INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0) 211 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0) 211 / 4 54 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
IBAN: DE53 3007 0010 0748 0213 00
BIC: DEUTDEDDXXX
USt-ID Nummer: DE119353203

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

21 December 2020
541/584

Dear Mr Liikanen

Re.: IFRS Foundation – Consultation Paper on Sustainability Reporting

The IDW (Institut der Wirtschaftsprüfer in Deutschland e.V.) would like to thank you for the opportunity to provide the IFRS Foundation with our comments on the Consultation Paper on Sustainability Reporting, hereinafter referred to as 'the Consultation Paper', which we believe to be of enormous importance to the whole future of corporate reporting and its regulation.

The IDW is a voluntary membership organisation representing the interests of the profession of public auditors in Germany and counts over 83% of this profession as members.

We have long been involved in developments concerning sustainability matters in a broader context. Currently, the IDW is involved in discussions concerning the German government's initiatives, most recently contributing to a consultation of further development of Germany's Sustainability Strategy 2021, which is based on the UN's Sustainable Development Goals. Not least through our long-term membership of, and involvement in the profession's work in this field within, the International Federation of Accountants (IFAC), Accountancy Europe (AcE) and the Accounting Bodies Network (ABN) arm of the Accounting for Sustainability (A4S) initiative, the IDW also continues to be actively involved at an European and an international level.

We are pleased to attach a copy of the English language convenience translation of the IDW's position paper issued in October 'The Future of Non-Financial Reporting and Assurance', which we view as highly relevant to the IFRS Foundation's consultation. This paper is part of a series of initiatives the IDW is undertaking to raise awareness of the urgent need for further action associated with sustainability issues and their connectivity to corporate reporting.

On the world stage, channelling support towards sustainable investments will be essential in any drive to meet climate-related and sustainable development goals. Such support should be understood in terms of being both direct, (i.e., financial investment, loans etc.) and indirect (e.g., buy-in from customers, suppliers and employees). Thus, whilst the roles of the financial sector and capital market investors are arguably of high significance to the achievement of these goals, other more diverse stakeholders' needs must also be viewed as important.

The main focus of corporate financial reporting has historically been directed towards the information needs of the reporting entity's capital providers. However, a clear and increasingly insistent demand has emerged from investors of all types and other stakeholders for additional sustainability-related information that is balanced, reliable and comparable. Indeed, information as to reputational and financial sustainability-related risks is also needed to gauge the resilience of entities for investment decisions, where the current financial statement approach to going concern is no longer considered wholly appropriate for these purposes.

Such information is also needed for entities' internal decision-making purposes.

The accountancy profession is committed to serving the public interest. The connectivity between broader sustainability reporting and 'traditional' financial reporting predisposes our profession's involvement in rising to the associated corporate reporting challenges. The broad knowledge base of the accountancy profession and its depth of experience are vital components in developing high quality and consistent measurement and disclosure requirements in sustainability reporting; requirements that lead to reliable reporting backed up by the appropriate processes, controls and systems needed to ensure such reporting can be subject to assurance.

However, the information called for is often far from homogeneous. As far as the largest reporting entities are concerned, internationally active investors (Institutional Investors Group on Climate Change) have recently, in two open letters[1], called for financial reporting to better reflect and disclose climate-related risks and for both accounting and auditing alignment to the so-called Paris 2050 net zero carbon emission goals. In the European Union, EU law requires large companies to disclose certain information on the way they operate and manage social and environmental challenges. Directive 2014/95/EU also called the non-financial reporting directive (NFRD) – lays down the rules on disclosure of non-financial and diversity information by large companies and amends the accounting directive 2013/34/EU. These companies have been required to include non-financial statements in their annual reports since 2018.

According to the European Commission's website, non-financial reporting helps investors, consumers, policy makers and other stakeholders to evaluate their non-financial performance and to encourage these companies to develop a responsible approach to business[2]. Further reporting requirements will come into force in the EU shortly, such as disclosures as to the proportion of turnover, capital and operating expenditure that meets the criteria to be classified as 'green'[3]. Of course, individual citizens and specific stakeholder groups may have further information needs that are best addressed outside corporate reporting (e.g., consumers may need specific product information). Ultimately – in the context of corporate reporting – meeting these diverse information needs, reference is often made to entities enjoying a so-called license to operate, which their stakeholders will only grant to transparent and sustainable entities.

Internationally, financial and most non-financial information is currently reported in a largely unconnected manner, as there is neither a common framework nor a common evaluation concept. Achieving a more fully integrated approach (i.e., revealing the connectivity, and by considering monetization of certain externalities) needs to become a high priority if corporate reporting is to meet the changing information needs outlined above.

The IDW acknowledges the developments in Europe, whereby EFRAG is currently preparing for the possible development of a reporting standard for non-financial information (NFI) for European application. In our view, developing an European solution may constitute a feasible intermediate step, although we

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[1] We refer to: https://www.unpri.org/accounting-for-climate-change/public-letter-investment-groupings/6432.article, as well as: https://www.iigcc.org/download/investor-expectations-for-paris-aligned-accounts/?wpdmdl=4001&refresh=5fbd205ea2cac1606230110.

[2] We refer to: https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en.

[3] We refer to Article 8 of the Regulation (EU) 2020/852: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN.

would expect that an international standard setter that is able to draw on all existing initiatives would provide an appropriate solution. In the long-term it will be essential to have an international solution in place, supplemented if necessary, by regional regulations such as those of the European Union. Any such regional or national regulations should be complementary and not conflict with standards developed internationally.

We would also like to mention the need to consider sustainability-related reporting in the context of smaller and medium-sized entities, many of whom are a asked to supply reliable information to external entities, be it entities within the same supply chain, or banks from whom they seek funding, or their insurance companies. It is essential that an international sustainability standard setting mechanism include an appropriate representation of SMEs.

In conclusion, the IDW fully supports the development of an international solution for interconnected corporate reporting in the medium to long term and is convinced that the IFRS Foundation should play a key role in establishing international standards for sustainability-related corporate reporting.

The IDW's responses to the questions raised in the Consultation are included in the attached appendix to this letter.

We would be pleased to provide you with further information if you have any additional questions about our response and would be pleased to be able to discuss our views with you.

Yours sincerely

Klaus-Peter Naumann	Bernd Stibi
Chief Executive Officer	Technical Director Reporting

Encl. English language convenience translation of the IDW's position paper: 'The Future of Non-Financial Reporting and Assurance'

Appendix

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?

In our opinion, a standard setting structure should be established at international level as quickly as possible, as there is a need for an international reporting standard with broad acceptance.

The need for sustainability reporting standards

Without question, a change in mindset to 'integrated thinking' within every business will be essential to meeting climate goals and building resilient business entities. High quality standards to drive appropriate reporting on sustainability-related matters have an essential role, because appropriate 'accounting' (in the sense of having available the necessary reliable financial and non-financial information i.e., facts and figures) for sustainability is needed to facilitate and inform integrated thinking.

The primary users of 'traditional' financial reporting also need appropriate sustainability-related information to factor into their assessments of enterprise value in making investment decisions. A continued lack of such information will increase the level of uncertainty in decision-making, ultimately to the detriment of the efficiency of the capital markets.

Further stakeholders' growing interest in a broad range of sustainability matters, including – but not limited to – climate change mitigation issues, also demands appropriate transparency in corporate reporting.

In this context, we also refer to IOSCO's response[4] to the open letter sent jointly by leading bodies in the area of sustainability reporting, which states amongst other things that a good flow of decision-useful information on sustainability factors from the corporate sector is essential.

[4] We refer to: https://www.iosco.org/library/speeches/pdf/20201029-Erik-Thed%C3%A9en.pdf.

The need for an internationally accepted solution

Worldwide, most business entities today are inextricably linked to global operations. Larger entities often participate in global financial markets and their investors and business partners are often geographically diverse. Smaller entities are often part of global supply chains either in terms of their customers and suppliers or their access to both private and bank funding. Thus, addressing sustainability (and reporting thereon in some form) must have a global dimension. The lack of consistency and comparability in sustainability reporting experienced at present is a barrier to effective global markets and trade and ultimately serves as an (unnecessary) barrier to the mitigation of sustainability related matters including climate change and social aspects in that it may be detrimental to integrated thinking as mentioned above.

An international sustainability standards board (SSB) could use the success of IFRS as a role model in following the former IASC approach of firstly assessing what is currently available, identifying the most appropriate approach and then subsequently developing this further and closing gaps until an appropriate sustainability-related standard or set of standards is in place.

For the reasons discussed in the Consultation Paper, we believe that the IFRS Foundation is currently the most well-placed global body to play a leading role in developing high quality setting standards for sustainability reporting at an international level.

We also refer to our comments in our cover letter in this regard.

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?

Yes. We share the views expressed in recent calls for the IFRS Foundation to become involved, as outlined in paragraphs 17-22 of the paper. We believe that the existing world-renowned governance structure supports the objective of achieving consistency and global comparability in sustainability reporting.

A standard setting board (i.e. a Sustainability Standards Board, SSB) to work alongside the current IASB would be in an optimal position facilitate appropriate connectivity between financial and non-financial reporting.

Were the IFRS Foundation to agree to tackle the issue of international sustainability reporting, its own mission would, of course, require appropriate adaptation, and the need for appropriate changes to the governance structure would need to be explored. Also, whilst an approach that seeks to draw upon the existing work of others already active in setting standards and frameworks in this field should lead to an expedient solution for corporate sustainability reporting, it will be necessary to establish a conceptual framework to guide a new standard setter that also draws in part on that of the IASB, since some qualitative characteristics would be common to both forms of reporting. It may be appropriate in the long-term to consider a joint conceptual framework for both standard setting boards to refer to with appropriate divisions to reflect the differences, as this approach could better foster connectivity between financial and non-financial reporting.

<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)?

We agree that the matters listed as requirements for success in paragraph 31 are essential.

As explained more fully in our cover letter, the development of a structure and culture that seeks to build effective synergies with financial reporting (we refer to paragraph 31(f)) is a key aspect of the discussion as to the role of the IFRS Foundation, that will need to be explained further.

We also agree that an approach that seeks to draw upon the existing work of others already active in setting standards and frameworks in this field, including initiatives underway in the EU, should lead to an expedient solution for sustainability reporting.

However, it will be necessary to establish a conceptual framework specifically for sustainability reporting to guide a new standard setter. Such a framework might draw in part on that of the IASB but would also need to address issues such as when monetization of external sustainability-relevant factors would be appropriate beyond solely verbal disclosures. In this context, we note that whilst there are currently many calls for information that is both reliable and comparable, there are further qualitative characteristics, including freedom from bias and completeness, that will also need to be considered in establishing standards, in order to limit the potential for 'greenwashing'.

Finally, we note the need to ensure sufficient expertise on sustainability-related matters within the relevant bodies involved with the IFRS Foundation's work.

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?

It would be entirely sensible to draw on the IFRS Foundation's existing relationships with stakeholders in fostering global adoption and application of future sustainability reporting standards.

In seeking global acceptance, it would also be beneficial for the IFRS Foundation to foster deeper or new relationships with a wider stakeholder base, particularly with non-governmental organisations (NGOs) and relevant legislators.

Question 5

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

Given the urgent need for a global solution, the IFRS Foundation's immediate focus should be on those bodies with an established and well accepted track record for developing frameworks and standards in the field of sustainability reporting, which may be evident from the extent of their application in practice. In this context, we welcome the announcement from five leading global organisations recently of their willingness to work together[5] and the recently announced merger between the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) to form the Value Reporting Foundation.

In order to proceed as swiftly and efficiently as possible, the identification of commonalities with connectivity to financial statements would be a useful first step in sustainability reporting standard setting. Further relevant matters to be reported would then be identified to be addressed in further steps.

[5] We refer to: https://impactmanagementproject.com/structured-network/statement-of-intent-to-work-together-towards-comprehensive-corporate-reporting/.

Without an appropriate focused approach there is a danger that standards would be considerably delayed, by lengthy debates as to their coverage and content. In other words, we believe the IFRS Foundation could work quickly using material already in place to achieve a first standard/set of standards that would connect sustainability-related information with that presented in the financial statements; thus in a relatively short space of time making an appropriate start to drive momentum.

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?

Clearly, global acceptance will be key to the success of any initiative by the IFRS Foundation. Thus, ensuring close involvement of a wide range of stakeholders will be essential, including – from the German perspective – representatives from Germany as well as the EU, both of whom are highly active in this field.

As noted in our cover letter, EFRAG is currently preparing for the possible development of a reporting standard for NFI for European application. In our view, ensuring adequate coordination and cooperation between EFRAG and an SSB is essential. The current reporting requirements in the EU focus on specific industries and larger listed entities, although these requirements already have an impact on smaller and medium-sized entities with whom they do business. The extent to which the EU Commission might amend the scope of legislation was recently subject to public consultation and we await the first draft of possible legislative changes early in 2021.

In our opinion, sustainability-related information covered by an international standard would most likely be supplemented by disclosure requirements in specific jurisdictions including the EU as necessary to align with existing legislation.

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?

There have been several calls to ensure an appropriate reflection of climate-related risks in the recognition and measurement of financial statement items and disclosures required under IFRS. Indeed, the IDW has recently co-signed a statement issued by the A4S ABN on 26 November 2020[6] calling for climate-related and other emerging risks to be reflected in the financial statements. Whilst this is now generally accepted as being essential, on its own it is not sufficient.

We acknowledge the urgent need for action on climate change. As noted in our cover letter, channelling support towards sustainable investments will be essential in any drive to meet climate-related goals. However, at the same time, care also needs to be taken to avoid unintended consequences of sustainability-related reporting such as incentivising ‘greenwashing’ or causing an exodus of investment from those entities who currently need to invest in transitioning their activities towards sustainable solutions.

Certainly, the financial impacts of climate-related risks and financial *and appropriate non-financial* disclosures should be accorded high priority, which is broadly in line with the EU’s Green Deal initiative. There are further sustainability-related issues (in the sense of ESG or CSR) already dealt with in the EU’s Non-Financial Reporting Directive besides just climate-related issues. The Coronavirus pandemic has also raised social awareness of other ESG or CSR aspects including employment conditions etc., so these should also be addressed as a matter of urgency (at least development of a transparent roadmap), once climate-related risks have been addressed.

Question 8

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

As indicated in our response to question 7, we would also suggest the remit of an SSB not be limited too severely to climate-related matters, since other initiatives including those at EU-level already have a broader remit. A so-called building block approach might be a sensible way forward, providing stakeholders are given full transparency on such an approach as to how sustainability-related reporting would be expected to evolve.

It would be counter-productive if national or regional initiatives on globally relevant social and governance aspects superseded the SSB’s work.

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[6] We refer to: https://www.accountingforsustainability.org/en/about-us/our-networks/abn/iasb-statement-of-support.html

Question 9

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

We understand the need for a stepped approach, focusing on connectivity with financial information reported in the financial statements (the impact of sustainability issues on the reporting entity). Establishing an overly broad remit for standard setting on sustainability-related issues beyond this (i.e., including comprehensive information on the external impact the reporting entity's activities) from the outset would require far more time, which is not feasible given the urgent need for a global solution.

Since materiality for financial statements is generally focused on the economic decisions of users, whereby the common financial information needs of users as a group are used as a reference point rather than the specific needs of an individual use, it makes sense to take users (of the financial statements and sustainability-related reporting) as a reference point in relation to those other forms of reporting that supplement users' views of the entity as (already) presented by the financial statements.

The current approach in Germany is to supplement the financial statements in this way by means of a management report (Lagebericht) with defined content (German Accounting Standard No. 20), the purposes of which are a) to provide an appropriate view of the entity's position, b) be consistent with the financial statements, and c) present the opportunities and risks of the entity's future development. An auditor in Germany expresses an opinion on the management report as a whole, not on the individual parts thereof. The German legislator stipulated that an entity's reporting of NFI (as required under EU Law) is part of the management report (but has currently also allowed flexibility in its placement, in that it may be reported in a separate report). However, when it is included in the management report, materiality would be determined by reference to the 'economic decisions of users' criterion noted above. Qualitative factors are, of course, more pronounced where reporting is less focused on numbers.

Although there seems to be an understanding, primarily in financial reporting circles that the economic decisions of *investors* are the main drivers of materiality (i.e., that users are first and foremost investors), 'users' of the financial statements and sustainability-related reporting can also be understood as including others such as customers, suppliers, employees etc. as they also make decisions on their (also financial) interactions with the entity. As the factors influencing users' decision-making may change over time (e.g., form a focus solely on profit to a focus including more sustainability-related matters) their informational needs change and so sustainability reporting will inevitably need to develop too.

For sustainability-related reporting that has a different purpose (e.g., to report on the entity's (external) impact on the environment) a different reference point for materiality may be appropriate. Potentially some aspects of reporting on the entity's external impacts might require a separate report, notwithstanding that the information will also be of interest to (a broader range of) users in deciding on their interactions with the entity. For example, materiality criteria for external impacts might need to be broader i.e., to include how severe (e.g., compared to the entity's industry peers or a predetermined value such as the EU taxonomy) the entity's impact is externally on a specific sustainability aspect, rather than users' economic decisions.

However, because many sustainability-related matters can have an impact on line items or disclosures in the financial statements (i.e., connectivity to the financial statements), we do not believe that a standard setter dealing with sustainability reporting can realistically focus solely on internal impacts in the long run.

In this context, we also refer to our responses to question 2 and 3 above, in which we mention the need for a conceptual framework to guide standard setting for reporting sustainability-related matters.

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?

Both regulators and users of audited financial information recognise that the confidence in financial reporting achieved by mandating financial statement audits is key to achieving an efficient allocation of capital and goods (e.g. investments). As an entity's stakeholders' decisions concerning the allocation of capital and 'goods' (e.g. consumer behavior, employment choice, etc.) are also based on non-financial reporting, an assurance requirement for non-financial information with the same scope and level of assurance as for financial reporting is absolutely necessary.

In Germany, although currently not required by law, it has become common for reporting entities to voluntarily request their NFI reports be subject to an assurance engagement – often by their statutory auditor. Whilst many such engagements relate to limited assurance, some entities request reasonable assurance on all or part of their NFI reports.

Indeed, the reporting entity itself needs to have access to sufficiently precise criteria to determine the content of the report and will also need to have appropriate systems in place to ensure access to reliable and complete data. In line with paragraph 22 et seq of the International Framework for Assurance Engagements[7] certain preconditions for an assurance engagement apply irrespective of whether information reported is to be auditable or subject to another form of assurance engagement, also irrespective of whether this may be limited or reasonable assurance.

An assurance engagement in relation to non-financial information will generally require specific specialist expertise, but so do certain audit issues currently (e.g. actuarial work regarding pensions). Audit firms already ensure they have access to necessary expertise and a sufficient understanding of the field of expertise[8] , as governed by auditing and quality control/management standards.

As noted in response to question 9, the German auditing profession has experience in obtaining reasonable assurance on the management report. This also includes assurance in relation to prognostic information, such as that involved in calculating impairment, fair value measurements, asset retirement obligations etc. Auditors also have the appropriate tools for performing assurance engagements relating to risk management systems. Furthermore, in contrast to other professional groups, auditors are subject to strict professional principles and requirements (e.g., on independence and quality assurance).

Question 11

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

Measuring and Valuing the Impact of Corporate Activities

This initiative should be used as an opportunity for a far-reaching further development of corporate reporting, the aim of which is to provide comparable information about the entity's results in a past reporting period and components

[7] Available from IFAC, published in the IAASB's 'Supplement to the Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements 2018 Edition Volume III'.

[8] We refer to paragraph 10 of ISA 620 'Using the Work of an Auditor's Expert' and paragraph 52 of ISAE 3000 (Revised) 'Assurance Engagements Other than Audits or Reviews of Historical Financial Information'.

of those results (historical reference) and on the possibility of achieving results in future reporting periods (future reference). Hitherto non-financial aspects should also be monetized to facilitate preparation of a full 'statement of comprehensive income', which can be used both to measure the achievement of objectives and to assess future results.

As a strategic partner, the IDW has also expressed support for the work currently being undertaken by the Value Balancing Alliance (VBA) to create a global impact measurement and valuation standard for monetizing and disclosing impacts of corporate activity[9]. The Value Balancing Alliance e.V. is a non-profit organisation with the ambition to change the way how company performance is measured and valued. The alliance's objective is to create a global impact measurement standard for disclosing positive and negative impacts of corporate activity and to provide guidance on how these impacts can be integrated into business steering[10].

Smaller and Medium-sized Entities

The IDW notes that not only the world's larger companies will need to have information on sustainability-related matters available (regardless of whether for internal decision-making and external reporting purposes). Many smaller and medium-sized entities (SMEs) are already being asked to provide specific sustainability-related information to external business partners within the same supply chain or to financial institutions from whom they receive loans or insurers with whom they do business. The combined significance of the SME sector to the global economy means that SMEs have a considerable societal and environmental impact.

Thus, whilst – from a cost benefit perspective – it may be less important for SMEs to report widely on sustainability-related matters in their annual reports, a proportionate approach is nevertheless needed for SMEs to ensure they can supply reliable information to external entities. To that end, an international sustainability standard setting mechanism must include an appropriate representation of SMEs.

As many SMEs, including German SMEs will not apply IFRS, the connectivity to their local GAAP is also potentially a further issue to be considered.

[9] Please see https://www.value-balancing.com/.

[10] Please see https://www.value-balancing.com/about-us/.

Resilience vs. Financial Evaluation of Going Concern

Investors and other stakeholders often state that they need comparable and reliable sustainability-related information to gauge the resilience of entities in which they invest or may invest, and so they use information on both the reputational and financial sustainability-related risks of these entities in their decision-making. In this context, they note that current financial statement approach to going concern is no longer wholly appropriate for these purposes.