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Comment letter on *[draft] IFRS S1 General requirements for disclosures about sustainability-related financial information* and *[draft] IFRS S2 Climate-related disclosures.*

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The following commentary was prepared as part of the work and research of the United Sustainability Group, Berlin. Its authors are:

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The International Sustainability Standard Board (ISSB) has become the main global standard setter in the field of sustainability-related financial information. We encourage the ISSB to consider the following recommendations on materiality in its *[draft] IFRS S1 General requirements for disclosures about sustainability-related financial information* and *[draft] IFRS S2 Climate-related disclosures.*

In short, **we believe that the ISSB standard's description of dynamic materiality and its application in reporting about sustainability-related financial information is insufficient to realize the ISSB standard's objectives.** This view is substantiated below.

Dynamic Materiality is insufficiently applied

The [draft] ISSB standard's definition of materiality is consistent with (and limited to) the concept of financial materiality:

> "Sustainability-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."[1] (primary users are defined as "[e]xisting and potential investors, lenders and other creditors"[2])

[1] ISSB 2022, #56

[2] ISSB 2022b, IG3

The ISSB additionally applies the concept of dynamic materiality, which indicates that the assessment of what sustainability-related financial information is in fact material can change over time, from one reporting period to another. The ISSB has made a significant policy decision in this regard, which is in line with the current findings and requirements of the accounting literature,[3] as well as the natural sciences.[4]

The ISSB states:

> "If approved, the Exposure Draft proposals would require an entity to reassess its materiality judgements at each reporting date to take account of changed circumstances and assumptions. The material sustainability-related financial information disclosed by a reporting entity might change from one reporting period to another as circumstances and assumptions change and as materiality judgements and the assessments of enterprise value by users of general purpose financial reporting evolve. The risks and opportunities that users reflect in their assessments of enterprise value can change from one reporting period to another. Some refer to this as 'dynamic materiality', although that term is not used in the Exposure Draft."[5]

Our central concern is that because the scope of materiality is constantly changing and evolving, **it is not sufficient to leave the assessment of what is material at each reporting period exclusively to the reporting entities themselves.** Since there is currently no standardized method for assessing which climate and environmental impacts can become material (to what extent, by what means, and at what time) and different users of the reports therefore apply different assessment methods and frameworks, what is needed first is **a systematic enumeration of all the entity's climate and environmental impacts, in conjunction with the context in which they arise**, in the sense of an 'inside out' perspective (also referred to as: "socially material issues"[6] or "impact materiality"[7]).

Otherwise, the authors worry, the evaluation of sustainability-related financial information will be made considerably more difficult. This is because users of general purpose financial reporting could not sufficiently assess question like: Has the reporting entity correctly assessed the dynamics of its social and environmental impacts? Which environmental impacts are not considered material by the entity's methodology (and therefore not mentioned in the reporting), but would still prove material if if other methodologies or perspectives were applied? Has all material sustainability-related financial information actually been disclosed, as measured against the investment and credit requirements and principles of the users of the entity's report?

A fundamental mismatch is to be expected. **This is due to a methodological lack regarding the procedures and standards for assessing dynamic materiality.** Only a complete list of all the entity's effects on its environment (and, in the context of the *[draft] IFRS S2 Climate-related Disclosures, on the*

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[3] "We call for a better articulation of the "dynamic" nature of the two materiality perspectives to understand how sustainability matters can come to be considered as financial dependencies, risks, and opportunities over time and in alignment with the scientific evidence monitoring the environmental sustainability and social well-being of our planet and its inhabitants." Michelon et al. 2022.

[4] "The terms 'single materiality', 'double materiality' and 'dynamic materiality' are used to distinguish different approaches. Double materiality is associated with the approach that organisations should disclose not only how nature may impact the organisation's immediate financial performance (so-called 'outside-in') but also how the organisation impacts nature ('inside out'). The concept of 'dynamic materiality' emphasises that there is a path for issues (including impacts) to become material over time. […] In line with the gradual convergence in the perspective on materiality in the market, the TNFD framework recognises that consideration of both nature-related dependencies and impacts is required for a comprehensive assessment of risks and opportunities, and that impacts on nature become relevant to enterprise value when assessed over a future time horizon (e.g. through scenario analysis)." TNFD 2022, p. 73

[5] ISSB 2022c, BC76.

[6] Laine & Michelon 2020.

[7] EFRAG 2022, p. 12.

climate) can create the necessary transparency to resolve this mismatch, or at least to manage it and account for regarding financial risks.[8]

For example, the European Central Bank identified huge transition risks and costs for the electricity and gas sector due to the consequences of climate change, which in turn lead to severe risks for creditors and investors.[9] However, these are not reflected in the strategies of many of these companies, which often lack comprehensive measures to adapt to climate change and its consequences.[10] With regard to the question of which climate-relevant impacts of the companies are to be classified as material, credit institutions seem to come to different (sometimes fundamentally different) conclusions than the companies themselves. In this context, **users of general purpose financial reporting can only make well-founded investment decisions against the background of a complete and transparent list of all impacts, a complete inside out perspective.**

This recommendation is of paramount importance for the effectiveness of the [draft] ISSB standards. Among other things, this relates to the ISSB's objective of risk management:

> "The objective of sustainability-related financial disclosures on risk management is to enable users of general purpose financial reporting to understand the process, or processes, by which sustainability-related risks and opportunities are identified, assessed and managed."[11]

The processes outlined here can only be understood if there is transparency about the entity's decisions as to which sustainability- and climate-related impacts (against the entire spectrum of environmental impacts) have been considered material. Even the impression of an adequate management of the identified risks would not lead to high levels of transparency and certainty for investors, lenders and other creditors, as the correctness of the identification of these risks (and their dynamics) in the first place could hardly be evaluated.

This logic can be transferred to the ISSB's objective of strategy:

> "The objective of sustainability-related financial disclosures on strategy is to enable users of general purpose financial reporting to understand an entity's strategy for addressing significant sustainability-related risks and opportunities."[12]

Expand the scope of users and provide information for other standard setters

Another crucial argument why the ISSB's concept of dynamic materiality should be expanded with a full inventory of the 'inside out' perspective is the following. Giovanna Michelon (2021), lead author of a open letter of 109 scholars from the accounting sciences on the ISSB and the materiality debate writes:

> "[…] [T]he ISSB's approach represents a departure from the early practice of sustainability reporting which takes a much broader stakeholder focus and assumes the purpose of sustainability reporting is wider than providing decision-useful information for investors. In this

[8] In comparison, EFRAG (2022, p. 12) writes: "In general, the starting point is assumed to be the assessment of impact materiality, as a sustainability impact may become financially material when it translates or is likely to translate into financial effects in the short-, medium-, or long-term."

[9] EZB 2021.

[10] New Climate Institute 2022; Oil Change International 2022.

[11] ISSB 2022, #25.

[12] ISSB 2022, #14.

> regard, there is concern that ISSB standards will serve the capital markets but at the expense of wider stakeholders, and ultimately, the wellbeing of our planet and our society."[13]

The authors of the Global Reporting Initiative (GRI) write:

> "While most, if not all, of the impacts […] will eventually become financially material, sustainability reporting is also highly relevant in its own right as a public interest activity and is independent of the consideration of financial implications. It is therefore important for the organization to report on all the material topics […]. These material topics cannot be deprioritized on the basis of not being considered financially material by the organization."

This view has a strong basis in the social and environmental reporting and accounting as well as the stakeholder theory literature.[14]

The ISSB has decided to address its standard exclusively to investors, lenders and other creditors. This is reasonable insofar as the IFRS Foundation is primarily responsible for the interests of these stakeholder groups and respectively designs its standards according to financial interests. However, **since the ISSB standards will be of paramount significance for the international field of sustainability reporting (and accounting), and this field is of great importance for other stakeholders as well, the IFRS Foundation should, at least subordinately, if it wants to live up to its paramount role, also take into account the information needs of these stakeholders.** Only by fulfilling the outlined suggestion to expand the ISSB standards to include a baseline presentation of the totality of environmental and climate impacts of reporting entities, the IFRS would meet this responsibility. The standards of other organizations, such as those in the field of environmental protection or human rights, could then build on the ISSB's standard and the content of reporting entities reports set forth therein, and apply their own 'materiality lenses' to the content. Furthermore, only then would the ISSB's standard be compatible with EFRAG's draft for the European Sustainability Reporting Standard (ESRS) as well as the new GRI standards.

Not implementing double materiality in the ISSB's standard would, as Michelon (2020) describes, disregard the academic literature in the field of social and environmental accounting and would have fatal consequences for the chances of success of the global sustainability transformation.

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[14] See f.e.: Aguilera et al. 2007; Bebbington & Gray 2007; Gray et al. 2014; Miles 2019.

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