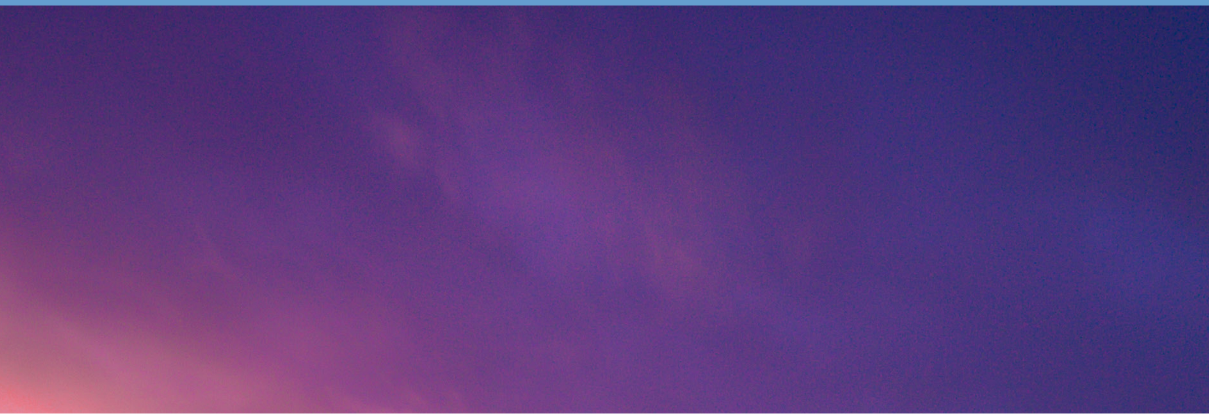


FRC
Financial Reporting Council

FRC Statement of Intent on Environmental, Social and Governance challenges

July 2021

Challenges and actions

There is an increasing focus both on how companies report the impact of their activities on the environment and on the wider environmental and social challenges to which company business models must respond. Companies, auditors, actuaries, investors and others face a changing regulatory environment as reporting and activity adapt to meet these needs. However, underlying this changing regulatory environment, a range of challenges need to be addressed to ensure that we build an effective framework fit for the future.

The Financial Reporting Council (FRC) regulates auditors, accountants and actuaries, issues accounting, audit, assurance and actuarial standards and guidance; and sets the UK's Corporate Governance and Stewardship Codes. Our work is aimed at investors and others who rely on company reports, audits, and high-quality risk management. In addition, our new proposed remit as we transition to become the Audit, Reporting and Governance Authority is "to protect and promote the interests of investors, other users of corporate reporting and the wider public interest". Under this remit, we want to leverage our role and responsibilities, alongside other regulators, the market, and other stakeholders, to help support a framework that allows for the growth of sustainable businesses. This involves understanding how the actions of companies affect the societies in which they operate; how they report on this; and how they are addressing this impact.

Underlying the changing regulatory environment, a range of challenges need to be addressed to ensure that we build an effective framework fit for the future.

Regulatory change

In the UK, the Chancellor of the Exchequer has foreshadowed requirements for a range of entities, including companies, asset managers and asset owners, to report using the disclosures developed by the Taskforce on Climate-related Financial Disclosures (TCFD) and for the implementation of integrated Sustainability Disclosures Requirements. The International Financial Reporting Standards (IFRS) Foundation has recently issued a consultation setting out constitutional changes to allow for the introduction of an International Sustainability Standards Board to support the development of a global set of standards intended to drive high-quality, consistent and comparable reporting.

These are welcome developments, however, they pose a set of challenges and highlight the need for ESG reporting to be developed using a common conceptual framework. In welcoming the proposals of the IFRS Foundation, the International Organisation of Securities Commissions (IOSCO), has stressed the importance that it sets in having that conceptual framework align with that used to develop financial reporting standards, and we agree that a more rigorous framework will become increasingly necessary in this area. There is also the need to continue to consider whether entities are adhering to current expectations, including in relation to the proper consideration of ESG issues in their annual reports, including the financial statements, and audits.

With information relating to ESG aspects of a company's sustainability becoming more significant, the underlying data systems, and the data that supports reporting, pose a challenge. Although investors, governments, and wider stakeholders call for expanded disclosure, the maturity of the systems that produce the information is significantly less sophisticated than for financial information. These challenges need collaborative solutions if ESG information is to be useful to stakeholders and provide them with consistent and comparable information.

The purpose of this paper, therefore, is to build on our previous work and conversations with market participants to set out areas in which such challenges must be addressed if we are to ensure entities act and report in a way that meets the ambitious demands of many stakeholders, some possible actions for addressing these, and the FRC's planned activities in this area.

Our thoughts on the challenges

As a result of our work and outreach we have identified a number of challenges that we have grouped into six stages – production, audit and assurance, distribution, consumption, supervision and regulation.

Production – better internal information leads to better decisions and better insight for stakeholders

Companies face challenges in how they measure, manage, control and assure ESG data. It can be challenging to use ESG information in decision making, including to get comfort on the level of estimation and inference involved, and to transform that data into useable and useful external disclosure across a range of formats, including within the financial statements. This situation is compounded by multiple thresholds, frameworks and guidance and the inefficiencies of meeting multiple obligations in a fast evolving domestic and international landscape. Differing stakeholders can have different information needs and these are not necessarily reflected. Often reporting is aspirational and high level (e.g., a commitment to meet a net-zero target, or a commitment to invest a certain amount to meet such an objective), however, it does not provide users with information about progress, whether the entity's strategy will deliver the commitment, and whether financial statements are aligned with the commitment.

Audit and assurance – reported information is robust and reliable

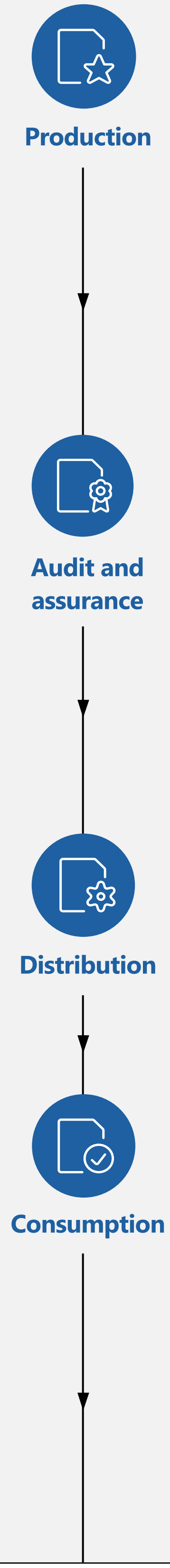
There can be a lack of credibility in ESG information, which entities are often keen to address by commissioning independent assurance. It is especially important to be clear about what is assured and what level of assurance is provided. A limited assurance opinion may well be insufficient to meet expectations. Although a reasonable assurance opinion provides a higher level of comfort that will better meet expectations, the current level of data maturity in most companies is unlikely to be sufficient to enable this to be provided and the criteria against which this would be assessed is unclear. Financial statements may also not take proper account of material ESG issues affecting the company.

Distribution – information is made accessible to interested parties

ESG information is often located in separate places, reports and media at different dates and often not in an accessible or reusable format.

Consumption – this information leads to better decision making by stakeholders

Users can often have difficulty obtaining ESG data and where it does exist it is often based on incomplete frameworks and differing methodologies, has limited comparability, or is not timely. The immaturity of the data (and lack of assurance) can mean that it is not considered to be as reliable as financial data. The lack of useful and useable information results in stakeholders finding it difficult to make effective decisions and investors finding it difficult to address their own regulatory requirements. ESG information is currently subject to a patchwork of regulatory oversight and enforcement, which does not aid consistency. Investors and others need to continue to develop their use of this information.

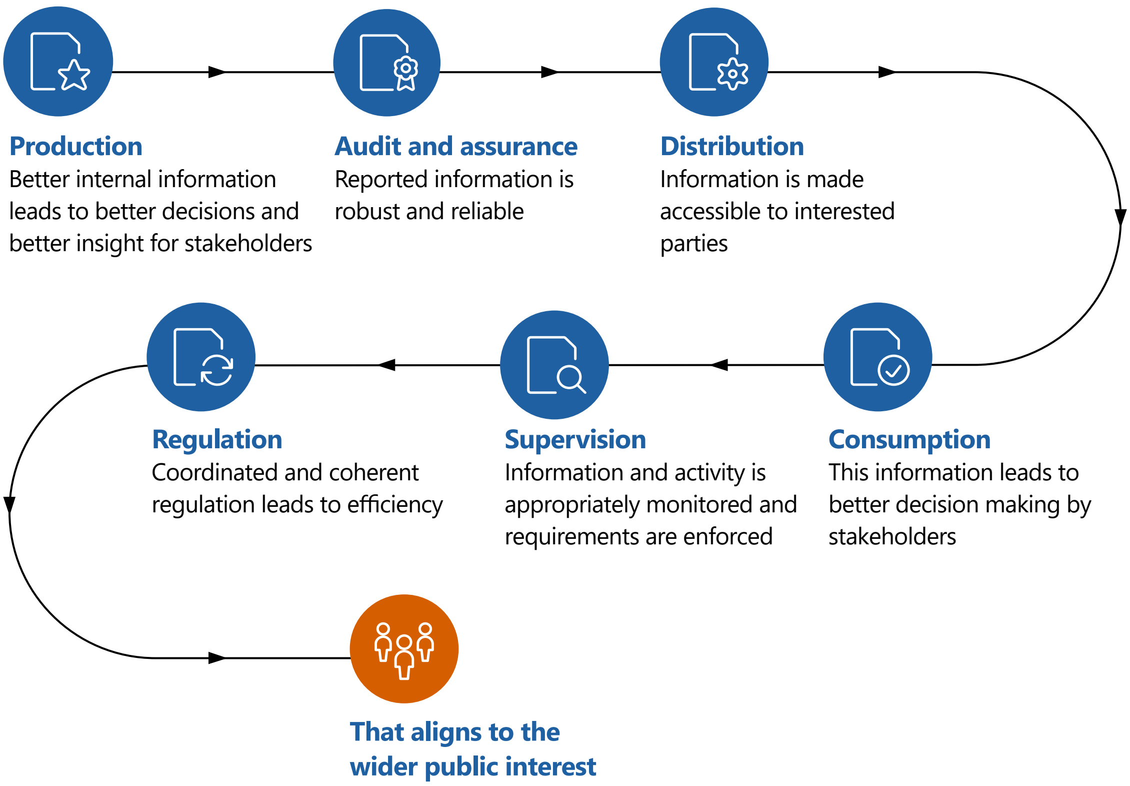


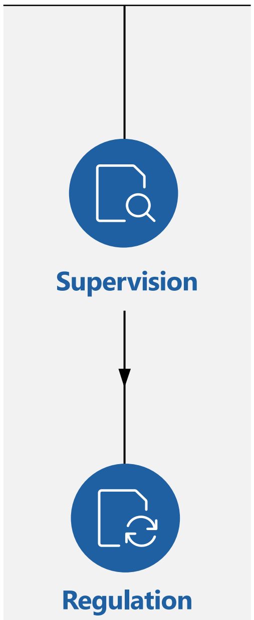
Supervision – information and activity is appropriately monitored and requirements are enforced

With increasing expectations of more and better reporting on ESG there is a need to supervise whether companies, auditors and assurance providers meet relevant existing and future requirements. The increasing expectations require the upholding of high standards and effective communication of regulatory expectations regarding reporting within the annual report and accounts and the audit of the financial statements.

Regulation – coordinated and coherent regulation leads to efficiency

Different countries, organisations and markets are responding to the challenge of ESG at different speeds and at different depths. There is a need to ensure that international ESG standards work effectively alongside a domestic framework, and as the international activity develops there is a need to address any gaps at a national level. Whilst UK regulators continue to coordinate across a range of areas, the regulatory framework often focuses on specific elements or challenges and does not always embody a clear, connected vision of the market. Without wider cooperation and cocreation it is unlikely that frameworks will be compatible, timely and of equal quality. Greater coordination is needed to ensure we have a reporting ecosystem that works as effectively as it can.





What needs to happen next?

Given the importance of both financial and ESG information to investors and others, they should eventually be compiled, considered, and disclosed under a consistent framework. However, there is a long way to go before ESG information, and the frameworks and structures that surround it, are as mature as those for financial information. There is no single way to address the ESG challenges identified above. However, the FRC proposes three modes of action as being most helpful in addressing the challenges.

Co-ordinating – Whilst there have been great strides with coordination on specific frameworks such as the TCFD, wider coordination is necessary within the UK and internationally. Across the company reporting, business, financial market, and regulatory ecosystem second order coordination (i.e., the practical implementation of high-level agreements) is needed to deliver an end-to end-system. This means developing a shared appreciation of the challenges and then leveraging our collective efforts to resolve them.

Connecting – Whilst the UK can progress its own agenda, we need to connect with others across the international environment to foster solutions that are proportionate and effective. This means building partnerships providing leadership, guidance and support where needed, and a commitment to drive change, at an international level.

Contributing – If ESG is to work, many policies, frameworks and approaches need to be aligned or connected. We need to collectively contribute to the discussion through thought leadership, experimentation and coordinated policy consultation responses. The UK has benefitted from the convergence of global accounting and auditing standards and the same benefits need to be secured in ESG reporting.

Actions we will take

Outlined below are the actions the FRC will take within the diverse regulatory framework to accelerate these changes. We expect much evolution of the UK's governance, reporting, audit, actuarial and investment systems as we aim for a more sustainable future. These areas will not achieve the necessary change on their own, but each plays a critical role in driving the tranformation we need, ensuring the public interest is met and developing more sustainable businesses.

To work towards a more consistent architecture, we will take proportionate action within our remit including developing Codes, standards, guidance and expectations. We will also work with and influence standard setters, regulators, market participants and other stakeholders to build a system that is forward-looking and fit for purpose. We will work to build expectations for collation and ensure the development of appropriate standards and controls, delivering robust internal information which is considered strategically and then reported externally where relevant through high quality disclosure, in a useable and useful format, leading to better stakeholder and investment decision-making, all in the public interest. Some of these actions will be short term and some we will take forward in the longer term. Not all of them can be delivered simultaneously, and we need to use our resources carefully, identifying those areas where we can make the greatest contribution and have the greatest impact.

Production

Appropriate measurement, control, and process: To help guide the systematic collection of robust, relevant, reliable and objective information, we will work to ensure that the requirements for information, and its digitisation, are based on sound internal frameworks and methodologies, and that the system supports the standardisation and consistency of such methodologies.

Use in decision making: To encourage better practice governance, oversight, and internal controls we will seek to work with partners to improve the use of quality non-financial information in the boardroom. Over time, this may lead to changes to our Codes and guidance and the regulatory framework. We will also engage more broadly with investors and other users of this information, to ensure that it meets their needs.

Governance and reporting: We will continue to consider the role of the UK Corporate Governance Code in ensuring boards are taking appropriate account of ESG issues in their consideration of the long-term success of the company and amend it as appropriate, recognising the challenges in doing so. We will consider these issues within future revisions to the Guidance on the Strategic Report to strengthen the framework and deliver coherent and accessible information.

Building practice: We will support companies as they move towards a digitally enabled reporting framework. We will highlight better practice approaches, and how changes can be most effectively implemented.

Financial statements: We will develop guidance on the consideration by UK GAAP reporters of the impact of climate-related issues on the company's financial statements, and whether changes need to be made to the accounting standards we directly control. We will also continue to support the appropriate assessment of ESG issues within the financial statements and engage on the development of international standards as necessary, building on UK leadership in this area.

Reconsidered scope: Our work will address the full range of ESG issues, beyond climate change. A future corporate reporting model should accommodate the interests of wider stakeholders as well as investors, including reporting on a company's wider impacts, and we will consider how best to report on these matters.

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Co-ordinating Connecting Contributing

Audit and Assurance

Building maturity: We will work to encourage the development of internal methodologies to ensure information is robust and aligns with the external reporting framework. Where relevant we will also work to ensure that this information is capable of being subject to assurance and provides high quality, consistent and comparable reporting.

Supporting the assurance market: We will work with companies and information users to ensure that the developing framework for audit and assurance of ESG information meets their needs. This will include a survey of investors and others to understand their needs.

A fit audit and assurance framework: We will consider ESG-related amendments within future revisions of the auditing and assurance standards. We will monitor the need for guidance on ESG-related audit and assurance and issue audit and assurance guidance at the national level as appropriate. We will continue to work with the International Auditing and Assurance Standards Board to influence international approaches to assurance of ESG-related information, and to the development of international auditing and assurance standards.

Distribution

Availability: We will work to ensure that there is an appropriate framework for information to be made publicly available on a more consistent basis. This will assist in meeting the public interest and overcome barriers to use.

Digitisation: Market relevant information is overwhelmingly consumed in electronic format, to support this trend we will encourage the electronic distribution of ESG data and a digital tagging system.

Tagging: We will aim for the development of a system where this information is accessible and useable in a digital format, which can only be addressed by a joined-up set of expectations, policies, and initiatives. This will be done in the context of the developing international approach.

Consumption

Quality reporting: ESG reporting will only be useful if it is of sufficient quality and the market understands and trusts the framework. We will work to understand what constitutes useful information and ensure that the reporting framework delivers information that is fair, balanced, and understandable, transparent, consistent, and comparable. We will support this through the provision of appropriate guidance and the identification of best practice.

Investor insight: We will ensure that the needs of investors for information material to their decision making is enhanced, and that reporting in this area continues to improve. We will also continue to monitor investors' approaches to ESG within their UK Stewardship Code reporting, and work with other regulators to align requirements and build an effective market for consideration of ESG in stewardship activity, including how this information needs to flow through the chain.

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Supervision

Audit supervision: We will continue to assess the degree to which auditors ensure that companies take appropriate account of ESG issues in their annual report and accounts.

Professional associations: We will continue to set high expectations for the professional activity carried out by those we regulate, and for the curriculum-setting and regulatory functions carried out by designated bodies.

Reporting supervision: We will regulate corporate reporting according to our powers, working with other regulators, and will monitor and enforce against existing and future regulatory requirements and promulgate evolving better practice against these requirements.

Monitoring: Within our remit for corporate reporting and audit, we will hold to account those who do not meet requirements, including as they develop within the changing regulatory framework.

Regulation

Regulatory coherence: We will lobby for a policy of 'report once, use often'. We will work with other regulators and departments to develop a vision for what ESG reporting can deliver in the longer term, and how this can best be achieved. We will seek better regulatory coherence and the reduction of unnecessary overlap and confusion in requirements, including around thresholds for reporting and proportionality.

Coordinated tagging: We will form a working group on digital reporting and work with others to ensure that information is defined and tagged.

Global reporting alignment: We support the movement towards global sustainability reporting standards. We support IOSCO's and the IFRS Foundation's focus on enterprise value creation, but consider reporting for wider stakeholders is also necessary at a domestic level. We will continue to support this work and offer our assistance as it develops, including seconding someone to help with this project. We will also continue to influence the development of IFRS, via the UK Endorsement Board, where we think there are specific issues relating to ESG.

Global efficiency: We will work with international regulators and governments to ensure as much alignment as appropriate in the digital system, to allow for more effective collation by companies and standardisation and useability for users.

Regulatory environment for actuaries: We will facilitate high-quality actuarial work by ensuring that Technical Actuarial Standards and other actuarial standards evolve to appropriately factor in ESG issues. We will continue to be active in considering the impact of these issues on actuarial work both individually and in conjunction with the Joint Forum on Actuarial Regulation.

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Financial Reporting Council

Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk