Nicolas d'Hautefeuille and Jean-Philippe Dorp personnal Answer to Jean-Paul Gauzes' Public Consultation Document on my ad personam non-financial reporting mandate

Nota Bene: **The answers below are our** *ad personam* **answers and can be published on EFRAG's site.**

Nicolas d'Hautefeuille is an investment banker and financial analyst for major corporate clients. He is a member of SFAF's valuation & accounting commissions, and belong to the Académie de comptabilité. Jean-Philippe Dorp is the chairman of the **CFA Society France**. Both of us would like to thank our colleagues for their trust and their support.

First of all, we would like to emphasize that EFRAG is doing a very useful work. More specifically, under Jean-Paul Gauzes' leadership, EFRAG found the right balance between supporting the IASB while increasing the ability for the European Union to influence international accounting standards to check that they create value both for European financial stability and profitable growth (as requested by the directive).

We fully support Jean-Paul Gauzes' vision that there is a strong need for the European Union to increase its oversight on accounting regulation and extra financial reporting; both are key drivers for economic growth and financial stability.

QUESTION 1 - DUE PROCESS

Do you agree that the above reflects the key due process steps for open and transparent non-financial standard setting? If not, which other steps would you advise me to consider or to remove?

Under Jean-Paul Gauzes' leadership, EFRAG has been highly successful to find the right balance between working together with the IASB while taking more into account Europe public good.

However, EFRAG is still lacking the human and financial ressources to implement this new policy.

I agree that EFRAG's due process are already the key steps for open and transparent regulations but I would advise that EFRAG should make 2 major changes in its due process:

1. **A strong increase in its research budget** to implement the « better communication » project ie back testing on the impact of accounting and extra financial reporting on the adequacy in financial metrics. Resources should be permanent as to offer visibility for EFRAG to manage long term projects aligned with its mission, while protecting its independence.
2. **A strong push in digital reporting** to manage the complex inter action between extra financial reporting and accounting.

EFRAG should upgrade its due process because if regulation provides more exhaustive and transparent nonfinancial reporting, auditors and financial analysts will challenge management on their financial reporting.

The O&G industry is a business case: when BP detailed the impact of green energy on its business model, this nonfinancial information triggered major impairment on its assets. Moreover, companies like BP shifting their strategy to low carbon energy require new communication framework in order to share targets and achievements with all their stakeholders.

EFRAG's due process must help both corporates and investors to manage this domino effect:

- Major changes in the "fair" value of capital is driving more free cash flow over the long term.
- But today neither management or investors can adjust DCF based on audited accounts.

QUESTION 2 - MEMBER STATES AND NATIONAL PUBLIC AUTHORITIES

Considering the proposed new governance structure (see section 5 EFRAG proposed new core structure) at what level do you consider that the relevant national authorities should be involved and should they be members or observers:

• EFRAG General Assembly? Yes as member

• The EFRAG Board responsible for the oversight of the Non-Financial Reporting Board (see diagram in the Preliminary Report)? Yes as member

• The Non-Financial Reporting Board? Yes as observer

• TEG for Non-Financial Reporting? No

Should a Consultative Forum (similar to the Consultative Forum of Standard Setters in the Financial Reporting pillar) or any other form of advisory committee; be created for the Member States and national public authorities? Yes

1. National authorities in democratic states are providing a strong input on the link between ESG reporting and profitable growth.
2. Non financial reporting is a key part of the regulation process. ESG must help corporates to optimize their capital allocation to implement Europe green strategy.
3. As part of the broader European strategy (RFF), policymakers will have to rely on consistent and reliable data to assess the impact of public resources on the private sector

For these 2 reasons, national authorities should be more involved on EFRAG's board and the IFRS Foundation should not take the lead on extra financial reporting.

Big states should become members and smaller states observers.

QUESTION 3 - EUROPEAN INSTITUTIONS AND AGENCIES

Considering the proposed new governance structure (see section 5 EFRAG proposed new core structure) at which level do you consider European institutions and agencies should have representatives and should they be members or observers:

• The EFRAG Board responsible for the oversight of the Non-Financial Reporting Board (see diagram in the Preliminary Report)? Yes as member

• The Non-Financial Reporting Board? Yes as observer

• TEG for Non-Financial Reporting? No

• The Working Groups? No

Should a Consultative Forum or any other form of advisory committee; be created for European Institutions and Agencies to provide input to the TEG for Non-Financial Reporting and the Non-Financial Reporting Board? Yes

The support from the European peoples is key to provide a strong legitimacy to EFRAG in its new mission: **increasing the links between EFRAG and the European parliament is instrumental to make the regulatory process more efficient and transparent. However, EFRAG must be protected from interference.**

QUESTION 4 - PRIVATE SECTOR AND CIVIL SOCIETY

Considering the proposed governance structure (see section 5), at which level do you consider private sector and civil society ought to have representatives:

• *The EFRAG Board responsible for the oversight of the Non-Financial Reporting Board (see diagram in the Preliminary Report)?* No

• *The Non-Financial Reporting Board?* Yes as observer

• *TEG for Non-Financial Reporting?* Yes as member

• *The Working Groups?* Yes as member

Trust in the accuracy and reliability of reporting provided by European corporates is driving financial stability. <u>But adjusting financial metrics is becoming too complex for investors which are relying more on data providers than on their own due diligence</u>. Digitalization should facilitate direct access to non-financial data from users.

EFRAG should nominate at its board users and academics who should check that extra financial reporting will impact capital allocation by improving the accuracy in the metrics provided by data providers.

This work on "back testing" has a high cost which should be supported by a strong increase in EFRAG's research budget. EFRAG must consider that the quality of the work done by users will be driven by incentives provided.

- The answers to IASB and EFRAG's request for comments are highly time consuming. EFRAG should provide compensation to the professional associations for their research programs.
- EFRAG should also pay professionals if they need to dedicate more than 20 % of their time to their work for EFRAG's TEG or other working groups.

EFRAG should take the lead on research to use the digital tool as a way to improve both financial and extra financial reporting; this policy will reduce conflict of interest and limit the ability for global firms to lobby unfairly European regulations.

QUESTION 5 - SMEs

Considering the proposed governance structure (see section 5), at which level do you consider SMEs (SMPs) should be represented:

• *The EFRAG Board responsible for the oversight of the Non-Financial Reporting Board (see diagram in the Preliminary Report)?*

No

• *The Non-Financial Reporting Board?*

Yes as observer

• *TEG for Non-Financial Reporting?*

Yes

• *A SME- focused Working Group?*

Yes

Would it be sufficient to seek input of SMEs/SMPs in the public consultation and outreaches rather than involve them in the governance bodies?

SMEs are the major driver for growth and employment in Europe. There is a strong need for a dedicated SME focused working group. SMEs will improve EFRAG's governance by increasing the feedback from the peoples.

However, as SMEs ressources are more limited than large corporates, their representation should probably involve more their professional associations.

More specifically, EFRAG should institutionalize the participation from mutualists associations in its governance bodies: mutualist groups' have built their core corporate values on ESG principles and are at the forefront of building a green strategy for Europe.

QUESTION 6 - COOPERATION WITH OTHER STANDARD SETTERS AND INITIATIVES

What do you see as main features of cooperation with the (global) reporting initiatives? What kind of involvement could you consider?

As the border between financial reporting and extra financial reporting is porous, EFRAG should work together with the IASB to implement its "better communication project".

More specifically, EFRAG should ask the IASB to update its accounting standards together with the FASB and the FRC to speed up the use of the XBRL/ESEF taxonomy as a tool to reconciliate IFRS and US GAAP.

Today adjustments on ARO (asset retirement obligations) is highly complex because standards are not consistent:

- In the US some industries are netting ARO with their tangible assets.
- In Europe ARO are adjusted as financial debt by rating agencies. This mismatch in accounting regulation is jeopardizing comparability to benchmark industries on a global basis.

Comparability in financial metrics is a key stake to implement extra financial reporting

- EFRAG must work together with the IASB, the FRC and the FASB to increase the level of disclosure on the assumptions used by corporates to make impairment test on the value of their assets and liabilities (goodwill and ARO).
- Each industry should be in charge to monitor the impact of extra financial reporting on its financial metrics to take into account the specificities in its business model. Working on "best practices" could be part of EFRAG's due process to adopt a step by step approach which will avoid the risk of "accounting or regulation cliffs".

QUESTION 7 - EFRAG BOARD

What in your view should be the maximum size the new EFRAG Board?

No comment

Which stakeholders should be represented and in which proportion?

Parity between national regulators and European agencies on one side and users (ie corporates, auditors, financial analysts and investors) on the other side

Should there be observers? If so, who should be the observers?

Yes, observers could help to create partnership with other regulators.

The IASB, FASB, the FRC and the Japanese regulator could be invited as observers to confirm Europe's commitment to make convergence or at least reconciliation in global accounting regulation its top priority.

Do you foresee any obstacles that may arise were the EFRAG Board charged with oversight to include representatives of the Non-Financial Reporting Board and the Financial Reporting Board?

No, it should improve the "working together" spirit and make the regulatory process more efficient.

Should the EFRAG Board appoint the members of both TEGs and the European Lab, or should this be done by their respective Boards (Non-Financial Reporting Board and the Financial Reporting Board)?

It should be done by their respective board to increase the "Public / Private" partnership ie the TEG and the European Lab should be managed by users with funding and oversight by EFRAG.

- The users must operationally be "at the helm" to make sure that this new regulation will be perceived as under their control.
- This due process will reduce the risk that users will perceive the new regulation as not efficient to help them to make capital allocation more efficient.

QUESTION 8 - NON-FINANCIAL REPORTING BOARD

What in your view should be the maximum size of the new Non-Financial Reporting Board?

A large board is less efficient.

Which stakeholders should be represented and in which proportion?

EFRAG should tailor its governance on its US and UK peers and built strong partnership with them. Non financial reporting is a global issue but driven by regional rules which should be discussed between national regulators to make them as consistent as possible.

EFRAG should build bridges with the FRC and the FASB because large European companies are global and will support regulation which are more consistent between Europe, the UK and the US. This is also the request made by the Financial Stability Board to the IOSCO.

Should there be observers? If so, who should be the observers?

Yes it could help to find the right balance between size and representativity

Should the Non-Financial Reporting Board members be appointed by the EFRAG General Assembly on recommendation of the EFRAG Board or directly by the EFRAG Board?

Directly by the EFRAG Board as a way to enhance EFRAG's legitimacy as the European accounting agency

How can the interconnectivity between the Financial Reporting Board and the Non-Financial Reporting Board be ensured?

This is the key challenge: EFRAG's due process must help European corporates and investors to manage this interaction between ESG, capital allocation and enterprise value with 2 priorities.

Priority 1. Extra Financial reporting must be clear and simple

Extra financial reporting should not fall in the same trap than IFRS standards: highly technical rules which will create the perception that Europe is once again on the path of over regulation with no clear analysis on the modelisation of the impact on share price and economic growth.

Priority 2. Capital allocation should be driven by EVA ie change in the fair value of both assets and liabilities

- Focusing more on the EVA financial model (economic value added) than on DCF will help corporates to provide more information on the key inter action between their return on capital and their cost of capital.
- ESG will increase market value and speed up economic growth if it helps European corporates to generate higher and more stable return on their capital than their competitors while reducing at the same time their cost of capital.

This spread between return and cost of capital is the key driver for free cash flow over the long term and is also the paradigm for financial stability and profitable growth.

A common, comparable and consistent framework for qualitative information on the three principles (E, S and G) should be encouraged.

QUESTION 9 - TEG FOR NON-FINANCIAL REPORTING

What in your view should be the maximum size of the new Non-Financial Reporting TEG?

A large board is less efficient.

Which stakeholders should be represented and in which proportion? Should there be observers? If so, who should be the observers?

TEG should work together with its US and UK peers and focus on building a strong partnership with them.

Do you agree that EFRAG TEG members are recommended by the EFRAG Non-Financial Reporting Board but appointed by the EFRAG Board rather than be appointed by the EFRAG Non-Financial Reporting Board?

Yes I agree

How can the interconnectivity between the Financial Reporting TEG and the Non-Financial Reporting TEG be ensured?

This is the key challenge: cf infra.

QUESTION 10 - ACTIVITIES OF THE EUROPEAN LAB

Do you agree that there is a need for a European Lab activity in the revised EFRAG governance structure?

Yes because managing the inter action between non-financial and financial reporting is highly complex: the European Lab should enlarge its research on the use of digital reporting (ie XBRL and ESEF taxonomy) as a way to provide more flexibility to corporates in their public reporting and in the management of their balance sheet.

Do you agree that the European Lab could address both non-financial reporting and financial reporting activities?

1. Yes the European Lab should transform itself into a Financial Lab should set best practices to help corporates to reconciliate their financial metrics with audited figures.
2. The Financial lab should also work together with ESMA to implement back testing on the adjustment made by rating agencies and data providers.

Do you have other comments or suggestions regarding the activities of the European Lab?

The European Lab should fund a major research project to position Europe at the forefront of the digital revolution in accounting and financial analysis.

- Back testing based on digital accounting should transform scoring from an art into a data science.
- Capital allocation will become more efficient and will help European corporates to compete with their US and Asian peers.

QUESTION 11 - FUNDING

Considering the proposed governance structure in this consultation document:

Should the majority of the funding, or even all the funding, be provided by the European Commission and the Member States?

No EFRAG should be funded more as an European foundation than a public agency

Is it important that the private sector contributes to the funding and why? Should the public-private sector partnership model also be reflected in the funding?

Yes, it will contribute to EFRAG's governance as a foundation

Would a levy at national or European level be feasible?

Yes if it can help both ESMA and EFRAG to be more independent by providing more stability in their budget.

As a rule, there is a strong logic to consider that both ESMA and EFRAG should benefit from more financial ressources than their international peers and the IFRS Foundation: their mission are more complex due to the specificity of the European Union which make the decision process more cumbersome.

What alternative financing mechanism would you suggest

The European Union should make a long term commitment: approval on a budget over 5 years by the European Parliament and the European Commission will mitigate the risk of "stop and go" in EFRAG's research programs and position Europe at the forefront of the digital revolution in financial and extra financial reporting.

ANNEX: QUESTIONNAIRE

Deadline for completion: 30 October 2020

Email: Nominations@efrag.org with copy to jean-paul.gauzes@efrag.org

Your response will be uploaded to the EFRAG website, unless you indicate otherwise.

In your opinion, if EFRAG were entrusted with the development of possible EU non-financial reporting standards in a revised NFRD, how would the following general and specific considerations, identified as relevant to standard setting mechanism, apply if EFRAG were to be the standard setter? (NB: this does not affect EFRAG' present mission)

Nota Bene: **The answers below are my personal opinion.** This opinion reflects my work as an investment banker and financial analyst for major corporate clients. It is also based on indepth discussions with SFAF's valuation & accounting & ESG commissions, and my colleagues from the Académie de comptabilité. I would like to thank them for their trust and their support.

First of all, I would like to emphasize that EFRAG is doing a very useful work. More specifically, under Jean-Paul Gauzes leadership, EFRAG found the right balance between supporting the IASB while increasing the ability for the European Union to influence international accounting standards to check that they create value both for European financial stability and profitable growth (as requested by the directive).

1. Governance – Structure and due process

1.1 Standards need to be developed in the public interest and no individual category of stakeholder may exercise undue influence: How can it be best ensured that standards are developed based on an inclusive and transparent due process? What should be the characteristics of such a due process?

My opinion is that EFRAG's governance is more balanced and efficient than the IASB's one. Users must work together with regulators to set efficient standards both for extra financial but also for financial reporting; to ensure that the process is more transparent and more efficient, EFRAG and ESAM should implement a 2 steps process.

1. **The first step is to discuss "best practices"** with users on an industry by industry basis ie EFRAG's Lab should act as a "go between" with issuers, auditors, financial analysts, assets managers, CRA but also data providers like Bloomberg and Factset.
2. **The second step is to transform these "best practices" into regulated standards** ie the European Union (working together with the US, the UK and the IASB) should either adopt global standards (like IFRS 15) or at least if convergence is not possible, take care that reconciliation in accounting and extra financial reporting will improve comparability.

1.2 Relevant European institutions and agencies shall be invited to be fully involved in the development of future standards, including the European Securities and Markets Authority (ESMA): How can these European Institutions and agencies be involved in the development of future standards and in the standard setter? Should there a particular role for ESMA?

Based on EU regulation, ESMA is in charge of implementing back testing on CRA's methodologies.

- More specifically, ESMA should check if the new methodologies applied by CRA to adjust actuarial debt are improving accuracy in ratings.
- ESMA should also check the consistency in the adjustment made by data providers on free cash flow, capital employed and WACC (cost of capital).

My perception is that there is a rising inter action between back testing, audit & ESG.

Today, there are rising concerns on the opacity of financial reporting but this opacity is as much the result of failure in audit than the lack of accuracy in the methodologies applied to adjust financial metrics by data providers and to take into account the strong impact of ESG on financial results.

ESMA must work together with EFRAG on building a bridge between ESEF (ie XBRL taxonomy for Europe) and ESG taxonomies as a way to make both extra financial and financial reporting more efficient to adjust financial metrics.

- Today financial analysts have limited time to spend on a full due diligence (due to the negative impact of MIFID on their breakeven).
- They are highly dependent for their benchmarking analysis of the quality of the adjustments made by global data providers (ie garbage in, garbage out!)

1.3 To permit relevant national public authorities to provide input about whether any future standards are responsive to the public interest, how can these authorities be included in the governance of the non-financial reporting pillar? Which authorities would be the most relevant and how should they be involved?

Extra financial reporting differs from financial reporting, because it is today more driven by regional or national regulation.

Based on this fact, there is a strong logic to consider that extra financial reporting cannot be implemented by setting global rules. This is the reason why EFRAG is more legitimate than the IASB to implement extra financial reporting for European issuers.

The other challenge for EFRAG is that the impact of "green" regulation is driven by its impact on capital allocation:

- Europe wants to take the lead to make industries more green.
- But extra financial reporting has less impact on primary financial statements than on the appendix, because ESG is often more a long term than short term issue.

To take an example, Danone made public the impact on its income statement of CO2 regulation.

- However, the most important information for financial analysts is to assess the impact of extra financial reporting on its business model.
- Danone should include in its appendix detailed extra financial and financial information on the impact of ESG on the return on capital by business unit.

Extra financial reporting will speed up the use of ESG in capital allocation if it helps financial analysts to implement sensitivity analysis on the impact of extra financial reporting on free cash flow.

- Today DCF (discounted cash flow) is computed by focusing only on free cash flow (ie FFO – CAPEX & working capital).
- Tomorrow, the challenge based on extra financial reporting is to take into account also the fair value of off balance sheet assets or liabilities which will become a full component of the analysis of the return on capital.

This information cannot remain "extra financial" but should over the time become a key part of the information provided by management to give a "true and fair" value of the company's financial results.

1.4 Should private sector and civil society representatives be involved in the standard setting work? If so, what would be suitable options for doing so in a balanced way? Which stakeholders1 should be involved? Should the standard setting pillar be a public-private partnership like in the financial reporting pillar?

EFRAG should work together with the SEC and the FRC's financial lab to make scoring "clear & simple".

- Making scoring "clear and simple" is the main driver for the IASB to help issuers to implement its "better communication project".
- FRC's financial lab has been successful to improve this "working together" spirit between issuers, auditors, financial analysts & regulators.

Rising complexity in IFRS standards are detrimental for the comparability in financial metrics, despite all the recommendation made at numerous time by both the Financial Stability Board and IOSCO.

EFRAG should support the work done by "Financial Labs" both in the EU, in the UK and in the US, to combine extra financial reporting with XBRL / ESEF taxonomy as a way to improve comparability in 2 major KPIs:

1. What is the impact of actuarial debt and "fair value" on interest cover for credit analysts?
2. What is the impact of change in "fair value" on Free cash flow and DCF for equity analysts?

1.5 If there were to be SME standards derived from the future EU non-financial reporting standards, how should the SME angle be addressed in the governance and in the standard setting process?

SME are one of the key motor for economic growth. Their small size is a major asset to speed up innovation.

However, Europe has not been able to compete with the US to transform "startups" into "licorns"; the main reason is the lower Enterprise Value for a listing on European financial markets than in the US, which increase the incentive to finance growth with the support from private equity funds.

- Today it is more efficient for European entrepreneurs to fund their project with private equity funds or to look for a listing in the US in term of optimizing enterprise value for their shareholders.
- This gap in value between listed and unlisted companies in the US or in Europe is jeopardizing economic growth in Europe. A more efficient capital allocation based more on EVA than DCF is key to increase return on capital for European companies.

1 The annex to the invitation of EVP Dombrovskis on the context in which the question of possible European reporting standard under the NFRD is being considered includes a list of possible relevant stakeholders.

1.6 Which governance structure would you foresee for the EFRAG EU non-financial reporting standard setting pillar? How would this fit in the overall EFRAG governance structure? What relation would there be with the financial reporting pillar, if any?

2. Governance – Cooperation with standard setters and other initiatives

2.1 Any future possible EU non-financial reporting standards must be built on existing reporting standards and frameworks to the greatest possible extent:

• How can the relevant existing standard-setting organisations be closely associated in future standardisation work? How would you see cooperation and involvement?

My perception is that users want that both the European commission and the IASB to slow down their production of new rules because they are often costly to implement for issuers and not always a progress for investors.

Setting “best practices” in term of financial reporting is less costly and probably more efficient because it creates a “win / win” situation between issuers and users.

• More broadly, how should cooperation with existing public and/or private initiatives producing international standards and framework be established, to ensure that any future non-financial reporting standards applying in the EU build to the greatest extent possible on existing standards and frameworks?

Global standards remain the ultimate goal. But working at the IASB level on global standards for extra financial reporting is probably not efficient today because it creates an incentive to look for more complex standards which are costlier to implement for users and not transparent for users.

The priority today both for financial and extra financial reporting is probably less convergence than reconciliation.

• How can the EU non-financial reporting standard setting have a global impact?

As a follow up to the conference co organized by the SFAF and JPA international on October 1rst and co-chaired by Jean Claude Trichet and Jean Paul Gauzes, please find below a project with Jean Philippe Dorp (chairman CFA France) to use accounting digitalization (ie XBRL in the US and ESEF in Europe) as a digital tool to transform scoring from an art into a science.

This project should generate huge synergies with EFRAG’s proposal to set up an European taxonomy for extra financial reporting.

2.2 How to establish an appropriate coordination between the financial and non-financial reporting so as to ensure that financial and non-financial reporting provide an integrated view of the performance, position, development and impacts of reporting companies?

There are 2 methods to include extra financial reporting in credit and equity analysis:

1. **The first method is to use ESG and extra financial reporting as a way to “notch”** (up and more often down) business risk as Moody’s and S&P are doing today. Equity analysts are also using higher WACC as a way to take into account extra financial risk in their DCF. But this approach has a major drawback: it does not create an incentive for companies to change their capital allocation.
2. **The second method is to adjust “fair value” in the capital employed** to compute the impact of ESG on EVA (ie return minus cost of capital) as a proxy for free cash flow. This approach is more efficient to increase the impact of ESG on capital allocation. However, “fair value” as implemented today by the IASB is making very difficult to adjust return on capital employed.

The solution to square this circle is not to change primary financial statements but to increase the information provided in the appendix to make sensitivity analysis on debt, free cash flow and interest cover.

3. Possible changes to finance of EFRAG

3.1 What ideas do you have for financing of the non-financial reporting pillar? Should the financing reflect the public-private partnership?

Europe has today a huge deficit compared to the US and the UK to fund research on the use of digitalization in financial analysis.

- Private financing is not appropriate because it creates a concern on “lobbying”.
- Public funding by the European commission is the only solution.

4. Do you have any other comments you want to share?

I would like to congratulate Jean-Paul Gauzes for his strong leadership. Thanks to his bold action, Europe is rebuilding its sovereignty on regulation without jeopardizing its strong push to create international accounting standards which will improve stability in global financial markets.

However, to make the regulation process more transparent and efficient, EFRAG must support more research on the impact of AI and ESG on credit and equity analysis.

- Scoring is less an academic issue than a practical issue for professionals.
- The challenge is to solve complex methodological issues which are the results of the rising complexity in accounting standards.