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#DeloitteESGNow — Setting the Standard: When ESG and Climate Reporting Meet Financial Reporting

by Gina Miani, Meadow Hackett Rutenbar, Christine Robinson, and Kristen Sullivan, Deloitte & Touche LLP

Introduction

At the 26th United Nations Conference of the Parties (COP26), the IFRS Foundation trustees announced the formation of an International Sustainability Standards Board (ISSB or the "Board"), a major development in the move toward improving the consistency and comparability of companies' sustainability disclosures to meet the needs of capital markets. The global ISSB standards are intended to promote transparency and consistency in sustainability disclosures to better inform decision-making for users of general-purpose financial reporting.

The Technical Readiness Working Group (TRWG), created by the IFRS Foundation trustees in March 2021, published two prototypes for general sustainability and climate-related disclosures. The prototypes will serve as the foundation for the ISSB's proposed standards, which are expected to be published by mid-2022. These two advances, along with the proposed environmental, social, and governance (ESG) rulemaking expected from the SEC in the coming years, demonstrate a new level of attention to companies' ESG and climate disclosures amid the increased demand for consistent, comparable, and transparent sustainability information.

As ESG disclosure moves from voluntary to authoritative, the role of the finance organization — including the CFO and the treasury, internal audit, accounting and reporting, and investor relations functions — will continue to be critical in this transformative period. The ISSB will help elevate sustainability standard setting in line with that of financial accounting and reporting. The finance organization will need to adapt quickly to advance high-quality ESG measurement and reporting and drive decision-making regarding the allocation of resources. Companies that take immediate action will be better positioned to address increased investor expectations, adapt to the role of assurance, and seize emerging market opportunities.

Developments at COP26

Formation of the ISSB Announced

At COP26 and in a November 3, 2021, news release, the IFRS Foundation trustees announced the creation of the ISSB, which seeks to develop "a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs." The ISSB will sit alongside the International Accounting Standards Board and have a similar structure, as instituted through the revised constitution published by the IFRS Foundation trustees.

To enhance coordination across the ESG reporting landscape, the ISSB will "consolidate . . . technical expertise, content, staff and other resources" through a merger with the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (VRF).[1] The technical standards and frameworks of the CDSB and VRF, along with those of the Task Force on Climate-Related Financial Disclosures (TCFD or the "Task Force") and the World Economic Forum (WEF) International Business Council's Stakeholder Capitalism Metrics, will provide a basis for the ISSB's technical work. The ISSB will draw upon expertise from several advisory groups, including technical advice provided by a new Sustainability Consultative Committee, whose members will include the International Monetary Fund, the Organisation for Economic Co-operation and Development, the United Nations, and the World Bank.

IOSCO Declares Support for the ISSB

The establishment of the ISSB has received large-scale support, including from the International Organization of Securities Commissions (IOSCO), which has noted that the creation of a consistent set of common international standards for sustainability disclosures is critically important for improving sustainability-related reporting. IOSCO not only has encouraged globally consistent standards but also has highlighted that (1) these standards should be subject to the scrutiny of auditors and (2) the "development of an audit and assurance framework and related standards for corporate sustainability-related disclosures" is a primary focus area for the international commission. IOSCO has stated that it would aim to consider endorsing the ISSB's standards for domestic and cross-border use by regulators before the end of 2022.

Deloitte's View

Deloitte welcomes the IFRS Foundation's announcement of its new ISSB as well as (1) the commitment by the CDSB and VRF to merge with the new Board and (2) the publication of prototype climate and general disclosure requirements by the IFRS Foundation's TRWG.

The global ISSB standards are an essential part of a system change that will be required to create a global baseline of sustainability information addressing the needs of global capital markets. To be effective, the standards will need to be brought into regulation around the world, together with associated enforcement, monitoring, governance and controls, assurance, and training. Worldwide adoption of the ISSB standards is needed to achieve true harmonization and replace the alphabet soup of voluntary standards and frameworks.

[1] The VRF was formed in June 2021 by the merger of the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council.

The announcement of the commitment by the CDSB and VRF to merge with the new Board sends a clear signal to the market that the ISSB is emerging as the global sustainability standard setter. This development will reduce fragmentation and confusion in the sustainability standard-setting landscape. The intention to use the technical standards and frameworks of the CDSB and VRF, along with those of the TCFD and the WEF International Business Council's Stakeholder Capitalism Metrics, will help ensure that the ISSB has a running start.

Click here to read Deloitte's full statement of support.

Architecture of ISSB Standards

The IFRS Foundation's TRWG has published two prototypes of disclosure requirements, one related to general sustainability (the "General Requirements Prototype") and the other related to climate (the "Climate Prototype"). These prototypes demonstrate significant evolution and build on the work of the Group of 5. They are designed to be included in general-purpose financial reporting, which is defined in the General Requirements Prototype as reporting that "[p]rovides financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity."

ISSB: Two Prototypes of Disclosure Requirements

Developed by the ***TRWG***

Climate-related disclosures:

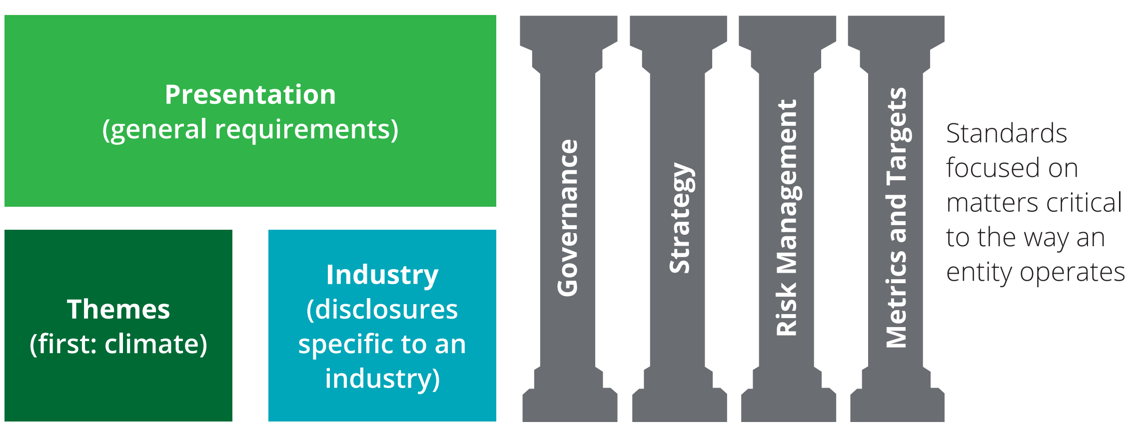
- Provide information about **exposure to climate-related risks and opportunities**, building on TCFD recommendations and industry-specific disclosures.
- Help users **assess the entity's future cash flows**, amounts, timing, and certainty over the short, medium, and long term.

General sustainability disclosures:

- Provide **material information** about the entity's **exposure to sustainability-related risks and opportunities**.
- Help **users of general-purpose financial reporting** make decisions about whether to provide economic resources to the entity.

IFRS Proposed Sustainability Disclosure Standards ***(by mid-2022)***

The IFRS Foundation trustees have emphasized from the outset that the new ISSB would address the breadth of sustainability topics that are critical to business, although the Board would initially prioritize climate-related disclosures given the global urgency to do so. The General Requirements Prototype will require companies to report across all material sustainability issues from day one by using a high-level framework. Over time, further thematic and industry-specific standards will provide more specific requirements.



Additional Highlights From COP26

Other key topics discussed at COP26 are highlighted below.

COP26 — Highlights

Government	Corporate	Global Finance
• 100+ countries pledge to end deforestation by 2030. • 100+ leaders pledge to cut methane by 30 percent by 2030. • 46 nations to phase out coal. • Newly announced Nationally Determined Contribution commitments. • Global carbon trading agreement reached.	• Glasgow Financial Alliance for Net Zero formation. • Alliance of CEO Climate Leaders letter to world leaders. • 200+ companies committed to reaching net-zero emissions by 2040.	• Funding the energy transition. • Funding South Africa's transition away from coal. • Financing for developing nations. • Ending fossil fuel financing.

Climate-Related Disclosures

The TCFD's recommendations have been central to the development of the Climate Prototype. This prototype is built on the Task Force's four pillars — governance, strategy, risk management, and metrics and targets — and reflects its core recommendations.

The objective of the Climate Prototype is, in part, to enable users of an entity's general-purpose financial reporting "to determine the effects of climate-related risks and opportunities on the entity's financial position, financial performance and cash flows." The Climate Prototype applies to climate-related risks that the entity is exposed to (e.g., physical risks and transition risks) and climate-related opportunities available to the entity.

Under the Climate Prototype, an entity would be required to disclose the following cross-industry metrics:

> (a) *greenhouse gas emissions* — in terms of absolute gross *Scope 1*, *Scope 2* and *Scope 3*, expressed as metric tonnes of *CO_2 equivalent*, in accordance with the Greenhouse Gas Protocol, and emissions intensity;
>
> (b) transition risks — the amount and percentage of assets or business activities vulnerable to transition risks;
>
> (c) physical risks — the amount and percentage of assets or business activities vulnerable to physical risks;
>
> (d) climate-related opportunities — the proportion of revenue, assets or other business activities aligned with climate-related opportunities, expressed as an amount or as a percentage;
>
> (e) capital deployment — the amount of capital expenditure, financing or investment deployed toward climate-related risks and opportunities, expressed in the reporting currency;
>
> (f) internal *carbon prices* — the price for each metric tonne of greenhouse gas emissions used internally by an entity, including how the entity is applying the carbon price in decision-making (for example, investment decisions, transfer pricing, and scenario analysis), expressed in the reporting currency per metric tonne of CO_2 equivalent; and
>
> (g) remuneration — the proportion of executive management remuneration affected by climate-related considerations in the current period . . . , expressed in a percentage, weighting, description or amount in reporting currency.

The current TCFD disclosure recommendations are the basis for the Climate Prototype and future standards. Many companies are reporting in a manner consistent with the TCFD's recommendations because doing so affords them the opportunity to develop resources and skills before adopting the new climate-related disclosure standard that is ultimately issued. To best prepare for the ISSB climate standard and continue to advance TCFD disclosures, companies may review the annually published TCFD status reports. Highlights from the TCFD's *2021 Status Report* are summarized below.

Highlights From the TCFD's *2021 Status Report*

- Over 2,700 public and private companies from 89 jurisdictions have become TCFD supporters, a 70 percent increase since last year. The G7 and G20 have also endorsed the TCFD Recommendations.
- TCFD-aligned disclosures are evolving to incorporate more quantitative analysis, with a focus on financial impact.
- Strategy is the most disclosed pillar, but the resilience of strategy under different future scenarios is not well disclosed. Governance is the least disclosed pillar.
- Progress is needed to enhance disclosure quality since only 50 percent of 1,651 companies reviewed provided disclosures in alignment with at least three recommended disclosures.
- The TCFD released supplemental and revised implementation guidance, including:
  - Enhanced guidance on disclosure of the financial impact of risks and opportunities on financial performance.
  - Supplementary guidance and examples on integrating transition plans into recommended disclosures.
  - Additional guidance on metrics and targets (the TCFD recommends disclosure of Scope 1 and Scope 2 emissions).
  - Climate-related metrics categories that the TCFD believes are applicable to all organizations.

Anticipating SEC Rulemaking on ESG

Proposed ESG Rules From the SEC Expected in 2022, With Implementation Requirements Currently Unknown

The ISSB's future proposed sustainability standards will set the stage for future regulatory developments. There is an expectation that financial regulators in multiple jurisdictions will look to these standards as the foundation for regulated ESG disclosure. While the SEC served as the co-chair of the IOSCO Technical Expert Group that advised on setting up the ISSB, it is unclear how the SEC might look to the ISSB regarding standard setting. The SEC continues to increase its focus on ESG overall, as reflected in the SEC's regulatory agenda issued in June 2021. This agenda included proposed rulemaking related to four ESG topics: climate risk, human capital, board diversity, and cybersecurity.

On the basis of public statements from the SEC, it appears that the Commission aims to have final rules in place by late 2022. Although the implementation period is still unknown, this anticipated timing highlights the need for companies to act quickly to prepare for regulation. The SEC is likely to introduce requirements to provide ESG disclosures in periodic reports, which can therefore be expected to increase attention on the timeliness of and avenue for disclosure. Although currently under development by the SEC, disclosure elements related to climate change may include mandatory quantitative and qualitative disclosures about company greenhouse gas emissions within financial filings. Expected disclosure elements for human capital may include metrics on workforce turnover, training and development, compensation and benefits, and workforce demographics. This focus may push companies to consider shifting from producing a separate sustainability report to aligning disclosures and integrating them into the companies' SEC filings.

SEC Sample Comment Letter on Climate-Related Disclosures

While the SEC considers rulemaking, it is also looking at compliance with disclosure requirements under the current rules. In September 2021, the SEC's Division of Corporation Finance (DCF) released a sample letter containing examples of comments that the DCF would consider issuing to public companies on climate-related disclosures currently included in their filings. The sample comments focus on the extent to which public companies are disclosing information in a manner consistent with the SEC's 2010 interpretive release on climate disclosures. In addition, the letter indicates that the DCF may review information disclosed outside a company's SEC filings (e.g., ESG and sustainability reports) and ask a company whether it should also include the associated information in its SEC filings. The SEC shared the sample comments with the public to provide context for and insights into the increased attention and focus on climate-related disclosures. For more information about the SEC's sample comment letter, see Deloitte's September 27, 2021, *Heads Up*.

Other Noteworthy SEC Developments

Recent SEC activities related to ESG and climate also include the following:

- The director of the SEC's Division of Enforcement warned companies not to mislead investors by omitting material ESG information.
- The DCF rescinded staff guidance that previously allowed companies to exclude shareholder proposals on climate targets, paving the way for shareholder votes on these proposals.

Role of the Finance Organization and Assurance Implications

To prepare for the forthcoming ISSB standards and SEC proposed rules, companies can:

- **Assess SEC comment letter priorities**, including the SEC sample comment letter on climate, against current ESG and corporate disclosures.
- **Refresh sustainability materiality assessments and conclusions**, as well as documentation of inputs and stakeholder considerations.
- **Align disclosures with existing sustainability standards and frameworks**, specifically those of the SASB and TCFD, which the ISSB intends to continue leveraging, as well as current jurisdiction requirements.
- **Consider ESG-related accounting implications**, such as the financial reporting impacts of environmental events and activities.
- **Engage with internal audit and external assurance providers** to assess preparedness to receive assurance over ESG information, enhance maturity of the ESG control environment, and prepare for accelerated reporting.
- **Enhance overall governance of ESG matters** at the board of directors and management levels.
- **Review current prototypes** to prepare for implementation of the proposed future ISSB standards.

Considerations for Issuers and Assurance

Considerations for Issuers		Assurance
Current State Reporting	Analyze current sustainability and climate disclosures against standards and frameworks (e.g., SASB and TCFD) and the ISSB prototypes.	• Integrate sustainability into the internal audit plan. • Evaluate the type and level of external assurance required to meet stakeholder expectations, perform assurance readiness with the goal of obtaining external assurance.
Governance	Assess board and management oversight, roles, responsibilities and accountability mechanisms over sustainability and climate disclosures.	
Enterprise Risk Management	Identify enterprise-wide sustainability and climate risks and opportunities; prioritize and assess materiality in short, medium, and long term.	
Data Processes and Controls	Assess implementing the forthcoming standards and the impact on internal reporting systems, skills needed, and additional training required.	

Proactive companies will come out ahead of those that hesitate to invest in ESG. Integration of ESG considerations into business strategy and financial planning can help inform decision-making and better position companies to manage risks, deliver shareholder value, and increase resilience.

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