DWS

IFRS Foundation
Columbus Building,
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Via email: commentletters@ifrs.org

31 December 2020

Re: Consultation Paper on Sustainability Reporting

Dear IFRS Foundation Trustees,

With more than €759bn in assets under management across major asset classes and ~3,333 employees worldwide, DWS is one of the largest asset manager in Europe in the retail and institutional markets. Operating across Europe, Americas and Asia, we are a truly global asset manager. We are a fiduciary partner to our clients and seek to contribute to a sustainable future: for instance, we recently became a founding member of the Net Zero Asset Managers Initiative.

Responsible Investing has long been a key part of our heritage, because it serves the best interests of those who entrust us to manage their assets. We are proud pioneer in responsible investing and early PRI signatory since 2008.

As the Global Head of Research at DWS, I am responsible for the DWS Research House, which oversees the CIO office for Responsible Investments (responsible for ESG Integration, Corporate Governance, and ESG Engine) and the DWS Research Institute (responsible for fundamental research on sustainability). I am also the Global Head of CROCI® Investment and Valuation Group at DWS, a team that I joined back in 1998. CROCI is a proprietary valuation framework launched back in 1996 to enable full comparability in equity valuation for investors across sectors and markets. Having worked and published for more than 20 years on the issue of corporate valuation[1], I welcome the initiative of creating a Sustainability Standards Board (SSB) to develop global sustainability reporting standards.

[1] F Curto, 'Valuing and Investing in Equities: CROCI, Cash Return on Capital Invested', AP, April 2020. www.elsevier.com/books/valuing-and-investing-in-equities/curto/978-0-12-813848-9

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Within the DWS Research Institute, my colleagues have been conducting research on the issues of sustainability over the past several years. A recent research paper[2], argues that Milton Friedman's argument that '*the social responsibility of business is to increase its profits*' is incorrect and should be consigned to the history books as there is ample evidence that traditional corporate reporting and the drive towards sheer profit maximisation has led to environmental damages and human rights abuses as well as greater inequalities. The report cites DWS and the University of Hamburg's analysis of the academic evidence for ESG and financial performance, which has been cited by many important institutions.

Our investors are demanding increasing disclosure about how their capital is used, the impact that their capital is having on the world, but we face significant challenges in delivering such information.

In another recent DWS paper[3], we highlight how much has been achieved but ESG investing will fail a large part of the investment community without a global ESG Accounting Standard, as ESG Investing is a tower of Babylon of ideas and approaches marring significant progresses.
'Transformational' investments with high impact are required in the coming decade to address systemic risks, according to the World Economic Forum, but a transformational investment starts with a transformational framework that:

- Ensures that the person on the street, the ultimate investor is clear about what sustainability means and what such investments aim to achieve.
- Re-assesses the roles of the different functions along the 'investment chain', currently characterised by the lack of disclosure, where a market of 'experts' and 'data providers' have emerged that claim that they can provide support but they are unregulated in nature and their roles are conflicted.
- Requires investors to step outside their traditional areas of expertise to perform their fiduciary frameworks. The absence of a global ESG accounting standard requires portfolio managers to define, measure and act on ESG issues, which creates an internal conflict of interest for investors, reducing their ability to drive transformational change.

Reporting on sustainable investing is currently a hodge podge that largely fails the issues of sustainability and investors. Further, it undermines the role that an independent accounting profession has performed since the 1870s, when such independence was argued and fought for by the Scottish Chartered Accountants.

Equity investment ought to be long term in nature but long term investors (and humanity) face many urgent challenges and we hope that the following pages will highlight the importance of IFRS acting with urgency. We specifically:

- Recommend to focus on reporting on double materiality of sustainability from the onset. It is essential given what our investors are demanding.

[2] Stakeholders and shareholders: Why Milton Friedman got it wrong, DWS Research Institute Sept 2020 www.dws.com/insights/global-research-institute/stakeholders-and-shareholders/

[3] A transformational framework for water risk, DWS Research institute, Nov 2020. www.dws.com/insights/global-research-institute/a-transformational-framework-for-water-risk/

- Believe that a gradualist approach is likely to fail, non-financial reporting is as important as financial reporting and needs to be fully auditable with management made accountable.
- Argue that the boundary between financial and non-financial reporting is already blurred and not delivering on non-financial reporting means not delivering on the objectives defined by IASB in Article 2 of its constitution.

I take the opportunity to thank you for giving us the chance of providing feedback and wish you all a happy and successful 2021.

Please do not hesitate to contact us should you require further information.

Yours faithfully,

Francesco Curto
Global Head of Research
Head of CROCI® Investment and Valuation Group

Question 1: Is there a need for a global set of internationally recognised sustainability reporting standards? If yes, should the IFRS Foundation play a role in setting these standards and expand its standard-setting activities into this area?

Yes and Yes. Over the past decade, we have seen a clear emergence of the ESG investor. The focus of investor has historically been on capital and the return on capital with little focus on how it was achieved. One of the fundamental features of the ESG investor is to have a better understanding about how capital is used by companies (what is their track record on human rights, gender equality, climate change, social impact, climate impact, biodiversity, life under water). Such information is not available and accounting standards are thus failing to provide essential information to an increasingly important stake of the investment community.

There is a view that ESG reporting is not core to the objectives of the IFRS Foundation as defined in the IFRS Foundation Constitution Article 2. However, we strongly disagree. First, the public interest is at the core of Article 2 and the public interest is to have clarity about how capital is used, else we would not see such an exponential growth in ESG investments.

Second, there is plenty of evidence and economic estimates of the economic damage associated with certain activities, thus the idea that such information is not financial in nature is ill-founded. In the comments made by EY[4] on the 22nd of December 2020, it was highlighted that the distinction between the capital markets approach and the multi-stakeholder approach 'will blur over time'.

It is our view that this concept has already blurred. 2020 was a record year for companies raising capital. However, the complete absence of essential disclosure about the sustainability aspects associated with that capital is undermining the proper functioning of capital markets. The absence of a framework defined by an independent, yet accountable institution, on the matter of sustainability, means we do not know how this capital will be used.

At the same time, investors have taken some of the roles traditionally performed by Accounting Boards with the support of unregulated and unaccountable organisations that decide how to measure ESG, collect data and sell data. The result is a hodge podge marred with significant conflicts of interests, a babel of views about what matters and not enough focus on the issue of sustainability, confusion about fundamental issues such as the meaning of 'sustainability' and a lack of consumer protection at all levels.

The Chartered Accounting profession was developed in Scotland in the 1970s with the purpose of providing investors with an independent, accountable measurement framework associated with measuring capital. In those times, the focus was purely on financial return, with no focus on sustainability.

Today the focus is on the financial return on capital as well as the sustainability of economic activity. It is high time that the Accounting Boards, Audit Committees and Auditors accelerate their action on sustainability. ESG Investing without a global standard will be marred with conflicts of interests, greenwashing and will ultimately fail investors desire to put capital at work to address humanity's

[4] EY, Response to IFRS Foundation Consultation Paper on Sustainability Reporting, December 2020 p.2

sustainability challenges. If the IFRS foundation does not move and act on such shortfalls, they will ultimately fail to deliver on the objectives stated in their constitution.

In defining the role to play, it is essential to go back to first principles regarding the user of capital and the provider of capital. Society requires a proper, independent, functioning Accounting Board to define the ESG measurement framework to be as global as possible and as comprehensive as possible. Reporting against this framework should be mandatory and information should be accessible for free to all, including retail investors who cannot afford the time and resources to understand what sustainability means and who is the proper data provider. Improving ESG data disclosure will also enable investors to go back to do their job of investing and engaging with companies, rather than defining standards and collecting information. **The end result ought to be that there is no other accounting standard or need for ESG data providers in this respect. The accounting standards will provide all the information required for investment, whether you are an ESG investor or not.**

In doing so, the Foundation will need to work closely with all the organisations that have been working on such issues for decades. There is a substantial body of knowledge and information already available on many issues. What is missing is an Accounting Board to coordinate, address conflicts of interest, and implement the framework by addressing ESG data disclosure gaps and integrating ESG issues into financial reporting.

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, but the IASB and the SSB ought to be seen as the two sides of the same coin. The coin being 'reporting'. This requires close connection between the two Boards.

We expect over the long term the two Boards to converge into a single Board as ESG/Sustainability grows in importance and there will not be any additional type of reporting with all standards being ESG / Sustainable in nature. However, it is possibly desirable to have a separate Board in the initial stage to ensure proper representation from the diverse stakeholders and appropriate sense of urgency and focus.

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)?

We suggest an additional requirement for success: whether improved ESG reporting and disclosure actually results in a material improvement in environmental and social issues aligned with the Paris Agreement and the Sustainable Development Goals.

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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 is essential for a global investor to have the same standard applied globally. Sustainability is not a local issue, it is a global issue. In a world where investors may face low expected returns for the coming decade, and where this decade is critical to whether sustainability objectives can be achieved, it is imperative that investors have access to information on how their capital is being deployed, what companies are doing to address the many environmental and social issues, and how that capital is contributing to a sustainable economic recovery.

If states or regions refuse to implement such a framework, it will send a very strong signal to the providers of capital. We therefore call on the IFRS Foundation and its stakeholders to use all possible influence with governments and regulators towards adopting a consistent application of SSB standards globally.

Question 5: How could the IFRS Foundation best build upon and work with the existing initiatives in sustainability reporting to achieve further global consistency?

There is no need to reinvent sustainability reporting. It is essential that the IFRS Foundation builds on the significant amount of work done over the past decade and develops close collaborations with current reporting bodies on sustainability such as SASB, TCFD, GRI, EFRAG and investor associations such as CERES, IIGCC and PRI and various business associations.
It is not that any of such organisation has the solution. It is essential, as discussed in Q1 that the SSB starts from first principles (capital providers and users of capital).

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?

There is much work that has been done in certain jurisdictions on sustainability reporting. However, each jurisdiction may have a different priority that reflects its national interests and SSB ought to provide a framework that satisfies global investors. Within this context, our suggestion is to engage and strengthen its ties with IOSCO and FASB, given their roles in the correct functioning of capital markets and investors protection.

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?

An increasing number of companies are already reporting climate-related financial information on a voluntary basis. There may be consistency issues to enable full comparability but we anticipate that this can reasonably easily addressed in the short term. What is urgently required is an overarching framework with a tight schedule associated with each step that will ultimately allow the investor to have all the required information to be able to compare and contrast companies on the issues of sustainability. Only focusing on climate change in 2021 is like looking in the mirror and missing many other essential and inter-related issues that investors face in the coming decade, such as equality

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(including a Just Transition to a net zero and climate resilient society), human rights, water, and biodiversity. Such issues are already driving companies' capital decisions and flows into ESG funds, but where is the proper associated disclosure?

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

See answer to question 7: broader environmental and social factors are required.

Question 9: Do you agree with the proposed approach to materiality in paragraph 50 that could be taken by the SSB?

No. It is far too slow. The SSB should start from the onset with a double materiality approach. This amongst various things would ensure that it does not fall behind what is happening in the EU with regard to financial reporting and the investors' commitment to net zero (essentially an 'inside-out' perspective). Asset owners with more than USD5 trillion in assets and asset managers with more than USD9 trillion in assets have made this commitment and these numbers will grow significantly in 2021.

The current ESG framework is already failing investors. Investors are already demanding information about whether child labour is used in the supply chain, the water impact of cotton used by clothes manufacturing and retailers, whether banks and insurance companies are financing coal plants. If the approach until 2019 was primarily about assessing the implications that externalities associated to the issue of sustainability had on a firm (outside-in), today investors are increasingly interested in assessing the impact that capital has on the world (inside-out). This shift has accelerated in 2020.

In a recent report published by the group of five frameworks and standard setters (CDP, CDSB, GRI, IIRC and SASB), the concept of 'nested materiality' was presented, highlighting the three approaches to materiality:

- Reporting reflected in financial accounts.
- Reporting on sustainability topics that are material to Enterprise Value creation.
- Reporting on matters that are significant to the economy, environment and people.

We disagree that SSB should target the first two items only. Such an approach will leave out a significant and increasing part of the investor market that aims to provide capital with a view of having a positive impact on the world while having a fair return on investments. Who will serve such investors? As highlighted in paragraph 46 'the current mission of the IFRS Foundation is to deliver robust, reliable and transparent information as input for decisions of the primary users of general-purpose financial statements.' Integrating the three boxes of nested materiality is essential to serve investors. Impact investing will not be served by the first two categories.

The progressive approach proposed in paragraph 50 was acceptable 20 years ago. But given the exponential rise in ESG investments on a wide array of ESG issues, a progressive approach risks continuing to fail the public. It also implies that IFRS will continue to miss on delivering on the Article 2 of its constitution as we argue that the boundary between financial and non-financial reporting has already blurred.

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Furthermore, significant amount of work has already been done. SSB is building on a vast array of knowledge and experience. While the complexity is high, we suggest that it is no different than what accountants faced 60 years ago when they needed to estimate the economic life of a nuclear power plant or of the capitalisation of development costs for an oil well or a mine. It is a challenge but there are many resources available to build upon.

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?

Yes, it is imperative that such information are fully auditable. What has traditionally been defined as non-financial reporting is today essential for capital allocation within the economy. It is the other side of the coin as mentioned in Q2. Non-financial reporting has to have all the characteristics of financial reporting.

We suggest that lessons be taken from the Investor Expectations for Paris-Aligned Accounts[5], to which DWS is a signatory.

Question 11: Stakeholders are welcome to raise any other comment or relevant matters for our consideration.

We agree with the EY recommendation about integrating sustainability reporting into management reports[6]. We see some merit in PWC proposal[7] that it is not necessary to issue separate standards for individual industries, but looking forward to additional details on their proposal.

We finally also encourage IFRS to begin to engage with the critical topic of how financial institutions use their role to support companies and the real economy to make actual improvements in climate and other sustainability issues: i.e. transformational or impact investments. This will be critical to support a focus on double materiality. For instance, DWS contributed to IIGCC guidance for net zero/Paris aligned investments[8]. The work of the 2 Degrees Investing Initiative on measurement and target setting for financial institutions[9] is also relevant.

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[5] IIGCC, Investor Expectations for Paris-aligned Accounts, Nov 2020. www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/

[6] EY Response to IFRS Foundation Consultation Paper on Sustainability Reporting, December 2020

[7] PWC 2020 Response to IFRS Foundation Consultation Paper on Sustainability Reporting, December 2020

[8] IIGCC August 2020 https://www.iigcc.org/our-work/paris-aligned-investment-initiative/

[9] 2 Degrees Investing Initiative 2020 https://2degrees-investing.org/topic/impact-target-setting/

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