IFRS Sustainability

Staff paper

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ISSB meeting

Date	**December 2022**
Project	**General Sustainability-related Disclosures**
Topic	**Fundamental Concepts**
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Objective

1. This paper discusses the use of fundamental concepts and terms within Exposure Draft IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* ([draft] S1). This paper focuses on the objective of [draft] S1 including the concept of value, the identification of sustainability-related risks and opportunities, and materiality judgements.

2. The objective of this paper is to:

   (a) describe the staff's analysis and recommendations on fundamental concepts and terms in [draft] S1; and

   (b) seek decisions from the ISSB on select matters.

Summary of the staff's recommendations

3. The staff is seeking decisions from the ISSB on its recommendations summarised below.

   Part 1: Value and sustainability

   (a) **Staff recommendation 1** (see paragraphs 31-35) – Clarify the framing and objective of [draft] S1 to:

      (i) describe how the value created, preserved or eroded for an entity (and its providers of financial capital) is inextricably linked to other stakeholders, society and the natural environment;

      (ii) describe how an entity relies on these resources and relationships (which some may refer to as 'capitals') to create value for itself and providers of financial capital;

      (iii) describe how, in interacting with these resources, an entity creates impacts and dependencies on them, which may 1) positively or negatively affect the resources, and 2) give rise to sustainability-related risks and opportunities that the entity is exposed to; and

      (iv) describe how sustainability-related risks and opportunities can affect the entity's performance or prospects, influence its business model or strategy and create or erode the value of the entity or the returns for providers of financial capital over the short, medium and long term.

   Part 2: Identification of sustainability-related risks and opportunities and assessment of material information

(b) **Staff recommendation 2** (see paragraphs 58-60): Amend the [draft] S1 Illustrative Guidance to further expand and clarify how to identify sustainability-related risks and opportunities and how to assess and disclose material sustainability-related financial information to meet the objective and requirements of [draft] S1. The staff recommends expanding and clarifying the illustrative guidance by specifically addressing the following:

(i) clarify the distinction and connection between identifying sustainability-related risks and opportunities that an entity needs to provide information about and disclosing material sustainability-related financial information (ie a two-step process);

(ii) provide further illustration on the identification of sustainability-related risks and opportunities to provide information about (the first step in the two-step process) by providing a general description, describing the factors and inputs to consider, illustrating a process that could be used as an example and emphasising which types of risks and opportunities to provide information about; and

(iii) provide further illustration on making materiality judgements in the context of sustainability-related financial disclosures (the second step in the two-step process) by discussing management judgement and entity-specific circumstances, primary users and the decisions they make, and making judgements in light of uncertain outcomes.

(c) **Staff recommendation 3** (see paragraph 65): Amend the [draft] S1 Illustrative Guidance by drawing on existing market resources (such as the SASB Implementation Primer) to provide further illustration of how preparers may approach the two-step process articulated above when their business activities span multiple industries (ie identifying sustainability-related risks and opportunities for disclosure and making materiality judgments). More specifically, the staff recommends that we amend the 'Industry-based SASB Standards' section of the illustrative guidance to add a specific example for how a conglomerate can use SASB Standards to inform the identification of sustainability-related risks and opportunities and the selection of metrics and other information.

Structure of the paper

4. This paper is structured as follows:

(a) Background (paragraphs 5-10)

(b) Part 1: Value and sustainability (paragraphs 11-35)

(i) Staff analysis

(ii) Staff recommendation

(c) Part 2: Identification of sustainability-related risks and opportunities and assessment of material information (paragraphs 36-65)

(i) Staff analysis

(ii) Staff recommendations

(d) Questions for the ISSB (paragraph 66)

Background

5. In March 2022, the Chair and Vice-Chair published [draft] S1, which sets out proposed requirements for disclosing sustainability-related financial information to provide users of general purpose financial

reporting with a complete set of sustainability-related financial disclosures. [Draft] S1 is supplemented with Illustrative Guidance, which further illustrates aspects of [draft] S1 but is not required to be applied for an entity to assert compliance with the Standard.

6. Over the past several months, the ISSB has discussed and redeliberated the use of terms and fundamental concepts within [draft] S1.

7. At its October 2022 meeting, the ISSB redeliberated the objective of [draft] S1, and some of its proposed requirements and defined terms. The ISSB agreed that:

   (a) the purpose of [draft] S1 is to require entities to meet the information needs of the primary users of general purpose financial reporting;

   (b) 'material' in [draft] S1 shares the same definition as that used in IFRS Accounting Standards; and

   (c) the definitions of 'value chain' and 'reporting entity' as proposed in [draft] S1 should remain unchanged.

8. The ISSB also tentatively decided:

   (a) to amend [draft] S1 by removing the definition of 'enterprise value' and the words 'to assess enterprise value' from the objective and description of materiality, while planning to continue to redeliberate the meaning of 'enterprise value' at a future meeting (in particular, how the term could be more clearly articulated and how it is related to material sustainability-related financial information); and

   (b) to remove the word 'significant' from the proposed requirements to describe which sustainability risks and opportunities an entity would be required to provide information about, while continuing to redeliberate the application of materiality and the process used by preparers to identify an entity's sustainability-related risks and opportunities, in particular those that it is required to provide information about in order to provide useful information to primary users.

9. The following sections of this paper present further staff analysis and recommendations to build on the feedback and tentative decisions from the October ISSB meeting.

10. However, this paper does not address disclosure about an entity's significant judgements and assumptions, including those related to materiality assessments. The staff notes that considerations of such disclosure requirements are related to the topics discussed in this paper and were discussed in the October 2022 Agenda Paper 3B *General Sustainability-related Disclosures—Fundamental Concepts* (matter to address 4) but staff does not provide a recommendation on this topic in this paper. This topic will be discussed at a future ISSB meeting.

Part 1: Value and sustainability

Staff analysis

11. While the objective and materiality assessment of [draft] S1 were intended to align with the IASB's *Conceptual Framework*, [draft] S1 included references to enterprise value. The inclusion of this term was intended to serve two purposes. First, it was intended to widen the scope of relevant disclosures beyond current IFRS financial accounting and disclosures to capture a broader set of information, including information that extends beyond current financial position and performance. At the same time, the term was intended to narrow the scope of disclosures to only include information about

sustainability-related risks and opportunities and their impacts that is useful to primary users in the decisions that they make.

12. Although the underlying information may differ, the purpose of the materiality assessment for sustainability-related financial disclosures and financial statements is consistent: to ensure that users of general purpose financial reporting have the information that is relevant to their decision making and that is reasonably certain to influence the decisions they make based on a preparer's reporting. However, the set of information covered by these two kinds of disclosures, or the context within which preparers should approach identifying what information to disclose, is different.

13. The staff believes that providing some context for the materiality assessment in [draft] S1 is important, as this helps illustrate the fundamental scope and objective of sustainability-related financial disclosures and focuses the assessment on how primary users use this information in their investment decision making. Accurately describing this context will help preparers understand which information they should identify and how to assess what to disclose. However, the staff believe that a more robust explanation is required to appropriately describe the context, one that captures more completely the meaning behind the term 'enterprise value'.

14. In addition, the staff notes that, based on some stakeholder feedback, [draft] S1 may not have sufficiently described sustainability-related risks and opportunities in the context of enterprise value and sustainability more broadly. The staff points to the relevant description of sustainability-related risks and opportunities in paragraphs 16-17 of [draft] S1 as the staff believes that this description helps provide some of the context that was intended with the use of the term 'enterprise value'. Moreover, it aligns with the rationale behind the discussion of value creation for the entity and others in the Integrated Reporting Framework. As a result, the staff believes that further emphasis on some of this existing language in [draft] S1 (again, paragraph 17 as an example) can help with the challenges related to the framing the objective of [draft] S1, especially in light of the ISSB's previous decision to remove 'enterprise value' from the objective and description of materiality while not seeking to change the fundamental focus of S1. In particular, the staff believes that while it is important to confirm that S1 is focused on the provision of information useful to primary users and information relevant to the sustainability of value from the perspective of providers of capital, it is important to more clearly articulate the broader concept of value that underpins this focus.

The Integrated Reporting Framework and the broader concept of value

15. The staff believes that the Integrated Reporting Framework offers an articulation of a broader concept of value that accurately and effectively provides context for the specific objective of [draft] S1.

16. The concept of sustainability is intended to capture and assess whether the entity's business model and strategy can create and sustain value over time from the perspective of users. The entity's ability to create and sustain value is influenced by impacts and dependencies on resources and relationships and by the external environment including both an organisation's external impacts—which could be informally referred to as its effects on people and the planet—as well as the longer time horizon over which these impacts may be realised and reflected in financial performance (and thus value to providers of financial capital) of an entity.

17. The description of sustainability and sustainability-related financial information in [draft] S1 is intentionally broad to reflect that the information related to sustainability-related risks and opportunities will change over time and the drivers of an entity's value from the perspective of primary users will vary significantly across entities based on the underlying nature and nuances of their business model and business activities.

18. The staff believes the concepts in the Integrated Reporting Framework can provide greater clarity on the description of sustainability and the ways in which an entity's ability to create, preserve and erode value over time, including value that is created, preserved or eroded for others, can affect the entity's value from the perspective of primary users—including, financial performance or prospects, availability and cost of capital and more. In other words, the Integrated Reporting Framework can connect what could be referred to as the 'people and planet impacts' of the entity to the interests of users.

19. The Integrated Reporting Framework discusses the creation of integrated reports, which aim to explain how an organisation creates, preserves or erodes value over time. It contains the following key points:

    (a) Value is not created, preserved or eroded by or within an organisation alone. It is:

        (i) Influenced by the external environment [in which the organisation operates]

        (ii) Created through [the organisation's] relationships with stakeholders

        (iii) Dependent on various resources [based on the organisation's business model]

    (b) The ability of an organisation to create value for itself is linked to the value it creates for others.

20. The Integrated Reporting Framework refers to critical resources and relationships, or 'capitals' and identifies categories of capitals (such as financial, human and natural capitals) which can be positively or negatively affected by the entities' activity, and on which the entity depends. Each of these 'capitals' is considered as a stock of value that the activities of the entity (as well as other factors like the external environment) can create, preserve, or erode. The Integrated Reporting Framework thus discusses 'value' as a broad concept relating to each of these capitals.

21. The Integrated Reporting Framework provides clarity on the fact that sustainable development over the short, medium and long term of macro and micro-economic activity (and therefore business entities) relies on a whole business stakeholders ecosystem, defined by the boundaries of its impact on the capitals (financial, human, natural, etc.). This ecosystem encompasses all the capitals that the activity relies upon and that are positively or negatively affected by the activity. The entity is part of an interdependent ecosystem that involves the generation and regeneration of these capitals. An entity's business ecosystem will sustainably provide the entity with the capitals it needs only if, through its activity and its output, the value of these capitals is preserved, regenerated and developed.

22. In the staff's view, [draft] S1 does not need to fully explain the concept of 'capitals', which is covered in depth in the Integrated Reporting Framework. However, it can draw on the idea of financial capital being connected to other sources of value, many of which do not sit directly within the reporting entity. This idea clarifies how value created for others can affect the entity, and also the importance of longer time horizons, because while these 'capitals' or broader sources of value may not affect the entity's financial performance in the near term, they may represent a sort of stored value that could impact its performance or the estimation of its value for users over time. These connections effectively clarify why users are interested not just in the value the entity creates for itself, but also in the value that the entity creates for others, because that value may ultimately affect, for example, the cash flows generated by the entity, its cost of capital, or the availability of funding.

23. This aligns with the explanation in paragraph 17 of [draft] S1, which describes how impacts, dependencies and relationships can affect an entity's financial performance and prospects. The Integrated Reporting Framework uses the phrases 'resources and relationships' as well as 'activities, interactions and relationships' to describe how value is created, preserved and eroded within the

capitals. In both [draft] S1 and the Integrated Reporting Framework, the rationale for the importance of these concepts and their link to the value of the entity for users is fundamentally the same. The staff believes that paragraph 17 of [draft] S1 is critical to this understanding and should be further emphasised in a manner that is consistent with the Integrated Reporting Framework to help clarify the objective of [draft] S1.

The concept of value in the IFRS Exposure Draft Management Commentary

24. These concepts also align with the explanations in the IFRS Exposure Draft *Management Commentary*. The Exposure Draft *Management Commentary* includes proposals focused on the concept of value that built on, and were meant to be largely aligned with, the Integrated Reporting Framework.

25. The Exposure Draft *Management Commentary* (paragraph 3.11) makes a distinction between the value created for an entity itself and value created for others, explicitly clarifying that the former can be referred to as 'enterprise value'.

> In this [draft] Practice Statement, 'ability to create value' refers to an entity's ability to create or preserve value for itself and hence for its investors and creditors. Some people refer to the value an entity creates for itself as 'enterprise value'.

26. The Exposure Draft *Management Commentary* explores the close relationship between the value the entity creates for itself and the entity's future cash flows, which is the concept grounded in the IASB's *Conceptual Framework*. Specifically, the Exposure Draft *Management Commentary* explains that an entity's activities create value for the entity if they enhance or preserve the present value of the entity's cash flows; conversely, the entity's activities erode value if they reduce the present value of the entity's future cash flows. It also clarifies that creating value is a precursor to generating cash flows; conversely, some activities might increase cash flows in the short term but erode value in the long term.

27. The Exposure Draft *Management Commentary* (paragraph 3.13) sets out disclosure objectives for six areas of content, including an entity's business model and strategy, which are anchored in how the entity creates value and generates cash flows. The Exposure Draft *Management Commentary* makes it clear that it uses the term 'value' to refer to the value created for the entity itself but recognises the link between 'value for the entity' and 'value for others':

> In this [draft] Practice Statement, 'value' refers to the value an entity creates for itself and hence for its investors and creditors. The term does not refer to the value an entity's activities might create or erode for other parties—for example, customers, suppliers, employees or society in general. However, management commentary includes material information about the impacts of an entity's activities on other parties if those impacts could affect the entity's ability to create value for itself.

28. By drawing the conceptual distinction between these two types of value—value created for the entity itself with its link to the entity's future cash flows, and value created for others—while acknowledging the relationship between the two, the Exposure Draft *Management Commentary* lays the groundwork for understanding them as different, but related concepts.

Two concepts of value in [draft] S1

29. The references to enterprise value in [draft] S1 were intended to help clarify and provide context between the broader and narrower concepts of value. Instead of requiring disclosure on *any and all* ways that an entity could create or erode value in the broader sense, [draft] S1 aims to produce disclosure on this broader creation of value *to the extent that* it affects the narrower creation of value

(value created for the entity and its providers of financial capital). The concept of enterprise value was thus intended to focus the scope of potential disclosures from the broad universe of potential disclosures on value created, preserved or eroded, to only those that would be of interest to primary users—that is, only those activities that ultimately have the potential to affect the entity's performance or prospects, influence its business model or strategy and create or erode the value of the entity from the perspective of users or the financial returns to providers of financial capital over time.

30. The staff believes that these concepts and their connections are critical to understanding the ways in which sustainability-related risks and opportunities are of interest to primary users. A proper articulation of value (in the broad sense) and its relation to enterprise value would also help situate the scope of S1 in relation to the Exposure Draft *Management Commentary* and financial statements. However, the staff believe that the term 'enterprise value' did not properly clarify these concepts and connections and instead created confusion in respondents' understanding of the scope and purpose of [draft] S1. Ideally, a longer form explanation could articulate both the broader concept of value and the concept of enterprise value, as well as the relationship between the two.

Staff recommendation 1

31. The staff recommend that the framing and objective of [draft] S1 is clarified to:

(a) describe how the value created, preserved or eroded for an entity (and its providers of financial capital) is inextricably linked to other stakeholders, society and the natural environment;

(b) describe how an entity relies on these resources and relationships (which some may refer to as 'capitals') to create value for itself and providers of financial capital;

(c) describe how, in interacting with these resources, an entity creates impacts and dependencies on them, which may 1) positively or negatively affect the resources, and 2) give rise to sustainability-related risks and opportunities that the entity is exposed to; and

(d) describe how sustainability-related risks and opportunities can affect the entity's performance or prospects, influence its business model or strategy and create or erode the value of the entity or the returns for providers of financial capital over the short, medium and long term.

32. The staff also recommend that this description recommended immediately above can be placed in a broader context around the term 'sustainability' and to help further explain the term 'sustainability-related'. This can be done by further explaining the relationship between an entity's activities and the impacts and dependencies created by those activities. More specifically, that sustainability can be characterised as 1) the ability for an entity to sustainably maintain relationships with and manage its impacts and dependencies within its whole business ecosystem and 2) a condition for an entity, through appropriate preservation, regeneration and development of their value, to access over time all the resources (financial, human, natural, etc.) it needs to achieve its goals.

33. The explanations recommended above would not fully explain the broader role of value creation and the ways that different resources and relationships work together to create value on behalf of an entity and providers of financial capital. It will be a succinct version designed to facilitate application and understanding of S1 (and the IFRS Sustainability Disclosure Standards more broadly). The staff does not believe that changes to [draft] S1 can or should aim to replace existing market resources, such as the Integrated Reporting Framework, that have been developed to address these conceptual questions in depth. The staff believes that the ISSB should continue to promote and support the Integrated Reporting Framework as a longer-form explanation of how the broader sense of value, along with various resources and relationships, can affect an entity's performance. The clarification of

the objective of [draft] S1 can be thought of as a summary of the discussion of value in the Integrated Reporting Framework.

34. By better articulating the two kinds of value and their close relationship, the staff believes that S1 can explain the importance of 'enterprise value', which is essentially equivalent to the narrower concept of value, or value created for the entity itself and thus for providers of financial capital. While, in the staff's view, enterprise value should not be formally defined in [draft] S1, this term can be productive in discussions around the amount, timing and certainty of future cash flows over the short, medium and long term and the value of those cash flows in the light of the entity's risk profile, and its access to finance and cost of capital. With an appropriate explanation, enterprise value can help link those discussions to the broader concepts of value created, preserved and eroded for other stakeholders, and help to indicate how concepts like cash flows, risk profile, and access to finance and cost of capital are highly related to and dependent on those broader concepts of value. The staff also note that the explicit link to cash flows is consistent with both the IASB's *Conceptual Framework* and the Exposure Draft *Management Commentary*.

35. Pursuant to the direction from the ISSB in its October meeting, this staff recommendation aims to preserve the focus of the required disclosures, while providing additional explanation that articulates the role that 'enterprise value' was intended to play in [draft] S1 within the broader context of value.

Part 2: Identification of sustainability-related risks and opportunities and assessment of material information

Staff analysis

[Draft] S1 Illustrative Guidance

36. [Draft] S1 is supplemented with guidance that helps illustrate aspects of the proposed reporting requirements. This guidance specifically focuses on implementing materiality judgements and selecting sustainability-related financial disclosures.

37. The Implementing Materiality Judgements section of the Illustrative Guidance leverages some language from the IFRS Practice Statement 2 *Making Materiality Judgements* (Practice Statement 2), but it provides very limited discussion on making materiality judgements and the characteristics of qualitative factors that are relevant to sustainability-related financial disclosures.

38. The next section of the Illustrative Guidance is Selecting Sustainability-related Financial Disclosures. This section emphasises the objective of the [draft] S1, noting that an entity is required to identify the significant sustainability-related risks and opportunities which could reasonably be expected to affect its business model, strategy or cash flows. However, the Illustrative Guidance provides very limited guidance on how to *identify* sustainability-related risks and opportunities and sustainability-related financial information, the factors that should be considered and how the identification of sustainability-related risks and opportunities interacts with the materiality assessment. The guidance uses illustrative examples to further describe how 'other sources of guidance' can help inform the identification of sustainability-related risks and opportunities and the selection of metrics or other information for disclosure.

39. Many respondents agreed that the Illustrative Guidance is useful but most of the respondents that provided feedback in this area recommended that the ISSB consider providing further guidance to help support identification of sustainability-related risks and opportunities and consistent application of [draft] S1.

Interaction and relationship between the identification of sustainability-related risks and opportunities and materiality assessment

40. Entities are required to disclose information about sustainability-related risks and opportunities that could reasonably be expected to influence decisions of primary users of general purpose financial reporting. To meet the objective of [draft] S1, the entity is required to identify sustainability-related risks and opportunities and assess materiality and disclose material sustainability-related financial information as it relates to the [proposed] disclosure requirements.

41. [Draft] S1 focuses on providing information useful for primary users to assess enterprise value and more particularly information about sustainability-related risks and opportunities that could reasonably be expected to affect an entity's business model, strategy or access to finance and capital, over short, medium and long term—and is also limited to that which is material information (see paragraphs 1, 2 and 16 of [draft] S1).

42. The staff believes that it would be helpful for the ISSB to consider amending and expanding the Illustrative Guidance to present the proposed disclosure requirements in a systematic way using a two-step process. For example, the following language from [draft] S1 could be incorporated into the guidance to clarify the interaction and relationship between identifying sustainability-related risks and opportunities to report on and the materiality assessment. This could also help clarify that materiality is not an attribute of a risk or opportunity, it is an attribute of *information* about that risk and/or opportunity.

    Step 1: Identify sustainability-related risks and opportunities to provide information about: Entity's sustainability-related risks and opportunities arise from its dependencies on resources and its impacts on resources, and from the relationships it maintains that may be positively or negatively affected by those impacts and dependencies (paragraph 17 of [draft] S1). A sustainability-related risk and opportunity can result in material sustainability-related financial information if it could reasonably be expected to affect the entity's business model, strategy and cash flows, its access to finance or its cost of capital, over the short, medium or long term (derived from paragraph 16 of [draft] S1) and information about such risks and opportunities could reasonably be expected to influence decisions that the users of general purpose financial reporting make on the basis of that information (derived from paragraph 51 of [draft] S1).

    Step 2: Identify and assess material sustainability-related financial information and disclosures: Identify sustainability-related financial information that gives insight into those sustainability-related risks and opportunities to which an entity is exposed and provides a sufficient basis for users of general purpose financial reporting to assess the resources and relationships on which an entity's business model and strategy for sustaining and developing that model depend (derived from Appendix A definition of sustainability-related financial information). In making the assessment of whether the information about an entity's sustainability-related risks and opportunities (i.e., as identified in Step 1) is material, the entity needs to consider whether its primary users could reasonably be expected to be influenced by the information when making decision about providing resource to the entity on the basis of that information.

43. The staff does not view this two-step process as a formal requirement of [draft] S1-yet, in practice, this is likely how entities would approach sustainability reporting (in the staff's view). Therefore, we believe that further emphasising the two steps would be helpful to illustrate how a company *could* approach the [draft] S1 disclosure requirements in a logical way – which may reduce costs of implementation and improve comparability. If included, the staff recommends that it be clearly stated that this illustrates a possible approach that an entity may use in applying S1 and notes that this description is aligned with the approach the IASB took in describing a four-step materiality process in the Practice Statement 2.

44. This systematic two-step process is also already embedded within the fair presentation section of [draft] S1 specifically as it relates to the use of other sources of guidance. Therefore, aligning the

illustrative guidance with the two-step structure could help further illustrate the fair presentation reporting requirements.

45. The distinction between identifying sustainability-related risks and opportunities and identifying material information about those risks and opportunities is also similar to the IASB's *Conceptual Framework* and Exposure Draft *Management Commentary*. For example, the process of applying fundamental qualitative characteristics of useful information described in the IASB's *Conceptual Framework* states that entities first, identify an economic phenomenon; then, identify the most relevant information about that phenomenon and determine if that information is available and can provide a faithful representation of that phenomenon. The Exposure Draft *Management Commentary* has proposed requirements for an entity to focus on key matters and to provide material information about those key matters.

46. Using a two-step process in the Illustrative Guidance is likely to be intuitive since it is similar to the approach used in IFRS financial reporting and in commonly used sustainability reporting frameworks. It also provides an example illustration to guide preparers through the process of narrowing down a broad set of risks, opportunities, and information to identify what to report on and the material disclosures that meet the objective of [draft] S1.

Describe sustainability-related risks and opportunities

47. The ISSB decided to remove the adjective 'significant' when referring to sustainability-related risks and opportunities throughout [draft] S1. Rather than relying on the term 'significant', the staff believes that amending the illustrative guidance to describe the type and extent of sustainability-related risks and opportunities that are likely to result in material information for primary users would help support entities in understanding and applying the [draft] S1 reporting requirements.

48. Substituting the term 'significant' with further illustrative guidance could include:

    (a) providing a general description of sustainability-related risks and opportunities which references the connection to an entity's business model, strategy and an entity's ability to create value and generate cash flows

    (b) describing the factors to be considered when identifying sustainability-related risks and opportunities including influences on external environment and dependencies on resources and relationships

    (c) illustrating a process that could be used as an *example* of how an entity could identify sustainability-related risks and opportunities

    (d) emphasising the focus is on all sustainability-related risks and opportunities that are reasonably likely to affect the entity's value and cash flows over the short, medium, and long term and are of increasing interest to primary users of general purpose financial reporting and that information about such risks and opportunities could reasonably be expected to influence decisions that the users of general purpose financial reporting will make on the basis of that information

49. Including guidance related to identifying sustainability-related risks and opportunities in the Illustrative Guidance would not replace management's responsibility for making judgements or management's existing risk management processes. Instead, illustrative guidance would be available as a tool to assist management in making those judgements in the context of understanding the types and extent of sustainability-related risks and opportunities that need to be reported as they are likely to result in material information to primary users.

IFRS Practice Statements

50. Customary practices have developed for applying materiality judgement in general purpose financial reporting. The IASB has also set out considerations for applying materiality judgements in the context of general purpose financial statements in Practice Statement 2. However, there is limited guidance for applying materiality judgements about sustainability-related financial disclosures. Absent further guidance, preparers may find it difficult to understand how and whether they can apply aspects of the customary practices for assessing materiality when applying materiality judgements to IFRS Sustainability Disclosure Standards. For this reason, the ISSB may consider expanding the proposed illustrative guidance by further building on the Practice Statement 2 to provide greater clarity on how to assess and disclose material sustainability-related financial information to meet the objective of [draft] S1.

51. While IFRS Sustainability Disclosure Standards are intended to be GAAP agnostic, leveraging Practice Statement 2 would help strengthen connectivity between the requirements of the ISSB and the IASB. The demand for increased connectivity has been highlighted by respondents to the ISSB's exposure drafts, the recent IFRS Foundation Trustees' consultation, the IASB's Third Agenda Consultation and the IASB's recent consultation on its current Management Commentary project.

52. For background, in 2017 the IASB issued Practice Statement 2, which provides guidance on making materiality judgements when preparing financial statements. Practice Statement 2 provides non-mandatory guidance and discusses materiality judgements in preparing financial statements. The guidance in Practice Statement 2 is principles-based. As noted above, [draft] S1 illustrative guidance did incorporate aspects of Practice Statement 2, particularly the guidance related to the general Characteristics of Materiality. However, there are additional aspects of the Practice Statement 2 guidance that were not incorporated in S1 illustrative guidance. The staff believes that language from the Overview of the Materiality Process section of Practice Statement 2 would be useful to include in [draft] S1 illustrative guidance as the principle based guidance in this section could apply when preparing sustainability-related financial disclosures.

53. IFRS Practice Statement 1 *Management Commentary* (Practice Statement 1) provides guidance to assist companies in preparing management commentary. Since the IASB issued Practice Statement 1 in 2010, investors and creditors' information needs have evolved and in May 2021, the IASB published the Exposure Draft *Management Commentary* which sets out the IASB's proposals for a comprehensive new framework for preparing management commentary. In the proposed guidance on making materiality judgments, the Exposure Draft *Management Commentary* builds upon Practice Statement 2, making adaptations to note that information provided in management commentary would need to be broader and more forward looking than information provided in financial statements about an entity's assets, liabilities, equity, income, and expenses.

54. Consistent with IFRS Sustainability Disclosure Standards, the Exposure Draft *Management Commentary* encompasses a less defined range of information than what is prescribed in the IFRS Accounting Standards (such as measurement and recognition criteria for financial statements). Both Exposure Draft *Management Commentary* and [draft] S1 aim to capture more qualitative and forward-looking information than financial statements and they discuss matters (such as sustainability-related risks and opportunities) that are entity specific and could affect the entity's ability to create value and generate cash flows over time.

55. Chapter 12 of the Exposure Draft *Management Commentary*, Making Materiality Judgments, includes principles-based guidance that would help management make materiality judgements in preparing management commentary, with a particular emphasis on identifying information that would explain what key matters are important for an entity's long-term success.

56. The Exposure Draft *Management Commentary* uses the notion of key matters to help entities identify material information for six areas of content to be included in management commentary. Those key matters relate to an entity's business model, strategy, resources and relationships, risks, external environment and financial performance and position. There is substantial overlap between the key matters for the six areas of content in the Exposure Draft *Management Commentary* and the objective and core content of IFRS Sustainability Disclosure Standards.

57. Staff believes that it may be useful to leverage components of the Exposure Draft *Management Commentary* given the similarities in the underlying nature and scope of information to be disclosed by entities. Based on the Exposure Draft *Management Commentary* consultation, most respondents suggested broad support for the guidance agreeing that it is comprehensive and would provide a suitable and sufficient basis for management to identify key matters and to disclose material information related to those matters.

Staff recommendation 2

58. The staff recommends amending the [draft] S1 Illustrative Guidance to further expand and clarify how to identify sustainability-related risks and opportunities and how to assess and disclose material sustainability-related financial information to meet the objective and requirements of [draft] S1. The staff recommends expanding and clarifying the illustrative guidance by specifically addressing the following:

    (a) clarify the distinction and connection between identifying sustainability-related risks and opportunities that an entity needs to provide information about and disclosing material sustainability-related financial information (ie a two-step process) – refer to paragraph 42 for further description of the two-step process;

    (b) provide further illustration on the identification of sustainability-related risks and opportunities to provide information about (the first step in the two-step process) by providing a general description, describing the factors and inputs to consider, illustrating a process that could be used as an example and emphasising which types of risks and opportunities to provide information about – refer to paragraphs 42 and 48 for further description; and

    (c) provide further illustration on making materiality judgements in the context of sustainability-related financial disclosures (the second step in the two-step process) by discussing management judgement and entity-specific circumstances, primary users and the decisions they make, and making judgements in light of uncertain outcomes.

59. The staff notes that in developing this recommended illustrative guidance, existing language would be leveraged from the Exposure Draft *Management Commentary* and IFRS Practice Statement 2 *Making Materiality Judgements* (specifically Chapters 7, 9 and 12), as well as some existing language in [draft] S1 such as paragraphs 16 and 17. The staff believes that existing language in these resources can be adapted to address the points in paragraph 58 (a) – (c) above, and as a result, this recommendation does not entail introducing substantially new ideas or concepts but rather adapting the existing materials cited above to help in the illustration of identifying sustainability-related risks and opportunities and disclosing material information.

60. For clarity, this staff recommendation is exclusively focused on amending the Illustrative Guidance. The staff is not proposing new or amended requirements.

Multiple industry business models

61. At its October meeting, the ISSB discussed challenges that companies that span across multiple industries have related to identifying sustainability-related risks and opportunities and material information for disclosure. This challenge may also apply to companies with a business model that

does not neatly fit into an established industry – or even business models that involve new or innovative activities.

62. The [draft] S1 Illustrative Guidance contains an illustration of how a preparer that neatly fits into a single industry may use the relevant SASB Standard to identify sustainability-related risks and opportunities and related information for disclosure. However, in acknowledging the challenges posed by preparers that span across multiple industries or cannot be easily classified, the staff believes that guidance from existing frameworks can help further illustrate the type and extent of sustainability-related risks and opportunities that are applicable to the objective of [draft] S1. Of the sustainability frameworks that require industry- or sector-based reporting, the SASB Standards have some guidance on how to approach reporting when a reporter's business spans multiple industries. This guidance is located in the SASB Implementation Primer.

63. The SASB Implementation Primer notes that while some preparers are 'pure play' that fit neatly within a single industry, others straddle multiple industries. In these cases, it is recommended that preparers review multiple SASB industry standards to identify disclosure topics and associated information that may produce decision-useful information for users. It also states that if an entity has a unique business model that defies traditional industry classifications, the entity may review disclosure topics (and associated metrics) from an array of SASB industry standards that have similar activities, to help identify relevant sustainability-related risks and opportunities to which they may be exposed to and use the associated metrics to communicate material information to investors.

64. In sum, and as articulated in staff recommendation 3 below, the staff believes that building on the [draft] S1 Illustrative Guidance can help address the challenges posed by preparers that span multiple industries or do not otherwise fit neatly into a single industry. Further illustrative guidance specifically related to SASB standards is particularly useful given that the ISSB decided to confirm the requirement to consider the SASB Standards as proposed in paragraphs 51(a) and 54 in [draft] S1.

Staff recommendation 3

65. The staff recommends amending the illustrative guidance by drawing on existing market resources (such as the SASB Implementation Primer) to provide further illustration of how preparers may approach the two-step process articulated above when their business activities span multiple industries (ie identifying sustainability-related risks and opportunities for disclosure and making materiality judgments). More specifically, the staff recommends that we amend the 'Industry-based SASB Standards' section of the illustrative guidance to add a specific example for how a conglomerate can use SASB Standards to inform the identification of sustainability-related risks and opportunities and the selection of metrics and other information. The staff would leverage language from the SASB Implementation Primer to draft the amended guidance.

Questions for the ISSB

66. The staff presents two questions for the ISSB.

Questions for the ISSB
1. Does the ISSB have any questions or comments about the matters described in this paper?
2. Does the ISSB agree with the staff's recommendations?