

Preliminary Thoughts on the TRWG Sustainability Disclosure Prototypes

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Study Group on Disclosure Policies for Non-financial Information

- In the Study Group on Disclosure Policies for Non-financial Information, we have been working on preliminary reviews on the prototype by the Group of five published in December 2020 since last June. We have been reviewing the TRWG (Technical Readiness Working Group) prototypes since last November.
- Additionally, we conducted a questionnaire survey to more than 300 industrial organizations regarding the TRWG prototypes while informing about the trends of the IFRS Foundation's initiative to develop international sustainability standards and the contents of the TRWG prototypes. To date, the study group secretariat has received opinions and comments from more than 40 industrial organizations and companies.
- This paper summarizes the basic views of the Study Group on the following three points, based on the reviews in the Study Group and the numerous numbers of opinions from industrial organizations and companies.
 1. Support for the definition of sustainability-related financial information which is clearly linked to corporate value
 2. Proposals to achieve the right balance between comparability and originality of corporate value reporting
 - ◇ Standard design based on principle-based approach
 - ◇ Consideration of the overall structure of the standard and the level of detail of the disclosure items
 - ◇ Provision of a guidance on materiality judgment
 - ◇ Enhancement of expression of business model
 - ◇ Development and update of standards based on best practices
 3. Proposals for prototypes of general requirements, climate-related disclosure, Appendix B, and its Supplement (Technical Protocols for Disclosure Requirements)
- We expect that this paper contributes to the discussion on the IFRS Foundation and ISSB (International Sustainability Standards Board), on Sustainability Standards Board of Japan which is a counterpart of the IFRS Foundation in Japan and on preparer and users engaged in sustainability-related information disclosure.

1. Support for the definition of sustainability-related financial information which is clearly linked to corporate value

- The Study Group strongly supports that the ISSB prototype defines sustainability-related financial information in a way that clearly links it to corporate value and defines sustainability-related financial disclosures as providing decision-useful information to the primary users of the general purpose financial reporting (potential and actual investors, lenders, and other creditors).
- The Ministry of Economy, Trade and Industry defines “Sustainability Transformation (SX)” as a management transformation that synchronizes the improvement of corporate sustainability (e.g., sustainable innovation and business model updates) with the improvement of social sustainability and overcomes an environment of uncertainty and promotes Sustainability Transformation (SX), as well as strengthening the capital market functions to support this transformation.
- We believe that the prototype has the potential to accelerate the Sustainability Transformation (SX) of companies by clearly linking the definition and purpose of sustainability-related financial information and sustainability-related financial disclosure to enterprise value, thereby improving the function of capital markets.
- In Japan, efforts toward enterprise value reporting based on integrated thinking have been made over a decade. More than 600 listed companies have already made disclosures in integrated reports, and efforts are underway to improve their quality. We hope that the IFRS Foundation’s overall initiative will be further developed to improve the quality and quantity of integrated disclosure of financial and sustainability-related information. In this regard, we also agree with the “preliminary thoughts” published by Financial Reporting Council on 9 February, which recommends the use of managements commentary as an overarching framework for narrative reporting covering financial and non-financial matters.
- Based on these perceptions, we would like to offer some constructive suggestion for the development of ISSB standards In terms of viability for preparers and benefit to users.

2. Proposals to achieve the right balance between comparability and originality of corporate value reporting

- First, we support the significance of the IFRS Foundation and ISSB initiative to improve the overall efficiency of the capital markets by improving comparability among companies on sustainability-related financial information.
- We also support the IFRS Foundation and ISSB's proposal for a baseline approach and a building block approach. Given the diversity of sustainability-related financial disclosures among countries and regions, the baseline and building block approach is a particularly important approach for the ISSB standards to develop as international standards in global markets, including emerging markets.
- In addition to comparability, the relevance of disclosed information to enterprise value (Value Relevance) is necessary for sustainability-related financial reporting to develop as decision-useful information for the primary users of general purpose financial reporting.
- On the other hand, it is difficult to properly evaluate enterprise value simply by establishing common metrics and targets among companies, given the diversity of sources of corporate competitiveness and business models, and the fact that some companies are in transition phases in terms of business models or industry sectors themselves.
- It is crucial that companies also disclose information that is unique to the company, such as what kind of business model corporate management is aiming for, what matters are considered material, what efforts are being made to reform the business model, and the changes over time toward transition.
- Conversely, it is necessary to avoid the pursuit of excessive detailed disclosure items that lead to reluctance in disclosure or formulaic disclosure (boilerplate disclosure) and reduce the value relevance of the disclosed information.
- Consequently, the standards for international sustainability-related financial reporting should be based on an appropriate balance between comparability of disclosures and originality in expressing value relevance.
- In view of the above, we recommend that the ISSB considers the following five points.
 - i. Standard design based on principle-based approach
 - In order for a standard for sustainability-related financial reporting to evolve as a principle-based standard under a building block approach, we recommend that ISSB clarify its basic approach to each of the disclosure elements.

(e.g.)

- ✓ Regarding the four pillars of reporting content, provide a basic idea of what the purpose of each pillar is and what information needs it serves for.
- ✓ Regarding the disclosure topics set out in the metrics and targets of Climate Prototypes, provide a basic idea of why the disclosure topics are considered material in relation to enterprise value.

- This will enhance the preparers and users' understanding of the value relevance of each disclosure topic and allow the preparers to make more specific judgements about the content of the disclosure.

ii. Consideration of the overall structure of the standard and the level of detail of the disclosure item

- We agree with the adoption of the structure of general requirements, theme, and industry to enhance comparability while adjusting the relevance of sustainability-related financial information and corporate value, which vary by theme and industry.
- On the other hand, the metrics presented in the Climate Prototype and Appendix B, and its Supplement (Technical Protocols for Disclosure Requirements) have some issues arising from the fact that they are too detailed, especially regarding industry-based metrics.

(e.g.)

- ✓ Some metrics are not necessarily material depending on the region or business model, and there are issues in considering them as international baseline standards.
- ✓ The current prototype includes many metrics that are based on standards and systems specific to the U.S. and other countries, and there are issues from the perspective of international applicability.
- ✓ For some companies, there is no industry sector that corresponds to the current Supplement, and for companies with multiple businesses, it may be difficult to determine which industry metrics should be disclosed.

- In addition, overly specific content and calculation methods for the metrics may make it difficult to respond flexibly to changes in the international environment and future changes in industrial structure and regulatory environments in various countries.
- For this reason, we propose that the disclosure requirements for each industry sector, especially in Appendix B, Supplement (Technical Protocols for Disclosure Requirements), should be more generalized and disclosure topic-based, and that the specific metrics be positioned as examples.

(e.g.)

- ✓ For example, for the HERS index required in the HOME BUILDERS industry, instead of making individual metrics a requirement, a higher-level concept of residential energy efficiency could be clarified as a disclosure topic, and the metrics could be positioned as examples.

iii. Provision of a guidance on materiality judgment

- We agree with the concept of materiality in the prototype of General Requirements as it is efficient and effective for both preparers and users. The prototype set out that the sustainability-related financial information is material if it influences users' assessment of the entity's enterprise value, and that "Even if the IFRS Sustainability Disclosure Standards set out a list of specific requirements or minimum requirements, if the information that results from applying the requirements is not material, the entity need not disclose it".
- We also understand the context in which the prototype does not explicitly provide a uniform quantitative threshold for materiality or what is material in a particular situation.
- On the other hand, the broad and detailed requirements in the Climate Prototypes and industry-based metrics have caused confusion on some preparers regarding materiality assessment.
- Materiality assessment is the act of a company determining the information which "could reasonably be expected to influence decisions that the primary users of general purpose financial reports make on the basis of those reports if omitting, misstating or obscuring." It is a key element in achieving a balance between comparability and uniqueness of disclosures.
- Therefore, it is necessary to avoid excessive variation in the granularity of material issues and the method of determining the degree of impact on enterprise value. From this perspective, we consider that it is helpful that ISSB develops a guidance document on the considerations and review process for materiality assessment.
- The current prototype set outs that entities directly determine the materiality of individual items or metrics; however, a two-step approach, in which corporate management identifies material management issues and then disclose material information that appropriately represents those issues, would lead to more value relevant disclosure based on corporate proactive judgement.
- The approach of determining disclosure information based on the identification of material management issues, has been adopted in the International Integrated Reporting Framework and the GRI Standards, and could ensure continuity with the existing accumulated practices in sustainability reporting and integrated reporting.

- iv. Enhancement of expression of Business model
- In the Prototype, the focus is put on the impact to business model, strategy and cash-flow raised by sustainability-related risks and opportunities. On the other hand, the importance of expressing an entity-specific business model is not a prominent feature. The information regarding what business model entities are enacting is essential for primary users of general purpose financial reports.
 - From this view, we suggest that “Strategy”, one of the four-pillars, be updated to “Strategy and business model” and that it requires the disclosure about endeavors that improve the value of the entity and its sustainability.
 - In addition, we suppose that it is an option to include the requirement regarding the disclosure of an entity’s impact on society and environment to the extent to which it affects the entity’s ability to create value and generate cash flows or the investors’ decisions in the “Strategy and business model” section.
 - This disclosure has the potential to prompt entity’s innovation that will increase the positive exogenous effects on society and the environment and the improvement of business models.
- v. Development and update of standards based on best practices
- Regarding Climate-related financial disclosure, high quality disclosures have been accumulating as “Best Practices”, based on TCFD (Task Force on Climate-related Financial Disclosure) recommendation etc. On the other hand, practices on other sustainability-related financial disclosure themes which have been raised relatively recently, such as human capital or biodiversity, are still improving.
 - Even in Climate-related financial disclosure, for example, while GHG Scope 3 is an important metric that reflects the entity’s exposure related to climate-related risks and opportunities, examination and practice regarding preconditions on the measurement of GHG and calculation (e.g. calculation scope, boundary, etc.) are still in the improvement. Internal carbon price is one of the new metrics that is required depending on its materiality in “TCFD Guidance on Metrics, Targets, and Transition Plans,” released in October 2021.
 - In light of this situation, we suggest that standards development should be based on entity best practices and be flexible in terms of ability to be updated.
 - In addition, it would be helpful if the IFRS foundation encouraged other standard setters, whose metrics and calculation methods are quoted in ISSB standards, to refine the contents and to improve the convenience of use for preparers and users.

3. Proposals for prototypes of general requirements, climate-related disclosure, Appendix B, and its Supplement (Technical Protocols for Disclosure Requirements)

I. General Requirements for Disclosure of Sustainability-related Financial Information Prototype

- We propose the following four points regarding General Requirements for Disclosure of Sustainability-related Financial Information Prototype.

i. Overall structure of Standards

- We are concerned that the repeating the four pillars in both General Requirements and Climate-related disclosure will lead to duplication. We share this concern with “FRC Response to ISSB on prototype” released on February 9, 2022.
- We also recognize that reservations should be made regarding whether the four-pillar structure should be followed as a basic structure in all other areas of standards other than climate change. Further clarification on the relationship between General Requirements and thematic standards and the frameworks in both standards is desirable.

ii. Reporting entity boundary

- In Paragraph 19 of General Requirements, it stated that ‘The reporting entity’s boundary for its general-purpose financial reporting shall be the same for its: (a) financial statements; and (b) sustainability-related financial disclosures.’ We suggest that further clarification regarding entity’s boundary is necessary.

(e.g.)

- ✓ For example, the industry-based metrics in the Climate prototype include metrics related to supply chains, but the aggregate scope of the financial statements does not usually include supply chains.

iii. Reporting channel

- In paragraph 59, while allowing external references including voluntary documents, the necessity of the entity’s responsibility for the referenced information and the classification of information is mentioned. This is an effective approach from both perspectives of ensuring flexible operation and quality of reported media.
- While Paragraph 61 does mention some requirements for external references, excessive reliance on external references could lead to situations where material information on sustainability is not disclosed in core general-purpose financial reports or information is dispersed across numerous reporting media.
- Further explanation of the position of each reporting medium when referenced to

external media and an overview of the information that should be included in each medium would be desirable.

iv. Statement of compliance

- Paragraph 67 of the General Prototype states that ‘An entity need not disclose information required by an IFRS Sustainability Disclosure Standard if local laws or regulations prohibit the entity from disclosing that information. If an entity omits material information for that reason, it shall identify the type of information not disclosed and explain the source of the restriction.’
- In addition, in section 2.2 and 2.3 of this paper, we suggested some proposals about the level of granularity of the disclosure items and the necessity of the guidance regarding determination of materiality.
- We believe that further clarification regarding the relation between these elements and the statement of compliance stated in Paragraph 88 is necessary.

II. Climate-related Disclosures Prototype

- First, in the title of this standard prototype, we would like to propose that the information to be disclosed based on this climate standard be more clearly stated. Paragraph 1 states that the objective of these disclosure requirements is to require an entity to disclose information about its exposure to climate-related risks and opportunities, assisting users of an entity's general purpose financial reporting in their assessment of entity's enterprise value. This is consistent with the objective of sustainability-related financial disclosures set forth in the General Requirements (i.e., to provide information that is useful to primary users of general purpose financial reporting in deciding whether to provide resources to the entity). On the other hand, the title of this prototype standard is "Climate-related Disclosures", which may lead to misunderstanding of the scope of risks and opportunities to be disclosed; therefore, we recommend that the title be changed to "Climate-related Financial Information Disclosure".
- Next, we would like to propose two points.
 - i. Clarification of handling of trade secrets
 - We would like to confirm that companies will not be required to disclose information that may harm their own competitive position.

(e.g.)
 - ✓ Paragraph 7.(b) requires companies to disclose the result of their value chain analysis, but it may be difficult to disclose information on suppliers that support each company's technology or risk information on specific business partners.
 - ✓ The information on financing and R&D required in Paragraphs 8.(a)i. and ii. is important for management strategy, and it may be difficult to disclose all of it.
 - ✓ Paragraph 9.(b) requires disclosure of an entity's committed capital allocation plans and planned sources of funding, which may have adverse effects on competition and worsen financing costs.
 - It should be clarified that such information related to the competitiveness of the entity need not be disclosed even if it is a requirement of the standard, and a proviso should be added in the objective or scope section.
 - ii. Clarification of handling of future and forecast information
 - Paragraph 5. "Strategy" requires an entity to disclose climate-related risks and opportunities that it reasonably expects could affect the entity in the short, medium, or long term, and the impact of those risks and opportunities on its business model, management's strategy and decision making, financial position, financial performance and cash flows.
 - We understand that information on the risks, opportunities, and impacts foreseen by an entity is very important for users of general purpose financial reporting to evaluate the entity's enterprise value. On the other hand, since this is forward-

looking information, when disclosing such information, we believe that it would promote proactive disclosure by companies to allow the disclosure to include in advance a disclaimer to the effect that there is no guarantee of their realization.

III. Appendix B of Climate Prototype and its Supplement (Technical Protocols for Disclosure Requirements)

- We propose the following three points regarding Appendix B of Climate Prototype and Supplement (Technical Protocols for Disclosure Requirements)
 - i. Clarification in the higher-level descriptions regarding what standards and measurement methods are acceptable among region-specific criteria and measurement methods
 - ii. Formulating guidance on the concept of selecting industry-based metrics for companies with specific business models and companies with multi-industry businesses
 - iii. Continuous and agile review of metrics including periodic solicitation of opinions in response to changes in the business environment (similar to the mechanism in the SASB(Sustainability Accounting Standards Board) standard)

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