Douglas Hileman Consulting, LLC

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ISSB S1: Definitions and Key Terms

Definitions and Terms

ISSB

The International Sustainability Standards Board (ISSB) released two Sustainability disclosure standards on June 26, 2023[1]. IFRS S1 is "General Requirements for Disclosure of Sustainability-related Financial Information."

There's nothing like reading primary documents. Who has the time? Even if you read the words – but what do they mean for your company? This post – one of a series – is intended to help preparers understand the standards, what's required, and how to prepare to comply[2]. "Preparers" includes anyone at an executive level or senior management. It includes anyone in functions (Environmental, HR, IT, Operations, Procurement, etc.) that are responsible for programs, and/or who provide information for disclosures.

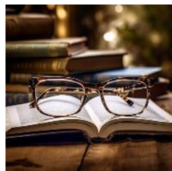
Part 1 highlights selected **Defined Terms** from Appendix A.

Part 2 highlights additional concepts in the S1 standard or Basis for Conclusions. Note that all these definitions and concepts will carry through to the S2 Climate Related Disclosure standards.

PART 1: ISSB S-1, SELECTED DEFINED TERMS – From Appendix A

Selected defined terms are excerpted directly from S1. Douglas Hileman Consulting LLC (DHC) supplements the definitions with insights and perspectives.

Disclosure topic: a specific sustainability-related risk or opportunity based on the activities conducted by entities within a particular industry as set out in an IFRS Sustainability Disclosure Standard of a SASB Standard.



DHC Perspective: SASB – the Sustainability Accounting Standards Board – was established over 10 years ago to provide a mechanism for investors to have meaningful data and information on sustainable business information that is "material" according to common definition for the general investor. SASB created Sustainability Industry Classification system to group companies by similar sustainability risks. SASB finalized standards for 77 industries. Each SASB standard includes approximately seven to twelve topics. SASB standards were never intended to represent every applicable topic – only those that are material to the general investor. SASB has now been merged into the ISSB. The SASB standards survived. Companies who have been following SASB

[1] S1 (General Requirements) and S2 (Climate-Related Disclosures). S2 builds on S1.
[2] Disclaimer: Douglas Hileman is neither a CPA nor an attorney. He has 40+ years of experience in Sustainability, including compliance, risk management, reporting, auditing and assurance. Neither this document nor other thought leadership at www.douglashileman.com constitute a consulting relationship. Readers are encouraged to do further reading and research.

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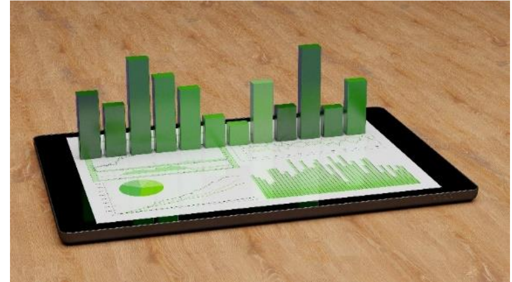
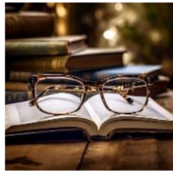
standards, and who have built robust systems and controls to support these disclosures have a significant head start on conforming with S1.



General purpose financial reports: Reports that provide financial information about a **reporting entity** that is useful to **primary users** in making decisions relating to providing resources to the entity. Those decisions involve decisions about:

a) Buying, selling or holding equity and debt instruments
b) Providing or selling loans and other forms of credit; or
c) Exercising rights to vote on, or otherwise influence, the entity's management's actions that affect the use of the entity's economic resources.

General purpose financial reports include – but are not restricted to – an entity's general purpose financial statements and **sustainability-related financial disclosures**.



DHC Perspective: This is both much broader, and much narrower than it might seem at first. When discussing "investors", many stakeholders stop at those who are trading stock on public markets (NYSE, NASDAQ, etc.). This definition is much more expansive, extending to those involved in debt instruments, loans, and any form of credit. It also extends to users who are – or who may – consider exercising their right for shareholder actions. This expands the applicability of the users tremendously over the common impression.

On the other hand, the definition limits the disclosures to topics in general purpose financial reports. Not to impact investors. Companies' standalone Sustainability reports – such as those following GRI guidelines – are not included. Nor are disclosures submitted to CDP, which has disclosure frameworks for both greenhouse gas emissions and water management. DHC contends that the distinction between these reporting channels and their respective purposes is a key reason for the confusion about the oft-maligned "alphabet soup" of disclosure standards and frameworks. Analysts – Bloomberg, Ecovadis, Sustainalytics, Moody's, etc. – are in a special class. They draw on information from all reporting channels for their analysis, and (in some cases) ratings and rankings. ISSB stayed squarely "in their lane" and maintained their focus on the audience for general purpose financial reports.

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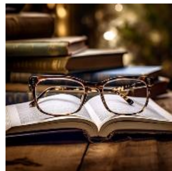
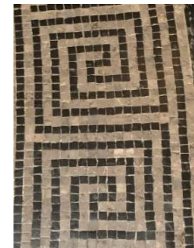
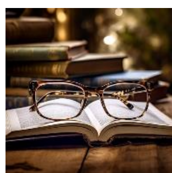
Impracticable: Applying a requirement is impracticable when an entity cannot apply a requirement after making every reasonable effort to do so.



DHC Perspective: ISSB realizes that companies will face challenges to collect all the information needed for all disclosure topics. Many companies have not yet developed systems, controls, or mechanisms to compile it. Many who have started this journey are confounded by the fact that the information simply isn't available. Or it isn't of sufficient quality to be included in financial filings. So ISSB has provided a limited "hall pass." Companies should not expect to take cover under this concept to escape efforts for sustainability disclosures. What is "*every reasonable effort*"? Did the company make a sustained effort, with resources devoted to it? Was the first committee meeting on a disclosure topic two weeks before fiscal year-end, and committee members were overwhelmed and gave up? Were those efforts documented? Are there action plans to pursue better data to enable disclosures in the future? Impartial reviewers – agency personnel, independent auditors, etc. – should be able to review documents and records so they can make their own conclusions as to whether it really was impracticable to fulfill the disclosure standard.



Material information: In the context of sustainability-related financial disclosures, information is material if omitting, misstating or obscuring the information could be reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.



DHC Perspective: "Materiality" is a perennial topic in disclosure standards, at conferences, by consultants, and assurance providers. Materiality is now incorporated into GRI Universal Standards. In a nutshell, "materiality" means "what matters most?" The next question is: to whom? For S1, note that material information does not need to be the tidbit that tips a (actual or prospective) investor's decision one way or the other. It merely needs to be something a "primary user" would *reasonably* want to know as part of their decision-making process.

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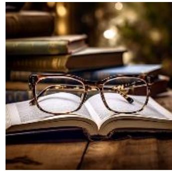
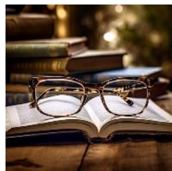
Primary users: existing and potential investors, lenders and other creditors.



DHC Perspective: Note that this includes "lenders *and other creditors*." Your bank. This could also include companies in your value chain that extend credit for components, or who extend credit for sales on consignment. It also includes "existing *and potential*." Your company does not need to have an existing relationship with these entities; in fact, you may not know who they are. S1 is silent on the analyst community. Analysts often work on behalf of investors, and may count themselves as primary users. Preparers may encounter a vast scope of information requests from analysts, extending well beyond general purpose financial reports. Preparers may contend that analysts are not "primary users."

Value chain: The full range of interactions, resources and relationships related to a reporting entity's business model and the external environment in which it operates.



DHC Perspective: The standard further notes that value chain includes interactions, resources and relationships used to create its products or services from conception to delivery, consumption and end-of-life. It is noteworthy that this definition is here at all. Financial reporting and disclosures focus primarily on aspects a company has ready access to data about: revenues, expenses, asset values, liabilities. These are within the organization's control. Yet organizations have dependencies throughout the value chain. Disruptions can affect financial performance, or even their existence. This definition is a clue of what lies ahead as companies identify material topics, identify and assess risk, and begin to collect reliable data.

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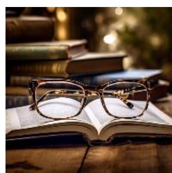
PART 2: OTHER KEY CONCEPTS

These terms are not defined in Appendix A of the S1 standard. They appear in S1 and/or are further explored in the S1 Basis for Conclusions or Guidance. These terms feature prominently in the standard and what preparers need in order to make sustainability-related financial disclosures. This section includes summaries of the concepts and perspectives.

Aggregation (see Organizational Boundary)

All Reasonable and Supportable Information "An entity shall use all reasonable and supportable information that is available to the entity at the reporting date without undue cost or effort to: identify sustainability risks and opportunities …. And to determine the scope of its value chain … "



DHC Perspectives: This concept relates to "impracticable" (defined) and signals that *some* level of effort is required to fulfill the sustainability-related financial disclosures. Companies may not have systems and controls to enable disclosures to the level of rigor they apply to financial reporting. S1 disclosure topics include qualitative and quantitative parameters, and topics where the preparer does not have full control[3]. Many companies have deferred in developing programs for years. Reasons may have included: the impression that ESG does not apply to them; confusion about requirements; belief that their existing efforts were sufficient; hope that the requirements would fade away; or unwillingness to do so. It may also be due to the small scope of the business, financial pressures, or limited resources (e.g., IT, talent).

ISSB acknowledges this with the "all reasonable and supportable information" concept Other parties (regulators, customers) may ask preparers what they did, and make their own judgment on "reasonable" and "supportable." Good practice would be to make good faith efforts, document the efforts, basis for decisions, and enhancement opportunities. Just as there are processes and controls for content that is disclosed, consider developing plans to mature your processes to enable disclosures in the future.

DHC suggests that companies get familiar with this concept, and set a bar for this term. You'll see it again in S2, the Climate-related Disclosures standard.

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[3] See "Three Attributes of Non-Financial Reporting" white paper at www.douglashileman.com. This construct is also included in COSO's supplemental guidance on Internal Controls over Sustainability Reporting (ICSR), released March 2023. The COSO document is also at the same website, and on the COSO website.

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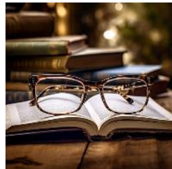
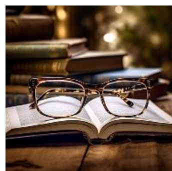
Clarity Material information must not be obscured by other information. An entity is required to make material information required by IFRS Sustainability Disclosure Standards prominent and distinguishable from immaterial information.



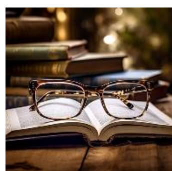
DHC Perspective: In other words, if primary users wish to consider the company's sustainability-related disclosures: a) they should be able to find them quickly; b) the disclosures should align with the disclosure standards; and c) they should not be cluttered with irrelevant information or fluff. Just the disclosures.

Competence S1 requires the disclosure of information about how the governing body(s) or individual(s) determines that the appropriate skills and competencies are available, or will be developed to oversee strategies designed to respond to sustainability-related risks and opportunities.



DHC Perspective: Note that the requirement is for <u>competence</u>, not "training." ISO management systems made the transition from "training" to "competence" over the years, so this should look familiar to those in Environmental, Safety, and Quality functions. Consider how competence is developed and maintained over time for this fast-paced world of Sustainability reporting and disclosures. Document efforts and rationale.

Connected Information **A**n entity shall provide information … that enables users … to understand … the connections between the items to which the information relates – such as connections between various sustainability-related risks and opportunities that could reasonably be expected to affect the entities prospects … "



DHC Perspectives: "Connected information" means connecting sustainability-related financial disclosures, the underlying information with the relevant portion(s) of financial information [assets, liabilities, sales, etc.]. Preparers are required to provide information so users of general purpose financial reports can understand connections between the information provided in disclosure topics and where / how they relate to the company's prospects for financial performance in the short, medium and long term.

DHC suggests that "connected information" harkens back to "connected thinking" – a term used in the International Integrated Reporting Framework[4]. In my view – perhaps controversial – ISSB's explanation is a significant improvement over IIRF. As a bit of wonky history, the signature graphic in the IIRF was a "spider", depicting inputs from six

[4] Note that the International Integrated Reporting Council (IIRC), which published the IIFR, now is within the IFRS Foundation, which created ISSB, which published S1 and S2. One small step for conversion of the alphabet soup.

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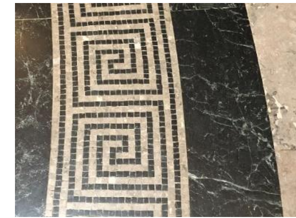
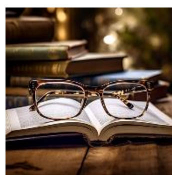
types of capital, an organizations activities involving those capitals, and outputs for those six capitals. Upon a closer read, the outputs were really about how the reporting entity used the six capitals for financial performance. Financial performance only. IIRF advocated integrated thinking to make organizations more conscious that they rely on human capital, natural capital, financial capital, etc. to make money – or not. Connected information acknowledges that non-financial issues pertaining to an industry do not exist in a silo. They can pose risk and opportunity. Human rights abuses leading to restrictions that are expected to limit availability, cost and quality of a key raw material for products that make up 30% of your sales? Primary users want more detailed information on precisely how, where and when. Disclose how, please.



As an aside, SEC's proposed climate disclosure rule had a similar provision. Often referred to as the "1% rule", the proposed rule would require disclosures of where climate-related risk had – or could – affect specific line items in financial statements by an amount of 1% or more. This is unlikely to survive unchanged for an SEC final rule. Nonetheless, the proposed provision aligns with what the investment community is clamoring for.

Core Content Core content consists of disclosures about: governance, strategy, risk management, and metrics and targets. The S1 Application Guidance expands: Information focusing on core content is necessary for users of general purpose financial reports to assess the effects of sustainability-related risks and opportunities on an entity's cash flows, its access to finance and cost of capital over the short, medium and long term.



DHC Perspectives: The disclosure about core content requires an explanation of what the entity is doing.

If this looks familiar, it should. These are the four major groupings of disclosure topics for the Task Force on Climate-Related Financial Disclosures (TCFD). I remind Clients and colleagues that TCFD was established by the Financial Stability Board – not the Sierra Club, Greenpeace, or a social justice group. Climate poses risk, including to the financial stability of economies, and financial performance of companies. This high-level taxonomy has become broadly accepted, and is now embedded into ISSB S1. Preparers responsible for all disclosures to capital markets will see this again in ISSB S2. The SEC proposed client rule also had these headings; it is a sure bet they will appear in the SEC's final rule.

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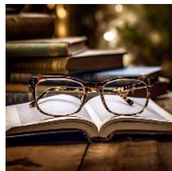
Decision-Useful - see Useful.

Errors Errors are omissions from and misstatements in the entity's sustainability-related financial disclosures for one or more prior periods. If an entity identifies a material error in prior period(s), it shall disclose its nature, the correction (to the extent practicable) for each prior period disclosed. If impracticable, the entity shall disclose how the condition came to exist and the corrections made.



DHC Perspectives: An error is a mistake; an "uh-oh". This can arise from erroneous calculations on a work sheet, double-counting data, omissions in data. It can arise from forgetting to include data from some business units or facilities in numerical data.

Note that corrections are required if the error is "material". What about all those narrative disclosures? If a disclosure indicated the CFO led the sustainability disclosure team, and s/he did not, is that material? Would it matter if the leader were actually General Counsel or an entry-level Sustainability specialist four levels down in the organization?

There are several things an error is not. Tailoring methods to produce better estimates is an improvement; it is not an error.

There are likely to be discussions about what constitutes an "error." As companies develop and improve systems and controls to gather data and information on disclosure topics, it is inevitable they will encounter inconsistencies and anomalies over time. Is it "material"?

Correcting the errors of the past is a new provision for sustainability-related financial disclosures. In DHC experience, it is helpful if companies develop and document processes to evaluate materiality of identified errors, and document how they implement this process for any/ all errors identified. Including those where corrections for prior reporting periods were not undertaken.

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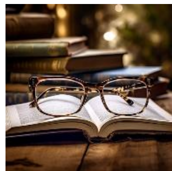
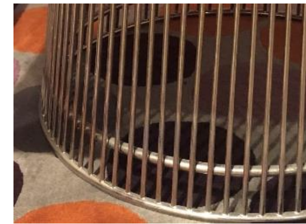
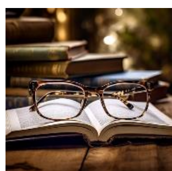
Judgments An entity shall disclose information to enable users of general purpose financial reports to understand the judgments, apart from those involving estimates of amounts, that the entity has made in the process of preparing its sustainability-related financial disclosures and that have the most significant effect on the information included in those disclosures.



DHC Perspective: "Judgment" appears 19 times in S1 – 12 times in the standard and seven in the Application Guidance. ISSB acknowledges that not all data is readily available to support the S1 disclosure requirements. But these judgments and the processes used to arrive at them cannot be hidden behind a curtain. Judgments are essential. Companies likely make judgements without realizing it. For example, entities will be confronted with choices of where to start in their supply chain to request data, accept or verify the data, and how much is enough. Companies can start with outreach to a certain percentage of spend – why? Why not the suppliers that provide critical materials for high-value products, and where there are no alternate suppliers?



Materiality S1 says that "Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates, in the context of the entity's sustainability-related financial disclosures."



DHC Perspective: Note that "material information" is defined, but "materiality" is not. Much has been written about "materiality" and more is certainly on the way. I like the quote "materiality is in the eye of the beholder." Many stakeholders are "beholders" of Sustainability information.

I highly recommend that anyone – an entity, a professional entering the Sustainability reporting and disclosure arena – take a time out when embarking on discussions around materiality. Material to whom? According to what criteria? Is the discussion really about double materiality? And for what purpose? The "beholders" relevant for S1 are primary users of general purpose financial reports.

Organizational Boundary/ Aggregation An entity is required to disclose sustainability-related financial information for the same reporting entity as the related financial statements. IFRS S1 requires consideration of all facts and circumstances when deciding how to aggregate and disaggregate

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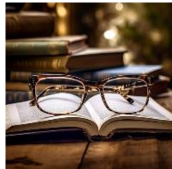
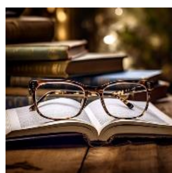
information in sustainability-related financial disclosures. It also requires that understandability of disclosures is not reduced "by obscuring material information with immaterial information, or by aggregating material items of information that are dissimilar to each other."



DHC Perspective: This makes sense at first blush. General purpose financial reports are at the consolidated entity level. ISSB is following principles and concepts of financial reporting. Recall, though, how companies can be snagged into scope. Consider a U.S.-based company with a global presence and business units in other countries. A business unit in Spain seeks a line of credit from a bank in Spain. The Spanish bank may request any type of Sustainability-related information in accordance with their own investment profile and appetite. They may request the information as disaggregated to show how they apply to activities in Spain. The Spanish bank is "making decisions relating to providing resources to the entity", as noted in the S1 definition of general purpose financial reports. The Spanish bank may expect complete sustainability-related financial disclosures of the entity *on a consolidated basis*. The U.S.-based company, confident that ISSB standards would not apply to them – are snagged.

Proportionality. Proportionality refers to the relative burden that could be placed on some entities to fully meet ISSB disclosure requirements, based on resource constraints, availability of data, or availability of competent specialists.



DHC Perspective: This allows organizations to "adjust the level of the bar." Entities can apply proportionality to get relief from complete disclosure requirements. They are not home free. Entities are still obliged to gather and disclose what they are able to prepare after using "reasonable and supportable information … without undue cost or effort."

There could be risk if an entity invokes proportionality and discloses an incomplete set of data and information on disclosure topics for their industry. Investors and analysts will be comparing disclosures within a sector to make investment decisions, such as selecting companies for ESG index funds. If companies with similar profile and profitability can make full disclosures, why can't you? Companies that are just beginning a Sustainability reporting journey may do well by doing benchmarking or less formal peer comparisons. Even this is fraught with pitfalls; public disclosures are from the prior reporting period, and peer companies are marching on with further improvements.

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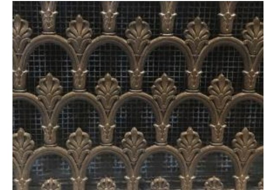
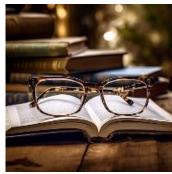
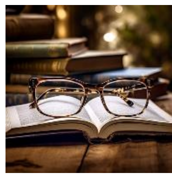


Risk Assessment An entity is required to assess the scope of all affected sustainability-related risks and opportunities arising throughout its value chain. Entities have existing processes and controls for risk identification and assessment. These processes typically include considering existing and new risks; evaluating applicability; consideration of likelihood, impact, and timing; and whether to implement additional measures to transfer or mitigate risk.



DHC Perspective: Risk Assessment is one of four categories in Core Content. Disclosure topics involve considerable narrative – how risks are identified and evaluated, explanation or processes, etc. IFRS is keenly aware that companies already have risk assessment processes and resources. These processes typically have a cadence for routine re-assessment. Better processes have provisions to reevaluate risk upon a significant development or trigger event. ISSB's provisions point affected entities towards leveraging existing practices to the extent they apply. Companies need not re-assess sustainability risk in every reporting cycle if this exceeds their general risk assessment cadence.

Uncertainties S1 states that "an entity shall identify amounts it has disclosed that are subject to a high level of measurement uncertainty … the sources of measurement uncertainty … and the assumptions, approximations and judgements the entity has made in measuring the amount."



DHC Perspectives: Any data is subject to some level of uncertainty. Sustainability-related information may be subject to more for one or more of several valid reasons. For example, a considerable amount of information originates from outside the company. Systems and controls are still maturing. This provision is consistent with a "comply or explain" approach that has become more common in Sustainability disclosure standards and frameworks. If an entity does not have data for a disclosure topic, it cannot simply ignore it. It cannot simply put the proverbial thumb in the wind and guess. The entity must identify and describe the uncertainties. Although unwritten in S1, the common expectation is that reporting entities will find and implement measures to reduce uncertainties.

The discussion of "uncertainty" in S1 relates to measurements – quantitative information. "Uncertainty" is not discussed in the context of narrative. DHC suggests that narrative, claims and assertions are inherently different, and should be subject to different controls and reviews. If a statement can't be supported, change the statement or remove it.

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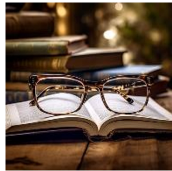
Usefulness Usefulness of sustainability-related financial information is enhanced if the information is comparable, verifiable, timely and understandable.

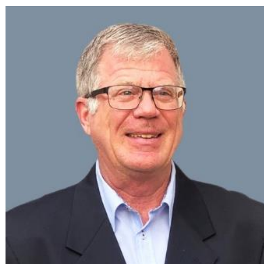


DHC Perspectives: Tune into any webinar on Sustainability reporting and disclosures, and you'll probably hear the term "decision -useful." Preparers' eyes often glaze over – who is making decisions, and about what? And what do they use this information for? The feedback loop from users to preparers is woefully thin. However, S1 hammers home that the intended audience is "primary users of general purpose financial reports." And that they may consider Sustainability disclosures as a factor in making decisions related to capital.

Sustainability-related disclosures are more useful to this cohort if they conform to the disclosure topics, if they are complete, and (for quantitative topics) they use the units of measure in the standards. They are useful if data is provided for the current and prior reporting period(s) to enable comparison of Sustainability-related data concurrent with comparison of financial data.

Companies are overwhelmed with questionnaire fatigue. If disclosures help stakeholders make decisions, useful disclosures could reduce this burden.

About Douglas Hileman Consulting LLC



Douglas Hileman helps clients with Sustainability compliance, risk, programs, reporting and disclosures and audits. He is an author of COSO's supplemental guidance "Achieving Effective Internal Control over Sustainability reporting (ICSR)", which has taken the accounting and audit community by storm. He is the only non-CPA and only ESG specialist on the author team. He has over four decades of experience in operations, corporate, management consulting, Big 4 firm experience (including during early Sarbanes-Oxley years), and with his consultancy. He was on the Volkswagen Monitor Team for three years, as the senior environmental management/ auditing specialist, working on behalf of the DOJ. He is in demand for training, workshops, and presentations at conferences. One distinction is his ability to bridge the gap between traditional financial reporting professionals (Accounting, Internal Audit, Finance) and functions responsible for much of the Sustainability data and information (Environmental, HR, IT, Operations, Procurement, Real Estate, etc.).

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