies produce.

We welcome the flexible model in the prototype that enables the use of cross-referencing to other reports and where cross-references are used these must be to a 'precisely specified part of that report'. We consider this level of precision will be necessary for monitoring and enforcement. We also recommend that the ISSB considers including some wording that would ensure that sustainability information in general purpose financial reports needs to be sufficient to meet the information needs of investors.

Inclusion of material from IASB standards

Whilst we agree that there should be consistency between the key principles in IASB standards and those in standards being developed by the ISSB, we encourage the ISSB to take the opportunity for a fresh look at the structure or content of its standards if it would enhance their effectiveness.

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ISSB Climate-related Disclosures Prototype Standard

High-level comments

The publication of the Climate-related Disclosure Prototype Standard is a welcome development in the establishment of the ISSB. Building on the TCFD recommendations and existing voluntary frameworks, this prototype presents the basis for a viable and internationally applicable standard.

Whilst this prototype standard is an evolution and standardisation of these voluntary frameworks, especially of the TCFD recommendations, there are some areas that require additional consideration and enhancement. In particular, the prototype standard could go further in focusing on and specifying subject-specific requirements rather than generalised reporting requirements. Additionally, further work is required to resolve the duplication of requirements between this standard, the General Requirement Prototype Standard and the Technical Protocols (including the industry-specific metrics).

Although the climate-related disclosure standard is the priority of the ISSB, its formation and structure will influence the development of future standards on other sustainability topics. It is therefore important for the ISSB to consider the development of this standard within the context of the broader set of standards and ensure its structure and content are appropriate and applicable to other sustainability topics.

We note that the TRWG intends to look at connectivity. In our view, it is important that climate-related disclosures typically included in the front half of annual reports are linked to the financial statements referencing the IASB's publication on the impacts of climate risk on the financial statements.

Building on existing best practice

The FRC conducts thematic reviews of UK disclosures to understand the quality of reporting and to ascertain the demands from report users. Our 2020 Climate Thematic[3] is one example. When developing the standards, we recommend the ISSB considers similar reviews and examples of best practice to ensure the standards address any gaps in disclosure and build upon existing good practice.

For example, in a recent paper about developing practice in climate-related disclosure, the FRC's Financial Reporting Lab[4] found that more needs to be done to make disclosures understandable and relevant for users. In particular, the research found that:

- Disclosures of climate-related risks and opportunities and the associated impacts on the business model are of mixed quality. More information is needed on how risks and opportunities are assessed, including prioritisation, likelihood, impact, and the timeframes over which they might crystallise.

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[3] https://www.frc.org.uk/getattachment/ab63c220-6e2b-47e6-924e-8f369512e0a6/Summary-FINAL.pdf

[4] https://www.frc.org.uk/getattachment/09b5627b-864b-48cb-ab53-8928b9dc72b7/FRCLab-TCFD-Report_October-2021.pdf

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- Reporting on scenarios remains a key area of investor interest, and an area of weaker disclosure. Some companies disclose climate change scenarios that may affect viability, but detail is scarce.
- Pledges and indicators, especially those related to net zero, are often ill-defined and difficult to understand, and have the potential to be misleading. 'Aims' and 'ambitions' should be clearly distinguished from policies which are actively being pursued and are included in business plans and budgets.
- There is often a lack of explanation of performance against targets and a disproportionate focus on 'good news stories'. Outcomes for the business as a whole should be balanced and faithfully represented.
- Scope and basis of calculation of metrics is often unclear, and more detail is needed about the methodologies used to calculate KPIs.

Taking on board the findings of these reviews, the ISSB should seek to provide further detail in the reporting requirements, where appropriate, to foster complete and balanced corporate disclosures.

Connection with the general requirements standard

The disclosure content outlined in the general requirements prototype standard is identical to the requirements outlined in the climate-related disclosure prototype standard. This duplication is confusing, and it is difficult to see how this will work practically and how this structure will be applied to future standards.

It may be more conducive to remove the general requirements from the climate-related prototype therefore keeping the focus on subject-specific requirements. For example, the general requirements for strategy could be removed, allowing for greater focus on climate change specific risk categorisation and requirements. Additionally, the broader governance and risk management requirements could be removed from the climate standard, leaving space for requirements that are specific to climate change to be developed.

As the climate-related disclosure standard is the first to be developed by ISSB, further consideration is required on how the proposed structure will be used for future standards on other sustainability topics. For example, will entities be expected to disclose the identity of the body or individual within a body responsible for risks and opportunities associated with each topic? Where certain requirements are applicable across all sustainability topics, it may be logical to remove them from the topic-specific standards and provide further guidance in the general requirements standard.

Building on the TCFD recommendations

The influence of the TCFD in the development of the prototype standard is clear, and we welcome the formalisation of the TCFD recommendations. However, in its current form the prototype presents a missed opportunity to build upon and enhance the recommendations.

The TCFD recommendations have been successful over the last 5 years in galvanising the market to improve reporting and in the process consider their strategy and response to climate change and its associated risks. The uptake of reporting against the recommendations has been swift and global, but issues remain around the comparability and consistency of disclosures. The development of the ISSB standard could, and should, identify areas that

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require additional context and/or explanation and should seek to enhance the recommendations.

This might include where the TCFD recommendations are duplicative. For example, the requirement to disclose information about the process for identifying climate-related risks is included in both Strategy (paragraph 6 (a)) and Risk Management (paragraph 11 (a)). Additionally, improvements may also include providing further detail for some requirements to remove the need for interpretation. The TRWG have already included further reporting requirements that are helpful, especially regarding resilience outlined in paragraph 10 which goes beyond the TCFD recommendations.

To ensure the standard enables the production of consistent and comparable disclosure, the ISSB climate-related disclosure standard should seek to remove ambiguity where possible. For example, paragraph 8 (d) requires entities to provide information about how significant climate-related risks and opportunities are included in the entity's financial planning decision making. Further detail could be provided as to what the disclosure expectation would be for this requirement, especially if it differs from the similar requirement in the governance section (paragraph 4 (e)).

ISSB may also consider how the recommendations of the TCFD are presented in the standard. TCFD reporting has been mandated in UK, and therefore could provide a useful example to the ISSB. The UK's legislation as outlined in The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022[5] may provide a helpful alternative structure that complements the TCFD recommendations. In paragraph 4 of the legislation, the TCFD recommendations have been restructured and summarised which is easier to understand. Additionally, the ISSB may consider using visual aids, similar to the table used by the TCFD to provide a snapshot of the four pillars and recommended disclosures.

Cross-sector and industry-specific requirements

The requirements of the climate-related disclosure prototype standard are broadly cross-sector. However, it is unclear whether the TRWG has considered how these requirements are applied to entities who determine that climate change does not present significant risks or opportunities. In the final report, the TCFD distinguishes between requirements for all entities despite materiality, namely the governance and risk management requirements, and others that depend on materiality. This addition in the TCFD recommendation allowed for flexible adoption of the recommendations, whilst also encouraging all entities to provide a minimum standard of information. Where entities conclude that climate change is not a significant issue to their business, will they be required to respond to all elements of the ISSB climate-related disclosure standard? This would be helpful to address in a Practice Statement on Materiality for application to sustainability disclosures. This concern may be resolved by removing general requirements from the prototype standard and focusing on subject-specific elements, therefore allowing entities to apply materiality judgements towards the inclusion of climate-related information in their reports.

Additionally, there are some requirements in the current prototype standard that are not applicable to all entities. For example, in paragraph 8 (b) entities are required to provide plans and critical assumptions for legacy assets, including strategies to manage carbon- energy-

[5]https://www.legislation.gov.uk/uksi/2022/31/regulation/4/made

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and water-intensive operations, and to decommission carbon- energy- and water-intensive assets. This requirement is only applicable to entities within specific industries, and therefore may be better placed in the industry-specific requirements in Appendix B.

The distinction between cross-industry and industry-specific metrics is well defined and welcomed. The industry-specific metrics are based on industry-based activities rather than sector classification which is a helpful distinction.

In the Technical Protocols for Disclosure Requirements, the SASB standards relevant to climate change have been listed. Although we encourage the use of SASB standards which are already established in the market, further work is required to ensure the suggested metrics are both subject-specific and industry-specific. For example, the additional requirements for the Apparel, Accessories and Footwear industry asks entities to provide a description of environmental and social risks associated with sourcing priority raw materials. This requirement encompasses broader environmental and social risks beyond climate and is somewhat duplicative of the requirements already described in the strategy section. The industry-specific metrics also include general metrics that are applicable to multiple industries which could be moved to the cross-sector requirement. For example, the requirement for entities to disclose total energy consumed, percentage grid electricity, and percentage renewable energy is not an industry-specific metric and could be applied to all industries.

Although it is understood that the SASB metrics were initially designed for the U.S. market, these need to be amended to ensure that they are internationally applicable. For example, there are multiple references to U.S. specific regulations, programs, initiatives and nomenclature which may prevent the industry-specific metrics from being adopted across multiple jurisdictions.

Therefore, further work is required to ensure the industry-specific metrics for the climate-related disclosure standard are subject- and industry-specific, and applicable across jurisdictions.

Risk and/or impact

The IFRS Foundation Trustees have instructed the ISSB to focus on disclosures relevant to value creation with investors as the primary report users. This has resulted in the design of a standard that is structured around risk and opportunities, with some inference to impacts and dependencies that influence and underpin value creation. Although this standard already includes some aspects associated with climate-related impacts, there are a few inconsistencies that ISSB may wish to address.

When setting the future topic standards, the ISSB should consider "value creation", not only from the perspective of the impacts of ESG matters on the ability of the company to create and maintain value (monetary or otherwise), but also on the impacts and dependencies that underpin value creation. Impacts and dependencies, and risks and opportunities, are interconnected through feedback loops, and therefore to address one without the other would limit the completeness of disclosure. As summarised on page 18 in the CDSB Framework Application Guidance for Biodiversity-related Disclosures[6], "*both dependencies and impacts generate economic costs and benefits for businesses and society, which consequently result*

[6] https://www.cdsb.net/sites/default/files/biodiversity-application-guidance-single.pdf

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in business risks and opportunities that can affect the present and/or future financial position and financial performance of the organisation." Therefore, the primary focus on risk and opportunities limits the scope of the standard and does not address the important and holistic interconnections between impacts, dependencies, risks and opportunities.

Although the climate-related prototype standard is framed around risk and opportunities, there is already some inclusion of impact-related information, including transition plans, mitigation activities, GHG emissions data, and climate-related (GHG emissions reduction) targets. The biggest omission in relation to climate-related impacts is information about alignment and how the entity's current business model and strategy contributes to emissions reduction ambitions in its own operations and value chain. Although this element is alluded to with the inclusion of "transition plans" and mitigation activities in paragraph 8, the requirements in the climate-related disclosure prototype could go further by including language around alignment. Additionally, framing alignment plans through mitigation activities assumes that only entities exposed to significant transition risks should provide information about commitments and plans towards aligning their business model with international climate targets. Using the definition of materiality provided by the TRWG, this information could be considered material under the ISSB framework especially as it relates to transition risks and the potential need for entities to change or adapt business models to reflect climate ambitions (both at entity level and national/international level).

We also note that investors are making investment decisions based on aligning their portfolios with their own net zero strategies. Therefore providing information on business impacts would enable investors to make an assessment of the company in line with their investment strategy.

The distinction and interconnection between climate-related risks and opportunities and climate-related impacts is relatively straightforward. However, this relationship is likely to be more complex for other sustainability topics. As the climate-related disclosure standard will influence the structure and content of the future standards, it is imperative that ISSB considers whether framing the climate-related disclosure standard around risks and opportunities is appropriate, and where this structure may need to be adjusted for other sustainability topics.

Additionally, there is disconnect between the narrative reporting requirements in the standard and the metrics in the Technical Protocols. The proposed industry-specific metrics not only lack subject specificity but are also predominately focused on impacts. There is therefore a disconnect between the narrative reporting requirements that are focused on risks and opportunities, and the impact focused industry-specific metrics. We recommend that the ISSB considers additional industry-specific metrics that address on climate-related risks and opportunities as outlined by the recent TCFD Guidance on Metrics, Targets, and Transition Plans[7].

Recommendations

[7] https://assets.bbhub.io/company/sites/60/2021/07/2021-Metrics_Targets_Guidance-1.pdf

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The current climate-related disclosure prototype standard is a successful first attempt at bringing together and evolving existing voluntary reporting standards and frameworks. However, there are some areas that should be addressed in future iterations as detailed above and summarised below. It is clear the TRWG already recognised these challenges which are helpfully outlined on page 18 of the prototype standard.

Our initial recommendations to the ISSB are summarised below.

- Use existing reviews of corporate disclosure and examples of best practice when setting the standards to ensure they address any gaps in disclosure and build upon existing good practice in the market.
- Further consideration is required about how this standard will fit within and influence the future suite of standards, and how the ISSB will resolve the duplication and overlap of reporting requirements across topics.
- The ISSB should ensure the climate-related disclosure standard is focused on subject-specific requirements that are applicable across sectors, and therefore consider how this standard, and future standards, are connected to and build upon the general requirements standard. This may require deviation from the TCFD structure within the climate-related disclosure standard where appropriate.
- The industry-specific metrics outlined in Appendix B and further detailed in the technical protocol require amendments to ensure the metrics are subject-specific and are not duplicative of the requirements within the cross-sector standard.
- Ensure the climate-related disclosure standard adequately addresses impacts and dependencies that influence an entity's risks and opportunities and underpin value creation.

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