General Response to IFRS Exposure Drafts S1 and S2: Outlining Serious Concerns

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Introduction

The ISSB's current focus on enterprise value as the sole determinant of materiality is conceptually incomplete, inherently short-term in scope, and parochially narrow-minded. The singular focus on enterprise value creates a dangerous precedent that social and environmental problems only matter insofar as they affect profitability, a precedent which will have reverberating effects far beyond the issue of climate change. If the current exposure drafts are not revised to embed a double materiality perspective from the beginning, there is an undeniable risk that corporate non-financial reporting at a global level will fail to play a meaningful role in the sustainability transition.

The Vice-Chair of the ISSB has stated publicly that investors should be considering businesses' impacts on society and the environment because "investors need this information to understand the risks." By explicitly referencing the importance of organizational impacts, this statement is intended to imply a double materiality perspective. They go on further to state that "in practice there is a massive overlap" between the EU requirements and the ISSB's proposals. **Despite these assurances, the implication that the ISSB is moving towards double materiality, and the notion that there is little substantive difference between the ISSB's exposure drafts and the proposed European Sustainability Reporting Standards associated with the CSRD, is disingenuous in the extreme.**

The European Financial Reporting Advisory Group has explicitly outlined its commitment to a double materiality approach, writing that "double materiality requires that both impact materiality and financial materiality perspectives be applied in their own right without ignoring their interactions." All of the ISSB's proposed standards, whereas, speak exclusively in terms of 'enterprise value', implying that impacts matter only insofar as they influence financial materiality. Where the EU standards refer consistently to "sustainability matters" in general, the ISSB standards refer only to "sustainability-related risks and opportunities" or "sustainability-related financial information". The EU's Climate Standard Prototype includes an obligation for organizations to report their climate impacts *in addition to* their climate risks, and for organizations to outline plans to ensure that their business models and strategies are "compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement." The ISSB's Climate Exposure Draft includes no such provisions of any kind, with no references to climate impacts, 1.5 degree alignment, science-based targets, the Paris Agreement, or similar concepts. **The disparities could not be more stark.**

Moreover, there is now evidence that the ISSB's current exposure drafts have been noticeably weakened since earlier prototypes. Wherever the original General Requirements prototype used terms resembling the EU's terminology, such as "sustainability matters", "sustainability initiatives", or "sustainability performance", these had been surreptitiously removed in the S1 General Requirements draft, being replaced by the weaker term "sustainability-related risks and opportunities." In the definition of "sustainability-related financial disclosure" as it appeared in the appendix, **the requirement to measure "an entity's performance on sustainability matters" was conspicuously removed.** In the definition of "enterprise value" as it appears in the appendix, all reference to the interdependence of enterprise value and stakeholder value was removed as well. Given these changes, it almost appears as though the drafters went to great lengths to remove any language which might give preparers the mistaken idea that the drafts were referring to sustainability as a thing in itself.

The alterations to the ISSB's Climate-related Disclosures Prototype are even more troubling. **All references to specific net-zero scenarios, including the IEA's 1.5 degree scenario, have been removed.** A "comply or explain" provision for scenario analysis has been added, which has a high potential to be abused. All references to the Paris agreement, Paris-aligned scenarios, or science-based targets, have also been removed. In the new draft, firms are no longer required to disclose their low-carbon investment as a proportion of overall investment, and the term "lower-carbon investment" has been changed to the more ambiguous "climate-related opportunities". In this draft as well, the ISSB has been moving *further away* from the EU standards, rather than aligning with them.

Our following response to the ISSB's exposure drafts outlines, in precise detail, the following five claims:
1. Sustainability without double materiality is not true sustainability;
2. Double materiality has overwhelming support;
3. Double materiality is better for investors;
4. Double materiality will not create unnecessary complexity or administrative burden;
5. The Climate Exposure Draft requires a double materiality lens and contextualization within a 1.5 degree temperature threshold.

We hope that these arguments will be adopted by the IFRS and incorporated into the final sustainability standards in an effort to transcend the single materiality paradigm and move towards a truly inclusive understanding of the term 'stakeholder capitalism'.

1. Sustainability without double materiality is not true sustainability.

There is an abundance of academic research conclusively demonstrating that a narrow focus on financial materiality for the purposes of non-financial reporting can impair a firm's contribution to sustainable development, or even negate it completely.[1] The systemic failures that we collectively face, from ecosystem collapse to economic inequality, are a result of the overriding focus on enterprise value creation at the expense of social and environmental value.[2] **As such, considering social and environmental value only insofar as they affect enterprise value is simply reinforcing the underlying problem.**

Sustainability is predicated on a recognition of the interdependence of firms and their external environments, a relationship which is bidirectional. Sustainability, in the context of double materiality, overtly acknowledges that enterprise value is dependent upon the underlying social and environmental value (i.e. system value). The concept of sustainability thus requires measuring and reporting on the impacts that an enterprise has on the world. The singular focus on financial materiality, whereas, is the opposite of this–it measures how the world impacts enterprise value. **It thus inverts the meaning of the term 'sustainability' by implying that it is merely about sustaining corporations in a world that is be-**

1. Citations sourced from an Open Letter to the IFRS Foundation. Adams, 2015; 2017; Michelon et al., 2020a; 2020b; O'Dwyer and Unerman, 2020; Schaltegger and Burritt, 2018; Schneider et al., 2017; Unerman et al., 2018.

2. Adams and Harte, 1998; 2000; Adams and McPhail, 2004; Antonini et al., 2020; Bebbington et al., 2014; Burchell et al., 1985; Gray et al., 1996; 2014; Gray, 2006; 2010; Hopwood, 2009; McPhail and Adams, 2016; Milne, 1996; Russell and Thomson, 2009; Schaltegger and Burritt, 2000; Sinkovics, et al., 2016; Williams and Adams, 2013.

coming increasingly unsustainable. This causes firms to have less interest in reducing their social and environmental impacts than on finding ways to limit how social and environmental crises will harm their financial position, while contributing to the problematic belief that sustainable or ethical behaviours should only be pursued whenever they are profitable (and ignored when they are not). It also has the consequence of causing firms to become blind to long-term social and environmental problems that are of grave concern to society but are not yet considered relevant business risks. There is substantial research demonstrating that the exclusive focus on financial materiality significantly lowers the number of sustainable development issues which come under corporate purview.[3]

The impetus for widening the adoption of sustainability reporting and aligning standards is a recognition of the fact that certain types of *non-financial* information, related to social and environmental issues, should be within the purview of organizational decision-making, rather than continuing to be siloed and ignored. This observation, in turn, is a result of the recognition of the inherent limits of financial information, and the need to broaden the focus of organizational decision-making processes to consider systemic challenges that are non-financial in nature. **The attempt to truncate non-financial information into financial information, therefore, is a category mistake.** It is a conceptual confusion based on a misinterpretation of the issues at hand. It is like the old adage–putting a square peg in a round hole. It simply reproduces the same flawed thinking that helped cause these crises in the first place.

This conceptual discrepancy, and the perverse consequences that it entails, can be illustrated with a few concrete examples. Imagine a company that negatively impacts or even destroys an ecologically sensitive area in a region of the world with poor environmental regulations and lax law enforcement. When considered from the lens of financial materiality alone, such a situation would not be considered a material business risk and thus remain out of the scope of the organization's reporting, despite obviously being a salient sustainability issue. Conversely, if a firm were to generate profits from the worsening effects of the climate crisis, for instance by increasing revenue related to the sales of air conditioning units in areas experiencing extreme heat waves, this could be considered a "climate-related opportunity." If this seems cynical in the extreme, one should note that it is actually identified as an example in the IFRS Climate Exposure Draft under the definition of "climate-related risks and opportunities." This clearly illustrates the fact that **the ISSB's definition of sustainability is not about reducing firms' negative impacts on society or the environment, but helping firms reduce their exposure to, or even profit from, the consequences of a changing climate and collapsing biosphere.** Despite the organization's attempt to position itself as the "International *Sustainability* Standards Board", it really should change its name to the more accurate (but less impressive) "International *Sustainability-Related Risks and Opportunities* Standards Board."

Although the ISSB consistently claims that its sole audience is investors, its attempt to establish itself as the only global baseline for *sustainability* standards will have consequences for all stakeholders, not just investors. There are a huge variety of stakeholders that will be users of sustainability information, including governments, NGOs and civil society, academics, and citizens. Sustainability problems are systemic problems by nature, which necessarily means that sustainability information affects many other interested parties, given that organization's impacts on the environment and society have consequences for all human beings on this planet. **In setting itself up as the authoritative global institution for determining the definition of 'sustainability', a concept which affects all stakeholders, while still maintaining that it serves only investors, the ISSB is acting in bad faith**. Such a contradiction could lead, in some cases, to the unfortunate situation in which a jurisdiction might reflexively adopt these disclosure standards without greater scrutiny, assuming that they are indeed "sustainability stan-

3. Adams, 2004; Antonini et al., 2020; O'Dwyer and Humphrey, 2020; Rodrigue, 2014; Rodrigue et al. 2015.

dards", and thus fail to appreciate the scale of the deficiencies in the ISSB's approach.

Defenders of the ISSB's approach have claimed that the difference between single and double materiality is not as extreme as others would charge. However, these defenders only believe this to be true because they are considering only the example of climate risk, where the linkage between single materiality and double materiality is more clear than for other issues due to the fact that climate policies are increasingly ambitious and stringent, carbon pricing systems are increasingly sophisticated, the cost of renewable energy is declining significantly while consumer demand shifts, and other trends. **For no other social and environmental issues is there such an appreciable link between single and double materiality.** For issues such as biodiversity and habitat fragmentation, human rights, health equity, community displacement, or Indigenous sovereignty, to name but a few, the relationship between impact and financial materiality is by no means clear (or might even be *inversely correlated*).

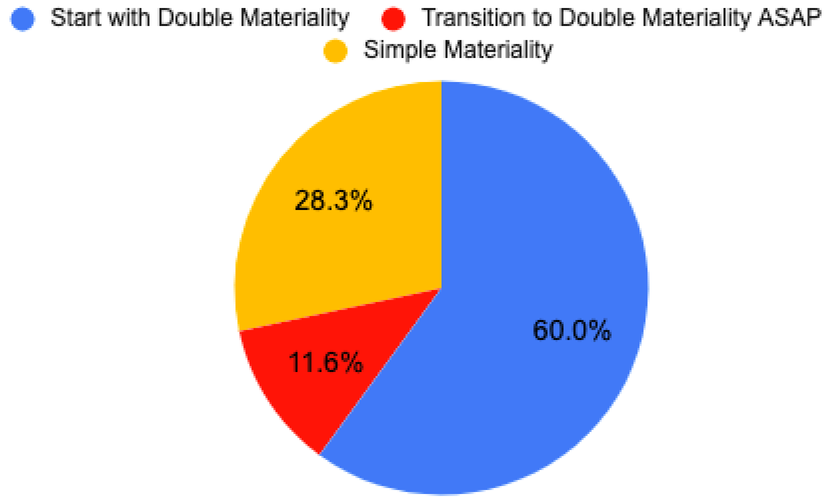
A single materiality lens implies that impacts only become material whenever they are risks to a business' profitability. The application of a risk management lens to the analysis of environmental and social issues thus significantly restricts the scope of which issues are considered by decision-makers. Of the key categories of risk, including physical risk, reputational risk, policy risk, and changing market conditions, none are sufficient to encompass the full range of an organization's impacts on society and the environment. In the case of reputational risk, the public might not be aware of all organizational impacts, and public opinion changes all the time, tending towards being concentrated in small windows of time. With respect to policy risk, there are rarely policies to cover all an organization's impacts, and often these policies are not stringent or comprehensive enough to have a tangible effect. In the case of changing market conditions, consumer demand is extremely volatile and price signals change all the time. In all these examples, there are no variables which can provide a consistent and reliable means for impact materiality and financial materiality to overlap in all cases, meaning that a sole focus on financial materiality will always be narrow-minded in some sense.

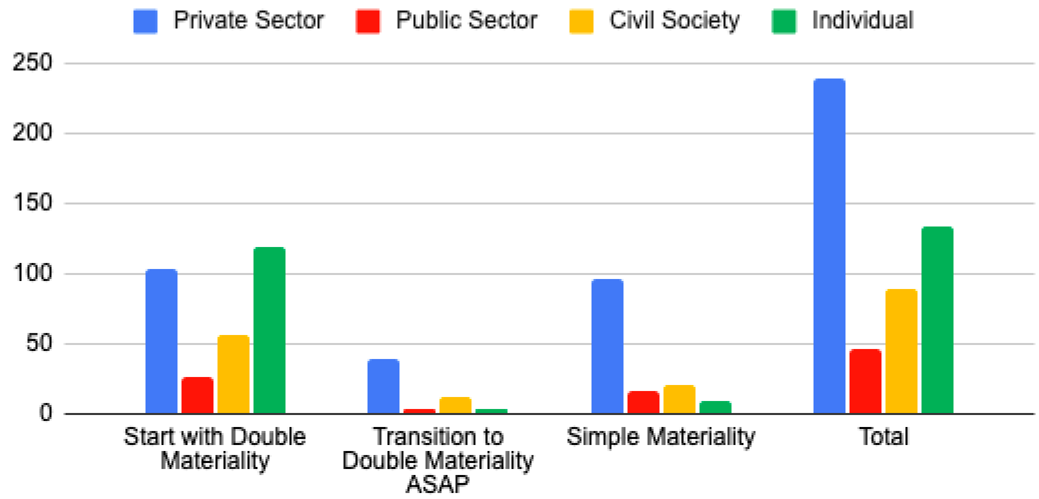
It should also be noted that the concept of double materiality is the only concept of materiality which fully allows organizations to appreciate the interdependence of shareholder and stakeholder value. The term 'stakeholder capitalism', which has been in vogue in recent years, reflects a broad understanding that the interests of an organization and its stakeholders are inherently intertwined. **A definition of sustainability that does not explicitly invoke the needs of stakeholders beyond shareholders does not, by definition, deserve the name "stakeholder capitalism".** In this respect, stakeholder capitalism without double materiality *is just capitalism*. If contemporary capitalism is defined by the primacy of shareholder value over all other forms of value, then the interpretation of social and environmental risks through the lens of their impact on profitability does not represent a departure from the status quo. A singular focus on enterprise value and financial materiality, in other words, is business as usual. Skeptics should not be assuaged by the recent agreement between the ISSB and the Global Reporting Initiative, which will be fundamentally untenable until the moment that the IFRS openly adopts stakeholders as a user group, and embeds stakeholder value throughout all of its proposed standards.

2. Double materiality has overwhelming support.

Support for double materiality is far from a minority position. An enormous and growing contingent of influential voices from around the world is unanimous in calling for a double materiality approach. Of the 577 comment letters submitted to the IFRS Consultation Paper in 2020, a large majority explicitly called for a double materiality perspective–a fact which was noticeably absent from the feedback letter released by the IFRS as a summary of the comment letters.

Our analysis demonstrates that, of the 508 respondents that answered Question 9 on materiality, 72% supported double materiality either being implemented immediately or as soon as possible, while only 28% explicitly supported the ISSB's stated approach. This group included a majority of private sector respondents (59%), as well as a vast majority of regulators, NGOs, and individuals (83%).





Although the double materiality concept enjoys greater cultural acceptance in the EU, there were also a wide variety of major organizations from outside of the EU that voiced support for double materiality in the original 2020 consultation. Some of these include:

- Morningstar
- CalPERS
- Mercer
- Willis Towers Watson
- Cambridge Associates
- Moody's ESG Solutions Group
- ISS ESG
- Suncor Energy
- Temasek

- SK Group
- World Federation of Exchanges
- International Trade Union Confederation
- International Organization for Standardization
- Global Risk Institute
- US Impact Investing Alliance
- UK Sustainable Investment and Finance Association

Major international NGOs which voiced support for double materiality in the 2020 consultation include the United Nations Development Programme, the United Nations Conference on Trade and Development (UNCTAD), the World Benchmarking Alliance, the Ellen MacArthur Foundation, Ceres, Shift, and B Lab, to name but a few.

Other major organizations, including the UN Principles of Responsible Investment, have joined these calls. Eric Usher, the head of the United Nations Environment Programme Finance Initiative (UNEP FI) has proclaimed that the financial materiality approach is insufficient, saying that the “exclusive focus” on financial risk has created a “short-term outside-in approach to materiality” which will not drive systemic change. The Transition Pathway Initiative has also written that “using financial materiality as a criterion for reporting can downplay or underemphasize important aspects of corporate performance, in particular those where the impacts or the costs are not borne by the company itself. It can also mean that issues that are seen as important by stakeholders, in particular those stakeholders who are not recognized as important by the company, are downplayed or ignored.”[4]

3. Double materiality is better for investors.

When considering social and environmental issues and how they affect business activities, **double materiality is the most decision-relevant perspective for investors and preparers.** This is because a double materiality perspective allows for the identification and attenuation of potential environmental and social risks *before* they become material financial risks, which makes it proactive rather than reactive. Double materiality is a more long-term approach when compared to single materiality, and it is this characteristic which makes it better at future-proofing business strategies against potential risks emerging from unstable social and environmental systems. There is often a ‘time lag’ between an environmental or social issue becoming important to investors and thus material within the enterprise value paradigm; by adopting a double materiality perspective, investors are provided with that information more quickly. At the same time, without a double materiality lens there is the danger that certain risks will not be considered material until it is simply too late to act on them. In the case of climate risk, while an enterprise value lens might appear sufficient for firms with a short investing time horizon, this could potentially lead to the lock-in of a significant amount of high-emitting infrastructure that might become stranded assets in the future but appear profitable given today’s constraints. Firms looking to make strategic investments in a low-carbon future on a multi-decade timescale will require a double materiality lens.

Moreover, predicting the point at which impacts become material business risks is very difficult to do, as it can happen quite randomly and unexpectedly (i.e. with ‘black swan’ type events). The purpose of impact reporting is that it makes businesses more resilient to future shocks by allowing firms to better anticipate the point at which impacts might become financial risks. Impact reporting and risk reporting are causally interrelated, and it makes no sense to arbitrarily separate them.

4. https://www.transitionpathwayinitiative.org/publications/67.pdf?type=Publication

A constitutive element of environmental and social risks is that they ultimately derive from a business' impacts on the world; for example, climate risks–the risks to a business derived from a destabilized climatic system–are ultimately generated by from climate *impacts*–the negative effects that businesses' activities have on the climate. A perspective which considers a business' climate risks without considering a business' climate impacts thus **fails to ascertain the root causes of climate risk in the first place**. To consider the financial risk derived from a firms' impacts on society and the environment, without considering those impacts as things in themselves, is like trying to stop a bathtub from overflowing without turning off the tap. Section 17 of the IFRS S1 draft openly recognizes this interrelationship, writing that "an 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." This stipulation makes it all the more strange that the IFRS excludes general impact reporting from its definition of what constitutes "sustainability" reporting.

Another significant benefit of a double materiality perspective is that it by necessity requires a greater involvement of stakeholders in the process of making materiality assessments. This inherently generates a greater diversity of perspectives and new ideas that leads to a greater quality of information, the identification of new risks and opportunities, and the prevention of duplicated work. Stakeholders often have more information about environmental and social issues than firms do, which can both help to improve the speed, reliability, and credibility of the materiality assessment process, making it both easier and more accurate.

There is also the possibility that by requiring mandatory impact reporting for all companies, independently of whether these impacts affect profitability, could aid in the comparability across firms and sectors. An approach which considers environmental and social issues purely through a risk management lens can easily be weaponized to suit particular biases or prejudices; for example, a firm which does not believe that nature risk exists or that its business is dependent on ecological integrity could justifiably determine that risks related to global biodiversity loss are not material for its business. However, if all businesses were required to report on all their impacts in a consistent way, irrespective of financial materiality, it would remove the possibility for the rationalization of inherent biases by creating a common framework for all businesses to report on. Reporting on impacts irrespective of impact materiality is the only way to achieve a consistent and comparable baseline independent of preconceived notions.

4. Double materiality will not create unnecessary complexity or administrative burden.

It cannot be reasonably argued that the double materiality concept is not well understood, or that it is too complex for use by preparers. Double materiality is already enshrined in the reporting paradigm of the European Union, with the European Financial Reporting Advisory Group writing that "the operationalisation of the concept of double materiality is key to sustainability reporting standard-setting in the EU." These EU standards are mandatory for the largest 50,000 companies operating in this region. The UK is also expected to adopt a double materiality approach in its planned Sustainability Disclosure Requirements (SDRs). Because the EU is the first mover in this space, major international investors are already using this approach, and are becoming familiar with its requirements. As such, creating a different set of global standards with a different approach to materiality will only create more confusion and exacerbate the administrative burden these firms face. By intentionally diverging from the EU, which is the undoubted first mover in this space, the IFRS appears to be intentionally creating fragmentation. This is fundamentally at odds with its stated goal of harmonizing the non-financial reporting landscape.

Conversely, alignment with the EU would streamline the reporting process and reduce the burden on international preparers with a global footprint, in particular large multinational corporations that operate in the EU and elsewhere.

There is also no reason to believe that adopting a double materiality perspective from the beginning will delay the adoption of standards or lead to greater complication. To the contrary, there is a real danger that the elusive and vaguely defined concept of 'dynamic materiality' will add complexity and delay adoption by creating a path dependence that will make a double materiality perspective more difficult to introduce later on. Dynamic materiality, which expresses the idea that financial materiality will naturally lead (by some unexplained mechanism) to impact materiality, is unworkable for the reason that it will compel actors to adopt incomplete standards that are not fit for purpose, and then make them more difficult to alter once they have become entrenched. Additionally, dynamic materiality is ambiguous because it does not specify at what points impacts become financially material, which could lead to a great deal of conceptual confusion. With the EU as the first mover, there is no need to reinvent the wheel twice over; the more robust concept of double materiality should simply be enshrined from the beginning.

Although the IFRS continues to argue that a double materiality approach will delay adoption of the standards, this neglects to mention the fact that most jurisdictions are likely to adopt whatever standards the IFRS produces regardless, given that the IFRS is the only truly global standard setter for corporate reporting. It is therefore the case that the IFRS sets the pace at which this adoption occurs, and that it has more power to shape norms than it currently admits. In fact, the IFRS' decision to enshrine sustainability reporting into its constitution was already a significant normative departure, presumably a larger change than the corresponding shift from single to double materiality. There is no reason to avoid extending the concept to its logical conclusion, which is the explicit embedding of stakeholder value creation in the form of a double materiality lens.

5. The Climate Exposure Draft requires a double materiality lens and contextualization within a 1.5 degree temperature threshold.

Perhaps most importantly of all, the ISSB drafts require not just a double materiality lens, but also **contextualization within relevant thresholds and limits defined by the Earth system (i.e. planetary boundaries) as well as international legal and human rights covenants.** Without reference to explicit contextual indicators defined by the ecological and social systems of which organizations are a part, there is a danger that sustainability disclosures will operate without reference to actual environmental or human well-being. In other words, the ISSB standards should be *normative* rather than *descriptive*; they should take a position about the strategies and transition plans that firms should adopt, with reference to specific desired future scenarios, rather than simply stating the parameters for how actions are communicated.

By primarily focusing on the disclosure of sustainability processes and information, the ISSB fails to provide firms necessary guidance around the hopeful content of these disclosures. For instance, with its current approach, it is sufficient for firms to disclose their risk management process, but **there is no guidance about *how* risk management should be undertaken, or how to determine if it is fit-for-purpose.** Alternatively, firms can disclose the climate change scenarios they use, but there is no guidance about *what* climate scenarios should actually be used, or *how* scenario analysis should actually be performed. In this respect, the ISSB drafts say nothing about alignment with 1.5 degree scenarios or the Paris agreement, about science-based targets, or about scientifically credible low-carbon transition plans. This is at huge contrast with the EU drafts, which include all of these components. To the extent that these elements were present in the earlier ISSB prototypes, they have since been removed.

Given this lack of guidance, the ISSB fails to equip standards users with a reference point from which to assess the content of firm's disclosures, creating the possibility that unsophisticated users could consider the presence of a sustainability disclosure to be a sufficient indicator of a firm's performance, without actually considering the substance of this substance. One must pose the question: is the presence of a disclosure enough to justify inclusion in an ESG fund? In such a case, there is a clear danger that sustainability disclosures could simply become little more than a 'box-ticking' exercise.

The ISSB drafts are currently written in a way that is intended to seem impartial, as though the organization is not taking a position on what firms should or should not be doing to achieve a net-zero future. However, if the ISSB does not make a normative claim as to which future scenario is most ideal, this creates the possibility that firms could easily choose to model a 3 degree scenario as the most likely scenario, and thus focus their energy on insulating themselves from the effects of climate change rather than actually reducing their organization's climate impacts. If all firms were to make this choice, this would in turn make a 3 degree scenario all but inevitable. It is in this sense that the ISSB is not an apolitical actor; in fact, the very existence of the organization signals a normative shift (i.e. the notion that firms should be moving towards robust sustainability reporting in the first place). In this respect, **the ISSB should embrace the fact that it is setting norms by definition, and rather than pretending to be impartial it should undertake to set those norms in a way that is best aligned with up-to-date science.**