Harvard Law School Forum on Corporate Governance

Global Institutional Investors on the IFRS Foundation's Sustainability Standards

Posted by Lindsey Stewart, KPMG, on Saturday, March 27, 2021

Tags: **Climate change**, **Environmental disclosure**, **ESG**, **Institutional Investors**, **Materiality**, **Surveys**, **Sustainability**
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Editor's Note: **Lindsey Stewart** is Senior Manager of Investor Engagement at KPMG LLP. This post is based on his KPMG memorandum. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum **here**) and **Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee** by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum **here**).

Executive summary

The IFRS® Foundation's September 2020 consultation on sustainability reporting proposes setting up a Sustainability Standards Board (SSB) to set standards and drive global consistency.

We reviewed the comment letters of a selection of 20 of the largest and most influential investor respondents to the Consultation—18 global institutional investors with close to $24 trillion of assets and two major investor associations. The responses provide a uniquely detailed and current view of the investor community's environmental, social and governance (ESG) reporting needs.

Among the investor community, there is an appetite across the board for a globally accepted, mandatory standard for sustainability reporting. There is also broad recognition that the IFRS Foundation is an appropriate body to co-ordinate such standard setting activity. Additionally, investors frequently emphasise the need for the IFRS Foundation to act quickly and to advance, rather than replace, the work done by existing owners of voluntary disclosure frameworks.

We focused on three other key areas of the consultation that yielded some interesting—and at times divergent—responses from investors: materiality, scope and assurance.

What should 'materiality' mean?

Most of the investor responses we reviewed expressed a belief that the proposed initial focus on financially material sustainability standards is appropriate—i.e. they believe the SSB should initially focus its work in areas where the information given by reporting entities would have the greatest impact on expected financial returns. These investors generally also believe that the SSB should retain the option to expand their focus to material impacts of a non-financial nature.

However, several investors disagree with the proposed approach, believing it is essential for the SSB to incorporate both financial and environmental/social impacts in its standard setting from day one. Investors holding this view believe this approach is necessary to reflect the changing nature of what is financially material and to align with existing regulatory initiatives (e.g. the EU Non-Financial Reporting Directive).

Notably, a number of investors believe that an industry-specific approach to materiality is essential, and that the IFRS Foundation should build on the work of existing reporting framework owners in this regard.

A climate-first approach?

A large majority of investors in our selection prefer a climate-plus approach to sustainability standard setting—incorporating a wide range of environmental and social themes while recognising that climate is the highest priority. Several of those agreeing with the climate-first approach proposed by the IFRS Foundation would like to see the scope expand to other environmental and social themes as soon as is practical.

What assurance is needed?

The investor responses we reviewed mentioned that external assurance over sustainability disclosures is considered essential. Many also noted that it would be desirable for sustainability disclosure to eventually be subject to the same level of assurance as those in the financial statements.

However, most of these also recognise that it will take time to create the conditions in which a mandatory assurance regime would be suitable.

Next steps

The IFRS Foundation intends to publish a roadmap and timeline for setting up a Sustainability Standards Board in the second half of 2021.

As the process of global standardisation takes its course, it remains important for investors to continue to request:

- meaningful, decision-relevant disclosures from companies on environmental and social themes; and
- assurance over value-relevant metrics outside the financial statements.

The IFRS Foundation's proposal

There has been a huge response to the IFRS Foundation's **consultation** on sustainability reporting (the Consultation), which was launched in September 2020. The key proposal in the Consultation is that the IFRS Foundation would set up a globally-recognised Sustainability Standards Board (SSB) to help drive global consistency in what has become a vital area of corporate reporting that is widely perceived to lack the level of rigour that has been applied to financial reporting and assurance for decades.

The Consultation received almost 600 responses from a wide range of stakeholders. However, it is noteworthy that the many official responses from global investment institutions provide uniquely detailed and current insights into the investor community's views on climate, sustainability and ESG reporting.

As a temperature check on the global investor view on sustainability and ESG standards, our team analysed comment letters from a selection of 18 leading global investors based in the UK, continental Europe, North America and Asia; and two major investor associations.

Among the investor community, there is an appetite across the board for a globally accepted, mandatory standard for sustainability reporting. There is also broad recognition that the IFRS Foundation is an appropriate body to co-ordinate such standard setting activity. Investors frequently emphasise the need for the IFRS Foundation to act quickly and to advance, rather than replace, the work done by existing owners of voluntary disclosure frameworks.

KPMG International has submitted its own response to the consultation which you can read in full **here**. Relevant extracts from KPMG International's comment letter are included throughout this post.

What should 'materiality' mean?

The IFRS Foundation asked stakeholders what approach should be taken to define materiality in any future sustainability standard. **[1]** To summarise, it proposes a focus on the financially material 'sustainability information most relevant to investors and other market participants', as opposed to an approach that equally prioritises impacts that are material to financial and environmental/ social outcomes.

The IFRS Foundation recommends a 'gradualist approach', stating that 'a double-materiality approach would substantially increase the complexity of the task [of setting up the SSB] and could potentially impact or delay the adoption of the standards', and that 'the SSB could consider how to broaden its scope as it proceeds with its work'.

The majority of investors in our selection agree with the proposed gradualist approach focusing first on financially material information. This is primarily because they identify investors as the primary users of the sustainability data that would be produced in line with the SSB's standards, such data being an important input to capital allocation decisions, and because —as one investor puts it—'standards that focus on [financial] materiality… are more likely to meet investors' needs for useful and comparable information about sustainability performance'.

That said, most of these investors do recognise a need for the initial focus on financially material information to expand to cover environmental and social materiality over time. One investor captures the thoughts of several of this group of investors by stating: 'It is likely that such an approach will not be sufficient for the future of sustainability reporting… We believe it is necessary for the IFRS Foundation and SSB to consider how its sustainability standard is able to evolve.'

A significant minority of investors in the selection object to the proposed approach initially focusing on financial materiality only, believing that a more holistic view of materiality should be incorporated from day one.

One such investor states that a focus on financial materiality only would be 'a backward step', emphasising that wider materiality considerations 'are key to setting effective and meaningful strategy at the company level'. Another notes that 'materiality is dynamic in its very nature, so what is not financially material now does not mean it won't be in the future'.

Some other investors draw attention to the double materiality focus of the EU's Non-Financial Reporting Directive, highlighting their belief that the SSB would need a broader materiality focus to 'ensure that it does not fall behind what is happening in the EU'.

One investor makes a salient observation, noting that a failure to focus on wider environmental and social factors 'would mean that overall sustainability standards may be weaker than they would have been had the IFRS Foundation remained with its current focus on traditional financial reporting.' The investor concludes that 'in order to be transparent, the IFRS Foundation should state how its approach responds to investors' consideration of double materiality which actually involves more long-term and forward-looking considerations.'

Interestingly, one respondent mentions that to incorporate a broader materiality lens 'it is appropriate for individual jurisdictions to expect minimum disclosures on the positive and negative impacts that companies have on society, the environment, and the economy to meet public transparency objectives. This information empowers a wide range of stakeholders to hold companies to account.'

Several investors highlight their view that industry-specific considerations are fundamental to determining an appropriate materiality focus. As one such investor puts it: 'Reporting standards should ensure that we move away from boilerplate disclosures and box-ticking approaches to consider the ESG risks and opportunities that are material to each company, industry and sector.'

These investors emphasise the importance of building on the work of existing disclosure framework owners in developing industry-specific standards. The Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD) are mentioned by the majority of investors in our selection—a significant minority also reference the work of the other members of what is known as the 'Group of Five'. **[2]**

Extracts from KPMG International's response to the Consultation

"We agree with the proposed approach to focus on investors' needs. This approach also is consistent with the IFRS Foundation's mission to provide transparency to global capital markets… We therefore recommend that the focus remains on investors' needs, with a framework that allows connecting to other branches of reporting, where appropriate, and that adapts to changing capital markets' needs."

"Whilst there will be overlap between the topics of interest to other stakeholders and those that are of interest to the capital markets, the information required by each group of stakeholders will typically be

different."

"The approach to materiality employed by the SSB will need to be dynamic as it establishes standards that are relevant and responsive to investor and capital market needs for sustainability information and other non-financial information that is focused on enterprise value creation, and those needs may change over time."

"We also stress the importance of a robust conceptual framework… [which] should allow co-existence and inter-operability with standards issued by other initiatives that for example address aspects of reporting based on regional or sectoral needs and public policy priorities."

A climate-first approach?

All investor responses in our selection agree that climate-related disclosures should be a high priority in the work plan of the SSB. The key question is whether investors think the SSB should:

- take a 'climate-first' approach and incorporate other environmental and social factors in time as resources allow; or
- take a 'climate-plus' approach incorporating all material sustainability factors from the start, including environmental and social themes.

A large majority (80%) of the investors in our selection believe a climate-plus approach is the most appropriate, for several reasons.

Investors in both camps agree that climate is the area with the most pressing need for standardised, materiality-focused disclosures. However, many climate-plus investors note that the work of the TCFD has already prompted a significant degree of 'organic convergence' in this area, perhaps leaving little for the SSB to do in this regard.

Additionally, one such investor makes the following point: "There are several reasons a climate-first policy is problematic. The first is that the other sustainability issues may be perceived as having less importance when in fact many issues are interconnected… Furthermore, a climate first approach may block off the work of various initiatives that we expect would figure prominently in the proper development of sustainability standards." Others note that 'limiting the scope to [environmental] or even only climate-related disclosures, for too long forces companies to apply one or more other standards to cover the other relevant sustainability matters, which contributes to maintaining the current high level of fragmentation' in sustainability reporting.

Climate-plus investors encourage a holistic approach to standard-setting for sustainability matters; however, several of them call out specific areas they would like the SSB to focus on, including:

- nature and biodiversity;
- water usage and/or scarcity
- human capital; and
- human rights, and equality, diversity and inclusion.

Recognising that effective standard-setting is a careful and deliberate process, one climate-plus investor states: 'Considering that standardisation is a long-term activity which takes several years to produce its results, it would be damaging to postpone work beginning on subjects as important and complex as biodiversity or social matters.'

Some investors at our December 2020 **investor roundtable** on the Future of Corporate Reporting reflected on this point acknowledging that: 'It will take years to work out what needs to go into these ESG and sustainability reports, as the scope has not yet been decided. The IFRS Foundation has lots of options on the table from purely financial climate reporting to including social factors.'

They acknowledge that the IFRS Foundation has a key role to play in managing due process, opining that the IFRS Foundation could implement some appropriate short-term measures then come back with a deeper approach at a later

date.

That being said, one investor's comment letter reflects the views of many when it states: 'While we do not generally oppose a phased approach, it would, in our view, still need to be subject to an ambitious timeline.'

The remaining investors in our selection agree with the IFRS Foundation's proposal to take a climate-first approach, although some of these note that the SSB should expand its remit to cover other environmental and social themes as soon as this is practical.

One investor puts it this way: "Climate first, but not at the expense of other topics. We recognise that climate change is among the most financially material sustainability topics… It may therefore serve as a good starting point. However, standards for other environmental or social topics should not be unduly postponed."

Extracts from KPMG International's response to the Consultation

"We agree that there is an urgent need to develop standards for climate-related financial disclosure and we agree with the proposal to prioritize climate-related financial disclosures. However… while we agree that an initial focus of the SSB would be to develop global sustainability-reporting standards for climate-related information given the urgent need, we recommend considering a broader scope to be covered by the SSB in the longer-term, allowing it to expand into other areas of non-financial reporting that are relevant to enterprise value creation and not be dominated by a single topic of concern."

"We also recognise that in the long term, societal perspectives and impacts (such as the impact of the enterprise on the environment and on matters such as biodiversity or responsible taxation) are likely to affect enterprise value creation."

"In our view, the market demand by investors for non-financial information relevant to long-term value creation encompasses a range of economic, social and governance topics. There is also a need for a wider set of information that is relevant for long-term enterprise value creation (e.g. intangible resources like brand, knowledge and know-how, patents and licences as well as relationships such as customer loyalty, employee engagement, etc). We recommend that the SSB consider designing a roadmap of priorities for its broader scope and further consult on its proposals. We believe that the SSB's governance and operational structures should be designed for this wider role even if the Foundation chooses to focus initially on individual ESG factors such as climate."

What assurance is needed?

All of the investors in our selection recognise a need for sustainability information to be subject to external assurance, with several of them describing assurance as 'essential', 'imperative' and 'a key part of providing relevant and reliable information to users of sustainability reporting'.

Several investors had interesting views to share on the level of external assurance that sustainability disclosures should be subject to– i.e. whether this should be 'reasonable assurance' (which is the same assurance standard that is applied to financial statement audits) or 'limited assurance' (a lower standard).

Those investors who commented on this are generally in favour of reasonable assurance but recognised some of the complexities involved in implementing this.

> "We are supportive of reasonable assurance, noting that further development in this area is also needed to ensure that the assurance provided adds value to the disclosures made by the company."
>
> "In the long term, the aim should be to achieve the same degree of assurance for mandatory financial and non-financial information (i.e. reasonable assurance)."
>
> "Current issues with regard to the comparability and reliability of non-financial information can only be fully resolved if such information is subject to reasonable assurance."
>
> "Information should be subject to external assurance and in the fullness of time, limited assurance should progress towards reasonable assurance."
>
> "Much of the information will not be auditable in the traditional sense just given the nature of some of the sustainability information, but it should be subject to some level of external assurance… On certain items, we would expect a reasonable level of assurance. On most items, limited assurance would be adequate."
>
> "Requiring reasonable assurance would also more appropriately reflect the high relevance of sustainability matters as well as allow [investors] to hold companies accountable… To this end, however, non-financial reporting standards and underlying methodologies will have to be sufficiently clear to be auditable and enforceable."

Although many investors are in favour of a mandatory reasonable assurance regime for sustainability disclosures, half of the investors in our selection observe that this will take time to implement, recognising that there is a need for robust standards and assurance methodologies to be set in place and for auditors and other assurance providers to up-skill.

As one investor puts it: 'We believe that independent examination should be recommended as best practice however, we think that it is premature for it to be made compulsory.' Another states that 'mandatory external assurance at this nascent stage may have a counter-productive effect of companies choosing to limit their disclosures to only those which have a high degree of certainty and verifiability, limiting its use and potential growth.'

A couple of investors weighed in on the cost-benefit considerations of obtaining external assurance. One mentioned that it is 'vital that the cost benefit equation is given due consideration as striking a balance on what represents value add will be important'. Another made the following observation.

> "Obtaining a high level of assurance will need to be resourced. However, this should not provide a reason for companies to resist such disclosure arguing that the cost of assurance outweighs the benefit, particularly when both those costs and benefits are borne ultimately by investors."

Extract from KPMG International's response to the Consultation

"We believe that in the long term, it would be most useful to users if non-financial information included in a company's annual report would be subject to independent assurance consistent with the assurance provided over financial information."

"However, we recognise that in the short term, assurance over specific aspects or disclosures of non-financial information in an annual report may be more readily achievable rather than assurance over the entire report."

Next steps

In February 2021, the IFRS Foundation Trustees **announced** that they would undertake further detailed analysis of the almost 600 comment letters they received in response to the 2020 consultation. It is their intention to issue a definitive proposal—including a road map and timeline—by September 2021, possibly leading to an announcement on the establishment of the SSB at the COP26 conference in November.

However, as the process of global standardisation takes its course, it remains important for investors to continue to request:

- meaningful, decision-relevant disclosures from companies on environmental and social themes; and
- assurance over value-relevant metrics outside the financial statements.

Endnotes

[1] Paragraphs 50 and 51 of the Consultation.
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[2] This refers to the five leading sustainability and integrated reporting organisations (CDP, CDSB, GRI, IIRC and SASB) that in **September 2020** announced their intention to collaborate on comprehensive corporate reporting standards.
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