Comment letter from 2° Investing Initiative & the Ecological Accounting Chair (Exposure Draft IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and Exposure Draft IFRS S2 Climate-related Disclosures)

1. Introduction

2° Investing Initiative (**2DII**) is an independent, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals. Globally focused with offices in Paris, New York, Berlin, London and Brussels, 2DII coordinates some of the world's largest research projects on sustainable finance. Its team of finance, climate, and risk experts develop research, tools, and policy insights to help financial institutions and regulators hasten and adapt to the energy transition.

2DII has been represented at the EC High Level Expert Group on Sustainable Finance, helped design Article 173 of the Energy Transition Law in France, and collaborates with financial supervisors in Europe and abroad on the application of climate scenario analysis on investment and lending portfolios.

The Ecological Accounting Chair (**EAC**) is a French partnership[1] research chair created in 2019, aimed at developing, promoting, and experimenting strong sustainability accounting frameworks. These frameworks are developed and articulated at three levels: organizations, ecosystems and nations.

The International Sustainability Standards Board (**ISSB**) established at COP26 to develop a comprehensive global baseline of sustainability disclosures for the capital markets, launched a consultation (the **Consultation**) on 31 March 2022 in relation to two proposed standards:

- Exposure Draft IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information (**General Requirements Exposure Draft**); and
- Exposure Draft IFRS S2 Climate-related Disclosures (**Climate Exposure Draft**) (together, the **Exposure Drafts)**.

This document provides general comments from 2DII and EAC in relation to the General Requirements Exposure Draft and the Climate Exposure Draft. Please do not hesitate to contact David Cooke, Law and Policy Lead (david@2degrees-investing.org) or Alexandre Rambaud, associate professor (AgroParisTech[2]-CIRED[3]), cohead of the EAC (alexandre.rambaud@agroparistech.fr) or further information on anything contained in this response.

2. General comments

The conception of materiality apparent in the Exposure Drafts lack clarity.

In relation to disclosure of sustainability information, there are two dominant materiality perspectives:

- the *outside-in* materiality perspective (also known as *financial or single materiality*) which relates to how sustainability issues affect the financial performances, position and development of the disclosing entity; and

[1] List of partners: https://www.chaire-comptabilite-ecologique.fr/Les-partenaires?lang=fr
[2] (French) National Institute of technology for life, food and environmental sciences
[3] International Centre for Research on Development and Environment

- the *inside-out* materiality perspective (also referred to as *impact or socio-environmental materiality*) which relates to the disclosing entity's impact on people and the environment.

Adopting either materiality perspective leads the disclosing entity to two different categories of sustainability information.

While the outside-in materiality perspective is derivative from traditional financial reporting, the inside-out perspective has gained prominence in relation to disclosure of sustainability information which relates to the disclosing entity's impact on people and the environment.

The definition of materiality in the General Requirements Exposure Draft is stated as follows: '[s]ustainability-related financial information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that the primary users of general purpose financial reporting make on the basis of that reporting, which provides information about a specific reporting entity.'[4]

There is no specific definition of materiality in the Climate Exposure Draft. Rather: 'the disclosures set out in Appendix B and its related volumes have been identified as those that *are likely to be useful to users of general purpose financial reporting in making assessments of an entity's enterprise value*. However, the responsibility for making materiality judgements and determinations rests with the reporting entity for all requirements in IFRS Sustainability Disclosure Standards, including this Standard. Therefore, an entity shall disclose information related to a specific requirement when it concludes that the information is material to the users of the information in assessing the enterprise value of the entity.'[5]

Therefore, on the face of the materiality definition provided in the Exposure Drafts, materiality is conceptualised purely through the lens of whether the relevant sustainability information 'could reasonably be expected to influence decisions that the primary users of general purpose financial reporting make on the basis of that reporting.' There is no explicit reference to either the outside-in or the inside-out perspective. As a strict matter of interpretation, the materiality definition can relate to information that would stem from both the outside-in as well as the inside-out perspective.

Indeed, the materiality definition provided in the Exposure Draft is similar to definitions in some existing legal frameworks.[6] But there is longstanding debate as to whether this materiality definition should be interpreted to cover the inside-out perspective as well as the outside-in perspective. And from a practical perspective, market behaviour in response to this materiality definition concentrates attention on the outside-in perspective.

Put simply, although this materiality definition may in theory capture the inside-out perspective, absent any other factors it does not in practice lead to market behaviour with comprehensive disclosure of the disclosing entity's impact on people and the environment.

This then raises the question as to what materiality perspective the ISSB wants to advance – is it exclusively an outside-in perspective or does it also include the inside-out perspective?

We consider that various statements in the General Requirements Exposure Drafts reveal an apparent confusion (or at least inadequate attention or lack of specificity) in relation to how the materiality definition should be interpreted.

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[4] General Requirements Exposure Draft, Paragraph 56. Further information and clarification is found in Paragraphs 57-62.
[5] Climate Exposure Draft, Paragraph B6.
[6] For example, in the UK materiality in the context of the Strategic Report is explained: '[i]nformation is material if its omission or misrepresentations could reasonably be expected to influence the economic decisions shareholders take on the basis of the annual report as a whole.' (FRC, 2022, Guidance on the Strategic Report).

For example, in relation to the General Requirements Exposure Draft the following observations would tend to imply the General Requirements Exposure Draft is focussed on an outside-in perspective:

- The title of the General Requirements Exposure Draft refers to 'Sustainability-related Financial Information.'
- Question 1 in the General Requirements Exposure Draft explains that: '[p]roposals in the Exposure Draft would require an entity to disclose material information about all of the *significant sustainability-related risks and opportunities to which it is exposed*. The assessment of materiality shall be made in the context of the information *necessary for users of general purpose financial reporting to assess enterprise value.*'
- Paragraph 1 of the General Requirements Exposure Draft explains the objective: 'to require an entity to disclose information about its significant sustainability-related risks and opportunities that is *useful to the primary users of general purpose financial reporting when they assess enterprise value* and decide whether to provide resources to the entity.'

On the other hand, the following observations may be conceived to imply the General Requirements Exposure Draft could also cover something like the inside-out perspective:

- Paragraph 6 of the General Requirements Exposure Draft refers to: '[s]ustainability-related financial information is broader than information reported in the financial statements and could include information about: … the entity's reputation, performance and prospects as a consequence of the actions it has undertaken, *such as its relationships with people, the planet and the economy, and its impacts and dependencies on them* …'
- Paragraph 17 of the General Requirements Exposure Draft refers to: '[a]n 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. When an entity's business model depends, for example, on a natural resource - like water - it is likely to be affected by changes in the quality, availability and pricing of that resource. *When an entity's activities result in adverse, external impacts - on, for example, local communities - it could be subjected to stricter government regulation and consequences of reputational effects - for example, negative effects on the entity's brand and higher recruitment costs.* Furthermore, when an entity's business partners face significant sustainability-related risks and opportunities, the entity could be exposed to related consequences of its own. When such impacts, dependencies and relationships create risks or opportunities for an entity, they can affect the entity's performance or prospects, create or erode the value of the enterprise and the financial returns to providers of financial capital, and the assessment of enterprise value by the primary user.'

Note that we say 'something like the inside-out perspective' because even in the above observations, the reference to impact is only relevant in the context that the impact can 'create risks or opportunities … [and] erode the value of the enterprise, the financial returns to providers of financial capital, and the assessment of enterprise value by the primary user.'

On balance the Exposure Drafts are likely to promulgate an exclusively outside-in perspective to materiality.

As demonstrated above, any possible reference to an inside-out perspective in the Exposure Drafts is weak. And as referred to on the ISSB website: '[w]hen the ISSB issues the final requirements, they will form a comprehensive global baseline of sustainability disclosures designed to meet the information needs of investors in assessing enterprise value.'[7]

[7] https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-disclosures/

This analysis is corroborated by the statements made by Emmanuel Faber at the "Etats Généraux de la recherche comptable 2022" (Accounting research forum 2022) of the French Accounting Standards Setter (Autorité des Normes Comptables). Indeed, he declared: *"[...] certains gouvernements vont faire le choix d'une matérialité simple financière. C'est celle sur laquelle nous [ISSB], nous, travaillons et nous sommes focalisés [...]" ("[...] some governments will choose a single financial materiality perspective. That's the one we [ISSB], are working and focused on [...]").*[8]

Observations such as these would lead one to assume that ISSB on balance favours/prioritises the outside-in perspective.

But an exclusively outside-in perspective to materiality is not a good basis for a disclosure framework related to sustainability information, as shown by scientific research.

Issue 1

Scientific research tends to show that a single materiality approach, or even a dynamic materiality approach, is not relevant to natural resource management

If the focus is exclusively on the outside-in perspective (or financial materiality perspective) to enable shareholders to maximise profits based on a complete understanding of the risks and opportunities, this is a reckless approach which is inconsistent with what a disclosure framework related to sustainability information should be seeking to achieve.

If alternatively, the focus is exclusively on the outside-in perspective (or financial materiality perspective) in the belief that this approach is a route to a more sustainable economy, then this also is a largely contested theory. The hypothesis that links this focus to a potential contribution to building a sustainable economy is that of *dynamic materiality*. Dynamic materiality is based on the possible convergence, in the long term, of single and double materiality. The core idea is that to maintain value creation in the long term would require the progressive consideration of environmental and social impacts, such as ESG-driven reputational problems, degradation of resources etc. Hence, by reasoning only in terms of single materiality, but over the long term, the company would automatically come to be interested in its impacts on the environment and people, and thus in double materiality. In short, 'single materiality + long-term value creation' would come close to double materiality, and thus be a relevant framework for piloting a company's contribution to building a sustainable economy. However, despite its apparent simplicity, this idea is largely contested by academic literature, as summarized in Annex 1.

This puts the Exposure Drafts at odds with the direction of travel for disclosure requirements and disclosure standards elsewhere.

Issue 2

The ISSB is opposed to the EU vision, which may pose applicability problems for companies subject to both frameworks.

[8] Statement made at approximatively 5:51:09 of the video available on this site (French Ministry of Finance site): https://video.finances.gouv.fr/lecteur_video/keypub/c0b3294c543c288817b7/id/1d80073de100d47a22c0ea81d12de9/type/pr/lang/fr

Even if the assumption about ISSB on balance favouring/prioritising the outside-in perspective is not correct, the absence of more detailed commentary and better explanation/articulation of the different conceptions of materiality in the Exposure Drafts is unlikely to lead to behaviour with comprehensive disclosure of disclosing entity's impact on people and the environment.

In the EU, disclosure requirements have sought to improve this materiality definition in the context of sustainability information. The Non-Financial Reporting Directive[9] (**NFRD**) introduced a requirement for relevant disclosing entities to report both on how sustainability issues affect their development, performance and position (the outside-in perspective) and on environmental, social and employee matters, respect of human rights, anti-corruption and bribery matters (the inside-out perspective). The conception of materiality in the NFRD therefore reflects a double-materiality approach in which the risks to the undertaking and the impacts of the undertaking each represent one materiality perspective (therefore covering both the outside-in and the inside-out perspective).

At least that was the theory. In March 2018, the European Commission initiated a fitness check assessment on public reporting by EU companies. The fitness check covered the NFRD and notes that this aspect of the EU framework for corporate reporting 'does not ensure that reporting practices are adequate to enable stakeholders to make informed decisions and hold companies accountable for their impact.'[10] In particular, it noted that the double-materiality perspective and the individual outside-in and inside-out perspectives are not well understood or applied.

The proposal for a new Corporate Sustainability Reporting Directive (**CSRD**) explains that '[i]t is therefore necessary to clarify that undertakings should consider each materiality perspective in its own right, and should disclose information that is material from both perspectives as well as information that is material from only one perspective.'[11] Article 1(3) of the proposal for a CSRD 'clarifies the principle of double materiality, removing any ambiguity about the fact that companies should report information necessary to understand how sustainability matters affect them, and information necessary to understand the impact they have on people and the environment.'

The trilogue negotiations between the European Commission, Parliament and Council have now concluded with an agreement for the CSRD.[12] While the text is not yet available, the key measure of the agreed CSRD is the development and adoption of mandatory sustainability standards based on double materiality (i.e. the disclosure of companies' impacts on the planet and people as well as risks and opportunities to the company arising from sustainability matters).[13] The Parliament and Council must rubber stamp the agreement reached during trilogues.[14] Then, the CSRD must be published in the Official Journal of the European Union marking the start of the transposition period for Member States to make necessary changes in their national legal frameworks.

These regulatory changes improve the conception of double materiality and explicitly refer to the outside-in and the inside-out perspectives in order to shift the behaviour of disclosing entities towards disclosing more

[9] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups
[10] Commission Staff Working Document, 2021, Fitness Check on the EU framework for public reporting by companies
[11] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting
[12] Concluded on 21 June 2022
[13] These will include quantitative and qualitative data, and cover both retrospective and forward-looking information. Draft standards (sector agnostic) have been published and are open for public consultation until August. These have been designed by a multi-stakeholder expert group to be feasible, flexible and implementable by companies. The expert group, part of the EFRAG new Sustainability Reporting Pillar, will now continue with technical proposals for sector-specific standards.
[14] While the JURI committee will vote on the agreement this Thursday 30 June, the latest information received indicates that a Plenary vote in the EU Parliament will not take place in July but in Autumn (due to time needed for linguists and lawyers to prepare the final text).

information on impacts on the environment and society regardless of how these relate to the enterprise value of the disclosing entity.

This is a very different approach to the current approach to materiality which is apparent in the Exposure Drafts. Therefore, if the current conception of materiality remains, the ISSB standards will be against the direction of travel in the EU.

Consequences of the Exposure Drafts being at odds with the direction of travel for disclosure requirements and disclosure standards elsewhere.

If the current approach to materiality which is apparent in the Exposure Drafts remains, this could mean that using the ISSB standards may not be appropriate for satisfying disclosure requirements in the EU.

Even without this potential issue, if the ISSB standards and the mandatory standards under CSRD develop as competing standards, this will create significant negative consequences for disclosing entities and users alike. What is more, the ISSB standards could effectively become a *global ceiling* in terms of ambition for disclosure of sustainability information (instead of the *global baseline* which the ISSB professes to be aiming for[15]).

Proposition 1

Considering these preceding observations, we believe that the ISSB must provide further clarification of the concept of materiality in the Exposure Drafts.

If the concept of materiality *is intended* to include both the outside-in and the inside-out perspectives, then in a like manner to recent EU developments, the definition should be improved to ensure it results in the desired behaviour by disclosing entities. As mentioned above, the recent EU developments are a direct response to the fact that further clarifications are required to properly establish double materiality.

If the concept of materiality is *not intended* to include both the outside-in and the inside-out perspective, then ISSB should similarly clarify this. Considering our comments above, we consider that ISSB should:

- provide an explanation as to why it is adopting this approach; and either
- if it considers that this approach is a route to a more sustainable economy/is fit for management of ecological issues, then it should
  - articulate its science-based theory of change as to why this might be the case and
  - respond precisely to the scientific controversies raised by single materiality with respect to ecological (including climate) issues such as those raised in Annex 1; or
- if it considers that this approach is focussed only on providing information to relevant stakeholders on the relevance of sustainability information to the financial position of the disclosing entity, it should seek to communicate this in a much clearer fashion and to articulate that the ISSB standards do not have the same objective or serve the same purpose as the mandatory standards under CSRD.

Additionally, if the ISSB seeks to adopt an inside-out perspective, the current disclosure requirements are not fit for purpose.

[15] https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-disclosures/

Proposition 2

Were an inside-out perspective to be adopted, the disclosure requirements would need to be amended. A further consultation would be required to define these requirements.

Proposition 3

In any case, given the specific nature of ecological issues, the ISSB should systematically rely on multidisciplinary scientific expertise (specialists in scientific ecology, IPCC climate scientists and bio economists) and provide scientifically sound arguments to design its standards moving forward.

In addition, there should be greater collaboration between the ISSB and EFRAG

Regardless of ISSB's response to the above, and even without any agreement on converging the different materiality perspectives apparent in the Exposure Drafts and the CSRD (and accompanying mandatory sustainability standards) greater collaboration between the ISSB and EFRAG in relation to their standard setting approach would be useful for both disclosing entities and users of information.

Greater collaboration would enable ISSB to provide support to EFRAG in relation to developing the disclosure requirements for the CSRD, thereby furthering ISSB's objective to provide a global baseline and create and effective regulatory model that could be adopted elsewhere.

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Annex 1. What science says about single materiality

We first want to highlight that the academic community has long been opposed to the outside-in perspective that seems to be supported by the Exposure Drafts.

This is demonstrated by a recent article[16] investigating the 'nature of academic engagement with policy and the (lack of) responsiveness by policymakers to the scientific community through the development of the International Financial Reporting Standards (IFRS) Foundation Trustees' Consultation Paper on Sustainability Reporting (IFRS Foundation, 2020).' **This paper also shows that the consideration of scientists by the IASB (and thus on the ISSB) is very, and in fact too, weak.**

The researchers prove that '[t]he majority (72%) of academic submissions were opposed to the IFRS Foundation Trustees' proposals on key issues. This dissenting majority collectively have substantial research records in sustainability reporting and its outcomes. Those supportive were significantly less likely to reference research or state their credentials and, despite being supportive, nevertheless raised concerns with the proposals.' The definition of materiality and the investor perspective were among the most criticized features yet, despite this large academic contestation, the same features are present in the Exposure Drafts.

We consider it is of critical importance for ISSB to consider this academic critique and provide below a short synthesis of useful references.

Many studies show that managing renewable resources (e.g. living organisms or abiotic resources) based on a cost-benefit analysis of integrating the flows of services/cash obtained by their exploitation (a single materiality view) can lead to extinction of the population or to a level that is not compatible with a safe minimum standard. On these issues, see for example:

- Clark, C. W. (1973). The economics of overexploitation. Science, 181, 630-634.
- Pearce, D. (1976). The limits of Cost Benefit analysis as a guide to environmental policy. Kyklos, 29, 97–112.
- Clark, C. W. (2010). Mathematical bioeconomics. Wiley.
- Hediger, W. (2003). Sustainable farm income in the presence of soil erosion: An agricultural Hartwick rule. Ecological Economics, 45(2), 221-236.
- Mitra, T., & Roy, S. (2006). Optimal exploitation of renewable resources under uncertainty and the extinction of species. Economic Theory, 28(1), 1-23.

Additionally, a recent academic report investigating the real-world impact of ESG integration by financial institutions concludes that 'ESG integration can drive change […] if the underlying ESG metric is a valid measure of company impact' and 'ESG ratings can reflect company impact when they focus on impact materiality rather than financial materiality.'

Finally, another recent article[17] explores in detail the stakes of a reporting framework aligned with climate science, discussing the articulations with financial issues. It concludes: *"[…] the ISSB [has a] detrimental approach on climate change […] As this paper shows, the balance between outside-in and inside-out perspectives is critical, and we hope to raise awareness among standard-setters. We encourage the ISSB to give due consideration to the impacts to the environment".*

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[16] Adams, C. A., & Mueller, F. (2022). Academics and policymakers at odds: the case of the IFRS Foundation Trustees' consultation paper on sustainability reporting. *Sustainability Accounting, Management and Policy Journal, To be publ.*

[17] Le Ravalec, M., Rambaud, A., & Blum, V. (2022). Taking climate change seriously: Time to credibly communicate on corporate climate performance. *Ecological Economics*, 200, Volume 200 (October 2022), 107542