

**Mr Erkki Liikanen
Chair of the Trustees
IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD
United Kingdom**

Ref: Response to Consultation Paper on Sustainability Reporting

Dear Mr Liikanen,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to provide input on the IFRS Foundation's Consultation Paper on Sustainability Reporting. We are pleased to provide you with the following comments with the aim of contributing to the development of a high-quality set of international standards for reporting on matters relating to Environmental, Social and Governance (ESG) aspects.

As part of ESMA's mandate to consider sustainable business models and ESG-related factors across the different areas of legislation within our remit, we have observed in the past years the growing interest by financial market participants as well as other stakeholders in disclosures relating to ESG factors (also referred to as 'non-financial information'), including information on unrecognised intangible assets, which could complement the more traditional financial metrics.

The implementation in the European Union (EU) of the Non-Financial Reporting Directive (NFRD) has so far only partly addressed the strong need for non-financial disclosures. As ESMA has repeatedly highlighted, the lack of a single set of generally accepted disclosure standards to support the implementation of the high-level disclosure requirements in the NFRD poses structural limits to the availability of relevant, reliable and comparable non-financial information.

In the past years, we have observed the emergence of multiple national, regional or even international standardisation initiatives with the result that *de facto* none of those alone has provided a set of generally accepted non-financial reporting principles capturing all relevant topics and all the relevant dimensions of materiality.

In this context, ESMA welcomes the initiative of the IFRS Foundation to consider establishing a Sustainability Standards Board (SSB) which could succeed in consolidating the best

practices arising from the existing frameworks and standards under the responsibility of a credible full-time board of independent technical experts which would operate under the steer of an enhanced Foundation and be overseen by a Monitoring Board representing public authorities.

In ESMA's view, there are three principles to take into account when establishing a standard-setter in this area: independent governance, public-sector oversight and ability of the disclosure standards to promote investor protection. The IFRS Foundation could leverage on the experience of the IASB to ensure the development of high-quality, global standards for non-financial reporting which could fulfil these principles, and which can be adequately connected to financial reporting requirements.

In developing the international standards, we recommend that the IFRS Foundation carefully considers the specificities of those jurisdictions, such as the EU, in which the development of legislation in the area of sustainable finance is quite advanced. While jurisdiction-specific disclosures can be envisaged to reflect national or regional specificities, it is also important to develop standards which do not unnecessarily result in duplicating disclosure efforts by market participants.

In this respect, ESMA also notes that one of the most critical aspects to address is the notion of materiality which will be embedded in the standards. ESMA believes that in order to be able to adequately promote transparency and investor protection, the standards for non-financial reporting need to refer to a notion of materiality that is capable of capturing both the impacts that ESG factors have on the reporting entities as well as the impacts that such entities have on the society at large. Such double perspective is key for a complete depiction of an entity's position and performance in the ESG area.

Finally, ESMA recommends that the non-financial reporting standards remain principles-based but ensure at the same time a sufficient level of detail to ensure their auditability and, ultimately, their enforceability.

Our detailed comments on the Consultation Paper are set out in the Appendix to this letter. In case you have any questions, please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

Appendix – Response to specific questions

Question 1

Is there a need for a global set of internationally recognised sustainability reporting standards? (a) If yes, should the IFRS Foundation play a role in setting these standards and expand its standard-setting activities into this area? (b) If not, what approach should be adopted?

As indicated in multiple public positions¹, ESMA supports the development of a set of international standards for disclosures relating to Environmental, Social and Governance factors (ESG) or, as referred to in the Consultation Paper, sustainability reporting². ESMA also believes that the IFRS Foundation could be in a favourable position to play a role as international standard-setter in this area, subject to the considerations provided further below and in response to the other questions.

While a single set of international standards addressing all ESG dimensions and all aspects of materiality is yet to emerge (as further discussed in our response to question 9), there is growing interest from the investment community, as well as from other stakeholders, for ESG-related aspects, as well as for information relating to unrecognised intangible assets, such as human capital.

In this context, the mismatch between the appetite for ESG information and the availability of generally accepted requirements in this area generates risks of misleading information to market participants (so called *ESG-washing*) and divergence in the quality of disclosures provided by issuers.

The corporate disclosure requirements currently in place at jurisdiction level – for example in Europe – may not yet fully address these needs and, therefore, there is room for the development of a globally accepted set of standards. If and when necessary, this common basis could be complemented at the level of individual jurisdictions to fulfil any additional jurisdiction-specific obligations.

In this respect, we note that international standards help prevent market fragmentation around the globe and ensure that investors and other stakeholders can rely on comparable disclosure. This is particularly important considering that global financial markets are confronted with challenges that are global in nature, such as climate change.

In our response to the European Commission's consultation on the review of the Non-Financial Reporting Directive (NFRD), in particular, ESMA indicated that the standard-setting process in

¹ ESMA's response to the European Commission's consultations on the review of the Non-Financial Reporting Directive (NFRD) and on the Renewed Sustainable Finance Strategy. ESMA supported the development of international standards

² In this response we refer to 'Sustainability reporting' interchangeably with 'Non-Financial Reporting' to indicate disclosures, such as those required under the Non-Financial Reporting Directive, addressing non-financial matters, most notably: environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.

this area should be inspired by high-level principles: it should be independently-governed, promoted and overseen by the public-sector and ensure investor protection.

With regards to the governance of the standard-setting process, we believe that it should ensure that full-time, independent board members and staff are responsible for developing standards for non-financial reporting. ESMA already indicated in its response to the consultation on the review of the Non-Financial Reporting Directive that the current institutional mandate and functioning of the IFRS Foundation represents a useful benchmark in this respect.

With regards to the role of the public sector, ESMA believes that, while private sector initiatives have been key in developing the non-financial reporting standards and frameworks which have become of wide application, it is now time for the public sector to promote consolidation of the different initiatives at global level. In this respect, the positive example of the Task Force for Climate-related Financial Disclosures (TCFD) shows that a strong and clear public sector commitment may provide the necessary incentives to private sector representatives to achieve a high-quality solution on a timely basis.

In its response to the consultation on the NFRD review, ESMA referred to an international solution for non-financial standard-setting that mirrors the governance and due process of the IFRS Foundation. ESMA noted that timing in this area is of essence. In fact, if such an international solution is not achievable in the near term, a European public body should be directly responsible for this task while remaining committed to creating the conditions for international standardisation in the medium term.

Concerning the establishment of a standard-setting solution that promotes investor protection, ESMA notes that the lack of available globally accepted non-financial reporting standards poses a significant risk of green-washing and social-washing which ultimately may mislead both professional and retail investors and risk resulting in capital allocation decisions which are not necessarily meeting the intended objectives. ESMA notes that it is important to consider that investors expressing ESG-related preferences do not only look at the financial performance of their investments in isolation, but they may also consider the broader ESG impact of the investee entities. In this regard ESMA acknowledges that establishing a dividing line between disclosure that is relevant for enterprise value creation and disclosure that goes beyond that, in practice, may prove to be complex (see further our response to question 3). For this reason, in our view, in order to be investor-protection oriented, non-financial reporting standards should not be limited to the so-called financial materiality. This aspect is further detailed in our response to question 9.

ESMA believes that the IFRS Foundation is well placed to implement a standard-setting solution for non-financial reporting that is in line with the above-mentioned principles. ESMA notes that the IFRS Foundation could also leverage on its role in financial reporting to help build the much-needed connectivity between financial and non-financial reporting.

However, while in our view the above-mentioned principles should be the cornerstone of any standard-setting solution, ESMA also emphasises that any international standards should take into account – and be compatible with – the developments that have occurred in jurisdictions,

such as Europe, where applicable legislation already sets out specific requirements, for example, a classification system (taxonomy) of sustainable economic activities. Acknowledging these developments is important to avoid unnecessary duplications for reporting entities which may ultimately result in complexity for users and to support the current transition towards a more sustainable financial system for jurisdictions that are most advanced in these efforts, while also catering for the situation of other ones which may be progressing at a different pace.

Finally, in considering taking up a standard-setting responsibility on sustainability reporting, ESMA believes that – as indicated in paragraph 35 of the Consultation Paper – the Foundation should build on the work already done by major players in this area, such as TCFD, CDP, CDSB, GRI and SASB.

Question 2

Is the development of a sustainability standards board (SSB) to operate under the governance structure of the IFRS Foundation an appropriate approach to achieving further consistency and global comparability in sustainability reporting?

The proposed establishment under the IFRS Foundation of an SSB may help support connectivity between financial and non-financial reporting. As indicated in response to question 1, the IFRS Foundation can create the necessary links with the work of the IASB and further progress on providing clarity on how the financial statements can be integrated with other information on the performance and position of entities from the ESG perspective.

In ESMA's view the development of an SSB would, on the one hand, allow it to benefit from the experience of the IFRS Foundation of development of high-quality reporting standards based on a comprehensive and transparent due process, and, on the other hand, help reduce the complexity in the current non-financial reporting landscape by consolidating the existing most advanced relevant reporting initiatives so as to foster comparability in this area.

Nevertheless, ESMA concurs with the conditions identified in paragraph 31 of the consultation paper to ensure the suitability of the standard-setting process. As further detailed in response to question 3, ESMA also notes that a wider group of stakeholders should be reflected in the composition of the trustees of the IFRS Foundation in order to properly support the Foundation's possible future expanded spectrum of standard-setting activities.

Question 3

Do you have any comment or suggested additions on the requirements for success as listed in paragraph 31 (including on the requirements for achieving a sufficient level of funding and achieving the appropriate level of technical expertise)?

ESMA supports the requirements for success listed in paragraph 31 and would like to stress three aspects in particular: achieving a sufficient level of global support from public authorities

and global regulators, working with regional initiatives to achieve global consistency and ensuring adequacy of the governance structure.

In relation to the first point, we note that, together with financial reporting, sustainability reporting serves capital allocation decisions and accountability of financial institutions and corporates in an economy which increasingly incorporates sustainability goals. In this respect, ESMA suggests that, as an underlying anchor for its standard-setting process in this area, the IFRS Foundation considers the United Nations' Sustainable Developments Goals or SDGs. ESMA acknowledges that such a link may need to be revised on a regular basis due to the evolving nature of sustainable finance and the possible revision or emergence of new overarching goals and frameworks. ESMA notes that it is becoming increasingly important that corporates claiming to be aligned with SDGs provide disclosures not necessarily on the goals themselves, but on data points which can provide users of non-financial disclosures comparable information on the contribution and progress made towards the achievement of these goals. While more detailed frameworks may impose specific disclosure obligations at jurisdiction level, such as the Taxonomy Regulation in Europe, we note that the SDGs still represent a framework to which several pieces of sustainable finance legislation may be linked³. This link, in our view, is of relevance also for investors and therefore should be carefully considered by the IFRS Foundation.

In relation to the cooperation with global regulators, ESMA highlights the importance of continuing the good cooperation between the IFRS Foundation and securities regulators also in the area of non-financial reporting. In this respect, the Statement of Protocols currently in place between the IFRS Foundation and ESMA has proved to be extremely effective in smoothing the collaboration between the respective staff of the IASB and ESMA and in fostering consistent application of IFRS. Should an SSB be established, such cooperation could also be extended to non-financial reporting matters.

With regards to the cooperation with regional initiatives, ESMA highlights that a modular approach to the adoption of international standards may be a valid solution to ensure that jurisdictions with different sustainability agendas apply the standards in a way that reflects their respective specificities (e.g. those with more advanced sustainability programmes and those who are still in a developing phase). We note that, in this respect, the joint statement by CDP, CDSB, GRI, IIRC and SASB⁴ included a proposal for a possible global corporate reporting system made up of "building blocks" based on distinctive materiality concepts. ESMA acknowledges that this proposal constitutes a possible modular approach to the development of international sustainability standards. However, while establishing a dividing line between disclosure that is relevant for enterprise value creation and disclosure that goes beyond this

³ Recital 2 of the Taxonomy Regulation indicates that: "The Commission communication of 22 November 2016 on the next steps for a sustainable European future links the SDGs to the Union policy framework to ensure that all Union actions and policy initiatives, both within the Union and globally, take the SDGs on board at the outset. In its conclusions of 20 June 2017 the Council confirmed the commitment of the Union and its Member States to the implementation of the 2030 Agenda in a full, coherent, comprehensive, integrated and effective manner, in close cooperation with partners and other stakeholders. On 11 December 2019, the Commission published its communication on 'The European Green Deal'."

⁴ <https://29kjwb3armds2g3qi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf>

concept may be helpful for illustration purposes, in practice such dividing line may be rather blurred and difficult to consistently apply, especially when assessing companies' activities and impacts in the medium and long-run. In fact, rebound effects⁵ may exist that make companies' impacts on the environment relevant for their value creation potential in the long-term. ESMA, therefore, suggests that one alternative dividing line which could still serve investor protection well could be to distinguish between 'inside-out' and 'outside-in' disclosures, i.e. respectively disclosures on the impacts of an entity on the ESG topics and disclosures on the impacts of ESG factors on an entity.

Thirdly, an adequate governance structure is important to promote sound standard-setting but also to bring credibility to non-financial reporting and bridge the gap with the level of relevance, reliability and comparability of financial reporting. In this respect, ESMA emphasises that the due process for a future SSB should be based on the contribution of and cooperation with all relevant stakeholders, i.e. investors, preparers, civil society, representatives of Non-Governmental Organisations with an interest in non-financial reporting, auditors, academics, non-financial agencies, as well as indirect stakeholders such as clients and customers. The IFRS Foundation should also consider which of these stakeholders need to be represented in the governance structure of the Foundation and which, if any, of these stakeholders should rather be involved in the standard-setting process primarily via the public consultation process. As part of the governance considerations, ESMA also stresses that the funding of the SSB should be adequate in order not to detract from the resources that are needed to continue ensuring high-quality standards for financial reporting purposes.

Question 4

Could the IFRS Foundation use its relationships with stakeholders to aid the adoption and consistent application of SSB standards globally? If so, under what conditions?

ESMA believes that one of the key features of the IFRS Foundation is its ability to conduct extensive outreach. However, as mentioned in previous responses, it is important that the Foundation expands its reach to stakeholders in sustainability reporting, such as NGOs and representatives of the civil society with an interest in this area of reporting.

In order to support the establishment of the SSB and the issuance of the first set of standards, ESMA would suggest that the IFRS Foundation establishes a consultative working group, where standard-setters and other organisations which have been active and issued guidance in the non-financial/ sustainability reporting area would be represented (e.g. TCFD, CDP, CDSB, GRI, IIRC and SASB).

ESMA also believes that roundtables or other forms of dialogue with government representatives of all jurisdictions with an interest in non-financial reporting, including but not limited to those that have adopted IFRS standards, financial market regulators and other

⁵ , Rebound effects typically arise when a company's action on the environment or other ESG factors circle back to have an impact on the company itself.

relevant stakeholders could be useful to identify the common ground for standard-setting in this area.

Question 5

How could the IFRS Foundation best build upon and work with the existing initiatives in sustainability reporting to achieve further global consistency?

As indicated in response to question 4, one way of building on existing initiatives is to create an advisory body for the SSB to help it in the establishment of its set of standards. This could be considered as a first step towards a consolidation of the existing major standards and frameworks with the objective of progressively narrowing down the number of organisations claiming to develop internationally accepted sustainability reporting standards.

In ESMA's view, the combination of the requirements from the existing initiatives should aim at capturing both the 'inside-out' and the 'outside-in' perspective of materiality, avoiding duplications and integrating the key features of each framework and set of standards. One useful articulation of the requirements could be around disclosures that reflect short-term as opposed to long-term impacts. The combination of standards should also ensure that an appropriate conceptual framework is established.

Question 6

How could the IFRS Foundation best build upon and work with the existing jurisdictional initiatives to find a global solution for consistent sustainability reporting?

As indicated in response to question 1, it is important that the IFRS Foundation acknowledges and builds on the developments already underway at the level of individual and regional jurisdictions. Such efforts should not aim at providing a *minimum common denominator*, but rather be able to provide the highest quality standards which can bring transparency on sustainability-related matters. In this way the international standards will be able to both match the ambition of the most advanced jurisdictions, while allowing for the adoption of standards in a gradual way by other jurisdictions. For example, one possible way of achieving a gradual adoption is the modular approach whereby jurisdictions could decide for the adoption of requirements relating to the 'inside-out' or 'outside-in' perspective or both. However, ESMA also believes that such modular approach should be allowed only for a transitional period in order not to introduce a structural fragmentation across the adopters of the international sustainability standards. To achieve this, for example, it could be envisaged that after a transitional 3-year period in which a jurisdiction can choose to comply to either disclosure perspectives (i.e. inside-out and outside-in) compliance with the standards issued by the SSB could only be claimed if all requirements are adopted.

In order to achieve a global solution for consistent sustainability reporting, especially for the requirements which may prove to be most difficult to align different jurisdictions on, i.e. those relating to the inside-out perspective, ESMA suggests that, as mentioned in response to question 3, the IFRS Foundation could consider anchoring the development of the requirements to the UN's SDGs, while still ensuring a focus on investor protection. This approach may help achieve alignment of objectives for a large number of jurisdictions.

In addition, ESMA believes that the IFRS Foundation could set up jurisdictional discussion fora involving multiple stakeholders in order to capture local needs and better understand how to structure the future international standards in a way that can achieve global consistency.

Question 7

If the IFRS Foundation were to establish an SSB, should it initially develop climate-related financial disclosures before potentially broadening its remit into other areas of sustainability reporting?

ESMA acknowledges the urgency of addressing the challenges posed by climate-related disclosures and, therefore, we support that climate-related disclosures are taken as a first project, while also planning the swift launch of the other relevant non-financial disclosure workstreams, as discussed further below. In this respect, the useful framework provided by the TCFD and the alignment efforts put in place by the major international standard setters around it can constitute a useful basis for the development of climate disclosure standards.

However, ESMA notes that the development of the first requirements should be accompanied by the establishment of a conceptual framework including basic concepts that shall form the basis for the individual standards. It is important to establish such framework at the beginning of the standard-setting process to avoid issues relating to inconsistencies across standards which have arisen in the context of financial reporting. In order not to delay the development of the first standards, such framework could be developed in stages.

In line with previous responses, ESMA also believes that the disclosures should not be limited to the 'financial' climate-related disclosures but also cover the broader inside-out perspective.

In addition, ESMA notes that the COVID-19 pandemic as well as public calls in relation to racial discrimination and gender inequality have put at the centre of the stage the social dimension and the relevance of the associated disclosures. ESMA therefore believes that it is important that the SSB works since the outset on covering the entire spectrum of the ESG space, including unrecognised intangible assets. In this respect, we recall the recommendations that ESMA has issued in its recently published statement on the European Common Enforcement Priorities (ECEP 2020)⁶.

International standards which would cover only part of the ESG disclosures will not serve well the objective of achieving a practicable standard for non-financial reporting especially in jurisdictions like Europe where the applicable NFRD requirements address all non-financial matters and not only climate. We note that by addressing only part of the ESG topics with its standards, the risk exists of continued – if not increased – fragmentation of standards in the areas that would not be covered by the international standards of the SSB.

⁶ [ESMA32-63-1041v](#) - European common enforcement priorities for 2020 annual financial reports - 28 October 2020

Question 8

Should an SSB have a focused definition of climate-related risks or consider broader environmental factors?

In ESMA's view an initial focus in climate-related risks may be a useful starting point if shortly followed by efforts in other environmental areas. We note that in the European context the Taxonomy Regulation focuses on six environmental objectives as follows: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.

Even when focusing on disclosures relating to climate-change-related objectives, the Taxonomy regulation requires also that the concerned economic activities do not cause any harm to the other objectives. In our view, this is an example to signal that as much as possible environmental disclosures standards should be developed in parallel in order to enable companies to report also on other environmental objectives (see also our response to question 7 on the need to address all ESG factors).

Question 9

Do you agree with the proposed approach to materiality in paragraph 50 that could be taken by the SSB?

As indicated in previous responses, ESMA notes that, in order to be effective in promoting transparency and investor protection, sustainability reporting should capture both dimensions of materiality, i.e. the impacts that ESG factors have on reporting companies as well as the impacts that these companies have on the ESG factors.

ESMA highlights that European legislation requires this double-materiality perspective and that the disclosure frameworks as well as the legislative requirements developed in Europe largely build on this notion since this double perspective is, in our view, key for a more complete depiction of an entity's position and performance in the ESG space.

ESMA acknowledges that international standards should be adaptable to jurisdictions with various legal frameworks, at the same time ESMA notes that the reality of ESG investing at international level requires a focus that goes beyond the traditional financial materiality, in order to effectively prevent the risk of misleading information being provided to users of non-financial information.

Furthermore, ESMA notes that a materiality lens limited to financial materiality may induce a focus in reporting companies as well as by users of this information on short-term-oriented disclosures, hence detracting from the potential of sustainability reporting to contribute to lengthening the disclosure horizon, and help prevent the risk of short-termism.

In ESMA's view, the complexities associated with combining financial materiality with a broader materiality concept would not lengthen the standard-setting process substantially and can be overcome by promoting a strong cooperation amongst the major international standard-setters and framework providers in this field.

Question 10

Should the sustainability information to be disclosed be auditable or subject to external assurance? If not, what different types of assurance would be acceptable for the information disclosed to be reliable and decision-useful?

ESMA supports the introduction of mandatory assurance on non-financial reporting requirements. In ESMA's response to the consultation on the review of the NFRD, we noted that the increase in the level of assurance on non-financial information should follow the strengthening of the reporting requirements and, in particular, the provision of a sound and credible international standard for non-financial information. In our view, an international reporting standard would also make it easier to adopt an international assurance standard. In this respect, the position of the IFRS Foundation in the international landscape is particularly favourable to ease the interaction with the International Audit and Assurance Standards Board (IAASB).

The existence of a single reporting standard would also make it possible to bring assurance of non-financial statements closer to the level of assurance on financial statements.

In its response to the NFRD consultation, ESMA noted that one possible approach to strengthen the assurance requirements would be to develop a phase-in approach whereby, at least for those parts of the non-financial reporting that include quantitative measures and the related disclosures, reasonable assurance would be required. For the other parts of the non-financial statement that include narrative disclosures unrelated to quantitative measures and indicators, for a transitional period, a limited assurance requirement could be applied. This would better fit with the nature of these disclosures, as it typically takes more time to establish and test evidence-based processes that support their preparation. After this transitional period, when the processes for the preparation of the non-financial disclosures – both qualitative and quantitative ones – have become more established, reasonable assurance should then be extended to the entire non-financial statement once having properly assessed the related cost-benefit balance.

Question 11

Stakeholders are welcome to raise any other comment or relevant matters for our consideration.

ESMA emphasises the importance of ensuring that, in developing international standards, the IFRS Foundation liaises with European bodies and institutions which have been actively involved in the development of disclosure standards on sustainability reporting. ESMA is ready to contribute to this process.

ESMA notes that jurisdictions and individual entities which are not IFRS adopters may become adopters of future standards for sustainability reporting issued by the SSB and, therefore, encourages the IFRS Foundation to ensure a broad outreach to the international community.

ESMA would also like to stress the importance that the SSB, if established, works on the development of requirements for the digitisation of sustainability reporting on the basis of a common XBRL taxonomy. Digitisation of non-financial reporting can further help in the integration between financial and non-financial disclosures.

Given the close connection between financial statements and issues that are typically reported in management commentaries, ESMA highlights the importance of ensuring that the future SSB considers how to build on the work already undertaken to develop the IASB's Management Commentary Practice Statement to create the necessary interconnections between the different parts on an entity's annual financial report.

Finally, ESMA supports the development of standards that are auditable as well as enforceable and, therefore, would encourage the IFRS Foundation to work closely with securities regulators to ensure that any future proposed requirements strike the right balance between a principles-based approach and a sufficient level of prescriptiveness.