Viewpoint: A response to ISSB's Faber's 'triple illusion' criticism of double materiality

Frédéric Ducoulombier, EDHEC-Risk Climate Impact Institute, says the ISSB chair straw-mans the positions of advocates of the EU ESRS's double materiality

In an op-ed published by French reference newspaper Le Monde* earlier this week, Emmanuel Faber, chair of the IFRS Foundation's International Sustainability Standards Board (ISSB), represents that the double-materiality approach to sustainability reporting is a simplistic concept whose popularity derives from a "triple illusion".

His offensive takes place as the first set of European Sustainability Reporting Standards (ESRS), which have double materiality at their heart, are under scrutiny by the European Commission's co-legislators prior to definitive adoption.

Materiality is a key principle of corporate reporting, but its definition has evolved over time.

What is now the traditional view of materiality in accounting is defined in relation to the financial decisions of providers of capital; Faber explicitly identifies with this so-called financial materiality perspective. This perspective need not disregard environmental or social factors, but considers that the only sustainability-related information that requires reporting is that which has financial materiality.

The double materiality view also considers the needs of a multiplicity of stakeholders that are or may be impacted by the activities of the reporting entity, and calls for the disclosure of the entity's material impacts on people and the environment irrespective of financial materiality.

> **"Financial materiality, however, is defined in relation to the judgment of a reasonable investor rather than the hypothetical reaction of an implicitly efficient market"**

Faber calls double materiality simplistic and then accuses parties espousing it of rejecting financial materiality, deeming it "simple". Let us review Faber's case.

Let us take the first illusion Faber sees, that the "performative power of materiality" – described as an "immediate, clear, and strong" market reaction – could extend beyond the economic sphere. Faber represents that impact materiality disclosures serve "a myriad of piecemeal usages" whose impacts are infinitesimal.

Financial materiality, however, is defined in relation to the judgment of a reasonable investor rather than the hypothetical reaction of an implicitly efficient market. For centuries if not millennia investors and other stakeholders have integrated non-financial considerations into decisions that financially impact companies; as the weight of stakeholders responding in similar ways to a given environmental, social, or governance (ESG) issue increases, the issue can become financially material for capital providers.

And while this most often happens gradually as societal norms change or impacts become better understood, the transition is sometimes so swift it can quickly bankrupt blind-sighted entities.

> **"Double materiality is not a Trojan horse of business-as-usual interests"**

The second illusion, according to Faber, would be that an exhaustive account of impacts be possible. However, the legislator is only asking for disclosure of material impacts of relevance to stakeholders.

The third illusion would be to equate disclosure with change in corporate behaviour and let double materiality "obscure the need for political ambition". There is theoretical merit in this warning of Faber, as the introduction of disclosure requirements has too often been promoted as a light-regulation solution to societal ills. Seen in this light, sustainability disclosures could be not only ineffective but also counter-productive in providing an excuse for lack of substantive action.

EU resolve tested

In practice however, the role of the Corporate Sustainability Reporting Directive (CSRD), which the ESRS flesh out, is to ensure transparency and accountability of companies in relation to their sustainability impacts, risks and opportunities in the wider framework of the substantive sustainability goals and policies of the European Green Deal.

Double materiality is not a Trojan horse of business-as-usual interests; actually, impact disclosures are opposed by some of the very same interests that are lobbying to derail or delay substantive regulation. Faber's criticisms of double materiality do not resist proper inspection, and instead of three illusions we are left with an illusionist.

Faber concludes his attack with a call to "put an end to groundless disputes" to "ensure that efforts converge towards the integration of the interdependence between economics and ecology". It may be surprising to conclude a diatribe with a plea for a truce and to seek the cooperation of people whose positions have been straw-manned and disparaged.

Proponents of impact materiality have heard these calls to put an end to divisive narratives before and many have concluded that they were simply uttered to avoid an honest debate about material differences of views in relation to the responsibility of businesses and the integration of ESG concerns into accounting and reporting systems.

Without serious scientific basis, it has been argued that in a world facing sustainability challenges, profit-seeking companies would necessarily integrate sustainability in the long term to ensure resilience and success. This may not have worked very well in the past, but this time it would somehow be different, the argument goes.

European Union legislators have resolved that this would not suffice and decided to measure the sustainability performance of corporates and to track their contribution to the bloc's sustainability objectives. This was despite intense lobbying by certain business and geopolitical interests that promoted mere alignment with the future ISSB standards. EU rulemakers' resolve is being tested.

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