PTF-RNFRO
Response to Consultation Document
4 January 2021

Consultation Document on the *Ad Personam* Mandate on potential need for changes to the governance and funding of EFRAG

Dear Jean-Paul

Thank you for the invitation to comment on the potential need to modify EFRAG's governance and funding to accommodate a potential expansion of its mandate.

This is an exciting moment in modernising the policy infrastructure of corporate reporting in the EU and is likely to have consequences for capital market participants for many years to come. As members of Project Task Force (PTF) on Non-Financial Risks and Opportunities and Linkage to the Business Model (RNFRO) we are not in a position to formulate a detailed response to every question set out in the Consultation Document but as experts in the area we have set out below our general observations and comments on the prospect of EFRAG being appointed as a standard setter.

As co-chairs of the PTF-RNFRO we remain at your disposal should you wish for us to elaborate on any of the points we have made in our submission. We wish you well in finalising your recommendations to the European Commission.

Yours sincerely

Dawn Slevin and Mario Abela

General Comments

- What is being proposed is a fundamental change to the mission, structure and governance of EFRAG as currently constituted. With that in mind it is important that these changes are not seen as an 'add on' but signal the EC's ambition for EU companies to have regard not only for their cash returns to shareholders but their impact on people and planet. Moreover, to achieve environmental and social policies set for EU, it is important that companies become active agents of making the relevant transitions needed to achieve the targets set. It makes sense for EFRAG to be renamed the European Corporate Reporting Advisory Group to reflect to stakeholders that its expanded role is to drive better integration between what has been an artificial split between financial and non-financial reporting.
- A critical organising principle for the new organisation should be to bring greater coherence in corporate reporting. As evidenced by several commentators, including the Corporate Transparency Alliance (2019) is that there is a current failure in corporate reporting and the disconnection that exists between what companies report in the financial statements and in the management report (and voluntary reports such as sustainability reports). A study by the WBCSD (2018) of risk reporting across global companies found that only 8% of companies reported the same risks in their financial filing and their sustainability report. Similarly, as the TCFD (2019) has highlighted whilst companies acknowledge that climate change is likely to disrupt their business model there is little evidence of any concomitant impairment adjustments to assets which are unlikely to produce the cash flows reflected in their carrying amounts. These examples highlight the need for there to be strong and effective dialogue between the elements of the proposed governance structure so that a binary split in financial and non-financial governance is seen as a transitional rather than a permanent disconnection in reporting in the EU.
- What is not addressed in the proposed mission is the objective of non-financial reporting. This could create a profound tension between the purpose of financial versus non-financial reporting. We think that would be unhelpful and it should be made clear that corporate reporting is aimed specifically at the needs of providers of capital to contribute to their decision-making. That does not imply that there is no role for broad stakeholder groups as they will be vital in understanding and adequately responding to the impacts and dependencies of companies' actions and omissions. It also does not preclude the development of special purpose reports for particular stakeholders such as employees or NGOs focused on the environment, but we should not pretend that one single report can satisfy the multitude of needs nor properly discharge the director's fiduciary duties relating to the stewardship of resources.
- Unlike financial reporting, non-financial reporting is still in the process of development and evolution and there is a lack of consensus on what characteristics about environmental and social factors should be reported and what methods should be employed to generate meaningful information for decision-making.
- Reporting arrangements are not an end but a means of promoting better transparency and accountability. In the context of non-financial reporting, the emphasis should be on the ability of reporting to provide an indication of how companies are making the transition to more sustainable business models.

Question 1 Due Process

1.1 The elements of the due process as described in Chapter 3 are similar to those currently employed by the IASB and other standard setters. There is, in our view, no compelling reasons to alter well-established due process steps. Given the nature of non-financial reporting and the diversity of the subject matter we think it needs to be more normative than currently explained in the proposals. More emphasis will need to be placed on eliciting responses from stakeholders who may not normally have the resources to participate in a formal due process. Accordingly, more emphasis will be needed on outreach to stakeholders as means of encouraging a diversity of voices to participate in the due process.

1.2 The stated objective of setting standards for financial reporting is to achieve public policy requirements of efficient capital markets, enabling more transparent and accountable businesses to achieve a more effective cost of capital and to protect capital providers. The reporting of non-financial information on environmental or social issues is equally critical for informing investor decision-making (and increasingly investors claim it is vital) but it has a related purpose of achieving other public policy goals. For instance, reporting on the impact of climate change has implications for the EU targets on carbon. For that reason, it is important that reporting provides transparency around how successful the company is transitioning to low carbon operations. That information is crucial for capital providers to understand the ongoing viability of a company's business model.

1.3 We are aware that there are many requests placed on stakeholders (including investors) and that will need to be managed carefully

1.4 to ensure there is ongoing and meaningful engagement by stakeholders in the due process. Consideration should be given to optimising reporting sources so that there is better use made by stakeholders of information that is relevant and material for their needs.

Question 2 – Member States and National Public Authorities

2.1 It is our view that representation from member states is needed at all levels of the proposed governance structure so that company actions are congruent with the realisation of public policy ambitions. Unlike current arrangements for financial reporting, the engagement of member states needs to be much more agile, given the diversity of the subject matter. Accordingly, it may demand the involvement and liaison with policy experts across a number of national government departments and central banks perhaps co-ordinated through Ministries of Finance. We understand that a workable structure is already in place for the sustainable finance initiative and there may be scope to leverage those arrangements.

2.2 The nature of how member states engage will depend on the level of the governance structure – at General Assembly and Board level it can involve more strategic specialists drawn from a diversity of finance, environmental and social disciplines, supported by technical expert groups connected with the EFRAG TEG technical discussions.

2.3 National regulators will need to play an active role on reviewing the quality of non-financial reporting and drive compliance and quality improvements. To date, we understand that regulators in only a few jurisdictions have been active in reviewing non-financial information.

Question 3 – European Institutions and Agencies

3.1 The forthcoming renewed Sustainable Finance Strategy, within the framework of the European Green Deal, will provide aids and tools (such as the EU Taxonomy) to support the fulfilment of EFRAG's objectives and ensure the financial system genuinely supports the transition of businesses towards sustainability, in the context of recovery from the impact of the Covid-19 impact. This and related initiatives will furthermore strengthen the working relationships between public authorities, private organisations and citizens, and we very much support the emulation of this approach by EFRAG.

3.2 In our view, the European Institutions and Agencies should be involved in the high-level governance of the new structure. In line with principles of good governance they should be involved in the boards as observers to ensure EFRAG is discharging is obligations consistent with its new mission. To maintain the independence of the organisation, the European bodies should play an oversight role and not become involved with its management and decision-making.

Question 4 Private Sector and Civil Society

4.1 The effectiveness of the organisation will depend on the quality of its relationship with private sector actors and civil society. It is important that the governance arrangements are not captured by any particular group but that there is broad and meaningful representation. As noted above, non-financial reporting is still developing and therefore there is still a great deal of consensus building that needs to take place. Accordingly, there needs to be an effective partnership between governments, business and civil society.

4.2 The private sector and civil society should be engaged in all levels of governance consistent the partnership notion described in 4.1 above. Because of the developmental nature of many areas of non-financial reporting, a principles-based and pragmatic approach needs to be encouraged to ensure there is an appropriate balance between costs and benefits with the goal of promoting more sustainable business being the overriding consideration.

Question 5 SMEs

5.1 There is no question that SMEs are a vital part of the EU economy and in many member states that make up the majority of business activity and employment. Since its inception, EFRAG has been faced with the challenge of adapting reporting requirements to the needs of SMEs. External reporting is a poor policy lever for SMEs given that there is limited practice when it comes to general purpose corporate reporting given the ownership structure of most SMEs. Alternative approaches should be considered that are more commensurate with the needs of SMEs and mechanisms that are more relevant to changing their behaviour consistent with social and environment policy objectives.

5.2 In this regard it would not be sufficient to rely on input from SMEs through public consultation and outreach alone. In consideration of the proposed EFRAG governance structure, SMEs and the EU economy would be better served when represented at the EFRAG Board level, the non-financial board level, and TEG level. The proposal for an SME focussed working group is welcomed, and this should be closely integrated with the operations of the above three EFRAG levels.

5.2 Once arrangements are established for listed companies it may be appropriate to use the experience and lessons learned to consider whether a similar approach should be established for SMEs or whether they would be better served by an alternative approach which differentiates needs across EU jurisdictions, for example. Other SME specific arrangements may include an SME Lab established to develop and support requirements for SMEs. This Lab could be based on a 'hub and spoke' arrangement where there is a coordinating role played by EFRAG with specific jurisdictional satellite projects working closely with relevant national agencies.

Question 6 Cooperation with other standard setters and initiatives

6.1 We think this is an area that will require careful attention. There are over 200 reporting frameworks (see Reporting Exchange) and guidance documents for non-financial reporting around the world and it is well-accepted that the reporting landscape is confusing for both preparers and capital providers. It will be important that these arrangements serve to consolidate and rationalise existing reporting and not add to the existing level of confusion. To that end, it will be important that there is strong and effective co-operation and working arrangements with global standard setters such as: the Global Reporting Initiative; the soon to be formed Value Reporting Foundation; and the Sustainability Standards Board being proposed by the IFRS Foundation, along with other subject and sector specific standard setters. It will be unhelpful for the EU to develop separate and uncoordinated requirements as that will most likely undermine comparability of reporting.

6.2 As companies currently report non-financial reporting under various frameworks, it will be important for the new arrangements to consider an appropriate transition path to enable companies to make the transition to European reporting arrangements without incurring substantial implementation costs. The development of an IFRS 1 *First-time Adoption of International Financial Reporting* Standards equivalent may be prudent to effectively adapt existing processes and systems at the corporate level.

Question 7 – EFRAG Board

7.1 We do not have any specific comments on the composition of the EFRAG Board. The Board should be based on principles of good governance by being independent, appropriate skills, diverse and be transparent and open in its decision-making. Its focus should be in provide oversight and ensuring that the organisation is delivering on its mission. It will be important for the Board to provide leadership to the reporting boards and promote integration and coherence in reporting within EU jurisdictions and where feasible internationally.

Question 8 – Non-financial Reporting Board

8.1 To be effective we believe that the Reporting Board should be diverse and broadly constituted but not attempt to be representative. It should have a mix of business (representing different economic activities and sizes of companies), public policy, civil society (NGOs with expertise on the matter) and technical members (drawn from financial, environmental and social disciplines). It would be desirable to have on both Reporting Boards one or several individuals with expertise in the interconnectivity of financial and non-financial information from a technical, policy and political perspectives. Our initial review of disclosures by European companies is that integration is a key weakness that needs to be addressed. These experts could act as active 'ambassadors 'to integrate agendas and approaches. It would be worthwhile to have observers from regulators and non-financial reporting standard setters. The board should have no more than workable number members and be agile providing appropriate direction to the TEG and working groups without constraining their activities. The two reporting boards should meet together as often as possible to ensure integration of agendas and approaches.

Question 9 – TEG for Non-financial Reporting

9.1 We do not have any specific recommendations for the formation and appointment of the TEG. As we have suggested in 8.1 above, it is important that the TEG remains relatively small so that it is agile enough to make decisions and be responsive. To support a small and agile TEG, because of the diverse nature of the subject matter it will be important for the TEG to be supported by ‘task and finish’ working groups drawn from environmental, social and non-financial reporting disciplines that can develop approaches for specific subject matter areas. It is important that for these arrangements to be effective that experts are not only drawn from within the EU but other jurisdictions to benefit from expertise developed in other areas.

9.2 The practice with the existing TEG where the membership is drawn predominantly from the accounting firms (either directly or indirectly) will need to be different as non-financial reporting expertise covering all aspects including environmental, social, intangibles and human rights is dispersed and will need to draw on a much more collaborative approach of working with various disciplines, including NGOs and standard setters to develop a robust set of reporting solutions.

Question 10 – Activities of the European Lab

10.1 The European Lab is relatively new, and we agree it can play a very positive role in supporting both boards and driving integration. It would be useful in the context of non-financial reporting for Lab to become more of an incubator stimulating new practices and experimentation occupying the proactive space informing future standard setting. In our view, it is important that the Lab evolves beyond showcasing good practice to becoming a thought leader in the international environment on the nature, direction and value of corporate reporting. European issuers are at the forefront of corporate reporting practice and it follows that it is well-placed to take a global leadership role in shaping future practices.