By e-mail
IFRS Foundation
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| Subject | Response AFM to Consultation Paper on Sustainability Reporting |

Dear Mr Liikanen,

The Dutch Authority for the Financial Markets (AFM) 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 Environmental, Social and Governance aspects.

The AFM is an independent market conduct authority that supervises the conduct of the entire financial market sector in the Netherlands: savings, investment, insurance, loans, pensions, capital markets, asset management, audit and financial reporting. The AFM is committed to promoting fair and transparent financial markets. Because of these broad oversight tasks, the AFM is a member of various European bodies and committees, such as the European Securities and Markets Authority (ESMA).

As a member of ESMA, the AFM acknowledges ESMA's response to the IFRS Foundation's Consultation Paper on Sustainability Reporting. In this letter, we wish to draw attention to several subjects that are of particular importance to the AFM. Our detailed comments on the Consultation Paper are set out in the Annex to this letter.

## A. Increased attention for non-financial information calls for international reporting standard

The AFM observes a strong increase in attention for reporting on non-financial information. This increased attention for non-financial information is visible across all sectors, especially the financial market sector.

The term 'non-financial information' is broader than sustainability reporting. Non-financial information includes:

1. Sustainability reporting, which includes all aspects of Environmental, Social and Governance aspects, including climate risk, and;

2. Unrecognized (intangible) assets - such as human capital, technology, and trademarks – that are important to value creation.

In Europe, the Non-Financial Reporting Directive (NFRD) provides general requirements for large public interest entities such as publicly traded companies to report specific non-financial information. Earlier this year, the European Commission launched a public consultation on the review of the NFRD. The AFM publicly responded to this consultation.[1]

The AFM supervises the compliance of reporting standards by listed companies, which includes compliance with the European NFRD, as implemented in national law. In its thematic reviews reports on the annual reporting by listed companies subject to supervision by the AFM, however, the AFM noted that there is room for improvement regarding the reported non-financial information.[2]

In line with our aforementioned consultation response to the NFRD review and the report on the disclosure of non-financial information, the AFM supports the development of a common standard for non-financial information. The AFM sees this development as a necessary step to improve the relevance, reliability, comparability, and consistency of the reported non-financial information. In this context, the AFM welcomes the initiative of the IFRS Foundation to consider establishing a new Standards Board in this area. Based on the aforementioned, we suggest widening its scope to reporting standards on the broader concept of non-financial reporting.

## B. Broad scope of sustainability reporting standard preferred

The AFM acknowledges the urgency of addressing the challenges posed by climate-related issues and, therefore, we support that climate-related disclosures are taken as a first project. We note, however, that the scope of sustainability reporting / non-financial reporting is much broader and includes unrecognized assets, many times larger than the assets in the balance sheet. Therefore, we suggest developing non-financial reporting standards in various areas in parallel, or that at least a picture is provided on when the proposed Standards Board is supposed to work on the other aspects as well. The AFM also believes that the disclosures should not be limited to the 'financial' climate-related disclosures, but also cover the broader inside-out perspective.

[1] Response AFM to public consultation on the review of the Non-Financial Reporting Directive, 8 June 2020 (link).
[2] AFM-report '*In Balance 2018 – Part A: Thematic review of non-financial information in management reports 2017*, 13 December 2018 (link)

International standards that 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 relate to more non-financial matters than climate.

## C. Double materiality desired for promoting transparency and investor protection

The AFM believes 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.

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

The AFM acknowledges that international standards should be adaptable to jurisdictions with various legal frameworks. At the same time, the AFM 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, the AFM 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, this may detract from the potential of sustainability reporting to contribute to lengthening the disclosure horizon, and help prevent the risk of short-termism.

## D. Auditable and enforceable reporting standard on non-financial information

The AFM supports the introduction of mandatory assurance by either auditors or other parties on non-financial reporting requirements. As noted in the AFM's response to the consultation on the review of the NFRD, the AFM believes that requiring assurance to be provided on non-financial information would enhance its reliability.[3] In our view, an international reporting standard would help the development of an international assurance standard.

The existence of a single reporting standard would be an important step to bring assurance of non-financial statements more in line with the level of assurance on financial statements. The auditability of information in general is improved if the reporting entity has good internal controls. To improve the auditability of non-

[3] Response AFM to public consultation on the review of the Non-Financial Reporting Directive, 8 June 2020 (link).

financial information, we suggest including in the development process of a non-financial reporting standard the aspects of the relevant internal controls for the reporting entity.

In our response to the NFRD consultation, we 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 statements once having properly assessed the related cost-benefit balance.

Finally, the AFM supports the development of clear and specific reporting standards that provide meaningful non-financial information and are auditable as well as enforceable. Therefore, we 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.

## In conclusion

Our detailed comments on the Consultation Paper are set out in the **Annex** to this letter.

The AFM would welcome the opportunity to answer any questions regarding our responses to the Consultation Paper. We look forward to your follow-up on the responses to the Consultation Paper.

Yours sincerely,
The Dutch Authority for the Financial Markets

Laura van Geest
Chair of the Executive Board

Hanzo van Beusekom
Member of the Executive Board

## Annex – Responses to specific questions

**<u>Question 1</u>:** *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?*

The AFM 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 reporting. The AFM 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.

The AFM observes a strong increase in attention for reporting on non-financial information. This increased attention for non-financial information is visible across all sectors, especially the financial market sector.

The term 'non-financial information' is broader than sustainability reporting. Non-financial information includes:

1. Sustainability reporting, which includes all aspects of Environmental, Social and Governance aspects, including climate risk, and;
2. Unrecognized (intangible) assets - such as human capital, technology, and trademarks – that are important to value creation.

In Europe, the Non-Financial Reporting Directive (NFRD) provides general requirements for large public interest entities such as publicly traded companies to report specific non-financial information. Earlier this year, the European Commission launched a public consultation on the review of the NFRD. The AFM publicly responded to this consultation.[4]

The AFM supervises the compliance of reporting standards by listed companies in the Netherlands, which includes compliance with the European NFRD, as implemented in national law. In its thematic reviews reports on the annual reporting by listed companies subject to supervision by the AFM, however, the AFM noted that there is room for improvement regarding the reported non-financial information.[5]

In line with our aforementioned consultation response to the NFRD review and the report on the disclosure of non-financial information, the AFM supports the development of a common standard for non-financial reporting. The AFM sees this development as a necessary step to improve the relevance, reliability comparability, and consistency of the reported non-financial information. In this context, the AFM welcomes the initiative of the IFRS

[4] Response AFM to public consultation on the review of the Non-Financial Reporting Directive, 8 June 2020 (link).
[5] AFM-report '*In Balance 2018 – Part A: Thematic review of non-financial information in management reports 2017*, 13 December 2018 (link)

Foundation to consider establishing a new Standards Board in this area. Based on the aforementioned, we suggest widening its scope to reporting standards on the broader concept of non-financial reporting.

**<u>Question 2:</u>** *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. 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.

The AFM believes 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, the AFM concurs with the conditions identified in paragraph 31 of the consultation paper to ensure the suitability of the standard-setting process. The AFM 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.

**<u>Question 3:</u>** *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)?*

The AFM acknowledges 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 listed entities. In this respect, the AFM 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. The AFM 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 that 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, the SDGs still represent a framework to which several pieces of sustainable finance legislation may be linked[6]. 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, the AFM 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 and IOSCO have proved to be extremely effective 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, the AFM 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 SASB[7] included a proposal for a possible global corporate reporting system made up of "building blocks" based on distinctive materiality concepts. The AFM 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 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 effects[8] may exist that make companies' impacts on the environment relevant for their value creation potential in the long-term. The AFM, 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.

[6] 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'."
[7] https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf
[8] 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.

Thirdly, an adequate governance structure is important to promote sound standard-setting but also to bring credibility to non-financial reporting and bridging the gap with the level of relevance, reliability and comparability of financial reporting. In this respect, the AFM 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, the AFM 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?*

The AFM believes that one of the key features of the IFRS Foundation is its ability to conduct extensive outreach. However, 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, the AFM 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).

The AFM 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 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 a 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 the view of the AFM, 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?*

The AFM believes 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, the AFM 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, the AFM 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.

As indicated in our response to question 4, the AFM 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 relevant stakeholders could be useful to identify the common ground for standard-setting in this area.

**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?*

The AFM 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. We note, however, that the scope of sustainability reporting / non-financial reporting is much broader and includes unrecognized assets, many times larger than the assets in the balance sheet. Therefore, we suggest developing non-financial reporting standards in various areas in parallel, or at least provide a picture on when the proposed Standards Board is supposed to work on the other aspects as well.

The AFM 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, the AFM 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. The AFM 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)[9].

International standards that 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 relate to more non-financial matters than climate.

**Question 8:** *Should an SSB have a focused definition of climate-related risks or consider broader environmental factors?*

According to the AFM, the SSB should consider broader environmental factors in the development of a non-financial reporting standard, in order not to limit its scope. In the non-financial reporting standard, however, the use of clear definitions for the information to be reported is beneficial for the relevance, reliability, comparability and consistency of the information to be reported. The AFM believes an initial focus on 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.

[9] ESMA32-63-1041v - European common enforcement priorities for 2020 annual financial reports - 28 October 2020

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?*

The AFM believes 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.

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

The AFM acknowledges that international standards should be adaptable to jurisdictions with various legal frameworks. At the same time, the AFM 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, the AFM 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, this may detract from the potential of sustainability reporting to contribute to lengthening the disclosure horizon, and help prevent the risk of short-termism.

In the AFM'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?*

The AFM supports the introduction of mandatory assurance by either auditors or other parties on non-financial reporting requirements. As noted in the AFM's response to the consultation on the review of the NFRD, the AFM believes that requiring assurance to be provided on non-financial information would enhance its reliability.[10] In our view, an international reporting standard would help the development of an international assurance standard.

The existence of a single reporting standard would be an important step to bring assurance of non-financial statements more in line with the level of assurance on financial statements.

The auditability of information in general is improved if the reporting entity has good internal controls. To improve the auditability of non-financial information, we suggest including in the development process of a non-financial reporting standard the aspects of the relevant internal controls for the reporting entity. In our response to the NFRD consultation, we 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 statements 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.*

The AFM suggests the IFRS Foundation liaises with European bodies and institutions, such as ESMA, as well as IOSCO, which have already been actively involved in the development of disclosure standards on sustainability reporting.

The AFM notes that jurisdictions and individual entities that 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.

The AFM 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, the AFM highlights the importance of ensuring that the future SSB considers how to build on the

[10] Response AFM to public consultation on the review of the Non-Financial Reporting Directive, 8 June 2020 (link).

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, the AFM supports the development of clear and specific reporting standards that provide meaningful non-financial information and are auditable as well as enforceable. Therefore, we 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.