ICAEW
REPRESENTATION 105/23

UK ENDORSEMENT OF IFRS S1 AND IFRS S2: CALL FOR EVIDENCE

Issued 17 October 2023

ICAEW welcomes the opportunity to comment on the 'UK Endorsement of IFRS S1 and IFRS S2: Call for Evidence' published by the UK Sustainability Disclosure Technical Advisory Committee on 19 July 2023, a copy of which is available from this link.

For questions on this response please contact the Corporate Reporting Faculty at crf@icaew.com quoting REP 105/23.

We consider that IFRS Sustainability Disclosure Standards are the right solution for the UK. We are pleased that the UK is making progress with the steps required to endorse the standards for use in the UK. An effective endorsement process is an essential step in implementing the International Sustainability Standard Board's (ISSB) Standards.

Subject to the findings of this endorsement process, we emphasise the benefit of endorsing the standards as published by the ISSB. There should be a high threshold set for deviating from the published standards.

We believe that the legislative mechanism used to adopt the ISSB Standards in the UK will be critical to achieving the benefits of the ISSB as a 'global baseline'. We have highlighted concerns with some routes to adoption and urge the UK Government to consider how these could be mitigated to ensure that the standards are faithfully brought into the UK corporate reporting framework.

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This response of 17 October 2023 has been prepared by the ICAEW Corporate Reporting Faculty. Recognised internationally as a leading authority on corporate reporting, the faculty, through its Financial and Non-Financial Reporting committees, is responsible for formulating ICAEW policy on financial and non-financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The faculty provides an extensive range of services to its members including providing practical assistance with common corporate reporting problems.

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KEY POINTS

INTERNATIONAL SUSTAINABILITY STANDARDS ARE THE RIGHT SOLUTION FOR THE UK

1. We welcome the opportunity to comment on the important matter of endorsing the International Sustainability Disclosure Standards – IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures* – for use in the UK. This consultation provides a critical opportunity for stakeholders to consider the practical application of the standards in a UK context.
2. We are very supportive of the development by the ISSB of a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs. We are pleased that the UK is making progress with the steps required to endorse the standards for use in the UK.
3. The UK reporting framework already includes various sustainability-related reporting requirements, such as the Financial Conduct Authority's (FCA) Task Force on Climate-related Financial Disclosures (TCFD) listing rules, the Streamlined Energy and Carbon Reporting (SECR) requirements and other strategic report requirements. These requirements are not well integrated, have scoping requirements that are difficult to navigate and are often overlapping and duplicative. Making the ISSB Standards available for use in the UK provides a golden opportunity to streamline these existing requirements while simultaneously supporting international consistency.
4. The existing UK climate-related reporting requirements mean that, in effect, many large UK entities have already begun to report against a significant proportion of the requirements of IFRS S1 and IFRS S2 and are therefore well positioned to build on this experience and implement the ISSB Standards.

AN EFFECTIVE ENDORSEMENT PROCESS IS ESSENTIAL

5. An assessment of IFRS S1 and IFRS S2 for their suitability in a UK context is an important step, as the standards should not be brought into UK legislation without comprehensive consideration of the potential consequences of doing so. Nonetheless, we believe that there should be a high bar to justify divergence from the published standards.

BENEFITS OF ENDORSING AS PUBLISHED BY THE ISSB

6. Subject to the conclusion of an endorsement process, we support bringing the IFRS Sustainability Disclosure Standards as issued by the ISSB into the UK reporting framework without amendment. To date, the UK Government has consistently supported the IFRS Foundation's ambition, through the ISSB, to establish a global baseline for sustainability reporting, from the G7 Finance Ministers Communique welcoming the development of the new board to the COP26 statement of support and beyond. Adoption of the standards in their original form, including the integral appendices, is the best way of achieving a global baseline.
7. Other than the global baseline benefit, we have identified a number of further benefits to endorsing the standards as published:
    a. Approving the ISSB Standards unamended for use in the UK will support the production of the consistent and comparable sustainability information that investors need.
    b. Endorsing the ISSB Standards without amendment is consistent with the UK's role as a leading international financial centre, its intent to be a global leader in the response to climate change, and the aim of appropriately increasing the flow of capital to sustainable business.

c. International businesses operating and reporting in multiple jurisdictions are already facing competing regulatory and reporting demands. Endorsing the standards as published by the ISSB would enable these businesses to focus on taking action to tackle their sustainability issues, rather than navigating requirements that are similar to but not the same as those in the ISSB Standards.

d. We know from experience of international financial reporting standards that most investors do not have the time or the resources to study the intricacies of local variations or to easily understand the implications of carve-outs or amendments. Carve-outs or amendments therefore undermine trust in reporting and can require burdensome explanations for companies that depend on access to international capital.

e. Endorsing the ISSB Standards without amendment would ensure that those companies applying the ISSB Standards on a voluntary basis are automatically compliant and their reports compatible with the UK-endorsed versions of the standards, reducing the burden on some UK companies.

HIGH THRESHOLD FOR DEVIATING FROM THE STANDARDS

8. We suggest that a very high threshold for carve-outs or amendments is established, such that issues must need to meet specific criteria before considering this course of action. Should a matter be identified that does breach this high threshold, there would need to be a thorough and transparent assessment by the UK Government before amendments are proposed or finalised for the purpose of UK endorsement.

9. For our own purposes, we have referred to the following criteria:

   a. The issue, if unamended, would make the standard unsuitable for UK legislation due to either:

      i. a fundamental lack of clarity or specificity; or

      ii. inclusion of external references that are outside of UK legislative control.

   b. The issue, if unamended, would contradict or clash with existing UK legislation.

   c. The issue, if unamended, would be considered detrimental to the long-term public good in the UK.

10. In applying the criteria above, we have not identified any fundamental barriers to UK endorsement, however we have identified areas that we believe need careful consideration as part of the endorsement process. These important areas for consideration are explained in paragraphs 17 to 26. Additionally, we have identified areas of the standards that we think would benefit from additional educational guidance (preferably produced by the ISSB) and implementation monitoring by UK regulatory authorities. These areas are explained in paragraphs 27 to 42.

11. Both in the course of incorporation into law and in the process of addressing any issues above, the government should avoid drafting which would result in compliance with UK endorsed sustainability standards being incompatible with full adoption of the ISSB's original standards on a voluntary basis using the same information.

CAREFULLY CONSIDER THE LEGISLATIVE MECHANISM

12. Our strong preference is that the ISSB Standards are referenced in UK legislation in a similar manner to IFRS Accounting Standards. We understand, however, that due to the lack of primary legislation, and in order to achieve timely endorsement and adoption, it may be necessary for the requirements of the standards to be written directly into legislation.

13. If this approach is taken, we would encourage the UK Government to view this as a short-term and temporary course of action that requires a better long-term solution, and to take steps to mitigate the concerns set out below.

14. Our detailed concerns with hardwiring the standards into legislation are set out in paragraphs 50 to 59 below, but in summary:

    a. In order to embed the text from the ISSB Standards into legislation, we are concerned that there would be a need to convert the standards into ‘legislative language’, meaning some important parts of the text could be removed or changed, which could alter their intended meaning and undermine the aim of achieving consistency and comparability. (See paragraphs 51-53)

    b. There is a risk that by not referencing the original standards as issued by the ISSB, relevance to UK companies of work on interoperability between standard setters may be undermined, and this may also compromise the potential for an equivalence regime to be established in future. (See paragraphs 54-55)

    c. Standard-setting through legislation does not lend itself to the flexible and adaptable approach needed for the fast-evolving area of sustainability reporting. Unless the legislation can be updated in a timely way, the legislative requirements could very easily become out of sync with the ISSB’s Standards. (See paragraph 56)

    d. Standard-setting through legislation adds another layer of unnecessary complexity, such as difficulties in providing enforceable interpretive guidance. (See paragraphs 57-58)

DETAILED POINTS

15. We have set out our detailed comments regarding the suitability of IFRS S1 and IFRS S2 for use in the UK in four distinct areas: potential endorsement considerations, post endorsement matters, interaction with existing UK reporting requirements and concerns about the legislative mechanism. When considering our feedback to this consultation we also considered all of the suggested topics listed in the call for evidence.

Potential endorsement considerations

16. In applying the ‘high threshold’ criteria set out in paragraph 9 above, we have identified areas that we believe need careful consideration as part of the endorsement process. While these are important matters for consideration, we do not feel they are significant enough to affect an overall decision to endorse the ISSB Standards for use in the UK.

SASB Standards

17. IFRS S1 paragraph 55(a) and 58(a) requires that ‘an entity <u>*shall*</u> refer to and consider the applicability of’ the SASB Standards. Notwithstanding our preference for endorsement of the ISSB Standards without amendment, we understand that this ‘external’ reference is likely to present a legal challenge for UK endorsement because of the mandatory nature of the requirement.

18. It is well-accepted that investors and other primary users believe that industry-specific disclosures are an essential factor to help them to understand and assess an entity. Therefore, we support, in principle, the need to ask reporters to consider reporting industry-specific information. We also accept that the requirement to <u>*consider*</u> the SASB Standards does not add to the information that a company would need to <u>*report*</u>. Rather, it requires

companies to use the SASB Standards as a tool to identify the relevant information required to meet the disclosure requirements in IFRS S1.

19. In line with our understanding that the text of the ISSB Standards would need to be written into legislation, we think it follows that (if mandatory consideration still applies) the entirety of the text of the SASB Standards would also need to be inserted into legislation. Writing the entirety of the SASB Standards into UK legislation does not appear to be a practical option and it is possible that further legal challenges might arise.

20. As explained in our response to the ISSB when the standards were at the exposure draft stage, we heard significant concerns about SASB Standards that meant that we did not support the proposed requirement to consider them when applying ISSB Standards. We expect the endorsement process will need to consider such concerns as, in our view, they remain unresolved.

21. One solution that ICAEW proposed when responding to the ISSB at exposure draft stage, that is still relevant, would be to change this requirement so that entities *may* refer to the external guidance (rather than *shall*) and therefore change the mandatory requirement to a voluntary one.

22. We believe that this solution, if needed, would have little to no impact on the reporting output of entities reporting against the standard. Entities are likely to, and should be strongly encouraged to, look at SASB Standards when reporting on their sustainability-related risks and opportunities as they are a useful starting point for identifying risks and opportunities as well as appropriate disclosures. We would not anticipate that changing the requirement from mandatory to voluntary consideration will have a detrimental effect on reporting – although all potential consequences of doing so would need careful consideration.

23. We acknowledge that this solution would set an unfortunate precedent by amending the standards as issued by the ISSB, albeit on a very limited and hopefully temporary basis.

GHG Protocol

24. A similar issue arises in IFRS S2 paragraph 29, which requires that ‘an entity *shall* measure its greenhouse gas emissions in accordance with the Greenhouse Gas (GHG) Protocol’. The GHG Protocol is a truly ‘external’ reference, because it is not part of the IFRS Foundation’s literature. The requirement in IFRS S2 is that entities shall apply the GHG Protocol (not just consider applying it) and is therefore a stronger requirement. Additionally, the GHG Protocol represents a specific measurement method rather than being exclusively focussed on disclosures or metrics.

25. We understand that the ISSB considered the feedback it received on this requirement and concluded that the mandatory nature of this requirement to use a specific measurement method is likely to result in more consistent and comparable disclosures. Making this requirement voluntary (by say changing the requirement from *shall* to *may*) would undermine efforts towards consistent and comparable metrics being disclosed and therefore the consequences of doing so could have a negative impact on the global baseline ambition.

26. If this reference is considered to be problematic from a UK perspective, it may be possible that the UK approach could take advantage of the relief offered in IFRS S2 paragraph 29. This allows a different method for measuring its greenhouse gas emissions if required by specific jurisdiction authorities or exchanges. In any case, we would encourage the Department of Business and Trade (DBT) to find and consult on a solution that supports a consistent and comparable measurement technique for GHG reporting, in keeping with the requirements of IFRS S2.

Post-endorsement considerations

27. Overall, we believe that the requirements described in IFRS S1 and IFRS S2 are straightforward to interpret. We think the standards have been well written and considered and, if adopted, should improve existing reporting of sustainability matters. We also believe the granularity and specificity of reported information will improve as a result of implementing IFRS S1 and IFRS S2.

28. We have identified a number of areas throughout IFRS S1 and IFRS S2 that have the potential to cause implementation challenges as practice develops and therefore should be carefully monitored as companies start to implement the standards. These areas may also benefit from additional guidance that could help entities to apply the requirements initially and to understand the reporting expectation in the short-term. These areas are explained further below. Our preference would be for any educational guidance to be issued by the ISSB directly so that it can be applied in a globally consistent way and therefore encourage the UK Government to influence this where possible.

29. We also acknowledge that, despite the fact that the requirements contained within IFRS S1 and IFRS S2 are based upon TCFD, there will nonetheless be some new and somewhat complex requirements for entities to implement. It will take time for companies to adjust systems and processes to report well under the new regime. We do not see these challenges as barriers to endorsing the standards as published by the ISSB but, as practice emerges, we think it will become more obvious where the areas of particular difficulty lie, and therefore where more guidance is needed.

Definition of Sustainability

30. IFRS S1 does not define ‘sustainability’ or ‘sustainability-related’. As part of ICAEW’s response to the exposure draft of this standard, we expressed the view that this lack of a clear definition makes it hard to understand what activities will be captured by the standard and to envisage how wide-reaching its implications will be. It is possible for the term to be interpreted in a number of different ways, which could lead to a lack of comparability and consistency when applying ISSB Standards.

31. While this remains a significant concern, we acknowledge that there is no straight-forward or universally agreed definition of sustainability. We also recognise that there are potential drawbacks of including one. We believe that it is possible that this issue is more conceptual than practical and therefore our conclusion is that this should be an area for DBT to closely monitor post implementation.

32. If DBT believes this matter requires more than a ‘wait and see’ approach, then one solution could be in the recent revision to The Financial Services and Markets Act 2023, paragraph 416B (2), which defines matters related to sustainability. This presents a definition already included in UK law that could be usefully referred to in the context of endorsing IFRS S1 for use in the UK. Having said that, the language used (‘matters relating to sustainability include…’) may not sufficiently provide a clear boundary of sustainability matters.

Application of materiality

33. IFRS S1 paragraph 3 requires an entity to ‘disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity’s cash flows, its access to finance or cost of capital over the short, medium or long term’. We believe the ISSB’s intention is that information should only be provided when it is material, so it should not be necessary to provide information about those risks and opportunities that are not relevant to primary users’ decisions. One concern is that application of the materiality filter may not be obvious to those less familiar with financial reporting requirements. Consequently, we believe that guidance is needed to clearly explain the materiality filter that the requirements in all ISSB Standards are subject to.

34. Such educational guidance could usefully emphasise the critical clarification in paragraph B25 of IFRS S1, which explains that ‘an entity need not disclose information otherwise required by an IFRS Sustainability Disclosure Standard if the information is not material’.

35. Additional materiality-related challenges that we would like to see educational guidance for include:

    a. how to prevent material information from being obscured by immaterial information (IFRS S1 paragraph B27);

    b. the application of materiality to long-term time horizons; and

    c. how entities are to identify matters for which information could reasonably be expected to influence the decisions of primary users.

Practical challenges of the value chain

36. We believe that the value chain definition included in IFRS S1 is well-articulated, however, the challenge of practical application remains. Guidance that explains the appropriate level of ‘reach’ into the value chain in the context of the ISSB reporting requirements would help entities. Guidance could address how companies could identify risks and opportunities across the value chain and how the value chain interacts with identifying material information, with supporting illustrations and examples.

Using SASB Standards

37. Our concern regarding the legal challenge of the reference to consider the SASB Standards in IFRS S1 has been explained above. Regardless of the outcome of the matter, we would welcome some further guidance about how entities may best use the SASB Standards. In particular, we would encourage guidance that sets out what would constitute adequate consideration of the SASB Standards, as this is likely to help both companies and their assurance providers.

38. We believe that for many businesses, particularly those whose activities span multiple sectors, it may not be clear which industry their activities fall into and (in attempting to establish which industry disclosures to use), there will be a need to read and digest a considerable volume of material. Guidance to help make this process more efficient would be welcome.

Scalability terms

39. The ISSB has included wording throughout both IFRS S1 and IFRS S2 that allow for scalability and proportionality for those adopting the standards. We support this approach and think that this wording will be of significant benefit to entities who are at various stages of their sustainability reporting journey and will help facilitate wider adoption and application.

40. One example of a phrase used in the standards to help with proportionality is ‘commensurate with the skills, capabilities and resources available’ (IFRS S1 paragraph 37 and IFRS S2 paragraph 18). Another example is ‘without undue cost or effort’ which is used throughout both standards.

41. While we believe these phrases to be particularly helpful, we also think that implementation guidance would help further if it were to set out examples of ways in which entities and assurance providers can:

    a. assess approaches that are or are not commensurate with an entity’s skills, capabilities and resources, and

    b. assess whether or not particular scenarios constitute undue cost or effort.

Other areas

42. The proportionality reliefs available in the ISSB Standards make many of the requirements more practical. However, there are particular areas of the ISSB Standards that we believe are likely to lead to implementation challenges and therefore would benefit from ongoing monitoring and additional practical guidance. These areas are as follows:
    a. financial impact requirements – in particular the need to distinguish one type of risk from another in this context when these risks are likely to interact with one another;
    b. financed emissions – the PCAF materials may serve as useful guidance to reference; and
    c. climate resilience and scenario analysis.

Interaction with existing requirements

Timing and location

43. We support the requirement in IFRS S1 to report sustainability-related information at the same time and in the same location as general purpose financial reports. It is important that sustainability risks and opportunities are not considered separately or through a different lens from all other business risks.
44. We would also like to emphasise that, in our view, ISSB disclosures should be appropriately integrated throughout the annual report rather than reported in silos. For example, all companies that are required to produce a Strategic Report must disclose a description of the principal risks and uncertainties facing the company. We think this requirement aligns well with the requirement in IFRS S1 to 'disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity', and should therefore be appropriately integrated.
45. Companies may find it helpful to present certain ISSB disclosures (such as detailed metrics) in a separate section within the annual report in order that they do not disturb the flow of the narrative – allowing cross referencing to deal with those requirements that are best integrated elsewhere.
46. In due course, we hope that DBT considers whether it would be appropriate to streamline existing UK reporting requirements (such as SECR, CRFD and s172 requirements) that overlap with UK-endorsed ISSB Standards, although we acknowledge that this will very much depend on the scope of company that is ultimately required to apply the ISSB Standards. In our view, the best approach would be to have one source of sustainability disclosure requirements, ie, UK-endorsed ISSB Standards.

Reporting approach

47. Paragraph 20 of IFRS S1 requires sustainability-related financial disclosures to be for the same reporting entity as the related financial statements. We support this requirement in principle, however in practice this it is likely to present challenges in the context of the UK reporting framework. This is something that we highlighted in our recent response to the UK Government's call for evidence on the non-financial reporting review.
48. We are particularly aware of existing issues for intermediate UK holding companies that do not produce consolidated accounts (taking the s401 exemption). If at some stage such companies are required to comply with the ISSB Standards, then information will also be required at an individual subsidiary level, rather than on a group basis by the parent company. The information reported by the parent will be on its own activities, rather than across the group of which it is parent which, depending on the nature of the group, may be of questionable value.

49. We do not see this as an endorsement issue – the IFRS S1 reporting approach requirement is reasonable and sensible. However, we believe this area is one which DBT will need to consider more fully when making decisions about the scope of entity required to apply the UK-endorsed ISSB Standards.

Concerns about the legislative mechanism

50. As expressed above, our strong preference is that the text of the standards should not be written into the legislative framework, but instead should be referenced in a similar manner to IFRS Accounting Standards. However, we understand that due to the lack of primary legislation and in order to achieve timely endorsement and adoption, it may be necessary for the requirements of the standards to be written directly into legislation.

51. On the basis that the standards are hardwired into legislation in this way, we have explained our detailed concerns that we believe the UK Government should consider and mitigate as part of the endorsement and adoption process. We also encourage the UK Government to view this legislative approach as an unfortunate but necessary short-term and temporary approach that requires a better long-term solution.

Legislative language

52. In order to embed the text from the ISSB Standards into legislation, we are concerned that there would be a need to convert the standards into legislative language. Throughout both IFRS S1 and IFRS S2, the term ‘for example’ is used to help illustrate a requirement. We understand that using the term ‘for example’ is not commonplace in legislation and there could be legislative grounds to remove this wording. This would be unhelpful at best, but potentially could cause confusion about why there is an apparent difference between the UK endorsed version and the original version of the standards.

53. Another consequence of changing the language to enable the standards to be suitable for legislation, is that this may create unintentionally a change to the meaning of a requirement. This would undermine the global baseline concept and cause unnecessary and undesirable divergence.

54. We are also concerned that there might be legislative challenges regarding inclusion of the text from the integral appendices of the standards. The integral appendices form a critical part of the ISSB Standards, such that the standards are incomplete without them. We stress the importance of ensuring that any required legislative restructuring does not undermine their integrity.

Interoperability and equivalence

55. Not referencing the original standards as issued by the ISSB is likely to remove the relevance to UK companies of the work on interoperability between sustainability standard setters. New and potentially unnecessary questions could arise regarding interoperability matters that have already been dealt with by the ISSB and others.

56. There is hope that at some stage in the next few months or years, there might be an equivalence regime agreed between the ISSB and Europe and/or other jurisdictions. By writing parts of the standards into legislation instead of the unamended ISSB Standards, this could create a real risk that the UK would be excluded from any such equivalence regime if this temporary method of incorporation has not been amended by that stage.

Futureproofing

57. The sustainability-standard setting world is in its infancy and is still fast-evolving; the need for a flexible and adaptable approach cannot be emphasised enough. Standard-setting through

legislation does not lend itself to a flexible or adaptable approach. For example, if changes are made to the ISSB Standards (which is anticipated in the medium term), then the underlying legislation would also need to be reviewed and updated for such changes and subjected to a UK endorsement assessment. Unless the legislation can be updated in a timely way, the legislative requirements could very easily become out of sync with the ISSB's standards and compromise attempts to achieve a global baseline in sustainability reporting.

Unnecessary complexities

58. Given the infancy of the sustainability reporting era, the likelihood of a need for interpretative guidance is very high. Writing the text of the standards into legislation risks undermining the status of technical interpretations and educational material produced by the ISSB. Both are likely to be of high importance given the developing nature of reporting practice in this area.
59. We think there needs to be some mechanism established to ensure that any guidance produced by the ISSB can be accorded the status and authority needed in a UK context.